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Financial Cooperation In Northeast Asia: An Overview of the Case for a Northeast Asian Development Bank

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INTRODUCTORY COMMENTS

As has been discussed at length in prior meetings of this Forum, there is great but largely unrealized potential for economic growth in developing Northeast Asia. The region's resource endowments and the complementarities between developing Northeast Asia and Japan and South Korea suggest that a sustainable growth process taking advantage of this potential could begin with the aid of regional trade and financial cooperation.

Many of the factors that prevented regional cooperation in developing Northeast Asia in the past have been disappearing, especially the ideological differences, setting the stage for greater economic integration. The increasing pragmatism of the countries involved, evidenced in their participation in the UNDP's Tumen Project, imply that the necessary conditions for achieving the region's potential, primarily replacement of the command economy with one more responsive to market forces and the adoption of more outward looking economic policies, are more likely to be provided than ever before.

China has been leading the way with its "socialist market economy." Russia is trying hard to find a functioning mix of market and managed economic policies but has not been as successful as China. Mongolia has

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been searching for its own path from a command to a market economy. Little has yet changed in North Korea, but North Korea is participating in the Tumen project and has discussed developing its own free ports and free trade zones.

In addition to the necessary economic reforms, there are two key financial problems that must be addressed if the region's potential is to be realized.

First, if successful development that uses the market – with or without government guidance – and international trade that supports such development are taken as the proximate goals, then both require a financial infrastructure that can allocate savings efficiently, stabilize the economy in the long-run and carry out the clearing of domestic accounts necessary to escape a barter/cash world. Financing trade and clearing payments must also be accomplished effectively – a difficult challenge in developing countries since they often lack the basic expertise and telecommunications network required. As I will detail below, the necessary level of domestic or international banking sophistication is not now present in Northeast China or the Russian Far East and is only a distant dream in North Korea and Mongolia.

Second, developing Northeast Asia is very short of the capital needed to start a sustainable growth process. This is especially true of funding for the transportation, energy and communications infrastructure, all of which must be greatly improved if the region's potential is to be achieved, but it is also true of the venture or start-up capital needed to support the establishment of regional enterprise.

Infrastructure projects often require large amounts of capital, involve externalities giving relatively high social returns not captured by market returns, have long gestation and then payout periods, and have relatively low market returns that make raising private capital difficult unless the risk is shared. No single company or even single country can normally take alone financial risks of the magnitude necessary for these and like projects. At a minimum it will be necessary to tap the financial resources of Japan and South Korea. More likely, especially for regional and national infrastructure projects, the rest of the world's capital markets will have to be tapped, something perhaps more easily accomplished by a multi-national bank than by individual countries in developing Northeast Asia or by firms in those countries. Because of this the World Bank was established to help finance the long term projects of the developing countries.

Once infrastructure needs are financed, outside funds must be found to finance the industrial restructuring and development that needs to take place. For example, there is a need for "start up" or seed money loans to help determine the feasibility of specific lines of production, to provide venture capital where risks are high (and private sources do not exist) and to foster learning by doing and agglomeration economies. However, lack of any track record and concern about past political problems in the region will limit the availability of private funds, giving a strong rationale for regional financial cooperation to help start the development process. Also, start up loans can lead to socially valuable externalities not captured by market returns for the "pioneer" businesses necessarily involved.

CURRENT FINANCIAL SYSTEMS IN DEVELOPING NORTHEAST ASIA

Although there is considerable variation in the structure of financial systems in developing Northeast Asia, with China ahead and North Korea behind, it is still possible to roughly generalize since none meet the standards necessary for sustainable development.

Basically, the financial systems in developing Northeast Asia are adjuncts of the planning authorities. They create money under the direction of the plan, which often leads to accelerating open or repressed inflation. Monetary policy is highly politicized, has very few policy tools because of the underdeveloped financial systems and is generally ineffective. Even where reform of the command economy has occurred (Northeast China, the Russian Far East) the financial system remains closely controlled by the local or national political establishments.

The banking sectors of developing Northeast Asia lack the experience and skills needed for most banking activities and policies. Banks have little experience evaluating loan applications and so can not choose between loan applications on a rational economic basis. They have too long operated as an arm of the state plan, extending loans to the enterprises and activities chosen to be subsidized by the plan. Decision making pays little or no attention to the relative rates of return from investment alternatives.[1] Trade finance involves similar problems plus an impressive array of bureaucratic regulations governing foreign exchange transactions.

Throughout the region whenever there is a slowdown nationally or provincially or even at the state enterprise level, the response is to throw newly created money at the problem. There is an immediate surge in the money supply to bail out the "insiders" in the system and so, of course, more and bigger economic problems including run-a-way inflation if the insider group is broad enough. Thus both the allocative and the *stabilizing efficiency of the banking systems* in developing Northeast Asia are compromised to the point where nothing short of a complete overhaul of the systems involved will make possible anything close to sustainable economic growth.

And, as if these problems were not enough, a major constraint on growth of trade and development of any sort, not to mention effective reform, is the low to non-existent level of day to day banking and financial services. Mongolia, North Korea and the Russian Far East are simply unable to accommodate the "monetization" of international trade. Northeast China is better, but only slightly so. There is little or no availability of foreign exchange and no banking sector that can clear balances in a timely manner domestically or internationally.

Credit cards and checks drawn on bank deposits, the lubricants that grease the wheels of commerce and make possible all the "just-in-time" production efficiencies in the developed countries, are non-existent. It is impossible to finance the working capital needs of production or trade on a timely basis using internationally known (and marketable) financial instruments. Despite the shortage of foreign exchange in most of the region, foreign currency checks, even certified or travelers checks, and internationally known and accepted credit cards (e.g., Visa) are not generally acceptable as well.[2] Economic exchange is on a barter or cash basis.

These circumstances partly explain the prevalence of barter trade between developing Northeast Asia's regions and countries. With the rudimentary financial system in place on all sides of the regional borders, barter is almost a necessity for any cross-border trade to take place. But with most trade in barter form, there is little market incentive for the development of a more tractable financial system, a classic "catch 22."

With the banking systems at such an early stage of development, it is not surprising that the other capital markets that fuel economic growth, stock and bond markets, are essentially non-existent in developing Northeast Asia. When banking/financial reforms are effectively underway, the establishment of these other markets will become a high priority.

One result of financial underdevelopment is that, to the extent they are not forced into government securities or bank deposits, savings often go into gold, jewels and other real assets not into productive investments. Real assets provide a hedge against inflation and against the common command economy financial disease, monetary recall. But, basically, real assets are held because there are few alternatives. In Northeast China at least returns on bank deposits are being set to attract funds and keep them inactive, but inflation has harmed the credibility of these returns.

With economic reforms accomplished, savers could have many profitable investment opportunities, but without financial and banking reforms there is no market channeling savings into these opportunities. Instead money is created, usually more than enough to offset current savings, and allocated according to the still existent plan or to some well established "buddy" system

Financial reform, especially banking reform thus has a high priority. Funding the infrastructure or industrial development deficits, will lead nowhere in the long-run without a banking system capable of the timely clearing of balances domestically and internationally and capable of efficiently allocating the savings it attracts as deposits. Financial reforms can help markets develop and production and trade expand beyond the barter barriers. Reforms will make possible a more efficient division of labor and provide demand led information to guide the allocation of scarce resources. Clearly, financial cooperation that helps to alleviate the shortcomings of the region's financial sectors and provide some of the long-term capital now missing will have a high marginal value.

THE RESOURCE GAP IN DEVELOPING NORTHEAST ASIA

No sophisticated analysis is needed to show that even if banking and financial policy reform takes place and the financial system both encourages savings and efficiently channels them into productive loans and investments, the component parts of developing Northeast Asia and so the region as a whole would still have a huge excess demand for investment funds at the interest rates set in world financial markets.

My guesstimate of capital requirements in Northeast China shows Northeast China with a huge and continuing capital deficit if, say, catching up with the Taiwan of a decade ago is set as that region's target twenty years from now. There is no reason to expect any more optimistic result for the other parts of developing Northeast Asia. It seems safe to say that large capital inflows must be attracted to the region for many years to come, if a self-sustaining growth process is ever to occur.[3]

Definitely, the region has a shortage of funds for infrastructure projects, especially since the social rate of return usually exceeds the low market rates on such projects. And, if the infrastructure is in place, the region will need to attract funds or direct investment to the industrial projects taking advantage of the infrastructure (or of the Tumen Free Trade Zone).

Given the environment for international borrowing and direct foreign investment in Northeast Asia and the meager track record of successful lending or direct investment, the private sector likely views investment in this region as highly risky and so uses a return below the probable social return to such investments in their decision making. Certainly, at the present time the flow of capital is slim and the issue is what would be necessary to change this situation.

FILLING THE RESOURCE GAP IN DEVELOPING NORTHEAST ASIA

The alternatives for filling the regional short-fall[4] of self-generated resources are foreign aid, borrowing from the existing multi-lateral banks, borrowing from the commercial banks, borrowing in world credit markets, either directly or through a regional development bank and encouraging direct foreign investment .

Other parts of the overall study will address private alternatives in more detail, but as discussed, the region does not have a track record to make it attractive to private funding sources or direct foreign investment. The record is being built, but there is a long way to go. And, attracting direct foreign investment in significant amounts - without subsidies - depends on monetary reform and infrastructure investments that themselves are unlikely to be done by direct foreign investors.

Foreign aid is out for political reasons and should be eschewed anyway given the tendency of such aid to create uneconomic and so unmaintainable projects. Using the existing multi-lateral banks is difficult for cross-border projects, including many of the infrastructure projects, since their charters will not allow such loans. There is much competition for multilateral bank funds as well as an experienced staff lending constituency in each of the banks that can effectively argue the case for keeping investments in their present country mix. Finally, North Korea does not qualify for multilateral bank loans. Effectively, these considerations leave regional financial cooperation of some sort as the most viable approach to closing the resource gap.

THE PATH TO FINANCIAL REFORM IN DEVELOPING NORTHEAST ASIA

Correcting the underdeveloped financial structure in developing Northeast Asia, the lack of government understanding of the role of finance and financial policy in development, and the absence of trained banking/credit personnel requires a multi-faceted, mostly educative approach.

Although a necessary first step, the demise of the command economy alone will not be enough to achieve sustainable economic growth in developing Northeast Asia. Even if private, cooperative, or state owned industrial firms are "freed" to make their own production plans, raise their own working capital and investment funds and in general operate in response to market forces, this will not trigger sustainable growth if the banking system is not modernized, bankers are not educated to do their job and the necessary telecommunications and travel infrastructure for doing this job are not in place.

Assuming the required infrastructure is provided, there are several alternatives for improving banking services. First, the door could be opened to experienced foreign banks if an immediate solution is sought. This is politically difficult, but would provide the fastest fix for international clearing and financing problems. Having foreign banks operating competitively would also provide much needed information about market prospects and so guidance for investors – that is their business.

Second, if this is not acceptable, then, with a longer-run view, regional training centers for banking services could be established. ASEAN, for example, has one, mostly for Central Banks, in Kuala Lumpar. Or a regional development bank, staffed with experienced personnel, could carry out the training function – either in house, in the regions existing financial institutions or by funding and running a "banking" school.

Once the banking system begins to function adequately and can perform both its allocative and monetary roles satisfactorily, then the goal should be the development of equity and bond markets to further support privatization efforts and marshall and channel savings. As the Asian Development Bank has done, a Northeast Asian Development Bank could provide stimulus and guidance for this process.

THE BASIC RATIONALE FOR A NORTHEAST ASIAN DEVELOPMENT BANK (NEADB)

There are many alternative approaches to financial cooperation that could help in solving the above problems. However, most would be piecemeal; only a regional development bank could be structured to cover fund raising of all maturities and for all purposes as well as contributing to monetary/financial reform. So I concentrate from here on, on a broadly construed Northeast Asian Development Bank.

The World Bank in Washington, D.C. and the many regional development banks have been established for similar purposes. The Asia Development Bank, the Inter American Development Bank, the African Development Bank, the Middle East Development Bank and the recently established European Development Bank are all examples of regional multi-lateral banks.[5]

A Northeast Asian bank would overlap the World Bank in all its members except North Korea. And, it would partly overlap both the Asian Development Bank and the European Development Bank, since China is covered by the Asian Development Bank and Russia by the European Development Bank. Mongolia recently joined the Asian Development Bank as well. Only North Korea is not covered by any multilateral development bank.

Thus it is necessary to explain why there is a need for a regional bank when, except for North Korea, the countries of the region are already members of one or more of the Asian Development Bank, World Bank or European Development Bank. There are several reasons.

First, infrastructure projects in Northeast Asia will be better planned and carried out as multi-national projects than on a country by country basis, as required by the charters or self-imposed lending criteria of the existing banks.

Second, given the very different economic systems involved and the transition problems being faced, it does not seem likely that any but a regionally specialized lending institution will be sensitive enough to the region's requirements and political realities.

For example, the interests of the Russian Far East are not well served by the European Development Bank, which is closer to and places greater emphasis on Eastern Europe and Western Russia. China is a major present and likely future borrower of both the World Bank and the Asian Development Bank and has an important lending constituency in both, but Northeast China has to compete in Beijing for access to Asian Development Bank/World Bank funds and the competition is stiff. Northeast China could be better served by a NEADB that brings into focus regional complementarities and cross-border requirements in making loans and giving advice.[6] As a new and relatively small member Mongolia is likely to be on the periphery of Asian Development Bank/World Bank concerns. North Korea's gain in being a member of a NEADB is obvious.

Third, staff of a regional bank would concentrate on Northeast Asia and not be continuingly shifting back and forth between Northeast Asia and the many other regions covered by the World Bank or the Asian Development Bank or the European Development Bank. Their careers and personal expertise would involve Northeast Asia only.

Fourth, a NEADB could have a broader mandate than the charters of the existing multi-lateral banks allow. For example, a NEADB could be involved in setting up a clearing union, in the financing of trade, in organizing working capital for large projects and in providing training for the region's embryo bankers. Given the existing structural problems in the region's financial systems, these extensions of the operating mandate could be important.[7]

Finally, initially at least, as opposed to the private banking sector, a NEADB is likely to better understand the risks and be more efficient in materializing project finance of the sort required in Northeast Asia. A NEADB could better overcome bilateral political barriers and better spread (or diversify) the risks of finance. This would be especially important for "seed money" industrial loans and large infrastructure projects.

POSSIBLE FUNCTIONS OF A NEADB

1. First and foremost would be the traditional development bank role of providing long-term capital where the social returns exceed the cost of capital.[8] This would go primarily for long gestation, high social return infra-structure projects, for large industrial/agricultural projects (e.g., minerals processing, irrigation) and for environmental protection where informed regional decision making perceives viable opportunities not seen by outside investors. That is, where returns perceived by government and/or fully informed local borrowers would exceed the going cost of capital with due accounting for risk in that cost, but private lenders due to mistrust or inexperience with the country involved would ration out the regional borrows. A NEADB could proceed alone or in consort with other multi-lateral banks or private lenders in financing such projects.

2. Whether for joint ventures or other forms of investment, large amounts of essentially venture or start-up capital are required in developing Northeast Asia. Funds are also required to support privatization of state enterprises and to support the capital growth of existing businesses and new firms once they become established. These funds will mostly have to come from outside the region, but especially from Japan, South Korea and Taiwan.

Regional cooperation can help in attracting investment capital by promoting common standards and by providing a means of settling disputes. A NEADB guaranteeing loans or acting as the prime mover in consortia for both equity and debt financing for the above purposes and in facilitating start-up financing could play a key catalytic role in getting the process going. However structured, the NEADB's role would be a sunset one. For, as information builds up and private investors adjust their risk premiums downward, NEADB would stop any direct involvement in lending/direct investment activities, letting the private sector take over.[9]

3. A NEADB initially could also undertake to provide many of the financial services (at the shorter end of the lending spectrum) not presently available on competitive terms in developing Northeast Asia and to help develop the capabilities of members to provide these services. Especially important are financing trade and providing working capital for production.

A related specialized lending function of a NEADB would be to help the growth of the service sector – largely missing under the region's old command economies. Development of firms providing business services of all kinds, including environmental services, and of tourist and personal service industries are all needed for balanced economic growth.

4. A NEADB could establish a regional clearing union as one of its specialized activities, helping the region economize on the resources held to clear transactions internationally. There are many precedents or prototypes for regional clearing unions, however none that includes parts of countries. For that reason a clearing union for Northeast Asia would be difficult but not impossible.[10] Intra-regional trade is low now, and the substantive benefits of a clearing union would be low, but such unions are a win-win way of working together and gaining confidence in each other.

5. An important service function of a NEADB would be in providing the economic research and information necessary for all of the above activities and for rational decision making by the region's governments and businesses. Business support activities or institutions are minimal in the region, but especially lacking are the data necessary for reasonably intelligent decision making. That information is a public good is just not recognized. But investors need facts, not wish lists, and they need them on a reliable, consistent, timely basis.

Essentially, there has been little need for and interest in these activities in the command economies of the region. Now that reform brings the need, established habits and ways of viewing the world hold back their development. Information that is collected and made public elsewhere remains confidential. A NEADB could help provide a outlet for dissemination of existing data and technical advice and a role model in *generating research/information and utilizing it.*

6. Finally, a NEADB could establish regional training centers and develop other ways to help regional nationals learn basic banking skills. As discussed, a financial structure that can carry out the clearing of domestic and international accounts necessary to escape a barter/cash only world is a number one priority for developing Northeast Asia. Helping provide this financial structure is a key way regional financial cooperation can help in supporting regional economic cooperation and development.

The next steps for each of the possible functions of NEADB set out above are the same, a careful feasibility study of each possibility, followed by seminars including representatives from all of the region and charged with deciding whether or not the possibility has potential and should be brought to the attention of the governments involved. Ideally, representatives of the governments would be observers at the seminars. The first of these steps is underway, financed by the Sanhak Foundation grant mentioned in the introduction.

In closing this section, it is worth repeating again that the justification for a NEADB's providing funding for the above activities and the described banking services exists because of the lack of development of the regional financial systems and the high risk premiums charged by private lenders and investors - so high that in many instances unguaranteed private loans or investments simply are not available. Credit rationing leaves developing Northeast Asia's borrowers on the outside looking in. And government guarantees cannot change this situation since such guarantees are no longer seen as worth much given the experience of profit destroying write offs of past guaranteed loans over the last decade and a half. A NEADB (or a special Northeast Asian branch of the Asian Development Bank or World Bank) is necessary to attract any significant amount of funds to Northeast Asia - but if its policies are successful this necessity will lessen with time.

FUNDING OF A NEADB

Japan and South Korea have the most at stake in developing Northeast Asia achieving successful economic growth and so in regional cooperation to attain that growth. There are many complementarities between Japan and South Korea and developing Northeast Asia, especially as slowing or falling labor force growth in both reduces their industrial competitiveness in many labor using activities. Also still important is the dependence of both countries on outside supplies of natural resources and the relative wealth of developing Northeast Asia in these resources. A NEADB could directly aid in following up these complementarities.

Politically, Japan can more easily take steps to defuse its unproductive conflict with Russia (and vice versa) in a regional organization such as a NEADB. Japan, especially Western Japan, can also more acceptedly develop its long-standing interest in Northeast China in a regional organization than on a bilateral basis. And, anything that reduces the isolation of North Korea and gives North Korea an incentive to avoid conflict is clearly to Japan's advantage. Also operating through a NEADB would make channeling funds into North Korea less political and more acceptable.

South Korea could see in a NEADB a way of sharing the coming burden of modernizing North Korea. South Korea also seems increasingly aware of the importance of China to its long-run economic performance and of Northeast China, where South Korea has a special locational and cultural advantage, as an entry point to China. A NEADB would help in achieving this political economic goal as well as in South Korea's having a large and growing nearby regional market to facilitate its current move to a higher technology based industrial structure.

In Japan and South Korea the main obstacle to support of a NEADB would be the dislike of "change" by the very powerful and very conservative bureaucracies of both countries. Japan has a payments surplus with which to transfer capital to Northeast Asia through a NEADB but South Korea does not and can not be counted on as a major capital contributor to a NEADB.[11]

In this context, Taiwan could be an important source of funds for a NEADB. Taiwan would stand to gain both economically and politically from such an involvement. China might object to Taiwan's possible political gain and so rule Taiwan's participation out, but if significant funds are involved for Northeast China and they can be "laundered" through a NEADB, China could go along with Taiwan being a member and capital provider to a NEADB as they have done so in the Asian Development Bank.

For both geopolitical and economic reasons, the United States might be interested in providing at least moral support to a NEADB. This would include not blocking in any way the access of NEADB security issues to US capital markets. While bilateral support of North Korea is now ruled out, using the NEADB route could be more acceptable. This might be true of Northeast China as well. Getting even a small capital contribution from the US would be more difficult. A major problem is the endemic lack of knowledge in US business and government circles about developing Northeast Asia and its growth potential.

The European Community's interest in a NEADB would be economic, not geopolitical. EC has sufficient trade presence now in developing Northeast Asia to have a stake in regional development and to effectively monitor what goes on. EC is more knowledgeable than the US about developing Northeast Asia and that could make membership in a NEADB plus the necessary capital contribution more likely than for the US.

NOTES

1. Since foreign investors will both pay attention to the bottom line and have experience in doing so, this is a strong reason to encourage foreign investment.
2. For example, there is no non-Russian bank in Primorsky with a full commercial licence for foreign exchange transactions, nor is there any bank, Russian or Joint venture with foreign correspondents. Basic financial services – including currency exchange, acceptance of credit cards and travellers' cheques – are either unavailable or operate on very high margins and require much time and patience.
3. Also required to transfer the real capital (machinery, transport equipment, business equipment, etc.) that will have to be imported at the beginning of the growth process.
4. This is of course relative and if developing Northeast Asia was willing to wait long enough a "boot strap" approach would be possible. One problem is that much of the existing natural resource base is subject to technological obsolescence and so there is some urgency in moving ahead.
5. In his section of the financial cooperation project report, Hiroshi Kakazu discusses the history of multi-lateral banking.
6. This does not rule out consortia led jointly by the World Bank and the ADB.
7. The possible operating structure, capital raising procedures and location of a NEADB are discussed in Hiroshi Kakazu's section of the report.
8. The infrastructure role of a NEADB will be covered in one of the three reports in the financial cooperation project.
9. The venture capital function and the following more specialized activities of a NEADB will be analyzed and discussed in Sueo Sekiguichi's section of the project report.

10. Financial records in Northeast China and the Russian Far East, of where shipments originate and where they go, could be enough.

11. South Korea has a surplus with developing Northeast Asia but a much larger deficit with Japan. In a sense, then, any contribution by South Korea would be an indirect contribution from Japan.