VI. FINANCIAL COOPERATION IN ASIA AND THE PACIFIC

INTRODUCTION

Regional development cooperation in finance is relatively new in Asia and the Pacific. The regional or subregional cooperation arrangements that existed prior to the 1997 Asian financial crisis were confined primarily to cooperation in research and training among central banks, clearing and settlement, reinsurance and small-scale development financing and swap arrangements. This was mainly due to the underdeveloped nature of financial markets in most countries in the region. All but a handful of countries in the Asia-Pacific region failed to nurture a market-oriented financial culture. Banks and other financial intermediaries have long dominated the financial systems even in the relatively advanced economies in the region.

The lack of financial sophistication has led to an outflow of savings from the region, much to the disadvantage of its developing countries, which are competing for financial resources for development in international capital markets. The region’s development financing requirements came mainly from ADB and other bilateral donors such as Japan and Australia together with multilateral lending agencies such as the World Bank and private capital flows in the form of FDI and portfolio capital, while IMF provided balance-of-payments support for countries in times of crisis. However, the availability of such financial resources for development purposes was not only limited but also concentrated in a handful of economies. Portfolio capital in particular was subject to sudden reversals, with destabilizing effects on economies, as witnessed during the Asian financial crisis, while credits from multilateral lending agencies, in particular IMF, were often linked to conditionalities.

Financial stability and the availability of capital are vital complements to national and international development efforts, a fact reiterated in the Monterrey Consensus. However, the lack of finance for development has become a major impediment to growth and development in many developing countries in the region. Declining ODA has compounded the scarcity of long-term private capital at low cost for development financing. Moreover, the underdeveloped nature of financial
markets has often restricted countries’ potential for growth in real sectors such as trade and investment, as they are interlinked. Weaknesses in the financial systems and the role that regional development cooperation in finance could play in financial and economic stability in the region were amply evident during the 1997 Asian financial crisis.

A notable development in the aftermath of the Asian financial crisis has been the emergence of keen interest in exploring various forms of monetary and financial cooperation in the region, particularly in East Asia. The main objectives of these initiatives have been to provide mechanisms for crisis prevention and management, policy dialogue and the sharing of resources aimed at maintaining financial stability. Several factors contributed to this new development:

- First, the unexpected and unprecedented contagion effect of the crisis suggested that financial crises in individual countries should not be a matter of indifference to other countries in the region because such crises may have significant spillover effects;
- Second, since the crisis had its origin in weaknesses in the financial and corporate sectors among several countries, cross-country cooperation on financial sector reform issues is considered beneficial to all;
- Third, there is increasing awareness in the region that policy dialogue at the regional level can usefully complement national-level policy-making and global-level policy dialogue.

The regional initiatives on finance that emerged after the crisis include the ASEAN Surveillance Process, the Manila Framework Group, the Chiang Mai Initiative (CMI), the ASEAN Framework Agreement on Services, which also covers financial services, and the Asian bond initiatives under the Asian bond market development programme. These developments have laid the foundation for a reasonable level of development cooperation in finance in Asia. However, as has been the case in the development of financial systems in the Asia-Pacific region, the emergence of regional development cooperation initiatives as well as their perceived benefits have been concentrated mainly in the East Asian subregion. Many developing countries in the Asia-Pacific region have yet to benefit from such new initiatives or to make use of the sophistication and innovations in financial services elsewhere during the last decade or so to their advantage in reaping the benefits of globalization.

It is in this context that the need for regional cooperation in finance will be felt by all countries in the Asia-Pacific region, underpinning the Monterrey Consensus for mobilizing domestic resources,

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1 Y. Iwasaki, “Monetary and financial cooperation in East Asia: the way ahead”, presentation made at the Boao Forum for Asia Conference, Hainan, China, 2 November 2003.
VI. Financial Cooperation in Asia and the Pacific

attracting international flows, promoting international trade as an engine for development, sustainable debt financing and external debt relief, and addressing systemic issues by enhancing the coherence and consistency of the international monetary, financial and trading systems.²

The objective of this chapter is to analyse the existing development cooperation initiatives in finance in the Asia-Pacific region, with a view to developing a monetary and financial framework which reflects the architecture necessary to support the development process in the region. It focuses mainly on selected aspects such as CMI, the Asian bond market and infrastructure development, with special emphasis on how these initiatives could be extended for the benefit of a wider section of developing countries in the region. Such a cooperative approach would enable countries in the region to protect themselves from risks arising from volatile international financial and capital markets in an increasingly globalized world and ensure sustainable development in the region.

A. EXISTING FINANCIAL COOPERATION IN ASIA-PACIFIC

1. DEVELOPMENTS IN RESPONSE TO THE 1997 ASIAN CRISIS

The 1997 Asian financial crisis set in motion two interrelated financial developments in the region. Most East Asian countries, including the crisis-affected ones, have increased the pace and scope of domestic financial reform to liberalize and open financial markets and improve corporate governance and risk management in financial institutions. The other development is the regional movement for financial cooperation and integration in East Asia, epitomized by CMI, which was organized by ASEAN+3.

(a) Chiang Mai Initiative

CMI was developed at Chiang Mai, Thailand, on 6 May 2000 to establish a system of swap arrangements within the ASEAN+3 countries. It covers the basic principles and operational procedures for bilateral swap transactions (see annex V). These are designed to provide liquidity support for member countries that experience short-run balance-of-payments deficits in order to prevent an extreme crisis or systemic failure in those countries and subsequent regional contagion, as occurred in the Asian financial crisis in 1997. Emergency support facilities such as CMI are similar in nature to other regional and international “lender of last resort” facilities.
Since the intent of CMI was to be proactive, it is based on a mutually agreed framework for intercountry cooperation within the ASEAN and ASEAN+3 countries that could be used to quickly and effectively render emergency assistance at the required levels when the need arises. Moreover, a multilateral approach would ensure that any conditionality associated with the financial assistance is consistent across all countries.

At present, the total amount of bilateral swap arrangements covering all 13 countries concerned is estimated at around $35 billion (see table VI.1). The maximum amount of money any individual country can draw varies a great deal. For example, in the case of Thailand, the maximum is around $6 billion, 10 per cent of which can be drawn automatically.

**Table VI.1. Progress on the Chiang Mai Initiative**

(End of December 2003)

<table>
<thead>
<tr>
<th>Bilateral swap arrangement</th>
<th>Currencies</th>
<th>Conclusion dates</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan-Republic of Korea</td>
<td>$/won</td>
<td>4 July 2001</td>
<td>$7 billion(^a)</td>
</tr>
<tr>
<td>Japan-Thailand</td>
<td>$/baht</td>
<td>30 July 2001</td>
<td>$3 billion</td>
</tr>
<tr>
<td>Japan-Philippines</td>
<td>$/peso</td>
<td>27 August 2001</td>
<td>$3 billion</td>
</tr>
<tr>
<td>Japan-Malaysia</td>
<td>$/ringgit</td>
<td>5 October 2001</td>
<td>$3.5 billion</td>
</tr>
<tr>
<td>China-Thailand</td>
<td>$/baht</td>
<td>6 December 2001</td>
<td>$2 billion</td>
</tr>
<tr>
<td>Japan-China</td>
<td>yen/yuan renminbi</td>
<td>28 March 2002</td>
<td>$3 billion</td>
</tr>
<tr>
<td>Republic of Korea-China</td>
<td>won/yuan renminbi</td>
<td>24 June 2002</td>
<td>$2 billion</td>
</tr>
<tr>
<td>Republic of Korea-Thailand</td>
<td>$/local</td>
<td>25 June 2002</td>
<td>$1 billion</td>
</tr>
<tr>
<td>Republic of Korea-Malaysia</td>
<td>$/local</td>
<td>26 July 2002</td>
<td>$1 billion</td>
</tr>
<tr>
<td>Republic of Korea-Philippines</td>
<td>$/local</td>
<td>9 August 2002</td>
<td>$1 billion</td>
</tr>
<tr>
<td>China-Malaysia</td>
<td>$/ringgit</td>
<td>9 October 2002</td>
<td>$1.5 billion</td>
</tr>
<tr>
<td>Japan-Indonesia</td>
<td>$/rupiah</td>
<td>17 February 2003</td>
<td>$3 billion</td>
</tr>
<tr>
<td>China-Philippines</td>
<td>yuan renminbi/peso</td>
<td>29 August 2003</td>
<td>$1 billion</td>
</tr>
<tr>
<td>Japan-Singapore</td>
<td>$/Singapore dollar</td>
<td>10 November 2003</td>
<td>$1 billion</td>
</tr>
<tr>
<td>Republic of Korea-Indonesia</td>
<td>$/local</td>
<td>24 December 2003</td>
<td>$1 billion</td>
</tr>
<tr>
<td>China-Indonesia</td>
<td>$/rupiah</td>
<td>30 December 2003</td>
<td>$1 billion</td>
</tr>
</tbody>
</table>

\(^a\) The dollar figure includes the amounts committed under the new Miyazawa Initiative: $5 billion for the Republic of Korea and $2.5 billion for Malaysia.

ASEAN+3 policy makers have made considerable progress over the past three years towards increasing the availability of liquidity, as they have succeeded in contracting a number of bilateral swaps and establishing informal mechanisms of policy dialogue and review among the ASEAN+3 countries. Since one of the objectives of CMI is to prevent future crises by stabilizing financial and foreign exchange markets, CMI must have great credibility. For this reason, ASEAN+3 authorities have been studying the modalities of monitoring, surveillance and cooperation in exchange rate policy among the participating countries.
(b) Asian bond market development: the Asian bond initiative

Since the East Asian crises in 1997 and 1998, many countries in the region have given priority in domestic financial reform to developing domestic capital markets in order to diversify their sources of financing and reinforce the stability of their financial systems. Recent calls for the development of regional capital markets have gained momentum owing to efficiency and cost considerations in domestic capital markets. At an informal meeting of deputy finance ministers of ASEAN+3 in Tokyo in November 2002, the representative of the Republic of Korea proposed discussing the feasibility of creating new Asian bond markets under the ASEAN+3 framework and improving the existing ones. This proposal received broad support among the 13 members and a month later Japan introduced a comprehensive plan for the development of regional bond markets in Asia, the Asian bond initiative.

The participants concluded that the public sector’s role was to improve and build the infrastructure, whereas the private sector would work to enlarge the borrower and investor base of the markets. Six working groups are engaged in (a) analysing the prospects for facilitating market access through a wide variety of issues and (b) creating an environment conducive to developing the markets. The issues to be examined concerning market access include:

(a) Bond issuance by Asian Governments to establish benchmarks;
(b) Bond issuance by Asian Governments’ financial institutions to finance domestic private enterprises;
(c) Creation of asset-backed securities markets, including collateralized debt obligations;
(d) Bond issuance by multilateral financial institutions and government agencies;
(e) Bond issuance to fund FDI in Asian countries;
(f) Issuance of bonds in a wider range of currencies and introduction of currency-basket bonds.

With regard to the creation of an environment conducive to active participation by both issuers and investors, the working groups are also examining:

(a) Provision of credit guarantees;
(b) Improvement of the credit-rating system;
(c) Establishment of a mechanism for disseminating information;
(d) Improvement of the settlement system;
(e) Development of the legal and institutional infrastructure for bond market development.
Given East Asia’s dynamism and its enormous pool of savings, it could accommodate large and efficient regional capital markets that are as competitive as global capital markets. If these markets are efficient and robust, they may improve the allocation of resources and also help to safeguard the region against financial crises.

The ASEAN+3 countries have been engaged primarily in constructing a regional infrastructure for Asian bond markets, including institutions such as regional credit agencies, cross-border securities borrowing and lending mechanisms, credit enhancement and guarantee agencies, clearing and settlement systems, a centralized depository system, and exchanges and over-the-counter markets for bond trading. In addition, the six working groups are devising plans for harmonizing various financial standards, regulatory systems and tax treatments throughout the region.

In addition to ASEAN+3, there is another regional organization that has been promoting the development of Asian bond markets. While actively participating in the ASEAN+3 working groups, Thailand has also been seeking the support of other Asian countries through the expansion of the activities of the Asian Cooperation Dialogue.

However, regional bond markets will not be efficient if these cooperative efforts are not carried out in conjunction with domestic financial reform in individual member countries, which will open up their capital markets. Capital market development in Asia has been hampered by many institutional weaknesses and regulatory controls. The major reasons include a lack of professional expertise in the securities business, the inadequacy of the financial and legal infrastructures including regulatory systems, low standards of accounting and auditing and the opacity of corporate governance.

Without domestic financial market deregulation and capital account liberalization, borrowers and investors in the region will not be able to take advantage of regional bond markets, as they will be restricted in cross-border lending and investment.

(i) Rationale and need

There are three main reasons that justify efforts to develop Asian bond markets:

- First, robust Asian bond markets will, at least in part, keep Asian savings in Asia, instead of sending them to other countries, in particular the United States, to finance their current account deficits;
- Second, deep and liquid Asian bond markets will help Asian economies to guard more effectively against future crises as they will be able to raise more funds in their own currencies in the regional bond markets, thereby avoiding the currency mismatch problem;
Third, such an initiative would emphasize the importance of sustaining the financial reform efforts that began after the 1997 financial crisis, especially since there have recently been signs of regression.

A number of recent studies show that the reform efforts in the region have slowed down and several countries have in fact relapsed into their old practices of managing financial institutions and old modes of formulating financial policy. Many advocates of the Asian bond initiative rightly argue that this initiative will exert peer pressure and at the same time generate incentives for Asian countries to continue with their financial reform.

Of these objectives, the second appears to be less important. Although efficient bond markets offer a wider range of sources of financing and instruments for saving, facilitating the development of a more diversified financial system, they are not a substitute for good macroeconomic policy. A review of the developments leading to the 1997 crisis suggests that the currency mismatch problem may also have been exaggerated as a cause of the crisis.

As to the first objective, it is difficult to argue with the view that channelling practically all the official reserves from Asia to developed markets is both a consequence and, to a lesser degree, a cause of the underdevelopment of the Asian bond markets. The ASEAN+3 countries collectively held nearly $1.9 trillion in reserves at the end of 2003, the bulk of which is invested in United States short-term treasury and agency securities. Judging from any criteria of optimum reserve holding, one cannot but argue that the ASEAN+3 countries have accumulated more reserves than necessary, even after considering that they should arm themselves with substantial “war chests” to fight future speculative attacks.

Many advocates of the Asian bond initiative point out that at least some of these reserves could be allocated to finance additional Asian investment. The huge holdings of dollar reserves also incur large losses as these reserves earn a low return while Asian borrowers pay much higher interest on their foreign loans.

(ii) Asian Bond Fund (I and II)

The preceding discussion leads to the conclusion that region-wide financial reform is and should be the most logical and viable objective of creating Asian bond markets. Depending on how they are structured and managed, these funds will maintain the momentum for domestic financial reform created by the 1997 crisis.
The Asian Bond Fund was launched in June 2003 by the Executives’ Meeting of East Asia-Pacific Central Banks (EMEAP).\(^3\) The initial round of the Asian Bond Fund, ABF I, is valued at around $1 billion and is earmarked for investments in a basket of dollar-denominated bonds issued by Asian sovereign and quasi-sovereign issuers in EMEAP (other than Japan, Australia and New Zealand). The second round, ABF II, will be a much larger fund involving private sector co-investors; it will also include bonds denominated in regional currencies.

The architects of ABF I and II rightly argue that the funds will serve as a catalyst for domestic financial reform in East Asia, as they provide incentives as well as the rationale for East Asian policy makers to restructure their domestic bond markets and cooperate in developing regional bond markets as well. In other words, ABF I and II will encourage East Asian countries to increase the supply of bonds in which the Funds could invest. However, in view of the small size of ABF I, market participants believe that it may have had little effect on the market for East Asian sovereign dollar bonds. If anything, the Fund’s investments may have crowded out private investors.

It is unlikely that additional demand for high-quality Asian bonds denominated in Asian currencies can increase the supply of these bonds. At present, there is strong private demand for high-grade Asian bonds denominated in either local or major international currencies. The planners of ABF II should realize that this excess demand has not generated any incentives to increase the supply of such bonds. Managers of ABF II will certainly not prefer Asian local currency bonds that private and institutional investors would not invest in. ABF II may then end up competing for a limited supply of high-quality Asian bonds, particularly when the spreads on them are as tight as they are now.

There are also two other concerns raised regarding the viability of ABF II. First, since ABF II is likely to invest in East Asian sovereign bonds denominated in local currencies, it may serve as a mechanism for having the fiscal deficits of some member countries financed by other members belonging to EMEAP. In that case, the investment policy of ABF II cannot be dictated solely by the profit motive, even if a private institution manages the Fund.

Second, if ABF II is of considerable size, then its investment operations could affect the foreign exchange and interest rate policies of the EMEAP member countries whose bonds are purchased or sold.

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\(^3\) The members of EMEAP include the Reserve Bank of Australia, People’s Bank of China, Hong Kong Monetary Authority, Bank of Indonesia, Bank of Japan, Bank of Korea, Bank Negara Malaysia, Reserve Bank of New Zealand, Bangko Sentral ng Pilipinas, Monetary Authority of Singapore and Bank of Thailand. ADB, “EMEAP Asian Bond Fund”, <http://aric.org/docs/asiabondmarket/emeap.asp>, 15 January 2004.
by the Fund. Even if the amount of a sale or purchase is relatively small, the Fund’s operations may send the wrong signals to financial markets against the wishes of the EMEAP central banks. This signalling problem is likely to remain, even if a private institution manages the Fund, insofar as EMEAP central banks have a controlling stake in it.

The preceding discussion suggests that the EMEAP member central banks could contribute more to the development of Asian bond markets if they were to use the ABF II leverage to strengthen the regional financial infrastructure, removing institutional constraints on the supply of high-grade Asian corporate and sovereign bonds.

(c) ASEAN Surveillance Process

Soon after the Asian crisis the Terms of Understanding on the Establishment of the ASEAN Surveillance Process were agreed in 1998. The objective of the ASEAN Surveillance Process is to strengthen cooperation by:

(a) Exchanging information and discussing economic and financial developments in the region as well as outside it;

(b) Providing an early warning system and a peer review process to enhance the stability of the macroeconomic and financial system in the region;

(c) Highlighting possible policy options and encouraging early unilateral or collective actions to prevent a crisis;

(d) Monitoring and discussing global economic and financial developments which could have implications for the region and proposing possible regional and national-level actions.

Periodic meetings and joint declarations of ministers have ensured that the member countries have continuously monitored the development of their financial markets. These meetings also provide a forum for the exchange of ideas on future financial reforms in the region which would increase the efficiency and stability of the financial markets. At the meetings there is recognition that future financial market architecture should be based on greater private sector participation, proper standards for transparency and disclosure, dissemination of necessary information, early warning systems and a well-sequenced approach to capital account liberalization depending on a country’s degree of development and macroeconomic stability.

(d) ASEAN Framework Agreement on Services

Another important agreement on financial cooperation is the Protocol to Implement the Second Package of Commitments on Financial Services under the ASEAN Framework Agreement on Services (2002). Based on the ASEAN Framework Agreement on Services (1995), member countries agreed to enhance cooperation to open service sectors, including financial services. The Protocol ensures that ASEAN member States that are non-WTO members are accorded the same treatment as other ASEAN members. Efforts have also been made to open up the region’s financial sector. A new modality, which is based on a positive list approach, has been considered by the Working Committee on ASEAN Financial Liberalization under the ASEAN Framework Agreement on Services. This includes the adoption of a combined unilateral and negotiated request/offers mechanism for the subsector(s) in the inclusion list in order to chart a road map towards a free flow of financial services by 2020. Negotiations have taken place for the current round, which is expected to be concluded by the end of 2004.

(e) ASEAN Swap Arrangement

ASEAN has a long and rich history of addressing financial sector issues. The Memorandum of Understanding on the ASEAN Swap Arrangement was signed in 1977 to promote monetary cooperation in the region. Initially, five major ASEAN members signed it and agreed to renew it periodically, revising the swap amount and time. The Ministerial Understanding on ASEAN Cooperation in Finance was initiated in 1997; it focuses on major financial areas such as banking, insurance and capital markets.

2. COOPERATION AMONG CENTRAL BANKS

The countries in the region also benefit from cooperation among central banks. The SEANZA Group was established in 1956, initially comprising central banks of British Commonwealth countries in the Asia-Pacific region, with a view to pooling their resources in order to provide intensive and systematic training courses for promising central bank staff.

The South East Asian Central Banks Research and Training Centre (SEACEN) was established in 1982; it currently represents central banks, monetary authorities or finance ministries of Indonesia, Malaysia, Myanmar, Nepal, the Philippines, Singapore, Sri Lanka,

Thailand, the Republic of Korea, Taiwan Province of China, Mongolia and Brunei Darussalam. Its objectives are to initiate and facilitate cooperation in research and training relating to policy and operational aspects of central banking.10

Asian Clearing Union

The Asian Clearing Union (ACU), established in 1974, is a facility for the multilateral settlement of payments among members (the central banks of Bangladesh, Bhutan, India, the Islamic Republic of Iran, Myanmar, Nepal, Pakistan and Sri Lanka). Its main objectives are to facilitate payments among member countries for eligible transactions, thereby economizing on the use of foreign exchange reserves and transaction costs, as well as promoting trade among the participating countries. Participants in deficit at the end of a settlement period are eligible to avail themselves of a swap facility. Every eligible participant is entitled to the facility from every other participant up to 20 per cent of the average payments made by it through the ACU mechanism to other participants during the three previous calendar years.11

ACU has not achieved its desired objectives mainly owing to limited intramember country trade. However, reinvigorating ACU may warrant consideration given the potential for more trade among ACU countries as a result of the increasing trend towards bilateral trading arrangements among Asian economies and the role that ACU could play in facilitating payments for such trade.

3. COOPERATION IN INSURANCE

Asian Reinsurance Corporation

The Asian Reinsurance Corporation (ARC), established in 1979, has a broad membership that includes Afghanistan, Bhutan, India, the Islamic Republic of Iran, the Philippines, the Republic of Korea, Sri Lanka and Thailand.12 The Bangkok-based Corporation, which began its underwriting business in 1980, helps to reduce the leakage of foreign exchange from the region in the form of insurance and reinsurance premiums.

While the low level of capitalization has restricted expanding ARC’s underwriting business, competition from private insurance companies has eroded its edge in underwriting. Its low rating has restrained international insurers, which obtain reinsurance only from companies with a triple-A rating. The injection of additional capital and greater market orientation would be necessary to make ARC a viable business enterprise.

4. DEVELOPMENT FINANCING ARRANGEMENTS

(a) ECO Trade and Development Bank

A proposal to establish the ECO Trade and Development Bank made in 1995 with the objective of financing intraregional trade and development projects in the ECO member countries, has recently been adopted by the finance and economy ministers of the member countries. The Organization also expects to establish an ECO reinsurance company along with the Bank. Efforts to develop a common framework for regional financial instruments are still in their infancy.

(b) South Asian Development Fund

The idea of establishing a South Asian Development Fund (SADF) was proposed at the Sixth SAARC Summit (1991) to mobilize external funds for the development of South Asia. The basic objective of SADF is to provide finance for industrial development, poverty alleviation, protection of the environment, balance-of-payments support and promotion of economic projects in the SAARC region. SADF has three windows for (a) identification and development of projects, (b) institutional and human resources development projects and (c) social and infrastructure development projects. The SADF Governing Board, at its sixth meeting in Malé, Maldives, proposed to establish a permanent secretariat and create a substantially larger core capital base for the consideration of its member States. Its current core capital base is $5.8 million.

(c) SAARC-Japan Special Fund

The SAARC-Japan Special Fund was established in 1993 to finance selected programmes/activities identified and managed by the SAARC member States and those identified and managed by the Government of Japan. Although SAARC’s secretariat undertakes continuous discussion on the macroeconomic stability of individual countries, it has made no significant move towards any financial integration of the SAARC region.

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14 SADF has provided funding support for feasibility studies in respect of 16 approved projects, of which 12 have already been completed.


16 Central banks of the SAARC region hold regular consultations on global financial and economic conditions and their impact on that region. SAARC plans to emphasize collective capacity development in the field of international finance.
B. PROSPECTS FOR FUTURE FINANCIAL COOPERATION IN THE ASIA-PACIFIC REGION

There are many economic, institutional and political barriers to financial cooperation and integration in Asia and the Pacific. These are mainly the diverse nature of financial sector development across countries and the lack of required infrastructure and policy frameworks. However, keen interest in the issue has been shown by subregions, in particular East Asia and South Asia, which have put financial cooperation high on their development agendas. The perceived benefits of such initiatives for the whole region would make reinvigoration of such efforts worthwhile. The potential for the Asian and Pacific region to be a driving force in shaping the global economy, when two potential large economies, China and India, are making moves in that direction, also makes greater financial integration a necessity.

What kind of regional financial cooperation initiatives could the policy makers in the region undertake to meet the challenges of the twenty-first century and make the region a third force in the global economy? What are the prerequisites that countries in the region must fulfil in order to benefit from such initiatives? This study proposes:

(a) A framework to enhance the mobilization of domestic and international resources for development in the region through the extension of the Asian Bond Initiative;
(b) A framework for addressing systemic issues through the extension of the Chiang Mai Initiative;
(c) A framework for the development of financial infrastructure in the region.

1. MOBILIZATION OF DOMESTIC AND INTERNATIONAL RESOURCES FOR DEVELOPMENT

(a) A road map for Asian bond market development

The first proposal is an extension of ABI to cover the entire region. This does not mean however, that all countries in the region should automatically become members of the Initiative. The architects of the existing ABI could develop a set of convergence criteria for eligibility to become members, as in the case of the Euro common currency area (see box II.4). Countries which satisfy such conditions could become members and benefit from an extended initiative. This would not only make the existing ABI more efficient and large enough to meet the bond-financing needs of Asia and the Pacific but would also provide an opportunity to those with limited access to international capital markets to raise funds for development within the region. Such an initiative could also be extended to financing SMEs in the region by providing guarantees and securitization of SME bonds.
(b) Deregulating and opening up domestic financial systems

The most logical and realistic road map for the development of Asian bond markets is to begin by deregulating and opening up domestic financial systems so that more investment-grade local currency bonds could be issued, domestic investors would be allowed to invest in foreign bonds and foreign borrowers could issue bonds denominated in different currencies in domestic markets.

At an early stage of development, when domestic bond markets are small and illiquid, domestic borrowers should be allowed to issue local currency bonds in regional and global bond markets. However, this step should be accompanied by efforts to develop and liberalize domestic bond markets to establish a large base of foreign and domestic investors.

Market liberalization and opening would be the first step to facilitate cross-border investment in bonds in Asia and the Pacific, which would in turn naturally form integrated regional bond markets. In this evolutionary process, those countries with a well-developed financial infrastructure and few financial restrictions would then emerge as regional trading centres for Asian bonds.

(c) Regional financial infrastructure

Market liberalization and opening would not, however, be sufficient to expand cross-border investment unless a regional financial infrastructure is also constructed that includes a regional system of clearing and settlement, regional credit guarantee institutions, hedging facilities and regional credit-rating agencies. In addition to the establishment of such an infrastructure, countries in the region should also be able to join forces to harmonize their legal and regulatory systems, domestic clearing and settlement systems, market practices and withholding taxes on bond coupon payments.

In developing strategies for the regional capital markets, countries could take either a market-led or government-led approach. The market-led or evolutionary approach relies more on competition among countries attempting to transform their domestic capital markets into regional ones. A market-oriented approach would be a more realistic strategy than a government-led one owing to leadership and other intercountry issues.

If a market-oriented strategy is pursued, the most efficient domestic capital markets will emerge as the dominant regional capital markets. Under this approach, Governments in Asia and the Pacific should work together to develop financial, legal and regulatory infrastructures at the regional level to ensure the efficiency and stability of the regional capital markets. The more direct Government-led approach requires active participation on the part of Governments not only in building the
financial and other institutional infrastructure, but also in offering a wide range of capital-market instruments tailored to the preferences of investors through, for example, schemes guaranteeing the principle and interest payments on private bonds, securitizing bank loans and credit enhancement.

Several countries have already taken steps to open their domestic bond markets to foreign borrowers and investors and to create an offshore market. Competition among these countries will ensue, and both borrowers and investors will migrate to the markets with the most efficient payment and settlement systems, thereby creating regional financial centres.

If an Asian bond market is to develop rapidly, Asian currency bonds, sovereign or corporate, would have to be tailored to the preferences of private and institutional investors in terms of maturity and credit quality. This is because, at the early stage of development, institutional investors, including various types of local currency investment funds, insurance companies and investment banks, would likely dictate what types of bonds could be issued and traded. These investors would also encourage healthy competition among the potential regional financial centres and the construction of regional financial infrastructures.

Multilateral lending agencies and regional development finance institutions could act as a catalyst for bond market development in the region. The initiatives taken by ADB to promote the development of domestic bond markets and by the World Bank to issue local currency bonds in domestic economies are positive signs in this respect.17

2. ADDRESSING SYSTEMIC ISSUES

Making CMI a regional financial arrangement

The second proposal is an extension of CMI to cover the entire region. CMI is currently in an embryonic stage of development, and as such must be greatly expanded and consolidated before it can serve as an efficient regional liquidity support system. In view of the relatively small amount of liquidity available through CMI, doubts have been raised as to whether the system of bilateral swap arrangements (BSAs) in its present form could serve as a credible and effective system of defence against speculative attacks in the future. Participants in international financial markets are not likely to be impressed by the amount of liquidity available and will therefore ignore CMI, unless the ASEAN+3 countries are prepared to increase the number of BSAs and increase the amount of each BSA.

An extension of CMI to cover a large section of the Asia-Pacific region would raise liquidity and make the initiative an effective line of defence against speculative attacks. Convergence criteria similar to that proposed for the Asian bond market could be developed for an extended CMI.

For it to serve as a fully-fledged regional financial mechanism further organizational and operational details would have to be worked out. A regional financial arrangement established by a group of countries for economic cooperation and policy coordination in general would comprise the following institutional components:

(a) A mechanism of short-term liquidity support for members experiencing balance-of-payments deficits;
(b) A mechanism of surveillance for monitoring economic and policy developments in the member countries and imposing policy conditionality on those countries receiving financial support;
(c) A regional collective exchange rate system designed to stabilize the bilateral exchange rates of the member countries.

There are several institutional and political constraints on further expansion of CMI that have to be addressed. First is the articulation of the ultimate objectives of the CMI arrangement, that is, whether CMI is going to be fostered as a regional liquidity-support programme or as a building block for a fully-fledged regional monetary system in Asia. If BSAs are activated collectively and supported by an independent surveillance system, then they would constitute a de facto regional monetary fund. CMI could then be used as the base on which an elaborate system of financial cooperation and policy coordination could be built by following in the footsteps of European monetary integration.

A second institutional constraint is related to the need to coordinate the activities of CMI with other regional arrangements such as the Manila Framework and EMEAP in which the United States, Australia and New Zealand participate. At some point in the future, member countries may have to decide on the mode of cooperation and division of labour to promote regional growth and stability among these institutions and CMI. Unless CMI is developed into a credible financing mechanism by increasing the swap amounts, its role will become similar to that of other regional economic arrangements, weakening the coherence of the group.

A third problem is that the fear of another financial crisis has receded owing to a recovery that was faster than those following previous crises. Such complacency causes countries to be less interested in enlarging and institutionalizing CMI operations. In recent years the interest of the region has shifted away from financial reform and addressing systemic issues to creating free trade agreements.
This movement is undoubtedly a desirable development and CMI could facilitate further liberalization of trade by stabilizing the bilateral exchange rates of regional currencies and minimizing the disruptive effects of financial market turbulence. This advantage suggests that there may be incentives to broaden the scope of CMI in parallel with negotiations on establishing free trade areas in the region.

The success of CMI as an effective system of defence against systemic crises greatly depends on the region’s capacity to deal with other systemic issues. As such, extension of CMI could be linked to addressing the following institutional requirements in order to develop sound domestic financial institutions which could weather stormy systemic crises:

- Ensuring consistency in macroeconomic policies to achieve market stability;
- Improving transparency and accountability rules to enhance governance;
- Establishing appropriate measures for the detection of external vulnerability through well-designed surveillance and early warning systems;
- Formulation of standards and codes to reduce a country’s vulnerability to financial crises and contagion;
- Dissemination of accurate information on a timely basis to market participants.

3. FINANCIAL INFRASTRUCTURE DEVELOPMENT

If countries are favourably disposed to the idea of the market-oriented approach, then the thrust of ABI may be directed towards supporting the creation of a regional infrastructure that includes a regional financial research institute, a regional clearing and settlement system and a regional rating agency. A financial institute may be created with a mandate to conduct economic and financial market research and monitor financial reform and market developments in the region. It could also be structured to serve as a forerunner of the surveillance and monitoring organization of CMI.

(a) Clearing and settlement

With regard to regional clearing and settlement, Asian currency bonds can, in principle, be settled through existing international systems such as Euroclear and Clearstream or other cross-border settlement methods. A recent proposal recommends linking the central banks and national clearing and settlement systems of East Asia to serve as the
clearing and settlement system for the Asian bond markets.\textsuperscript{18} This proposal deserves further study to cover an expanded membership in the Asia-Pacific region. At the initial stage, this system would handle only the clearing and settlement of local currency-denominated Asian government bonds.

The advantage of this system is that it could resolve the problems related to the different time zones in which business is conducted. Since most Asian currencies are not internationalized, the payment settlement of Asian bonds denominated in local currencies must be finalized in a local market, even though the transfer of ownership of securities settlement can be done through a global system located in Europe. However, given the time difference between Europe and Asia, real-time payment settlement of Asian bonds is not possible unless changes are made in the global clearing and settlement system. An Asia-Pacific regional system could cover the third time zone, that is, the non-business hours of Europe and the Americas.

Currently, global clearing and settlement systems are reluctant to link their systems with the local systems of Asia, which are subject to many restrictions on bond market transactions. Efficiency considerations will, however, compel the integration of the Asian clearing and settlement system with global systems in the future. It is therefore advisable that the system be devised in a way that would facilitate eventual integration.

(b) Credit rating

Liu and Ferri\textsuperscript{19} show that corporations in developing countries face discrimination in credit rating by global agencies in that their ratings are strongly affected by the sovereign ratings regardless of their domicile. Firms in developing countries are given low ratings because their sovereign ratings are low. This is mainly a result of the poor quality of institutions and information disclosure. From the perspective of the architects of ABFs, the most serious roadblock they will face in promoting the funds would be an inadequate supply of high-quality Asian bonds in which the funds could invest because of the absence of regional credit-rating agencies.

The long-term solution to this rating problem is to improve the rule of law and the quality of information disclosure by investing more heavily in social capital and institution-building. In the short run, the

\footnotesize{\textsuperscript{18} G. Oh and others, “Building a settlement infrastructure for the Asian bond market: AsiaSettle”, paper presented at the Workshop on East Asia’s Strategy for Regional and Global Financial Cooperation”, organized by the Asia Pacific School of Economics and Government, Australian National University, and Northeast Asian Institute of Business and Economic Research, Korea University, 11 October 2003.}

\footnotesize{\textsuperscript{19} L.G. Lui and G. Ferri, “How do global credit rating agencies rate firms from developing countries?”, ADB Institute Research Paper 26, September 2001.}
establishment of Asian rating agencies through ABFs independently or jointly with member States could be considered. Regional schemes could also be organized to cooperate with global rating agencies in order to devise separate firm-level ratings based on firm-specific risks only.

There is little disagreement that efficient and stable regional bond markets will help to increase access to and diversify the sources of financing for firms in Asia and the Pacific. What is required at this stage of development is to ascertain the characteristics of regional bond markets that would best serve the interests of the region’s savers and investors.

Borrowers have the option of issuing bonds in the local, regional and global bond markets. As shown previously, most of the large corporations that can obtain investment-grade ratings have been migrating to the global bond markets. They also have access to the global and domestic equity markets. Many small and medium-sized firms are not capable of raising capital from either the local or regional bond markets, despite the fact that some of them have good credit records. Who then, will, raise funds in the regional bond markets in Asia and the Pacific?

Since institutional investors prefer quality, there will not likely be strong demand for high-yield Asian bonds. A large increase in the supply of top-grade Asian bonds cannot be expected in the foreseeable future. Since issuance costs in Asian bond markets are likely to be higher than those of global markets at the beginning, there will be few top-grade Asian firms tapping the Asian bond markets. These structural constraints suggest that such markets would have a better chance of survival if they were designed to be complementary to either the domestic or the global capital markets. Indeed, a poor strategy for the Asian bond markets would be to attempt to lure away creditworthy Asian borrowers from the global bond markets.

The regional bond markets in Asia cannot remain separated from the global financial markets. With the opening of financial services, foreign investment banks, brokers and dealers will play an important role in developing regional capital markets in Asia, particularly by forming a critical mass of issuers and investors from the region. Because of their dominance in supplying capital market services in global financial markets, they will also be instrumental in harnessing the linkages between regional capital markets and global markets.

If the planners of the Asian Bond Initiative emulate the issuance procedures, regulations and market infrastructure of the global bond markets, the Asian bond markets may not take off; most likely they will become moribund like the so-called Samurai and Shogun bond markets. At the same time, the Asian bond markets will not thrive and become viable sources of financing if they are designed primarily to accommodate the borrowing of low-rated or unrated Asian bond issuers because there would be little demand for high-risk Asian bonds.
There are numerous categories of bonds ranging from top-grade and low-risk bonds to high-yield and high-risk bonds in the global bond markets. Because of their nascent features, the success of Asian bond markets will depend on identifying and bringing into the markets those issuers that do not have access to the global bond market but do have good credit records. To this end, creating regional credit rating agencies specialized in rating Asian bond issues would be of critical importance in launching and developing regional bond markets in Asia.

(c) Guarantee mechanism

Initially, substandard bonds issued by creditworthy Asian firms could be made more attractive to risk-averse foreign investors through credit enhancement and guarantees of these bonds (see annex VI). However, credit enhancement and guarantee facilities often do not exist. Where they do exist, the cost of the credit quality improvement tends to be high, making bond financing less attractive than bank financing. Several regional institutions, including multilateral ones, have expressed interest in guaranteeing Asian currency bonds, but they would be selective in choosing the bonds they could accept, lest they should be seen as subsidizing the issuers. If the guaranteeing cost at these institutions is lower than the market level, then their clients would be mostly sovereign and small and medium-sized business issuers.

This mechanism could be extended to cover SMEs of developing economies in the region through innovative institutional arrangements. For example, a central authority could undertake the bond issues on behalf of SMEs. This would allow the provision of guarantees to a central institution with a sovereign counter-guarantee instead of guaranteeing individual SMEs. Efficient institutional arrangements such as debt recovery laws and transparency and accountability rules would be essential for the sustainability of such an arrangement.

4. SECURITIZATION OF SME BONDS

Another option to help small-scale entrepreneurs to make use of the Asian Bond Initiative is the securitization of SME bonds. Securitization is a form of structured financing in which securities are issued through repackaging a series of assets that generate cash flow in a way that separates these assets from the credit profile of the company that originally owned them (see annex VII for an example). High-yield bonds issued by those corporations and financial institutions with speculative grades could be transformed into investment-grade paper through the creation of special-purpose vehicles which issue and market bonds of their own backed by the substandard bonds that they pool. Securitization can take on a broad variety of attributes depending on the structure, the underlying assets, the way underlying assets are managed and the types of asset-backed securities issued.
The potential benefits of securitization include cost-efficient funding, credit risk mitigation, diversification of funding sources and tenor and currency management. In most cases, the real motivation for securitization is more likely to be risk mitigation and de-leveraging of the balance sheet at the lowest cost rather than merely obtaining access to cheap funding.

Securitization is useful to resolve the maturity mismatch problem in several ways. First, a securitization deal enables the creditworthiness of asset-backed securities to be independent of the creditworthiness of the company that originally owned the underlying assets. The credit assessment of asset-backed securities is made solely on the basis of the cash flows created by the underlying assets. In addition, securitization schemes such as collateralized bond obligations and collateralized loan obligations can reduce the overall credit risk of the asset pool by diversifying the idiosyncratic credit risk of each borrower.

Despite the benefits from credit risk diversification, securitization by itself cannot remove the credit risk. Instead, it enables issuers to sell the credit risk at a lower cost. It reduces the overall cost of raising funds by creating securities whose credit risk profile is tailored to the risk preference of investors. In particular, bonds with a higher credit rating than the underlying assets can be issued by using the senior/subordinate tranches. Generally, senior bonds receive higher credit ratings than collateralized assets and can therefore be absorbed more easily by the market.

In addition to senior/subordinate tranching, other credit enhancement methods such as over-collateralization, spread accounts, cash collateral accounts, credit swaps and credit guarantees can be used to enhance the creditworthiness of the asset-backed securities and make them attractive to an even greater range of investors.

C. LOOKING AHEAD: A VISION FOR FINANCIAL DEVELOPMENT AND INTEGRATION IN ASIA AND THE PACIFIC

1. FINANCIAL MODERNIZATION AND INTEGRATION

The financial systems in the Asia-Pacific region are known to be unevenly developed, often bank-based, controlled by the State and closed to foreign competition. Banks and other financial intermediaries of these countries, including China and Japan, are saddled with large amounts of non-performing loans. Unless these bad loans are removed, they could pose a serious systemic risk for a country’s financial system and expose it to financial crises. China, Japan and the South-East Asian countries affected by the 1997 financial crisis are taking steps to deal with this issue.
Financial markets and financial service businesses are tightly regulated and closed to foreign investors and borrowers, thereby restricting cross-border financial transactions in the region. The lack of financial integration has resulted in inefficient allocation of resources and has also rendered the region highly susceptible to financial instability caused by speculation, panic, mania and investors’ herd behaviour.

A number of East Asian countries which suffered severe financial crises in 1997-1998 have taken steps to restructure their financial systems and have initiated institutional reforms, including reform of their legal and regulatory systems. However, despite these, the momentum of the reform efforts has to be intensified in order to improve the efficiency and the stability of the financial systems.

These crisis-affected countries have amassed huge amounts of reserves to build a “war chest” for fighting future financial crises instead of strengthening their financial markets and institutions; at the same time investment in infrastructure and social and rural development has been less than desired. Some of the reserve holdings of China; Hong Kong, China; Japan; the Republic of Korea; and Taiwan Province of China could also be lent to other countries for their productive investment, but there are no channels to facilitate such lending.

In a world economy that is being rapidly globalized, Asia-Pacific economies cannot remain much longer outside the integrated global financial system. Therefore, one possible vision for the future of the financial sector of Asia and the Pacific is financial modernization and integration through financial reform, institution-building and cooperation.

What is required of ESCAP members to achieve this vision? What could ESCAP do to assist its members in realizing the goal of financial modernization? The following are some suggestions that the ESCAP members may wish to consider:

- Sustain the efforts of extensive financial reform and institution-building: members may adopt different financial reform plans with different speeds of implementation tailored to their reform capacity.

- Develop the banking sector and capital markets simultaneously: recent studies have shown that banking and capital market developments are complementary to each other. Credible and reliable legal and regulatory systems are prerequisites to developing an efficient banking sector; they also underpin efficient capital markets.

- Adopt from the emerging international standards for accounting, disclosure, corporate governance, risk management and capital adequacy at financial institutions. Introducing these standards to many territories of Asia and the Pacific may run into formidable road blocks; indigenization rather than the grafting of these standards is the preferred strategy.
• At a certain stage of financial development, emerging market economies of Asia should embark on gradual deregulation of capital account transactions and the opening of financial service businesses. Here again, different countries may consider different scopes and speeds of financial opening that befit their institutional capacity.

• There is no one-size-fits-all exchange rate regime for emerging market economies. Most countries which are not active participants in the global capital market may decide what is best in their interest.

• If monetary integration is the ultimate objective of the countries participating in regional arrangements, they will find it expedient to accept a collective exchange rate regime and tighten policy coordination.

• Experience has shown that financial reform is often derailed by opposition mounted by the vested interest groups. One possibility of diffusing such domestic political resistance is to exert peer pressure on individual members by collectivizing the financial reform within a regional financial arrangement organized by a group of like-minded countries. For example, ASEAN+3, ECO, SAARC and other similar regional arrangements could construct a common framework of financial reform for the participating countries. Member countries could then devise their own reform plans based on the common framework. To be effective, the collectivization scheme would have to be supported by monitoring the implementation of reform in each country. A self-enforcement mechanism could be introduced and a review process could be instituted at the regional level.

2. AN ASIAN MONETARY FUND: CAN THE REGION JUSTIFY ITS CASE?

The idea of establishing an Asian monetary fund was first proposed by Japan in September 1997 following the Asian financial crisis. The original objective of such a fund was to make available a pool of funds to be quickly disbursed as a means of emergency balance-of-payments support for economies affected by the crisis. Although many in the region welcomed the proposal, it failed to gain support from the United States and IMF on the grounds that it would weaken the role of IMF in the international monetary system.

The proposal has recently met with some support from early opponents, as such a fund could play a complementary role to IMF by providing funds required in a crisis situation which IMF alone would not be able to galvanize. It could also engage in crisis surveillance and prevention at the regional level. However, the realization of an Asian monetary fund would greatly depend on the region’s ability to fit into the international financial architecture.
monetary fund would greatly depend on the region’s ability to fit into the international financial architecture. An extended CMI could be a stepping stone for the establishment of such a fund. Further, the linkages between the fund and IMF would have to be spelled out, as they should be complementary and not competing arrangements.

3. CURRENCY UNION: A LONG-TERM VISION?

Although the Asian and Pacific region by no means constitutes an ideal group for an optimum currency area compared with today’s Europe, some subregions, particularly East Asia, are as well qualified for a common currency as the members of the EU were in the 1970s and 1980s. Empirical studies invariably point to the large increase in intraregional trade in East Asia in recent years as a development conducive to financial and monetary integration in East Asia. Trade and investment liberalization have been the driving forces behind much of the increase in intraregional trade. This increase has in turn served to synchronize business cycles across East Asian countries, thereby producing economic conditions that are favourable to the creation of a currency union in the region.

Against these trade and macroeconomic developments, financial deregulation and market-opening have drawn Asia away from regional financial integration. Financial liberalization throughout the region has led many countries to establish closer linkages with international financial markets than before, but not with markets of other neighbouring countries in the region. In contrast, however, the financial markets of European countries were much more integrated with one another in the 1970s and 1980s than the markets of Asian countries are at present. As indicated in chapter I, with the increasing tendency towards regional cooperation in trade in Asia and the Pacific, better currency management and monetary and financial integration will become necessary.

As the EU’s experience suggests, the Asian and Pacific region needs to have a long-term vision with a gradual and pragmatic approach towards creating a common currency area, which should be preceded by trade liberalization and financial integration.

D. A POSSIBLE ROLE FOR ESCAP IN PROMOTING FINANCIAL COOPERATION

As a regional arm of the United Nations for the Asian and Pacific region, ESCAP is entrusted with the mandate to promote economic and social development through regional and subregional cooperation and integration. Over the years, ESCAP has supported regional movements for trade liberalization and integration; it has also participated in numerous projects for social development, including poverty reduction in Asia and the Pacific.
ESCAP was instrumental in establishing ADB in 1965 to provide development finance and technical support to developing countries in the region (see box II.1) and the Asian Clearing Union in 1973, for which ESCAP continues to provide advisory services. With the mandate given by the Monterrey Consensus for promoting the role of the regional commissions in supporting policy dialogue among countries at the regional level on macroeconomic, financial, trade and development issues, a reinvigoration of ESCAP’s role in facilitating financial cooperation among Asia-Pacific countries is timely. In this respect, the following proposals are recommended.

1. BUILDING CHANNELS OF COMMUNICATION AND POLICY DIALOGUE: MAKING ESCAP A “KNOWLEDGE CENTRE”

As noted in chapter I, there are separate tracks of regional economic cooperation, particularly in the fields of trade and finance. For instance, ASEAN is forging its own arrangements and arrangements with other regional partners in the context of ASEAN+3 and ASEAN+1. Similarly, SAARC is pursuing its own initiatives. Likewise, the Pacific Islands Forum and ECO have their own tracks. There is some merit in bringing these initiatives together, at least starting with a deeper understanding of the cooperation mechanisms involved and the ways that inter-subregional cooperation could be fostered.

In this regard, ESCAP, whose membership covers the Asia-Pacific region, could serve as a mechanism to play a facilitating role in promoting greater awareness among subregional groups of the cooperation mechanisms that are being pursued, including their linkages to the multilateral process.

A possible way to proceed could be for ESCAP to be granted “observer” status in various forums such as ASEAN, ASEAN+3, SAARC and ECO on a mutually agreed basis with those subregional organizations. ESCAP currently has observer status at the Forum Secretariat ministers meetings in the Pacific Islands Forum Secretariat. Such observer status would enable ESCAP to forge inter-subregional awareness of developments in the fields of trade and finance that are emerging in the region.

In this way, ESCAP could facilitate policy dialogue between different subregional groupings on macroeconomic and financial issues. With its wide experience in areas such as trade and investment, transport and ICT, ESCAP is well placed to be a regional knowledge centre facilitating financial cooperation in the Asia-Pacific region.

2. CONCLUDING REMARKS

Despite its short history, ASEAN and three North-East Asian countries, China, Japan and the Republic of Korea, have been able to initiate and lead financial cooperation and integration by successfully...
launching the two regional initiatives for developing a liquidity support system (CMI) and regional bond markets in Asia (ABI). The progress that ASEAN+3 has made in consolidating and expanding the two initiatives also raises the question of expanding its membership and of broadening and deepening its relations with non-member countries and other regional trade arrangements. In particular, the success of ABI requires the participation and support of other non-ASEAN+3 countries in the region.

East Asia could play a critical role in providing leadership for an extension of ABI and CMI to other countries in the Asia-Pacific region. It could also take the lead in designing a plan of action which could include a set of convergence criteria for becoming members of such initiatives at a future date. While improving efficiency, such initiatives would also be a catalyst for financial integration in the Asia-Pacific region and provide an opportunity to reap the benefits of globalization.

The success of such initiatives would greatly depend on the region’s ability to fit into the international financial architecture, necessitating reforms to make their financial markets sound, efficient and deep so that they could support economic development while withstanding external shocks.