

Exploring Financial Cooperation between China and ASEAN Countries under CAFTA

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Abstract

The commencement of CAFTA (China-ASEAN Free Trade Area) has significant implication for the financial cooperation in this region. This paper is to discuss the related issues. Based on the observation on the past financial cooperation between China and ASEAN countries, we could see the generally low-level and unbalanced capital flows among private sectors, and the relatively more achievements in the area of currency cooperation between the state monetary authorities. Hence, to improve the financial cooperation under CAFTA is necessary and helpful for the regional trade and economic development. Meanwhile we should not neglect the influence from changes in the global and regional economic environments. This paper then proceeds to make some recommendations on how to strengthen the financial cooperation between China and the ASEAN countries, as well as discuss about the difficulties and challenges that might be encountered in the way of pushing forward with financial cooperation.

Keywords: *ASEAN, CAFTA, financial cooperation, capital flows, currency cooperation*

JEL classification: *F15, F21, F33, F36*

1. Introduction

On 1st January 2010, China¹-ASEAN Free Trade Area (CAFTA) was officially launched to promote trade in the region by providing a system of institutional arrangements. ASEAN countries, including Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, Vietnam, have more than 4 million square kilometres of territory and population of nearly 592 million. CAFTA, by combining China and the ASEAN member countries is thus the world's largest free trade zone with more than one

quarter of the population of the whole world. Not only will the people and the economy of the region be influenced significantly, there will also be a profound impact on the world at large.

With the development of trade the cooperation at the financial level also becomes more necessary and important. In fact, in both the private sector and the public sector, China's financial transactions with ASEAN countries have been ongoing and developing gradually. In the private sector, there are foreign direct investments (FDI) or other forms of capital flows; on the official level, there is cooperation conducted mainly by government entities (such as the Ministries of Finance, Central Banks) in the area of regional currency cooperation and other aspects. Especially in the event of financial crisis, there will be a stronger impetus to push forward such cooperation. The 1997-1998 East Asian Financial Crisis and the 2008-2009 Global Financial Crisis are the cases in point.

However, the economic situations in both Southeast Asia and the world at large are constantly evolving. How to implement a more effective cooperation under a new environment so as to benefit the people in both China and ASEAN countries is an issue that requires careful thinking and exploration. It constitutes the focus of this paper.

In the following sections of this paper, we shall begin with an observation on the past financial cooperation between China and ASEAN members, including the status of private sector capital flows and currency cooperation between the state financial and monetary authorities. This is the basis for our further discussion. We shall then analyze the financial cooperation under CAFTA, while considering the changes in global and regional economic environment. This will be followed by some recommendations on how to strengthen the financial cooperation between China and ASEAN countries. Also in this section, we shall discuss the difficulties and challenges that might be encountered in the way of pushing forward the financial cooperation. The final section summarizes and concludes the paper.

2. Observation on Financial Cooperation between China and the ASEAN countries

Since China began the process of reform and opening up in 1978, China's economic transactions with the outside world have been increasing gradually. After over 30 years of development, China has grown to be the world's second largest economy². China also ranks high in foreign trade and in attracting foreign direct investment. In general, however, usually observed are China's economic relations with the United States, Japan and Europe. Less has been focused on regarding the financial cooperation between China and the ASEAN countries in the past.

Financial cooperation is a very broad concept. A rigorous definition is absent in the literature. It can refer to the cooperation in the exchange rate regimes or liquidity arrangement between the national financial or monetary authorities, or it may also include a wider range of capital flows and other related activities. Here in our discussion we use the latter definition. Therefore, the observation on the financial cooperation between China and the ASEAN countries could unfold from both levels.

2.1. Capital Flows among Private Sectors

The Balance of Payments (BoP) presentation records all the economic transactions between the residents in a country and non-residents in the rest of the world in a certain period. The Capital and Financial account, in turn, records transactions involving the capital flows. More specifically, there are two sub-accounts, the Capital Account and the Financial Account, which focus on different types of capital flows respectively. Therefore, we can employ the BoP to observe the capital flows in the private sector.

According to the statistical data, the figures in the Capital Account which are mainly related to the migration activities are relatively small these years³. Therefore, we only observe the Financial Account here which includes three items – foreign direct investment (FDI), portfolio investment and other investment.

Table 1 Capital and Financial Account in BoP[†]

<ul style="list-style-type: none"> II Capital and Financial Account <ul style="list-style-type: none"> A. Capital Account B. Financial Account <ul style="list-style-type: none"> 1. Direct Investments 2. Portfolio Investments <ul style="list-style-type: none"> 2.1 Equity Securities 2.2 Debt Securities 3. Other Investments <ul style="list-style-type: none"> 3.1 Trade Credits 3.2 Loans 3.3 Currency and Deposits 3.4 Other Assets or Liabilities

Note: [†] Here is an excerpt from China's Balance of Payments. For the purpose of simplifying the analysis some adjustment is made such as removing the two columns of assets and liabilities. Only the basic types are listed.

Source: Official website of the State Administration of Foreign Exchange of China, <www.safe.gov.cn>.

Table 2 FDIs to China, 1997-2008 (US\$ million)

Year	Singapore, Malaysia, Thailand, Indonesia, Philippines (1)	ASEAN-10 Countries (2)	The five countries/ ASEAN-10 (3) = (1)/(2)	Singapore/ ASEAN-10 (4)	Whole World (5)	ASEAN/ Whole World (6) = (2)/(5)
1997	3417.85	3428.00	99.7%	76.0%	45257.04	7.6%
1998	4198.08	4223.18	99.4%	80.6%	45462.75	9.3%
1999	3274.97	3288.77	99.6%	80.3%	40318.71	8.2%
2000	2836.71	2844.58	99.7%	76.4%	40714.81	7.0%
2001	2969.77	2983.95	99.5%	71.8%	46877.59	6.4%
2002	3200.42	3255.94	98.3%	71.8%	52742.86	6.2%
2003	2853.09	2925.43	97.5%	70.4%	53504.67	5.5%
2004	2909.62	3040.53	95.7%	66.0%	60629.98	5.0%
2005	2937.27	3105.43	94.6%	71.0%	60324.59	5.1%
2006	3033.78	3351.13	90.5%	67.5%	63020.53	5.3%
2007	4001.03	4391.24	91.1%	72.5%	74767.89	5.9%
2008	5105.58	5460.99	93.5%	81.2%	92395.44	5.9%

Source: Official website of the State Bureau of Statistics of China, <www.stats.gov.cn>.

2.1.1. Foreign direct investments (FDIs)

China has been rather policy-oriented to attract foreign direct investment for quite a long period. Inward FDIs indeed play a very important role for the economic growth and development in China. Table 2 shows the FDIs to China from 1997 to 2008, including FDIs from ASEAN countries.

As Table 2 shows, in the past decade, ASEAN countries' FDIs into China accounted for a very small proportion in the total FDIs China has acquired, being always less than 10 per cent. This figure even declined in recent years. Among the ten countries in ASEAN, the five countries of Singapore, Malaysia, Thailand, Indonesia and the Philippines are the main sources of FDIs for China. Their FDIs are more than 90 per cent of the total FDIs from ASEAN countries to China. Furthermore, Singapore ranks first among the ten countries, accounting for about 80 per cent of the total investment from the ASEAN countries.

At the same time, there is also foreign direct investment into ASEAN countries from China. Comparatively, however, China has been placing more emphasis on the inward FDIs than the outward FDIs. There are more friendly and encouraging policies upon the inward FDIs and rather strict controls on outward FDIs. For example, the foreign investors are guaranteed various kinds of favourable policies such as tax deduction when they enter China's market, but local investors have to get rather complicated administrative approval for their investments abroad. Nevertheless, as there are more and more foreign exchange reserves accumulating in China, and more solid strength of Chinese enterprises, there are increasing foreign direct investments from China to other countries in recent years.

Table 3 shows China's outward FDIs, based on data from the publications of the National Bureau of Statistics.

Similar to the ASEAN countries' FDIs in China, China's investments in ASEAN countries are also at a relatively very low level, being less than 5

Table 3 China's FDIs Abroad (US\$ million)

Year	Total Amount	FDIs to ASEAN	FDIs to ASEAN/Total Amount
2004	5497.99	150.22	2.7%
2005	12261.17	57.71	0.5%
2006	17633.97	248.45	1.4%
2007	26506.09	684.11	2.6%
2008	55907.17	1890.24	3.4%

Source: Official website of the State Bureau of Statistics of China, <www.stats.gov.cn>.

Table 4 China's FDIs to ASEAN Countries, 2000-2008 (US\$ million)

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008
Brunei	-	-	0.2	0.2	3.0	0.1	4.8	17.2	-
Cambodia	-	2.9	49.2	26.2	33.0	102.8	130.1	164.9	76.9
Indonesia	-2.8	-1.5	0.0	-0.4	294.6	299.5	123.6	117.2	380.2
Laos	9.1	11.8	1.3	1.8	0.1	4.5	5.3	1.7	42.9
Malaysia	0.7	16.9	13.2	1.8	2.0	1.0	-6.7	4.6	56.5
Myanmar	-	0.5	4.8	-	108.1	1.2	1.5	1.7	349.2
Philippines	0.0	0.1	-	0.0	-0.2	-0.2	2.3	-0.1	-0.2
Singapore	-168.6	91.5	-170.9	131.7	212.6	69.2	616.7	594.2	478.0
Thailand	7.2	-2.5	20.9	23.8	-3.8	11.6	49.9	73.7	69.0
Vietnam	21.0	24.2	9.4	1.5	85.6	48.2	88.7	251.8	44.6
ASEAN-10 (Total)	-133.4	143.9	-71.9	186.6	735.0	537.9	1016.2	1226.9	1497.1

Source: The ASEAN Secretariat, Jakarta, *ASEAN Statistical Yearbook 2008*, July 2009, p. 143, Table VI.14.

per cent of its outward FDIs. In recent years, however, China's investments in ASEAN countries increased rapidly with an average annual growth rate of above 20 per cent⁴.

Meanwhile, there is the *ASEAN Statistical Yearbook 2008* issued by the ASEAN Secretariat in July 2009, with more detailed data on FDIs from China, as shown in Table 4.

It could be seen that there are quite many differences between the data presented in Table 4 and the data supplied by China's side. Nevertheless, we could still find the relative status of China's FDIs in each ASEAN member country. Singapore is the ASEAN country which had the largest proportion of all the FDIs to ASEAN from China. Relatively, Indonesia, Cambodia, Vietnam and Myanmar also received rather large amount of FDIs from China. On the contrary, Malaysia, Thailand and the Philippines only received small amount of FDIs from China.

2.1.2. Portfolio investments and other investments

Compared to FDIs, there are stricter controls on the capital flows related to portfolio investments and other investments. In 1996, China has fulfilled the Clause Eight of IMF and realized the complete convertibility of RMB for the transactions under the current account, but China is still working on the process of free capital movement gradually, being concerned with the complexity and the potential shock of capital flows. Regarding statistical data, on the one hand, due to the more stringent controls these types of capital flows have relatively small scale; on the other hand, it is really difficult to find statistical data which are solely about the portfolio and other investments between China and ASEAN countries. Therefore, we can only use some sporadic observational data here.

Among the foreign capital flows into China, some are obtained through the issuance of shares in foreign capital markets. It is a kind of capital flow belonging to the Portfolio Investments. In this respect, Singapore and Malaysia are the more popular destinations for China. Sometimes China's companies went to Thailand, Brunei, Cambodia and the Philippines to raise capital by going to the public.

As can be seen from the Table 5, although China's companies went to Singapore and Malaysia for their capital markets, the total amount of capital inflows can be said to be "insignificant", being less than 1 per cent of the world's total. On the contrary, since the RMB has not yet been fully convertible, and there is strict regulation on China's capital market, capital outflows resulting from the issuance of shares are still quite limited.

In addition to the primary market, there are also capital flows between China and the outside world through the secondary market. Two institutions

Table 5 China's Capital Raised by Issuing Shares Abroad, 1998-2008 (US\$ million)

Year	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Malaysia	8	2	-	-	-	21	-	531	919	600	1387
Singapore	-	3	41	169	214	142	-	551	35	168	185
World Total	209474	212825	864146	279453	226823	263548	344300	348038	405519	357172	285793
(Malaysia + Singapore)/ World Total	0.0%	0.0%	0.0%	0.1%	0.1%	0.1%	0.0%	0.3%	0.2%	0.2%	0.6%

Source: Official website of the State Bureau of Statistics of China, <www.stats.gov.cn>

play important roles in this regard, which were introduced in 2002 and 2006 respectively. The former one is the Qualified Foreign Institutional Investors (QFII) system and the latter one is the Qualified Domestic Institutional Investor (QDII) system. QFII allows the capital to enter the Chinese market for the purpose of investment, and QDII allows the opposite direction of capital flow. As of June 2010, a total of 96 institutions from around the world have become China's QFIIs, of which there are only seven coming from the ASEAN countries – six from Singapore and one from Malaysia. As for QDII, among 601 funds China has issued, only 15 belong to QDII. These funds may seek investment opportunities in the global capital markets; however, it seems that there are few investments in the ASEAN countries.

Moreover, there are also capital flows in various types such as the debt, bonds, loans, etc., between China and the outside world, but existing information shows that the amount of capital flow under these channels between China and the ASEAN countries is still relatively small.

2.2. Financial Cooperation among Financial and Monetary Authorities

In contrast to the financial cooperation in the private sector, it seems that there are more achievements in cooperation between financial and monetary authorities of China and the ASEAN countries. Earlier, it was the occurrence of the Asian financial crisis in 1997-1998 that made these countries in East Asia realize the necessity and importance of regional financial cooperation. Specific exploration was then made to push forward currency cooperation in this region. After one decade's efforts, there are already some significant outcomes in this area (which would be discussed in detail in the following paragraphs). Again, the global financial crisis in 2008-2009 which originated from the sub-prime debt crisis in the USA accelerated the financial cooperation in East Asia, including China and the ASEAN countries. So far, we could observe financial cooperation in the official sector between China and the ASEAN countries in the following aspects.

2.2.1. Chiang Mai Initiative (CMI)

After the 1997-1998 East Asian financial crisis, the financial cooperation among East Asian countries was pushed forward with a direct outcome – the “Chiang Mai Initiative” between the ASEAN countries and China, Japan and Korea in May 2000. The Chiang Mai Initiative aims to create a network of bilateral swap arrangements (BSAs) among the ASEAN+3 countries, with which the short-term liquidity difficulties in the region could be solved to some extent. Meanwhile they could supplement the existing inadequacy of the international financial arrangements.⁵

Since then, there is a meeting of ministers of finance in May each year to discuss about further specific arrangements for this Initiative. The 7th ASEAN+3 Finance Ministers' Meeting set up a review plan on the Initiative for the purpose of exploring more efficient cooperation. The problems such as the amount in swap, the format of help and the relationship with IMF loan were reviewed. Then a more important development was achieved in the following meeting in May 2005. The finance ministers agreed to take some measures to enhance the effectiveness of the CMI, including "(1) integration and enhancement of ASEAN+3 economic surveillance into the CMI framework, (2) clear defining of the swap activation process and the adoption of a collective decision-making mechanism, (3) significant increase in the size of swaps, and (4) improvement of the drawdown mechanism."⁶

At the 10th ASEAN+3 Finance Ministers' Meeting in May 2007 (Kyoto, Japan), the finance ministers unanimously agreed that, in principle, a self-managed reserve pooling arrangement under a single contractual agreement is an appropriate form of CMI multilateralization (CMIM), proceeding with a gradual approach.⁷ At the same time, the amount under swap agreement has been increased substantively. As of the end of that year, there were already 17 swap agreements and total amount was US\$84 billion.

In the new round of global financial crisis in 2008-2009, China and the ASEAN countries continued to work on liquidity arrangements, with the central banks collaborating on the bilateral liquidity agreements. Till the end of 2008, China and Thailand, the Philippines, Malaysia, Indonesia and other countries signed a total of 230 billion swap agreements. In February 2009, ASEAN and China, Japan and South Korea held a special finance ministers' meeting and introduced the "Asian economic and financial stability plan of action" to address the worldwide financial crisis; at the same time, the reserve pool under the "Chiang Mai Initiative" was increased from US\$800 billion to US\$120 billion.

The 12th ASEAN+3 Finance Ministers' Meeting, held in the midst of the 2008-2009 global financial crisis, reached agreement on all the main components of the CMIM, and decided to implement the schedule before the end of 2009 (see Appendix).⁸ It marked the milestone of CMI in its progress. Till the latest Ministers' Meeting in May 2010, the CMIM was officially announced to come into effect on 24th March 2010. At the same time, there were agreements on all the key elements of the regional macroeconomic surveillance unit of the CMIM, called the ASEAN+3 Macroeconomic Research Office (AMRO).⁹

2.2.2. *Economic Review and Policy Dialogue (ERPD)*

From the development of the "Chiang Mai Initiative", we can see the importance of inter-regional policy dialogue. In fact, effective economic

review and policy dialogue would contribute to the prevention of financial crises. On the one hand, the abnormal phenomena and irregularities could be detected in the earlier stage under effective review; on the other hand, the remedial policy actions could be designed and implemented through policy dialogue more efficiently. All these will lay a solid foundation for providing immediate assistance in the event of a crisis. Out of these considerations, the Economic Review and Policy Dialogue system was established in May 2000. With the existence of this mechanism, ASEAN+3 could conduct meetings at the ministers' level annually and at the deputies' level twice a year to discuss economic and financial developments in the region.

Furthermore, there are similar efforts – the Group of Experts (GOE) and the Technical Working Group on Economic and Financial Monitoring (ETWG) – established at the 9th ASEAN+3 Finance Ministers' Meeting in May 2006 (Hyderabad, India) so as to explore the ways for further strengthening surveillance capacity and cooperation within this region.¹⁰

2.2.3. Asian Bond Markets Initiative (ABMI)

A regional financial market could work for the more efficient allocation of funds within the region. With depth and width, efficiency and liquidity, this kind of market could contribute positively to the development of the economy in the region. Therefore, another exploration of financial cooperation in this area is to first build up a regional bond market.

The EMEAP¹¹ members made the first step for the Asian Bond Funds in 2003 by investing US\$1 billion in bonds denominated in US dollars. In the same year, the Asian Bond Markets Initiative (ABMI) came into being so that an efficient and liquid bond market in Asia could be ultimately founded. With this market the capital resources within Asia would be allocated more efficiently. The ABMI mainly conducts its activities in two areas. One is to make a wider variety of issuers and types of bonds access to the market. Another one is to build up the infrastructure for the unified bond market in Asia.

Along with the effort and progress made under the ABMI since 2003, the Asian bond markets have recorded remarkable growth in terms of size and diversity of issuers. To further develop the Asian bond markets, in 2008 the New ABMI Roadmap was issued, in which there are more strong commitments to the concrete progress of ABMI from each country. Generally, the themes of New Roadmap include promoting issuance of local currency-denominated bonds, facilitating the demand of local currency-denominated bonds, improving regulatory framework, and improving related infrastructure for the bond markets.¹²

In the Boao Forum in April 2009, China promised to set up a China-Asian Investment Fund of US\$10 billion. In the latest Ministers' Meeting in 2010,

a trust fund with US\$700 million was established as the Credit Guarantee and Investment Facility (CGIF) under the Asian Development Bank (ADB). The main objective of the CGIF is to support the issuance of corporate bonds in the region, and thus contribute to the development of the regional bond markets.¹³

From the observation we made on the financial cooperation among the official institutions, we find that there is not only the cooperation between China and the ASEAN countries, but also the cooperation involving two other important economies – Japan and South Korea. In fact, based on the geographical and economic links, it is difficult to conduct financial cooperation without these two important countries in East Asia. As for the cooperation related to China's currency, however, we could focus on the cooperation between China and the ASEAN countries.

2.2.4. Development of transnational settlement of RMB

Although Renminbi is still not a fully convertible international currency, it would be a good try and start if it could first be used in the East Asian region. At the same time, this could provide a good environment for the financial cooperation between China and the ASEAN countries.

On 6th July 2009 China launched an attempt in cross-border trade settlement of RMB. Many domestic banks then began their RMB settlement in the ASEAN countries. On 6th July, the Jakarta branch of the Bank of China and the Shanghai branch handled the first operation in Indonesia successfully. On 29th July, the first business in Singapore was finished by the cooperation between the Shanghai branch of the Bank of China and the Overseas Chinese Bank in Singapore. On 31st July, the Manila branch of the Bank of China introduced the RMB cash business in the Philippines. From August 2010, China began the foreign exchange spot transaction between RMB and the Malaysian ringgit in the inter-bank foreign exchange market. In addition, the central banks of China, Vietnam and Laos signed cooperation agreements of bilateral settlement. These are also substantial steps for regional financial cooperation.

In addition to these aspects of financial cooperation, there are also cooperation in research, such as the 10+3 Research Group, etc., and various forms of financial aids. Collaborative research is helpful in improving national data sharing and information exchange. Financial aids are especially significant for those members which are lagging behind in economic development.

3. Financial Cooperation between China and ASEAN Countries under CAFTA

Since the beginning of China-ASEAN Free Trade Area (CAFTA) on 1st January 2010, the region starts the progress into the zero-tariff era. This will

influence the economy and trade of this region substantively. At the same time, the financial cooperation will also enter into a new phase based on the previous development.

The geographic link between China and ASEAN makes CAFTA the trade area with the largest population in the world. Trade between China and ASEAN has become more and more important in their respective foreign trade relations. In the first four months of 2010, ASEAN is China's fourth largest trading partner: China's fourth largest export market and the third largest import market. In the year 2009, China is ASEAN's third largest trading partner: the fourth largest export market of ASEAN and the second largest import market. Along with the initiative of the CAFTA, it could be expected that trade between China and ASEAN would increase continuously. Based on the above observation, however, we can see the rather low level of financial cooperation, especially in the capital flows between private sectors including FDIs.

According to the traditional international trade theory of comparative advantages, trade and capital mobility should be substitutes rather than compliments. The standard Heckscher-Ohlin theory postulates that trade integration invalidates the need for capital to flow to capital-scarce countries. Hence, trade will not result in capital flow, nor will it need capital flow. On the other hand, in a recent paper, Antras and Caballero (2009) showed that in a world with varying degrees of financial development, trade and capital mobility become complements since trade integration increases the return to capital in less financially developed economies.

In addition, two features of the development of financial system require more financial cooperation between countries. First, for a single country, the development of its financial system directly influences the development of its economy. Although the occurrence of the financial crises will soon lead to economic recession, a growing number of theoretical and empirical studies support the view that financial development has a positive impact on economic development. Second, with the development of economic globalization, the financial cooperation between different economies contributes to trade and economic development. Of course, similar to the last point, the sudden reversal of capital, speculative attack and even the financial crisis, will also have a serious impact on economies. To some extent, it is just a sign that the financial cooperation should also be improved.

Therefore, CAFTA creates the space for trade within the region. This potential would be implemented more efficiently with the help resulting from financial cooperation. Financial cooperation could work for the construction of infrastructure, the division of labour and many other aspects. The capital flows between the private sectors could enhance the efficiency of allocating funds and accelerate the deepening of finance markets. The financial and

currency cooperation between governments would provide a better regional financial environment. All these will then be helpful for trade and economic development in the region.

Meanwhile, we cannot limit our vision only in the area where the financial cooperation develops. International economic environment is always changing. We must take that into account so as to develop the regional financial cooperation strategically.

One decade after the 1997-1998 East Asian financial crisis there was the sub-prime debt crisis which occurred in the USA in 2007. That crisis finally turned into a global financial crisis in September 2008, impacting the whole world substantively. According to the statistical data, currently many countries have begun to recover from the crisis; however, analyses on this crisis will never stop.

As soon as this global financial crisis took place, there were many kinds of analysis on the reasons of this crisis. Among them, much of the literature attributed the happening of the crisis to the “global imbalance”, which means mainly the big current account surplus acquired by China and other Asian countries and the big deficit in other places, particularly in the USA. No matter this kind of accusation is justified or not, we could at least think about this point for the further development of financial cooperation between China and the ASEAN countries.

Table 6 shows the balance of current account status of China and the ASEAN countries in recent years. Except Cambodia and Vietnam, China and the ASEAN countries have large current account surplus, especially Malaysia, Singapore and China. Once the financial crisis occurred, this kind of unbalanced situation became the accused target by trade partners. On the other hand, there was demand from the countries in deficit to have the deficit decreased or adjusted. This made China and most ASEAN countries need to rethink their economic development strategies. The CAFTA could be just considered as a response to this request. External current account surplus is not sustainable in the long term; hence the economy should stimulate the effective demand within the region, and adjust the growth structure. Then, as already mentioned above, trade and in-depth economic development will inevitably require a wider range of financial cooperation.

One direct result of current account surplus is the accumulation of foreign reserves, which is also an important perspective in understanding and developing the financial cooperation.

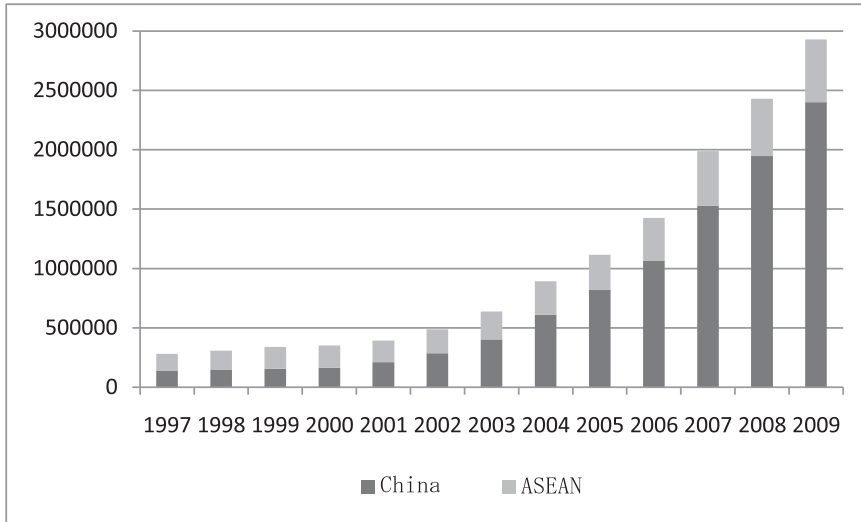
Figure 1 shows a very dramatic change of China’s and the ASEAN countries’ foreign exchange reserves since the 1997 Asian financial crisis. Particularly, since 2001, foreign exchange reserves of China and the ASEAN countries have been experiencing very high growth rates. ASEAN countries have acquired an average annual growth rate of 14.3 per cent, while China’s

Table 6 ASEAN Countries and China's Current Account Balance as a Percentage of GDP, 2000-2007 (%)

Year	2000	2001	2002	2003	2004	2005	2006	2007
Brunei	66.8	67.2	63.5	37.9	35.2	70.5	72.5	13.0
Cambodia	-2.8	-1.1	-1.2	-10.0	-7.4	-4.2	-0.7	-1.5
Indonesia	4.8	4.3	3.7	3.4	0.7	0.1	3.0	2.4
Laos	-0.3	-4.0	0.2	-2.0	-7.5	-6.5	1.2	2.6
Malaysia	9.4	11.7	8.4	12.8	11.9	14.5	16.2	15.6
Philippines	-3.0	-2.4	-0.4	0.4	1.9	2.0	4.6	4.3
Singapore	11.6	12.5	12.7	23.4	17.0	19.1	22.5	22.1
Thailand	7.6	4.4	3.7	3.3	1.7	-4.3	1.1	5.7
Vietnam	-1.1	2.1	-2.5	-4.8	-2.1	-0.9	-0.3	-4.1
China	1.7	1.3	2.4	2.8	3.6	7.2	9.5	11.0

Sources: Data for ASEAN countries are from the *ASEAN Statistical Yearbook 2008* published by the ASEAN Secretariat, Jakarta, in July 2009, p. 50, Table IV.12. There are no statistics for Myanmar; hence it is not listed in the table. China's data come from the *International Financial Statistics*, 2010, published by IMF. The GDP is in RMB, and we use the yearly average exchange rate to obtain the figures in US dollar.

Figure 1 Foreign Exchange Reserves of China and ASEAN Countries, 1997-2009 (US\$ million)



Source: IMF, *International Financial Statistics*, 2010. The figure for China in 2009 was from the official website of the State Administration of Foreign Exchange, <www.safe.gov.cn>. The figures for ASEAN were added for the ten members except some missing data.

average annual growth rate is as high as 35.4 per cent. Till the end of 2009, total reserves of China and the ASEAN countries were more than half of the total of that in developing countries, accounting for over 1/3 of the world's total reserves. According to the traditional theory about the demand for foreign exchange reserves, such a high level of foreign exchange reserves is far greater than the appropriate amount based on the level of imports. Many economists explain this phenomenon by considering the influence from the Asian financial crisis. These countries have seen foreign exchange reserves as an insurance fund against the speculative attacks and a protection from the crisis (Aizenman, 2006). Therefore, after recovering from the crisis, these countries are keen to continuously accumulate foreign exchange reserves, and most of the reserves are held in the form of dollar-denominated assets.

Then, what could be done in the financial cooperation between China and the ASEAN countries in such a scenario?

First, this great amount of foreign exchange reserves is clearly a very important resource for financial cooperation. The 1997 East Asian financial crisis began to promote the financial cooperation in this region. So, how to prevent speculative attacks and the exchange rate fluctuations from the

potential outflow of capital is an important task of financial cooperation. Based on such thinking, both the “Chiang Mai Initiative” and the various types of cooperation between China and the ASEAN countries are about the liquidity arrangement and cooperation between central banks. This is helpful for the avoidance of financial collapse. With a great amount of international reserves that are mainly denominated in US dollars, central banks could support each other in liquidity in time of need within the region. By the end of 2009, the US\$120 billion reserve pool based on the “Chiang Mai Initiative” has been build up. In the future, the problem in financial cooperation is how to effectively and efficiently use these resources.

Second, on the contrary, effective currency cooperation should be able to decrease the need for foreign exchange reserves for the member countries. It is costly to hold foreign exchange reserves. On the one hand, the accumulation of foreign exchange reserves means the delay of consumption of this region because of the current account surplus. On the other hand, the foreign exchange resources occupied in the form of reserves could be more profitable for the economy, i.e. the opportunity cost of foreign exchange reserves might be higher than the investment return of reserves. Therefore, it might not be an optimum choice to accumulate foreign exchange reserves continuously. Through effective currency cooperation, the member countries could share to some extent the foreign exchange reserves, which makes it possible to decrease the accumulation of foreign exchange reserves in each individual country. Then, the more specific institutions are required in the financial cooperation. Meanwhile, if we look at this phenomenon from the angle of capital flow, there are capital outflows from China and the ASEAN countries through the channel of foreign exchange reserves, and capital inflows at higher cost. It is a kind of capital cycling out of region. To make it within the region is a direction for further financial cooperation.

Third, while we are exploring the financial cooperation based on the foreign exchange reserves, what deserves more attention should be the reform of the international monetary system by the efforts of China and the ASEAN countries. The reason that “global imbalance” was criticized by some economists lies not only in the imbalance of trade, but also in its effect on capital flow. The huge amount of foreign exchange reserves entered the US capital market again, which create a very loose monetary environment and help pop up the bubble of assets prices. When the bubbles burst, the financial crisis comes. Every country then could not avoid the impact in such a globalized world. It is also why the criticism and review on the prevailing monetary system occurred as soon as the crisis took place. After the collapse of the Bretton Wood System, US dollar is still the most important reserve currency. It is the reason that so many countries have been accumulating the US dollar-denominated reserves. Then, how to reform this international

monetary system? China, and the cooperation between China and the ASEAN countries, should play active roles in the process of reform. This is also for the benefit of the region.

Another change in the international economic environment that we must notice is the sovereign debt crisis emerging in the Euro zone from early 2010. The Euro area is always a good sample and even model regarding regional currency cooperation. The united or single currency looks like the summit of currency cooperation. Hence, naturally it is also implicitly the aim of currency cooperation for other regions. For example, there was once the dream of an “Asian currency” for currency cooperation in this region. The occurrence of the European debt crisis, however, forced us to rethink. Is there a real “optimum currency area” in reality? How could it be lasting in practice? As for the East Asian region including China, how should we choose and realize an appropriate format of regional currency cooperation? So far, there is still much uncertainty in the change and development in this region, hence it is still not feasible to set up a format for the currency cooperation (Huang, 2010), let alone the unique currency.

Above all, with the changing international economic environment, China and the ASEAN countries should make use of the opportunities supplied by CAFTA and push forward the financial cooperation. In this process, because of its status in economy scale, population, etc., China should take the responsibility of being the leader. It is not only the responsibility of China in this region, but also the basis for her to play the role of a big country in the world.

4. Directions and Challenges of Financial Cooperation in the Future

If the importance and direction of financial cooperation between China and the ASEAN countries could be agreed, then the specific exploration needs to be exercised in reality. Of course, we have observed the efforts and achievements in this respect in the first part of this paper. However, there are still many to be done in the future. In October 2009, just before the beginning of CAFTA, the “Leaders’ Forum on the Financial Cooperation and Development between China and ASEAN” took place in the city of Nanning, Guangxi Province, China. The participants ultimately announced a “Joint Declaration”, in which three goals were pointed out. They are to protect the financial stability of the region, to enforce the currency cooperation in the region and to accelerate the capital cooperation within the region. We could consider these three goals as the long-term and macro-goals for the financial cooperation between China and ASEAN. By the guidance of these three goals, many specific policies or activities could be carried out in financial cooperation between China and ASEAN regarding the changing international economic environment.

4.1. Capital Flows in Private Sector

According to the past experience, both China and the ASEAN countries depend on the foreign direct investments to quite an extent. The data shows a simple positive relationship between the economic development and the amount of FDIs. Nevertheless, the FDIs between China and the ASEAN countries are very limited in the past according to the previous data. These countries even compete with each other in attracting FDIs from other countries outside this region because of the similar economic development level and the policies favourable to the export industries (Yu, 2008). Therefore, with economic development and increase in intra-trade among these countries, there is potential to increase the direct investments between each other. Especially, with the rapid growth these years, China has seen the growth of many big corporations. These corporations equip themselves with advanced technology, scientific management and grand capital. They have good conditions to invest abroad. On the other hand, there are also abundant resources in the ASEAN countries. Hence, China's enterprises should seek opportunity in investing in these neighbouring countries and make use of the advantages in these countries. Of course, the direct investment decision-making depends not only on the private sector, but also the policy environment. Therefore, both China and the ASEAN member countries should create a friendly policy environment to accelerate the further development of direct investment. It is good for capital to find better investment opportunities and also helpful for the increase of trade within the free trade area.

In the other formats of capital flows, there is also low level investment between China and the ASEAN countries. However, East Asia has been a popular destination for the global capital for rather long period. Comparatively, this region was not affected so much in the global financial crisis that just passed. Rather high growth rates are still projected for this region. Then a question is how to enjoy the benefit of economic growth in this region by the countries involved. It means countries in this region could actively make use of the investment opportunities within this region. Therefore, after the commencement of CAFTA, China and the ASEAN countries should increase the capital flow by investing in the capital markets mutually. At the same time, some capital flows such as loans and trade credits could accelerate trade in this region. In addition, besides the traditional fund investments or credit arrangements, each country could also make innovation or more flexible formats to facilitate the specific projects based on the features and characteristics. Another critical factor that may influence the success of cooperation is the policies in reality. It means that the governments should keep making efforts in pushing forward the cooperation and free flow of capital in this region. Meanwhile, the financial infrastructure inside each country is a necessary condition for the cooperation among countries (Cowen *et al.*, 2006).

Another important point is that the capital flow is a kind of flow of qualified financial practitioners to some extent. This flow includes two levels of meaning. Firstly, the practitioners in the finance areas need to know of the policies, institutions and environments in the markets in this region. Secondly, there should be the exchange and movement of the qualified human resources among the countries. All these construct the solid foundation for the capital flow. Therefore, from the angle of China, a friendly environment should be built up for the better understanding of the ASEAN countries' finance markets and the exchange of personnel in the financial sectors since the operation of CAFTA. If the government could issue some encouraging policies or tax preferences, there could be more incentive for further cooperation in the financial areas.

While the capital flows in the private sector will benefit the region, there are also more risks. The capital flows are the choice of individuals. However, they are limited by the policy environment to quite an extent. Therefore, the capital flows between China and the ASEAN countries in the future should follow the principles of "market activities accelerating policies" and "policies regulating the markets" for the prevention or control of the risks.

4.2. Financial Cooperation among Authorities

From the observation made, it can be seen that there are already many achievements in the financial cooperation among the authorities in East Asia. Then, what are the future directions? Based on the previous analysis on the world economic environment, the cooperation could be continued in the following aspects.

4.2.1. Further developments on Chiang Mai Initiative

CMI multilateralization and the Reserve Pool began to run after several years' preparation. Obviously, this is not the end of the financial cooperation, but a new start. Firstly, there will be more problems coming out in practice. To solve these problems will be the main task in the future. Secondly, so far the scale of this Pool is US\$120 billion, which needs adjustment along with the development of the economies and the change of the financial environments. Thirdly, the issues related to foreign exchange reserves have been discussed before. How to improve the management and cooperation in foreign exchange reserves is a challenge for China and the ASEAN members. Fourthly, the conditions on the credit arrangement under the Reserve Pool should also be adjusted when necessary in accordance with the specific situation.

4.2.2. Improvement on the system of risk surveillance

Because of the continuously changing environment, the risks in the financial areas have become more complicated. Hence in the future, more efforts are

needed in developing the system of risk surveillance in this region. Both qualitative and quantitative methods (indices) could be employed.

4.2.3. Construction of regional bond and capital market

There are already much effort and progress in the construction of the regional bond market. In the future, on the one hand, the regional bond market is going to operate with mature arrangements by more construction; on the other hand, the regional capital market deserves similar attention and efforts.

4.2.4. Cooperation currency and exchange rate regimes

As of the commencement of CAFTA, the expanded use of RMB in the region is significant due to the status of China in this region. More developments about RMB's transaction and settlement in the ASEAN countries are needed, which is also a good condition for the cooperation. As regarding the exchange rate regimes, the Southeast Asian countries were suffering in the financial crisis of 1997-1998 with their currencies in free fall, while China resisted the pressure to devalue its currency, thereby saving the Southeast Asian countries from being further hurt. Since then, China has received more and more recognition from the Southeast Asian countries as a responsible big country playing a constructive role in the regional economic and political affairs (Zhao *et al.*, 2007). So in the future, to find a way of cooperation in exchange rate regime is also an important task for this region, particularly for China.

4.2.5. Financial cooperation in the "Greater China" zone

At the beginning of this paper we use "China" in the scope of "Mainland China". In fact, in geopolitics, Hong Kong, Macau and Taiwan are all parts of the "Greater China" zone. Therefore, the financial cooperation in this zone is very meaningful for the financial cooperation in the Southeast Asian region, not only at the level of economic development, but also at the level of regional peace and stability.

4.3. Difficulties and Challenges in Financial Cooperation

Generally, China and the ASEAN countries are very different in development level, economic scale, business cycles and political regimes. Even inside the ASEAN, the regional cooperative organization, the members are diversified in culture, religion, resource-endowment and so on. The legal system, regulations and taxations are all different in each country. Cooperation is difficult under such context.

In particular, there are also many differences in the financial areas, such as the liberalization level, the regulations and the related policies. Hence each country is faced with the difficulties in dealing with the relationship between financial development inwards and financial cooperation outwards. At the same time, how to learn from the experiences of other regions is also important.

So far, there are many arrangements related to the cooperation besides CAFTA or CMI. To balance the efforts from various organizations is critical for the efficient use of the resources.

In addition, the financial cooperation between China and the ASEAN countries are crisis-driven, according to the past experience. Therefore, two questions are calling for our attention. The first one is to make financial cooperation a routine task. The second one is to build up the surveillance and signaling system for the financial system, which is the most direct way to prevent financial crisis. However, with the occurrence of the global financial crisis, how to understand the supervision on financial system becomes a question. Hence, this is also a challenge for China and the ASEAN countries.

To improve the performance of financial cooperation, macroeconomic coordination is necessary for China and the ASEAN countries. Obviously, at the level of economy development, the macroeconomic policy goals are not exactly same for each country. How to deal with the problem may thus influence the financial cooperation.

5. Concluding Remarks

With the advance of trade in this region by the induction of CAFTA, cooperation at the financial level also becomes more necessary and important. In this paper, we have discussed the related problems on financial cooperation between China and the ASEAN countries.

After the introduction, we presented an observation on the past financial cooperation between China and the ASEAN members, including the status of private sector capital flows and currency cooperation between the state financial and monetary authorities. In fact, since the 1997-1998 Asian finance crisis there has been continuous progress in financial cooperation. Nevertheless, in contrast, the capital flow among private sectors is rather limited and unbalanced. This was followed by an analysis on how to understand the financial cooperation under CAFTA, while we considered the change in global and regional economic environment, such as the latest global financial crisis and the sovereign debt crisis in the Euro zone. Subsequently, some recommendations were made on how to strengthen the financial cooperation between China and the ASEAN countries, mainly from China's perspective. Also discussed were the difficulties and challenges that might be encountered along the way of pushing forward the financial cooperation.

Appendix

The multilateralized arrangement will be governed by a single contractual agreement. The total size of the CMIM is US\$120 billion with the contribution proportion between ASEAN and the Plus Three countries at 20:80. The maximum amount that each country can borrow is based on its contribution multiplied by its respective borrowing multiplier.

Country	Contribution (US\$ billion)		Borrowing Multiplier
Brunei	0.03		5.0
Cambodia	0.12		5.0
China	38.4	China (excluding Hong Kong, China) 34.2	0.5
		Hong Kong, China 4.2	2.5*
Indonesia	4.77		2.5
Japan	38.4		0.5
Korea	19.2		1.0
Lao PDR	0.03		5.0
Malaysia	4.77		2.5
Myanmar	0.06		5.0
Philippines	3.68		2.5
Singapore	4.77		2.5
Thailand	4.77		2.5
Vietnam	1.00		5.0

Note: * Hong Kong, China's borrowing is limited to IMF de-linked portion because Hong Kong, China is not a member of the IMF.

Source: <http://www.mof.gov.cn/zhuantihuigu/12jiecaizhenghui/lijieshengming/200905/t20090508_141000.html>.

Notes

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1. Unless defined otherwise, "China" here means the mainland area of China.
2. According to the latest data of 2010, China has overtaken Japan in GDP.
3. Capital Account includes the capital transfer and the purchase or relinquishment of non-financial assets. According to the International Monetary Fund database (IFS, 2010), prior to 1996 the balance of capital account was nil; the values are relatively small since 1997.
4. The calculation of the rate of growth has also referred to the data from the official website of the Association of Southeast Asian Nations <www.aseansec.org>.
5. <<http://www.mof.gov.cn/zhuantihuigu/12jiecaizhenghui/>>.
6. <<http://www.mof.gov.cn/zhuantihuigu/12jiecaizhenghui/lijieshengming/>>.
7. <<http://www.mof.gov.cn/zhuantihuigu/12jiecaizhenghui/lijieshengming/>>.
8. <http://www.mof.gov.cn/zhuantihuigu/12jiecaizhenghui/lijieshengming/200905/t20090508_141000.html>.
9. <<http://www.mof.gov.cn/zhuantihuigu/12jiecaizhenghui/>>.
10. <http://www.mof.gov.cn/zhuantihuigu/12jiecaizhenghui/caijinghezuochangshi/200904/t20090429_138273.html>.
11. The "Executives' Meeting of East Asia and Pacific Central Banks" (EMEAP) was established in 1991, initiated by Japan. The members include central banks or monetary authorities of Australia, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippine, Singapore and Thailand.
12. <http://www.mof.gov.cn/zhuantihuigu/12jiecaizhenghui/caijinghezuochangshi/200904/t20090429_138273.html>.
13. <<http://www.mof.gov.cn/zhuantihuigu/12jiecaizhenghui/>>.

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