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SYSTEMIC RISKS OF ASEAN+3 FINANCIAL INTEGRATION: CHALLENGES, OPPORTUNITIES AND THE FUTURE¹

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Abstract

There has been rapid *de facto* trade integration in ASEAN+3 over the past decades, and experts have noted that this leads to greater *de facto* financial integration. These two therefore have reinforcing effects on each other. However, this cycle brings with it systemic financial risks that could lead to balance of payments crises, capital reversals, and exchange rate variability from current account imbalances which have caused global disruptions historically. The way to keep history from repeating itself is to address these risks. The Chiang Mai Initiative Multilateralization (CMIM) is one way of doing so, by providing an insurance mechanism that can safeguard the trigger points for said crises. However, the development of *de jure* integration policies such as this has been slow, much slower than policies that further trade integration, posing a systemic risk. This paper clarifies the implications of this; discusses the possible reasons for this discrepancy; and provides potential solutions that will enable ASEAN+3 to speed up the process of prudent financial integration.

Keywords

ASEAN+3, CMIM, financial integration, FTA, trade integration, systemic risks

Context: Development of Regional Trade and Financial Cooperation in ASEAN + 3

The ASEAN+3 is a regional economic cooperation mechanism established among the ASEAN economies² and the Plus (+) 3 economies including China (and Hong Kong), Japan and South Korea. The group first met during the Asian Financial Crisis in 1997 as a mechanism to promote regional financial cooperation and avoid future liquidity crises.³ Since then, it has evolved into a set of over fifty bodies, hosting an annual summit, and a cooperation framework in 20 areas including macroeconomic coordination, trade, finance, food security and energy. This section describes the advances the group has achieved in terms of financial cooperation and trade liberalization.

In 2001, ASEAN+3 leaders decided to seek trade liberalization among the economies.⁴ Trade liberalization among ASEAN economies was already advanced via the ASEAN Free Trade Area. Further trade liberalization involved the negotiation of agreements between ASEAN and the plus 3 economies (China, Japan and South Korea). This initiative translated into the bilateral free trade agreements negotiated between ASEAN and each of these economies and that came into force between 2006 and 2010.⁵ This is often described as an ASE-

² These include: Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Thailand, Singapore, Vietnam.

³ The Asian Financial Crisis evidenced the interdependence of trade, investment and financial flows among the different economies in East Asia. Therefore the long-term solutions required a regional approach leading to financial cooperation. The ASEAN leaders extended an invitation to other economies in East Asia to envision a mechanism on financial cooperation aiming at avoiding future liquidity crisis. From the perspective of Sussangkarn (2011), the rationale behind this form of cooperation was simple: while some countries in the region had saving deficits, other economies such as China, Japan and Singapore were running of savings surpluses. The region needed a mechanism to channel the surplus of some countries into liquidity for the others in times of crisis. This was particularly important after the experience of countries like Indonesia and South Korea where the implementation of IMF programs had high political costs.

⁴ In 2001 ASEAN+3 countries launched The East Asian Vision Group (EAVG), to map out the major purposes, basic principles, and specific measures of cooperation in the region. The EAVG proposed the establishment of the East Asian summit, the East Asia Forum and the East Asia Free Trade Area as long-term goals.

⁵ The first negotiation to conclude was the ASEAN-Korea free trade agreement. The agreement was ratified and came into force in 2006. This agreement was followed by the ASEAN-Japan Free trade agreement concluded in 2007 and implemented since December 2008 including areas of trade of goods, services, investments, rules of origin and disputes settlement. The last of these agreements was the

AN+1+1+1. However, the region has not to the date negotiated a multilateral trade liberalization agreement among the 13 participant economies.

One of the earliest proposals for such multilateral arrangement was the East Asia Free Trade Area (EAFTA) suggested by China in 2001 and the later initiative for the ASEAN+6 Comprehensive Economic Partnership in East Asia (CEPEA) also including Australia, New Zealand and India as proposed by Japan. These two initiatives eventually merged into an ASEAN centered process currently known as the Regional Comprehensive Economic Partnership (RCEP). The negotiations of the RCEP as a region-wide (ASEAN+6) free trade area were launched in 2012 and are still in the early stages of the negotiation. Parallel to the RCEP, China, Japan and South Korea begun the negotiation of a Trilateral Free Trade Agreement in 2013. This agreement could eventually also be expanded to include ASEAN members. Both initiatives are far from conclusion due to the enormous historical and trade-related differences among the participating economies.

The benefits of the evolution of the current network of bilateral agreements towards an ASEAN+3 wide Free Trade Area have been discussed in the work of Urata (2007) who demonstrated the “trade creation”⁶ effect of the establishment of this kind of agreement among the economies in the region. Kwan and Qui (2010) explain the trade creation effects of an ASEAN+3 trade agreement from the perspective of the complementarity of the natural endowments, technology advancement and industrial structures of the countries in the region. Other authors such as Bhagwati (2008), Menon (2013), and Fukunaga and Isono (2013) explain the importance of an ASEAN+3 trade agreement as a mechanism to harmonize trade liberalization across the region. From their perspective, a free trade area including the 13 economies would reduce the risk of a potential “noodle-bowl” effect due to the differences in terms of rules of origin (ROO) and non-tariff barriers that exist on the current bilateral agreements between ASEAN and the plus 3 economies.

Parallel with trade integration, the first stages towards regional financial cooperation were the establishment of the ASEAN+3 Economic Review and Policy Dialogue (ERPD) in May 2000, the Chiang Mai Initiative (CMI) later that year, and the Asian Bond Market Initiative (ABMI) established in 2001. The ERPD is a surveillance and policy dialogue mechanism between the Finance Ministers of ASEAN+3 economies. The CMI was conceived as a series of bilateral swap agreements among ASEAN+3 economies with the purpose of constituting a regional liquidity pool to be used in case of problems with the balance of payments. The ABMI promoted the integration of regional capital markets and aimed to mobilize international reserves into regional markets therefore contributing to regional financial stability.

The initial push towards these initiatives started to wane in the following years as a consequence of rapid economic growth in the region and the accumulation of currency reserves as an alternative mechanism to have liquidity. These initiatives were tested during the 2008-2009 economic crisis. During this time, regional economies facing liquidity crisis opted to negotiate bilateral swap agreements with the US Federal Reserve (Singapore and Korea) and with China (Indonesia) instead of using the CMI pool of reserves.

ASEAN-China free trade agreement, which came into effect in January 2010 including zero-tariff trade, services and investments.

⁶ Urata's findings point towards “trade creation” effects of an ASEAN+3 agreement, as oppose of the “trade diversion” effect often occurred during first years of other regional free trade areas such as NAFTA and Mercosur. In a similar line, Petri, Plummer and Zhai (2011) on their assessment of the RCEP (including ASEAN+6) estimated that annual welfare gains would raise to US\$215 billion by 2025, mostly from the liberalization of trade and services between China, Japan and Korea (therefore trade liberalization only among ASEAN+3 economies would have a similar effect).



Research Question, Aims and Focus

The previous section contextualizes the research question. Evidently, trade and financial integration in ASEAN+3 have had contrasting fortunes, with the latter receiving constant criticism. In this light, the question this paper addresses is:

“What are the implications of the discrepancy between the development of trade and financial integration in Asia on system risk, and what can be done to address these?”

The first aim for this paper is to assess the implications for the said discrepancy, from the perspective of financial crises. The next is to explore a possible solution to this issue, and the causes behind its delayed growth and implementation. The last is to offer possible solutions for improving regional cooperation in preventing future crises.

The focus of the paper is on East Asia, which has mostly positive experiences with trade integration but contrastingly negative experiences with financial integration. In scoping the policy recommendations, the paper is focused on the Chiang Mai Initiative Multilateralization (CMIM) as the main form of financial integration in East Asia. It seeks to understand the reason behind its lagging institutional development. Last, it seeks to draw insights from more successful experiences in developing regional cooperation, benchmarking with strategies applied by the European Union (EU) in the past.

Research Methodologies Implemented

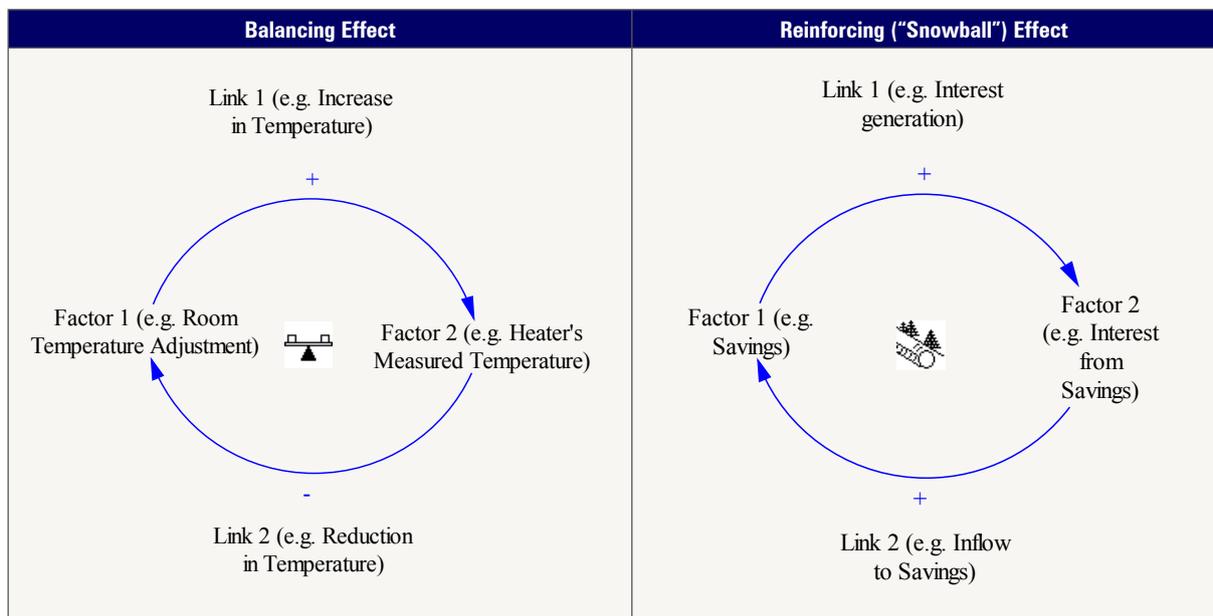
To address the research question, the group applied two key methodologies. Dynamic causal loop analysis, and historical analysis combined with literature reviews, and comparative institutional assessment with a benchmark institution.

Dynamic causal loop analysis

The first method, dynamic causal loop analysis, is well-established in the field of dynamic modelling, also known as system dynamics. It involves laying out the factors that are influencing a particular problem, identifying the links between these factors, and in turn, the directionality (meaning, a positive or a negative impact) for each of the links. This is important because two factors which affect one

another over time in a positive way can lead to reinforcing or “snowball” effects. For instance, in the context of a savings account, higher investments leads to higher total savings, which then leads to even higher interest gained. In contrast, factors can have a negative impact on one another over time, leading to a balancing effect. For instance, in in-door heaters which seek to maintain certain room temperature, an initial low level of temperature leads a heater to burn fuel to raise the room temperature. If the room temperature increases too much, the heater, then brings the room temperature back down. In both cases, the process is dynamic because these factors influence one another over time, with one factor leading to another. These two factors are illustrated in the table below.

Table 1. Illustration of Causal Loop Analysis



The factors considered often have multiple loops and directionalities. In integrating these, simple multiplication of the signs is done to identify the systemic outcome. As shown below, having the same sign leads to a reinforcing effect, and opposite signs leads to a balancing effect.

Table 2: Simple Multiplication of Two Links to Identify Systemic Outcomes

Sign of First Link	Sign of Second Link	Systemic Outcome
Positive	Positive	Reinforcing Effect
Positive	Negative	Balancing Effect
Negative	Positive	Balancing Effect
Negative	Negative	Reinforcing Effect

By extension, a chain of causal loops could lead to a snowball effect if there is an even number of negative signs (e.g. negative + negative + positive); and it could lead to a balancing effect if there is an odd number of negative signs (e.g. negative + negative + negative + positive).

In the context of the research question, the **outcome examined** is the **risk of a financial crisis**. The way to analyze the impact of factors to said risk is that if there are reinforcing effects in factors related to risk, this implies magnification of the said risk (i.e. the risk of another financial crisis). This then contributes to recommendations on addressing that risk based on which of those factors are critical to reversing the trends.

Historical analysis and literature reviews

The next methods, historical analysis and literature reviews, are an essential partner of causal loop analysis, but also have stand-alone functions. First, they validate the relationship between the factors in the initial risk diagrams developed, based on past events. Next, they also make possible the equally herculean task of understanding the factors affecting the risk drivers and how they could actually be addressed. In this process, the group looked into the reasons behind the reluctance of countries to make use of the CMIM. The output of this process was the identification of the key reasons for the slow growth of regional institutions for financial cooperation in mitigating the risks uncovered from dynamic causal loop analysis.

Comparative institutional assessment

In the last method, comparative institutional assessment, the group benchmarked ASEAN+3 with the European Union (EU), which has had better progress on regards to developing regional institutions that are crucial for addressing systemic risk. Building on the historical analysis of factors impeding the growth of said institutions in ASEAN+3, the team looked at what the EU has done differently to make its own institutions work.

In combination the three research methodologies allowed the group to uncover the possible trajectories of future financial risk at the level of international and country-level trade and finance, to identify issues behind the slow growth of regional institutions which could mitigate risks, and to derive possible recommendations for addressing said issues at the institutional level (learning from comparatively more successful examples).

Findings: Causal Loop Analysis For Drivers Of Trade And Financial Integration, And Implications For Financial Crises

Reinforcing Effect between Regional *De Facto* Trade and Regional Integration

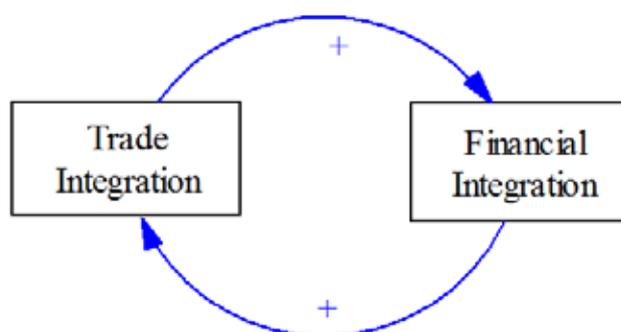
Regional trade cooperation leads to greater regional trade integration. According to the Asian Development Bank's Asian Regional Integration Center (ARIC), trade among ASEAN+3 economies has increased on average by 10.8% annually since 1990. *De facto* trade integration ("in fact", or actual integration measurable quantitatively) is commonly measured in increases in exports, although from the perspective of individual countries, these are measured in terms of the ratio of exports to GDP (Cheung, Yiu and Chow, 2008). At the regional level, this is measured in trade within the region (intra-regional trade) in merchandise (goods) and commercial services.

The Monetary Authority of Singapore (MAS) shows that trade integration has been growing in Asia, and this has been driven by the emergence of cross-border production networks. This has further been driven by "increasing complementarity among countries" as well as an "increasing shift in organisational focus from the firm to the 'contractual network of firms tied together by mutual long-term interest'" (MAS, 2007:63; Stopford, 1994). Said network structures have led to increasing trade in intermediate parts needed for production (MAS, 2007:64).

What are the implications of increased trade integration? Aizenman (2005) notes that trade integration leads to financial integration through the following mechanism:

- Increased intra-regional trade and investment can generate greater demand for cross-border trade-financing activities and capital flows;
- Greater trade openness increases the effective cost of restrictions on capital flows, creating the impetus for further financial openness and integration

Figure 1: Reinforcing Effect between Trade and Financial Integration



Greater financial integration then leads back to increased trade integration:

- Deeper financial integration should help to channel Asia's large pool of savings towards financing investment within the region. The pooling of liquidity could reduce financing costs for (regional) firms and encourage investment, the expansion of regional production networks, and therefore, trade integration.

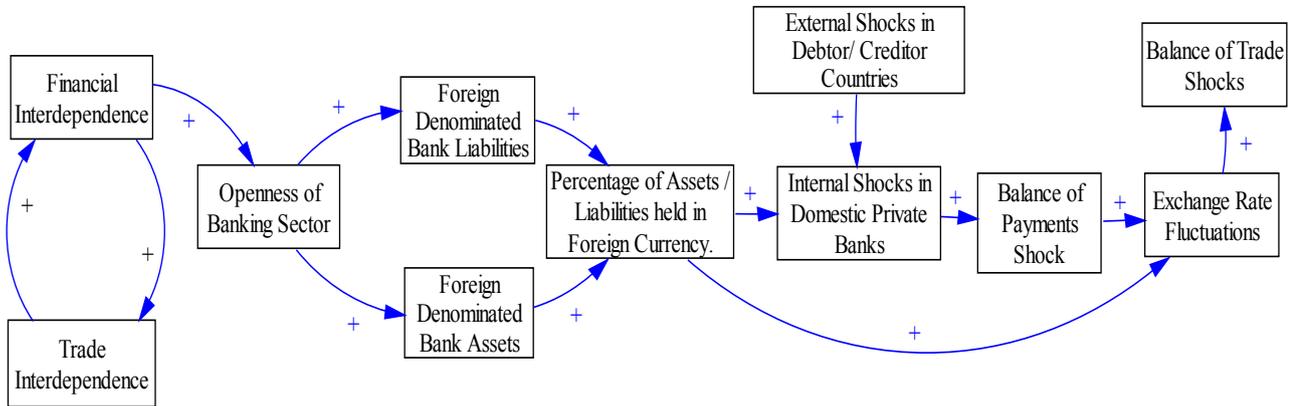
These insights therefore show that there are positive feedback effects of trade and financial integration on each other.

What are the implications of the reinforcing link between trade and financial integration on the risks of future financial crises? In the next section, literature reviews on the past financial crises provide insight on how either of the two have led to past financial crises.

Impact of Financial Integration on Balance of Payment Shocks: First Generation Crises

First generation financial crises occurred in the 1980s. Greater financial interdependence led to a higher percentage of banking sector assets and liabilities held in foreign currencies. This then led to greater vulnerability of banks to internal shocks whenever external shocks in debtor/creditor countries occurred. These then lead to balance of payment shocks. Moreover, whenever a large portion of debt were foreign denominated, this led to exchange rate fluctuations, and therefore, balance of trade shocks as well. Given these dynamics, Figure 2, below, shows that the reinforcing effect between financial and trade interdependence could lead to a greater risk of first generation financial crises, a re-enactment of what happened in the 1980s.

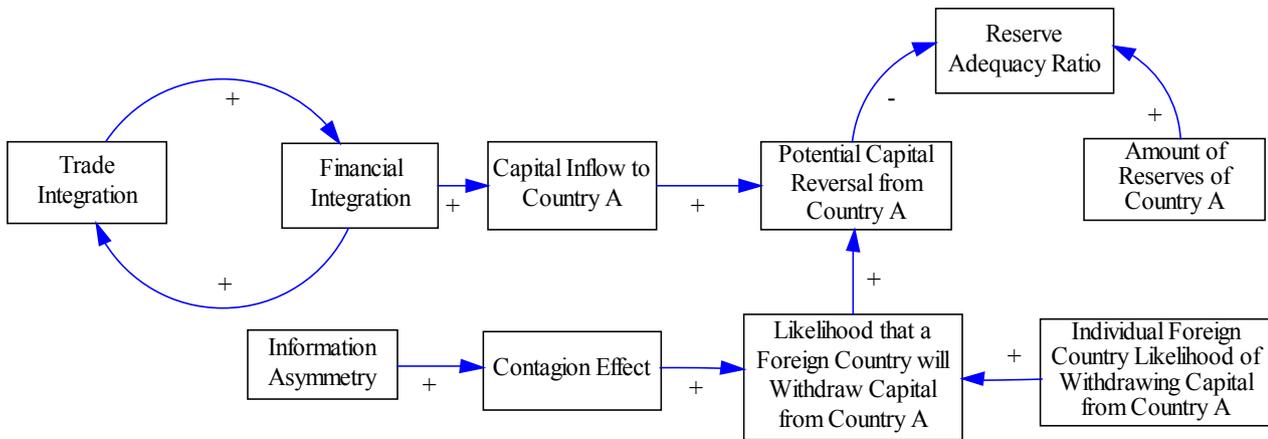
Figure 2: First Generation Crises — Balance of Payments Shocks from Private Bank Activity



Impact of Reinforcing Effect on Capital Flows: Second Generation Crises

The Asian Financial Crisis in 1997-98, an example of a Second Generation Crisis, was largely driven by increased trade integration, which led to greater financial integration within the Asian region. This then resulted in large inflows of capital, especially to the net exporting countries. However, random events such as sudden capital outflows from countries whose exchange rates showed unfavourable trends triggered other countries to simply withdraw their investments. This then led to capital reversals. The top portion of Figure 3 show this.

Figure 3: Second Generation Crisis — Increased Capital Flows and Contagion



The real threat, as the crisis has shown, is that given information asymmetry (meaning, no one in the market had certainty as to what would happen in the future), decisions were made in an uncoordinated manner. The bottom portion of Figure 3 shows that whenever countries have insufficient information (“information asymmetry”) about the actual state of the ailing country, they tend to copy the behaviour of the market, making capital withdrawal a “contagious” phenomenon. Last, since massive capital outflows reduced the ability of countries to stem the impacts of previous outflows.

Figure 3 shows succinctly that in the face of financial integration and interdependence, the task of balancing an economy and stemming instability is

made more difficult by market instability. As a result, risks of future crises are magnified by the reinforcing effect between trade and financial integration, as the amount of reserves adequate for overcoming these risks can be very high.

Impact of Trade Interdependence on Current Account Imbalances: Third Generation Crises

Last, the 2007-08 Global Financial Crisis exemplifies that increasing trade interdependence also leads to higher potential exchange rate instability through the current account imbalances. This was known as Third Generation financial crises.

Figure 4: Third Generation Crisis — Current Account Imbalances

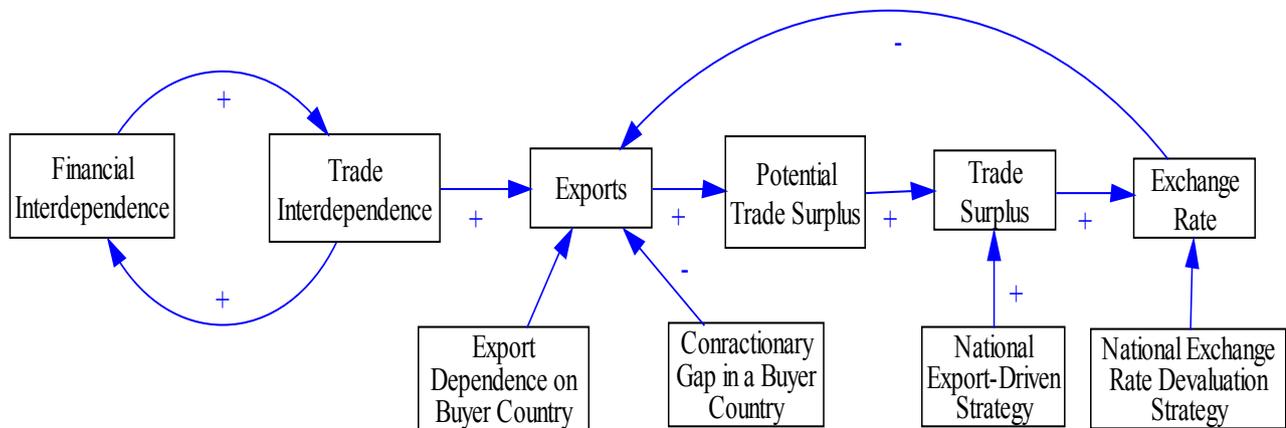
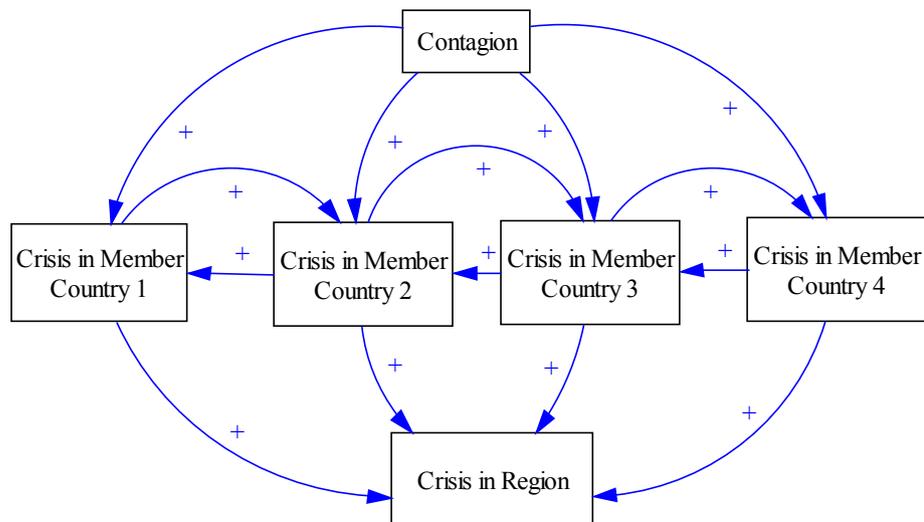


Figure 4 shows that regionally and globally as well, increased trade interdependence between developed nations in the West and developing nations in the East (as a result of increased exports) allowed for the financial crisis in the US to affect Asia. The reason was that this generated large trade surpluses on the side of Asia, and have largely affected exchange rate appreciation on Asia's part (given that trade has been done in US dollar terms). This then led to consistent trade surpluses, also known as "current account imbalances". The implication of these trends was that these increased the exposure of a country to the risk of crisis whenever the net importing countries in the West faced contractionary GDP gaps. In the 2007-08 crisis, the US economy faced a slump, reducing their capacities to import. This led to volatility in the trade balances and as a result, in exchange rates, of net exporting countries. In the future, greater trade interdependence naturally increases the risk of instability, as is described in Figure 4.

Contagion Magnifying Risks of Instability from First, Second and Third Generation Crises

The three risks mentioned earlier, based on past experience, were magnified by information asymmetry. The reason is that bad decisions tend to spread, whenever there is no adequate information on the causes of disruptions (e.g. if investors knew disruptions were temporary, they would not immediately pull out). As such, a crisis in one country affects other countries, through contagion (Figure 4).

Figure 5: Implications — Overall Regional Crises Increasing



Implications of Reinforcing Effects and Crises

The risks of any of the three generations of crisis are currently increasing, with deepening financial and trade interdependence globally as well as regionally. These are further magnified by the contagion effects, resulting from information asymmetry and contagion. An implication that can be drawn from of the dynamic causal loop analysis is that it is not sufficient for countries to accumulate reserves at the country level alone. In effect, the ideal reserve-adequacy ratio would be very high. In addition, the option of bilateral swaps still poses a risk, as this is not an automatic mechanism (e.g. it takes time to draw agreements for swaps, and one country's failure immediately affects the other). The analysis points to the need for regional cooperation, both to provide sufficient reserves and to ensure cooperation by countries. We explore this further in the next section.

Findings: Historical Analysis Of Factors Driving Slowdowns In Financial Regional Cooperation, Focusing On CMIM

As mentioned at the beginning, the initial push towards these initiatives started to wane in the following years: countries have resorted to accumulating currency reserves and having bilateral trade during crises, rather than turning to the CMIM. The previous section likewise showed that said bilateral swaps would not be a sufficient insurance mechanism to ward off the next crisis -simply put, financial and trade integration are both drivers for financial crises, but are also mutually reinforcing-. The implication was that there is a need for greater regional cooperation to avert future crises. We now explore the difficulties faced in the development of institutional arrangements, as these could hamper the development of regional cooperation.

Progress of Institutional Arrangements in Addressing Increasing Risks

Several authors, including Sussangkarn (2011), Park and Song (2011) and Dent (2013), describe a series of reasons explaining countries' choices of using bilateral agreements instead of using the CMI initiative. The first one is related to the size of the funds. South Korea for example was entitled to US\$18.5 billion under the CMI agreements. This amount is small compared



to the US\$30 billion obtained from the United States' Federal Reserve Bank (data from Dent 2013). According to these authors, another apparent reason for the dismissal of the CMI funds was the link to IMF. Under the CMI the countries could only access up to 20% of the funds without pursuing a program with IMF. In a regional context where many of the countries still resent the IMF-imposed reforms after the Asian Financial crisis this condition was far from ideal. Another limitation with CMI is that nobody knows if its use would create the same confidence effects that a swap with the US Federal Reserve generates among investors.

The failure of the CMI to serve as a first line of defense against liquidity shortages led the regional leaders to the reform of the mechanism. Established in 2010, the CMIM pooled the bilateral swap agreements into a single multilateral contract. The rationale was to have larger reserve pool and a more institutionalized mechanism.⁷ The CMIM established a self-managed reserved pooling⁸ for US\$120 billion and defined a centralized decision-making procedure for contribution and borrowing accessibility. An additional initiative to strengthen

⁷ Even before the 2008 crisis, Kuroda and Kawai (2003) envision the necessity that "A framework for regional financial cooperation may include three areas: regional surveillance and monitoring for crisis/contagion prevention; schemes to augment international liquidity for crisis management; and programs to assist crisis-affected countries to resolve the systemic impact of the crisis and accelerate the recovery process" towards a more effective financial cooperation in East Asia. The reforms introduced with the CMIM aim in the directions suggested by these authors.

⁸ Under the self-managed reserves pool, ASEAN+3 members committed to make funds available, however the money remains in the Central Banks. This is why some authors adduce that the agreement is not really a reserve fund. The countries commit to make funds available but are not actually polling them beforehand.

regional financial cooperation was the creation of the ASEAN+3 Macroeconomic Research Office (AMRO) in 2011. The AMRO was established as a mechanism “to monitor and analyse regional economies, contributing to the early detection of risks, swift implementation of remedial actions, and effective decision-making of the CMIM”.⁹

Table 3: Developments to the CMIM after 2012.

	Previous (2010)	Announced May 2012
Size of pool	US\$120 billion	US\$240 billion
IMF de-linked portion	20%	30% and up to 40% in 2014 (subject to review)
Maturity (full amount)	90 days	12 months with 2 renewals
Supporting period (full amount)	2 years	3 years
Maturity (IMF de-linked)	90 days	6 months with 3 renewals
Supporting period (full amount)	1 year	2 years
Scope facilities	Crisis resolution function	Crisis resolution function renamed as CMIM stability facility. Introduction of crisis prevention function: CMIM precautionary line.

Source: Siregar and Chabchitichaidol (2013).

Why Has Regional Financial Cooperation Lagged behind Regional Trade Cooperation?

Amid increasing risks from financial and trade integration -risks which are too high for a state to depend on itself solely-, the pace of the development of agreements in regional financial cooperation has lagged behind that of trade cooperation.

If there is one area in the integration process of East Asia that can be said to be successful, it has to be trade, as can be shown from the previous part. Indeed, it is trade integration that helped propel East Asia to a whole new level of economic development, which in turn gave the region much bargaining power vis-à-vis the developed world such as the EU and the US.

One could argue that formal multilateral or region-wide frameworks are still lacking in East Asia (except for ASEAN) and therefore, *de jure* trade integration isn't so successful. But the abundance of bilateral agreements and the *de facto* regional trade integration and, more broadly, trade interdependence are more important indicators.

On the other hand, despite all the professed interest and enthusiasm, financial integration, another crucial component in the regional integration efforts, has stalled in both *de facto* and *de jure* senses. In fact, it has lagged far behind trade integration in both breadth and depth. Which begs the question: why can't financial integration in East Asia keep pace with trade integration?

The answer can be found in a number of factors.

To begin with, the intellectual underpinnings of trade integration and financial integration have not seen paralleling developing and the different swings and shifts ensure they are often not on the same page.

Since Adam Smith made a powerful case for free trade in 1776, the doctrine has endured all kinds of scrutiny, sometimes coming under scathing attacks. “Yet the idea of free trade, the conceptual case for free trade, has

⁹ Idem.



survived largely intact against the tide of repeated critical inquiry” (Irwin, 1996:10). Practitioners and politicians tend to deride academicians for their detachment from the real world. But as John Maynard Keynes’ famous quote illustrates, the ideas of these scholars are more powerful than commonly understood. Indeed, even in times of economic crisis, such as the latest global recession, when there would normally be strong protectionist and nationalist sentiments, countries would still engage in and push for trade integration to varying degrees, guided by the idea that closer trade relations will bring substantial benefits.

However, the picture is quite different for financial integration. Although the history of financial integration can be traced back to more than three centuries ago, the related theories only flourished after the demise of Bretton Woods systems. And unlike its trade integration counterpart, studies on financial integration often produce inconsistent or even conflicting conclusions, extolling the virtues of financial deregulation at one time (such as the 1980s and early 1990s) while urging caution and questioning the benefits of closer financial integration on economic growth at the other (such as now) (Gehring, 2013). It is no more typified than the IMF’s “ideological shift” on capital controls in 2012 from opposition to acceptance (IMF Staff Papers, 2012).

Against this backdrop, it is not surprising that the progress of financial integration has generally trailed that of trade integration. But the yawning gap in East Asia also has much more to do with its experiences in these two areas.

For its dealings in trade, East Asia’s experience has largely been positive. Since the 1960s, a succession of East Asian economies already began to adopt more open trade and investment policies instead of the inward-looking development strategies. Then the 1970s and 1980s saw the rise of the “Asian Tigers”. After China joined the WTO in 2001, East Asia has been rapidly turning itself into a new center of world economic growth. Most agree that the “East Asia Miracle” is largely attributable to the openness of East Asia to fore-

ign trade, with the establishment of a series of bilateral free trade areas, such as the ASEAN FTA and the three ASEAN+1 FTAs.

But the region's memory of financial integration is quite negative, with the specter of the 1997-1998 Asian Financial Crisis constantly hanging over its head, when the region as a whole, and Indonesia, South Korea and Thailand in particular, were considered to be treated in a humiliating way by the IMF. Indeed, one of the legacies the crisis left is that financial integration is primarily driven by a defensive logic to prevent further crisis, rather than guided by a forward-looking logic, where deeper financial reforms and better governance are perhaps more important (Park and Wyplosz, 2008).

In fact, this mindset led to East Asian countries accumulating large amounts of foreign reserves, making the Chiang Mai Initiative, one of the most lauded examples of East Asian financial integration, virtually redundant when the 2007-2008 global economic recession struck (Park and Wyplosz, 2008). Moreover, East Asia's attempt to control capital flows seems to also have discredited further financial integration when countries in this region proved to be much more resilient during the global financial crisis than others, especially the EU, which experienced much more rapid and deeper financial integration. And it seems the more integrated the region is, the higher the threat of financial crisis contagion.

No less significant, the less-than-proactive attitude of East Asian countries towards financial liberalization is because trade integration is on balance much easier to implement in terms of institutional arrangements compared to financial integration, which usually requires highly developed financial regimes. And indeed, welfare gains from trade liberalization are considered much more tangible and stable than opening up the financial sector (Aizenman, 2005).

Finally, perhaps a more important factor lies in the history and geopolitics of East Asia. Unlike Europe, where there has never been such a power dominating the whole continent, East Asia was for a long time dominated by China before Japan took over at the turn of the 20th century. In between, regional powers would also flex their muscles in Southeast Asia. Now, with China's rise and its new assertiveness, a sense of apprehension hangs over East Asia. It has left a trail of territorial disputes and seeded deep distrust in the region, especially between China and Japan, and China and most of the ASEAN nations.

The implications for integration are three-fold. First, there is great sensitivity about the erosion of sovereignty. As a region heavily reliant on trade, governments in East Asia are quite concerned about the stability of exchange rates. Since free capital flows implies they either have to adopt the floating exchange rate regime or lose control of their monetary policy and being dictated by others on what to do and how to do it (especially in light of what happened in the Asian Financial Crisis), which may prove to be economically unprofitable and politically disastrous; no wonder these countries are reluctant to take concrete measures towards closer financial integration, let alone contemplate the prospect of a possible single currency.

Second, the progress of integration can be easily hampered by the flare-up of any historical or political disputes. Indeed, with trade integration already going on for almost five decades, any fresh political disputes can easily stall the progress of any financial cooperation attempts, which are still at a relatively incipient stage. Third, while trade integration can be largely driven by markets, financial integration needs much more official coordination. But key driving countries as France and Germany for the EU integration are constantly missing in East Asia. Indeed, any country wishing to exercise leadership in the region is perceived with suspicion.

With all these factors combining to make their impact felt, it is little wonder that financial integration has lagged behind trade integration in East Asia.



Findings: Comparative Institutional Analysis, Learning From The European Union's Experience

European Union's Experience in Regional Financial Cooperation

Addressing these three problems may seem to be an insurmountable task requiring changing mindsets and removing political differences. However, are these required before one can move forward? Valuable lessons can be learnt through the experience of the European Union given its success in moving forward with trade and financial cooperation.

The European countries sought to integrate trade and finance simultaneously to avoid another world war. To move towards greater trade liberalization, the European Economic Community (EEC) was founded in 1968 and the Single Market was completed with the "four freedoms" of movement of goods, services, people and money in 1993. As for financial cooperation, European Monetary System (EMS) was founded in 1979, and the euro was introduced in 1999. Another factor leading to cooperation in Europe was the fear of crises. For instance, in recent years, financial crisis led to deeper financial cooperation in the form of the European Financial Stability Facility (EFSF), later European Stabilization System (ESS), and the European System of Financial Supervision (ESFS).

Table 4 summarizes the differences between EU and ASEAN+3 in trade and financial integration:

Table 4: Summary of Differences between EU and ASEAN+3

	EU	ASEAN+3
Motivation	Policy driven The creation of an internal market for goods and services, labor and capital is a longstanding central goal. European integration was pursued in order to avoid another world war (EU, 2012).	Market driven Open-integration harmonization of financial regulation East Asian countries remain mainly concerned with avoiding currency and financial crises. There is less political will in East Asia for regional integration (Pasadilla, 2008).
Currency	European "currency snake", EMS, euro	Diversity of currencies. Some countries have free-floating currency while others are pegged to the US dollar.
Trade structure	Intra-regional trade was at 63.35% in 2012 (ARIC, 2015)	— Not multilateral (ASEAN+3) but bilateral (ASEAN+1+1+1) — Intra-regional trade in ASEAN+3 was about 38% in 2012 (ARIC, 2015)
Organizations	EU, ECB, ESM ESMA, EBA, EIOPA (Micro Prudential) ESRB (Macro Prudential)	CMIM, AMRO AMBI
Process of integration	First worked toward regional integration, then global	Both regional and global integration are pursued simultaneously.
Market Similarity	Similar integrated market	Diverse (GDP/capita, Size, Openness etc.)

Potential policy directions for ASEAN+3

So what lessons can East Asia learn from the EU?

Firstly, political will and organization is lacking in the ASEAN+3 structure. Unlike the supranational nature of the EU, ASEAN+3 has a very loose intergovernmental structure. While institutionally the European Commission and the European Central Bank play a much central role in the process of the EU financial and trade cooperation, there are no comparable organs in East Asia. Indeed, in the case of CMIM, AMRO largely plays no more than an advisory part. Part of the reason lies in the EU's stronger political will, which is sorely needed in East Asia if the region hopes for further integration.

Secondly, cooperation with IMF should be one solution. European countries which faced crises such as Ireland, Portugal, Greece, Spain and Cyprus gained help from EU and also from the IMF. In addition, IMF, EU and ECB imposed conditionality and observance together (it is called troika) (EFSF, 2013). Moreover, the European Financial Stability Facility (EFSF, currently ESM) cooperates very closely with the IMF (ESM, 2013). In fact, IMF donated €250 billion Euros (EU's contribution is €500 billion) for EFSF funds.

Specific policy recommendations for ASEAN+3

In light of the previous analysis, following are some key reform recommendations for making the CMIM more attractive:

1. ASEAN+3 needs to expand the size of the CMIM. The current US\$240 billion swap facility is not enough to deal with large liquidity crises. ASEAN+3 needs to establish a mechanism to coordinate the bilateral and multilateral swap arrangements;
2. The CMIM also needs to devise a mechanism to facilitate the disbursement of funds. A country facing a liquidity crisis needs quick access to the funds and this is constrained under the current self-managed system;

3. Review IMF conditionality is another area that most of the authors point out as necessary to boost the attractiveness of the CMIM;
4. ASEAN+3 needs to further strengthen the AMRO in order to be able to perform better bilateral and multilateral surveillance, therefore reducing the dependence from the IMF to perform these functions.

Conclusion

ASEAN+3 economies are important trade partners with extensive production networks across the economies. The first years of integration among these economies took form into a series of bilateral free trade agreements, further advancing trade liberalization in the region. These agreements are slowly evolving into a multilateral system, with initiatives such as the Regional Comprehensive Economic Partnership (RCEP) involving the 13 economies in the region. The conclusion of such agreement is not going to be free from obstacles and it is not likely to be achieved in the short-term despite of its potential trade creation and FDI mobilization effects. However, looking towards 2020, these agreements are plausible. Financial integration among ASEAN+3 economies needs to keep pace with their increasing trade interdependence and the establishment of these agreements.

The most important goal of regional financial cooperation is to avoid systemic risk. One of the most important ways to achieve this is by identifying and communicating risk. This is the reason why in a scenario of increasing interdependence, the economies in ASEAN+3 should work together towards a stronger CMIM and AMRO.

To achieve this goal ASEAN+3 economies need to build capabilities in the form of a stronger AMRO for bilateral and multilateral surveillance and a CMIM that is effective as a first line of defense, and the group has provided recommendations to speed up the process of financial integration by better identifying and communicating risks so as to keep pace with trade integration. This may be difficult to achieve in the short term, but is realistic in the medium-to-long term; moreover, the risks greatly justify the need for their implementation.

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