Final Report

Directions of East Asian Regional Financial Cooperation

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February 2006

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This paper looks at the development of financial cooperation in the region and make suggestions for future directions. The painful lessons of the financial crisis in the region that started in Thailand in 1997 have been the impetus for economic cooperation within the region. That the ASEAN+3 group was able to form stems directly from the crisis. Since then, a number of concrete financial cooperation schemes have been initiated in the region, ranging from surveillance mechanisms, the Chiang Mai Initiative and the Asian Bond market. Ideas for further financial cooperation are being discussed and debated. As the region becomes more integrated economically, a clear-cut financial architecture for regional cooperation will definitely be productive.

In the next section, the roots of the Thai crisis are discussed and lessons drawn on how such a crisis can be avoided in the future. In section 2, the contagion to other countries and the IMF’s role are briefly described. Section 3 reviews the objectives of regional financial cooperation. In section 4, several modes of regional financial cooperation are presented. Finally, section 5 gives a summary and recommendations.

1. Roots of Thailand’s Financial Crisis in 1997

Over the course of several decades, the Thai economy had been growing at a very satisfactory rate. Between 1960 and 1995, the average real GDP growth of Thailand was about 7.7% per annum. This led to substantial improvements in the welfare of the population. The proportion of the population under the poverty line declined from about 60% in 1960 to less than 15% by the mid 1990s. In the early 1990s, the Thai economic
performance was regarded as an example of the so-called “East Asian Economic Miracle.” Yet, just a few years after this, the country got into a severe financial and economic crisis. The country became effectively insolvent in that there were not enough usable foreign exchange reserves left to meet its foreign obligations. Assistance from the IMF was needed, and a painful adjustment process to recover from the crisis had to be carried out, leading to essentially a lost half decade of development; the average growth rate between 1996 and 2001 was about zero.

Part of the reason for the crisis may have come from the very success that Thailand had experienced. The good economic performance over many decades, particularly the very rapid growth after 1995, probably led to a sense of economic over-confidence. Huge amounts of foreign direct investment flowed into Thailand (and also other Southeast Asian countries) after the exchange rate realignments as a result of the Plaza Accord in 1995. This led to an even livelier boom in the economy, with real GDP growth averaging about 9.5% per annum between 1985 and 1995. There was in general a high degree of confidence in the strength of the Thai economy. Thailand (as well as other Southeast Asian economies) was becoming an important production center for many products, and exports were booming. At the beginning of the 1990s, the Thai authorities also wanted to turn Bangkok into a major financial center for the region to rival Hong Kong and Singapore. This was expected to complement Thailand’s role as an already important production center for the region.

A series of financial liberalization was therefore embarked upon. The risks inherent in this process were not foreseen. This may have been due to the success that Thailand had in the past in linking to the global economic system on the trade and direct investment side. Chart 1 shows that the ratio of exports of goods and services to GDP had generally been increasing since 1960. This ratio surged particularly after 1985 as a result of large flows of direct investment and rapid export growth. Therefore, Thailand has been able to take advantage of the benefits of globalization, at least on the trade side. This led to the perception that the country will also benefit from financial globalization.

Many financial liberalization measures were carried out starting at the beginning of the 1990’s. Thailand’s agreed to adopt Article VIII of the International Monetary Fund (IMF) in May 1990. This lifted foreign exchange controls on current account transactions,

* The authors would like to thank Professor Eiji Ogawa and Professor Richard Baldwin for useful
and marked the beginning of a series of financial liberalization measures. On the exchange control front, the second round of liberalization abandoned most restrictions on capital account transactions in April 1991. The third round, in February 1994, gave more freedom to outward direct investment, travel expenditures, and additional channels of cross-border payments. In March 1993 the Bangkok International Banking Facilities (BIBF) were established to serve as a means to develop an international financial center. To enable the BIBF to compete with other centers, BIBF transactions were granted some tax privileges (e.g., reduction of corporate income tax, exemption from special business tax and withholding tax on interest income). Furthermore, the government in January 1995 decided to allow the BIBF to open up branches in upcountry provinces.

On the interest rate front, the authorities gradually removed interest rate ceilings in order to encourage savings mobilization and to make the financial system more dynamic. Interest rate ceilings on long-term time deposits were abolished in June 1989, on short-term time deposits in March 1990, on savings deposits in January 1992, and on loan rates in June 1992. In addition, the central bank in 1992-93 gave commercial banks more flexibility by loosening the requirement of government bond holding as a prerequisite for opening up new branches. The obligations of commercial banks to extend credits to rural borrowers or those in the vicinity were also relaxed to cover more related occupations and wider geographical areas. Furthermore, the definition of “liquid reserves” was broadened to include Bank of Thailand and state enterprise bonds, as well as debt instruments issued by financial institutions or government agencies approved by the central bank.

Commercial banks were permitted to undertake new businesses, such as debt underwriting and dealing, acting as securities registrars and custodians, selling public sector debt instruments, mutual fund management, financial consulting, and feasibility studies. Finance and securities companies were on the same footing. Their new lines of operations included leasing, management of provident/private/mutual funds, custodial services, and foreign exchange businesses.

Meanwhile, a number of new frameworks and organizations were formulated. For example, the Securities and Exchange Act was passed in May 1992, giving qualified limited companies access to direct financing through issuance of common stocks and debt instruments. The Act established the Securities and Exchange Commission (SEC) as an
independent agency responsible for supervising capital market activities related to equities, bonds, and derivatives. In 1993 the government spearheaded the formation of a credit rating agency, Thai Rating and Information Services (TRIS), and in 1994 private parties organized a bond dealers’ club to function as a secondary debt market, adding more liquidity to debt instruments. Regarding the payment systems, the central bank improved clearing and settlement, which helped lower transaction costs and facilitate business expansion. The BAHTNET and THAICLEAR networks were put into effect so as to better serve customers’ needs. The latest development on this front was the introduction of electronic retail fund transfers through Media Clearing.

The above-mentioned series of financial liberalization was undertaken between 1988 and 1996 for the following purposes: to strengthen competition in the domestic financial system, to give more resilience to financial institutions as preparation for the worldwide liberalization of trade and services, and to expand the role of Thailand to serve as a regional financial center.

The financial liberalization measures mentioned above caused a flood of external capital into the Thai market in 1990-96, fueling investment spending, speculation, and current account deficits. Net capital inflows between 1990 and 1996 averaged 10 percent of GDP each year, thus expanding the outstanding external debt from US$ 29 billion in 1990 to US$ 108.7 billion in 1996, or from 34 percent of GDP to 59 percent of GDP, respectively. What was even more dangerous was that short-term foreign debts were increasing very rapidly. By the end of 1996, the total amount of short-term foreign debts was about US$ 47.7 billion. This was larger than the amount of official foreign reserves at that time which was about US$ 38.7 billion. Even after taking into account the foreign assets of the banking system, the country’s total foreign assets (official and private) were less than the amount of short-term foreign debts.

The rapid growth of short-term foreign debts was not that surprising. Borrowings from foreign banks (mainly in OECD countries) tended to be short-term. This is because of the Basel Capital Accord provisioning requirements for risk assets. For lending to non-OECD financial institutions, if the lending has a maturity of over one year, a 100% risk weighting for assets should be applied, but if lending has a maturity of up to one year, only a 20% risk weighting is necessary (see Table 1). Because of this rule, there is a build-in incentive for short-term lending to developing countries. The explosion of short-term capital flows to developing countries in the 1990s was closely related to this Basel Capital
 Accord. Thailand was no exception. Her attractive growth prospects together with stable exchange rate of the local currency induced abundant capital inflows.

The large capital inflows into Thailand spurred an investment and real estate bubble and import spending. Meanwhile, domestic financial institutions were pressured by strong competition to extend excessive and imprudent credits, engendering too much risks and deteriorating asset quality. Distressed by possible financial panic or bank runs, the central bank could not resist extending financial aids to ailing commercial banks and finance companies. These aids aggravated macroeconomic imbalance.

At that time, the Thai baht currency was under a fixed exchange rate system. It was tied to a basket of currencies, although by far the largest weight in the basket was given to the US dollar. The strengthening of the US dollar in 1996 considerably weakened Thailand’s competitiveness. This, together with the emergence of China into the world export markets, contributed to the export downturn in 1996, when exports fell by about 1.3%. Such contraction was in contrast to export growth of over 20% in both 1994 and 1995. The export decline and surging imports from the overheating economy led to surging current account deficits in 1995-96 (about 8% of GDP). On top of this, Thailand’s excess inflation in comparison to the U.S.’s surged from 0.3 percent in 1993 to 3.0 percent in 1995-96.

By the end of 1996, pressures on the baht grew forbiddingly. Market perception was that the baht needed to be devalued to protect the country’s competitiveness and restore macroeconomic balance. Speculators attacked the baht in various waves. Should anyone investigate the situation thoroughly, he would agree that these speculators were rational, as supported by the following reasons, so they should not be blamed. First, Thailand was overspending too much for too long (1990-96). Second, lenders started to doubt the country’s genuine debt servicing capacity, because foreign exchange reserves lagged behind short-term foreign debt outstanding to a growing extent (see Table 2). Third, lenders could hardly believe that any small developing country would be able to cope successfully with liberal capital flows by pursuing a rather rigid exchange rate policy. Besides, creditors could quickly terminate their commitments to debtors because of widespread short-term lending as mentioned above. Therefore, numerous creditors withdrew their funds while speculators attacked the baht by various means.
In spite of the weakening economic fundamentals, the Thai authorities stuck to the rigid exchange rate regime and staunchly defended the value of the currency. More and more reserves were used for this purpose through forward contracts to see the US$ at the current baht-US$ rate. By May 1997, the amounts traded were alarmingly large, and by the middle of 1997, the central bank used up almost all of the country’s reserves to defend the value of the baht. By the end of June 1997, official foreign reserves net of committed forward obligations declined to only about US$ 2.8 billion. And as more and more money was being used to defend the baht, the country approached insolvency, because it held US$ 48.5 billion of short-term foreign debts in the middle of 1997, and yet generated a current account deficit of about US$ 1 billion per month.

By mid-1997, the country was basically insolvent in that it simply possessed not enough usable foreign currencies to meet all of its foreign currency obligations, whether for trade payments or to repay foreign debts. As a result, the baht was floated on July 2, 1997 and Thailand sought assistance from the IMF. The baht float imposed additional burdens on the financial and business sector. The exchange rate depreciated from about 25.8 baht per US$ at the end of June 1997 to about 53.8 baht per US$ by the end of January 1998. Afterward the currency began to stabilize and strengthen a little as the current account turned into surplus as a consequence of the baht depreciation and the economic downturn. However, the average exchange rate for 1998 was still 41.4 baht per US$, a depreciation of 38% compared to the level before the baht float.

Because of the large depreciation of the baht, those with unhedged foreign debts were driven to bankruptcy, and the country experienced a deep recession in 1998 (real GDP declining by more than 10%) with broad adverse economic and social consequences throughout the economy. It took more than five years for output in the economy to recover to the pre-crisis peak, and even now there are still some remaining problems of non-performing assets to be cleared up.

From the experience of Thailand’s economic crisis, many policy errors can be seen and lessons drawn to prevent a similar crisis from occurring in the future.

- There are plentiful risks associated with financial liberalization given the volatility of financial markets. These need to be carefully monitored and sequenced. In particular, rapid increases in short-term capital inflows should be carefully managed.
• Under a fixed exchange rate system, it is very difficult for governments to de-peg the currency, particularly when there is a need to devalue the currency. Protection of the value of the currency is normally regarded as an important symbol of national strength. Also, during the time when the currency is under attack, governments normally regard a devaluation as a capitulation to speculators, and will therefore tend to be even more stubborn in defending the currency.

• The adequacy of foreign reserves cannot be measured simply by foreign currency requirements on the trade side (e.g. the number of months of imports), the adequacy of the reserves to back up the amount of short-term foreign debts is also extremely important.

• When capital funds are liberalized to move across border, a flexible exchange rate regime is more compatible.

• When financial liberalization is pursued, supervision of financial institutions needs to be even more prudent as bad lending decisions by financial institutions can easily amplify into a bubble situation and create systemic risk to the whole economy.

• Strong attention should be paid to development of a well functioning long-term capital market as alternative financing sources to bank lending. In particular, if the country has a savings gap or current account deficit to be filled by foreign borrowings, and if these borrowings are mainly from bank lending, then most of these borrowings tend to be short-term (because of the Basel Capital Accord provisioning requirement) and create a lot of risks. Therefore, policies that build up the capacities of domestic companies to raise long-term capital are crucial to prevent another similar crisis.

In general, there is a need to ensure the consistencies of various policies. Should foreign exchange funds be allowed to move freely across border, their prices or exchange rates ought to be liberalized as well so as to reflect market conditions. Otherwise, an excess of inflows or outflows could easily materialize, depending upon market sentiment and expectations, and given political constraints in managing a fixed exchange rate regime, the risk of a crisis will be high. The liberalization of financial institutions is an equally controversial issue. Given that domestic financial institutions are not adequately prepared or experienced, the question is whether they should be liberalized, since liberalization
could easily bring about more risks. But once these immature entities are granted more freedom, there is no doubt that the central authorities should closely monitor and carefully supervise them throughout the liberalization process, especially during the initial adjustment period.

2. Crisis Contagion and IMF Resolution

Since several other countries in the region pursued similar macroeconomic policies (e.g. maintaining pegged exchange rate regimes for too long) and possessed similar weaknesses in financial and corporate systems, it is unsurprising that after the baht was floated, Thailand’s neighbors suffered a loss of confidence. The market sentiment changed drastically leading to a series of capital outflows and currency depreciation. In each country, weak financial systems, excessive short-term un-hedged foreign borrowings by the domestic private sector, and a lack of transparency about the ties between government, business, and banks have both contributed to the crisis and complicated efforts to defuse it.

The IMF was called in to provide financial support for three of the countries most seriously affected by the crisis, namely Thailand, South Korea, and Indonesia. Basically these countries became insolvent, in terms of not having enough foreign currencies in their systems to meet their foreign currency obligations. A particularly striking common feature of the three countries when compared to other countries in the region is the very high ratio of short-term foreign debts to reserves (see Table 2). These three countries were the only three in the region where the ratio of short-term foreign debts to official reserves at the end of 1996 was more than 100%. The ratio for Thailand was 110%, Indonesia was 167%, and South Korea was even higher at 195%. Such high ratios are very dangerous, because if these short-term debts are not rolled over for any reason (for example from a loss of confidence), then the countries would go bankrupt for not having enough official reserves to repay these debts.

With these countries approaching insolvency, the IMF was asked to provide foreign exchange liquidity supports. The amount for Thailand was US$ 17.2 billion, for Indonesia US$ 49.7 billion, and for South Korea US$ 58.4 billion. These assistances were tied up with stringent IMF conditionality. Each country had to adopt many policy reforms, such as fiscal and monetary tightening as well as structural reforms of the financial and
real sectors, increased prudential standards, improved governance, foreign access and privatization.

These various measures were meant to restore confidence as well as generate increases in foreign currencies so that the countries can eventually recover from their insolvency positions. However, the nature of the IMF conditionality that was applied in East Asia has been much debated in the aftermath of the crisis. Critics point to a number of areas, such as:

- Harsh nature of the tight fiscal and monetary policies without due regard for social or political consequences,
- Unwillingness to allow non-market based interventions such as controls on capital flows,
- Imposition of full guarantees for creditors of financial institutions,
- Imposition of relatively rapid structural reform measures, such as stringent financial standards and corporate restructuring as well as privatization of state owned enterprises,
- Lack of input from within the region so that the programs do not take sufficient account of the socio-political realities of affected countries.

Many of these criticisms are valid up to a point. However, once a country becomes insolvent in terms of not having enough foreign currencies to meet its obligations, the solution will inevitably involve some pains. The urgent issue is how to turn around the foreign exchange position so that the country can fully participate in the international economic and financial system again, and what policies are necessary to do this with as little pain as possible.

In Thailand, the macroeconomic assumptions behind the initial design of the IMF program were flawed in that the IMF did not expect such a severe downturn in the economy or the rapid turn around in the current account. Therefore, apart from the stringent fiscal and monetary policies, many of the other conditions that were imposed were designed partly to elicit a low outflow of foreign capital (with full guarantees for creditors of financial institutions), or to generate additional sources of foreign exchange earning (such as structural reform measures and privatization to attract foreign investment). As it became clear in 1998 that the macroeconomic assumptions were wrong, the fiscal
position was eased substantially, but many of the other structural conditions continued to be maintained even though the rationale for them to help in attracting foreign exchange no longer held.

The structural reforms that were imposed as part of the IMF program also need a relatively long time to successfully carry out. In Thailand, the current account moved from deficit to surplus in September 1997 due to the baht depreciation and economic recession, net foreign reserves increased from US$ 2.8 billion in the middle of 1997 to US$ 16.2 billion by the middle of 1999. In August 1999, Thailand decided to forgo further disbursement from the IMF package, just about two years after entering into the IMF assistance program. As a result, the various conditions imposed by the IMF became no longer binding. Thus, the rationale for imposing structural reform conditions that require a long time to successfully implement is not clear.

The financial contagion that affected Thailand, Indonesia, and Korea also hit other countries in the region such as Malaysia and the Philippines. However, as can be seen from Table 2, the other countries in the region had much lower ratios of short-term foreign debts to official reserves than the three countries mentioned earlier. Therefore, other countries did not go bankrupt and could manage the contagion at less economic costs than the three IMF-supported countries.

Malaysia and Hong Kong also successfully adopted non-market approaches to deal with the contagion from the crisis; capital control in the case of Malaysia and direct government intervention in the stock market in the case of Hong Kong. The success of these non-market interventions also raised questions about whether alternative policy packages from the IMF may have provided a less painful remedy for East Asian crisis affected countries.

3. Objectives of Regional Financial Cooperation

The occurrence, contagion, and pain of the financial crisis in East Asia reflects several weaknesses in the financial structure of the region. Examples of these weaknesses are the following. First, there was a lack of early warning system and effective surveillance process. Should correct indicators be available in time and comprehensive surveillance be continually undertaken, then crisis is more likely to be avoidable. Second, in case the crisis could not be prevented, intra-regional aid should have been resorted to, since that would have been less painstaking than the one from the IMF but yet effective.
Third, in general there was insufficient financial cooperation in East Asia. A clear-cut evidence of this drawback was on fund recycling. East Asia as a whole (including 5 ASEAN countries, South Korea, China, and Japan) was in fact a region with net surplus saving. As demonstrated in Table 3, in the years before the crisis (1993-97) the aggregate current account of East Asia was US$ 96 billion per year. After the crisis (1998-03) this figure was more than doubled to US$ 202 billion per year. An immediate and important question that arises is why these enormous surpluses were channeled to financial institutions in the West before they were partially recycled back to East Asia again. Doing so definitely brought about two disadvantages to East Asia. First, financial institutions in the West certainly charged heavy fees to Eastern borrowers because of inadequate acquaintance or risk aversion. Second, they were tempted by the above-mentioned Basel Capital Accord to extend mostly short-term credits, which created additional risks to borrowers regarding the uncertainty of credit roll-over.

Before exploring various modes of regional financial cooperation in East Asia, it is useful to explicitly indicate the various rationales underlying financial cooperation. Two rationales result directly from the crisis. These are:-

1. To prevent the recurrence of a crisis.

2. To better manage a crisis whenever it occurs.

In addition, as the economies in the region have become more and more integrated economically, greater financial integration can support the economic integration. So another rationale is:-

3. To Support the Economic Integration of the Region.

Finally, East Asian countries are now holding most of the world’s foreign exchange reserves. How these are invested have significant impacts on currency movements as well as global interest rates. East Asian countries need to be proactive in this regard. Therefore, another rationale for financial cooperation is:-

4. To Influence the global financial environment impacting on the region.

4. Modes and Directions of Regional Financial Cooperation

This section reviews the progress made on various areas of regional financial cooperation and make suggestions for future directions.
4.1 Chiang Mai Initiative

The Chiang Mai Initiative (CMI) is the first concrete financial cooperation initiative arising from the ASEAN+3 group. The self-protection measures by and for EA countries first took shape in the form of the Manila Framework Group in November 1997, which was set up as a form for regional economic surveillance and crisis management. Its membership consists of 14 Pacific nations. Subsequently, the ASEAN Surveillance Process was established in 1998 with an overall objective of strengthening policy-making capacity within the group. Peer review and surveillance were extended to cover not only major macroeconomic aggregates but also sectoral and social policies so as to improve policy coordination. Finally, in May 2000 the finance ministers of ASEAN+3 countries reached an agreement on the Chiang Mai Initiative, which was the first significant regional financing arrangement to enable member countries to cope with disruptive capital flows and maintain exchange rate stability.

CMI was designed to expand the existing ASEAN Swap Arrangement (ASA) by increasing the size of swap arrangements, and to create a network of bilateral swap agreements (BSA) between the countries of ASEAN+3. The ASA, first established in August 1977, was designed to alleviate temporary liquidity shortages among central banks in member countries. Its basic idea is that a country under speculative currency attack can borrow foreign currency, usually the U.S. dollar, from another country and use the funds to stabilize the exchange rate. Since pre-emptive measures are very important, quick activation and disbursement are essential. Moreover, the funds available under ASA and the first 10% drawn from the BSA are unconditional, or without any linkage to IMF assistance/requirements. For the rest, a condition is that the country is under the IMF assistance program. The swap transactions (between U.S. dollars and domestic currencies) are allowed for a period of up to 6 months, subject to rollover of not exceeding 6 months.

Subsequently, ASEAN+3 has agreed to expand the CMI by increasing the amounts of the swap arrangements and also to increase the percentage that could be withdrawn without linking to an IMF program from 10% to 20%. The latest amounts of the swaps amounts to about US$58.5 billion as shown in Figure 1.

While the total of all the various swap arrangements in Figure 1 may appear large, the amount available to each country is in fact not that large, especially if one thinks of the
ability of countries to draw on these swap agreement without having to enter into an IMF supported program. For example, if these expanded ASA and BSA were already in place prior to the crisis in 1997, prior to asking for IMF assistance Thailand would have been able to draw something like US$ 2 billion from the CMI swap arrangements. This amount is insignificant compared to the scale of problem that Thailand was in by about mid-1997 or compared to the sizes of the IMF packages for the crisis affected countries (US$ 17.2 billion for Thailand, US$ 42.3 billion for Indonesia and US$ 58.4 billion for the Republic of Korea). Therefore, the amounts of money available currently under the current Chiang Mai Initiative are still too small to make a lot of difference.

To turn the CMI into something more meaningful, at least two things will be necessary. First, the amounts of money need to increase and instead of remaining a cumbersome series of bilateral swap arrangements, the scheme should be multilateralized. Second, an organization to coordinate the funding mechanisms of the expanded CMI need to be set up. This takes us back to the initial idea to set up a regional monetary organization for East Asia, the so-called Asian Monetary Fund (AMF) proposed by Japan during the early stages of the financial crisis. This idea was shot down at the time, partly because the necessary ground work to develop a consensus on the idea was not carried out sufficiently in the region. It is recommended that serious thought be now given to the setting up of such an organization.

There is nothing new in setting up a regional monetary organization. There are already the Arab Monetary Fund and the Latin American Reserve Fund (LARF). So the argument that a regional monetary organization will lead to all kinds of moral hazards and conflicts with the IMF is not backed up by evidence. Of course if the organization is badly designed then this might be the case, but with careful design such problems can be avoided. In fact, if a new regional monetary organization is to be set up for East Asia, it will have to work very closely with the IMF, especially in the early years of establishment.

Setting up such an organization in East Asia will also facilitate the coordination of a lot of necessary work to support many areas of financial cooperation that need to be promoted in the region in future. Currently, there is no clear focal point in the region for work on these issues, whether on surveillance, on crisis prevention and resolution, on harmonization of codes and regulatory standards, on exchange rate and monetary coordination etc. This organization would be involved in coordinating the expansion of the CMI process and to transform it into a multilateral mechanism.
At this stage, political commitment to set up such an organization should be sought from the ASEAN+3 leaders, with broad outlines of the rationale and scope of work of such an organization. The role of such an organization should be broad, and not simply limited to the management of liquidity support for crisis-hit countries and crisis resolution. Its scope of work should also cover the broad range of work needed to support further monetary cooperation in East Asia, including work that are related to laying the groundwork for possible eventual monetary integration, if such an integration should happen sometime in the far future.

As far as relations with the IMF is concerned, the way that the organization can work in complementary fashion to the IMF can also be laid out. At the beginning, this should involve a very close link to the IMF (concerning liquidity support and conditionality) in a similar way that the current CMI is closely tied to the IMF. This is because the new organization needs time to establish its technical expertise and develop reputation to generate the confidence of the financial market. Over time, the scope of the links to the IMF can be reduced, though there should still be some links maintained. Exactly how much links and in what way remain to be worked out.

However, it should be clear from the very beginning that an East Asian monetary organization is not a way for crisis affected countries to avoid tough conditionalities. If a country pursues bad policies and become insolvent and need to borrow from the region monetary organization (or the IMF), it will need to take corrective policies to bring it back to financial health and this will inevitably involve painful policies. Where the regional monetary organization may provide value-added to the IMF is better knowledge of the realities and constraints facing countries in the region, so that recovery packages can be tailored to fit both the recovery requirements and the realities in the region.

4.2 Asian Bond Fund

As was earlier indicated, lack of access to long-term investment financing was an important reason for the rapid build up of short-term foreign debt in the crisis affected countries prior to the crisis. Because of the limited access to markets for long-term financing and the lack of adequate domestic saving, the private sector in the crisis affected countries had to rely on bank lending from abroad to finance their investment. These borrowing (mainly from OECD countries) will tend to be of a short-term nature. This led
to a double mismatch for many of the borrowers as these borrowing were used to financed medium to long-term projects and many projects only earned revenues in local currencies.

At the same time, while some countries had saving deficits before the crisis, the East Asian region as a whole was experiencing a saving surplus. Therefore, a major lesson that needs to be learned from the crisis is that an effective regional long-term capital market to recycle some of the surplus saving in the region for long-term financing within the region needs to be develop so that countries and particularly companies can have easier access to long-term investment financing that addresses the twin mismatches indicated earlier. If this can be developed, then there would be much less need to rely on short-term foreign borrowing and contribute to future financial stability in the region.

An important point is that the main need is to recycle long-term financing to the private sector. This is because the public sector is able to easily tap long-term financing when required, whether through bilateral channels, multilateral channels or in the domestic and foreign capital markets. In Thailand before the crisis, almost all the short-term foreign debt arose from bank borrowing from abroad by the private sector. Therefore, the success of the development of the regional bond market in reducing the risk of a future financial crisis of a similar nature to the previous crisis will have to be judged on whether the resulting bond market can affectively meet the long-term financing needs of the private sector.

4.2.1 Recent Concrete Developments

Prior to the crisis, the domestic bond markets in most of the developing East Asian countries were very thin or almost non-existent. Governments in most countries were running budget surpluses for many years before the crisis, so the supply of government bonds was minimal. There was therefore no clear benchmarks for private sector bonds, and bond trading in general was very limited. In that environment, it was not surprising that the private sector was unable to tap the bond market for investment financing.

The situation now is very different. After the crisis, the government in most of the crisis affected countries had to incur large budget deficits in order to get the country out of the resulting recession and clean up the financial sector. This has led to the emergence of a much deeper market for government bonds in these countries. Together with generally low deposit rates arising from an excess liquidity in the financial system, government bonds have become very popular. The larger private corporations have also taken
advantage of the situation, by issuing long-term debt instruments to the general public, using the rates on government bonds as benchmarks. Bond trading is now much more active than before (see the data for Thailand in Table 4).

Given more active and robust domestic bond markets in the region, the ability of the private sector to raise long-term funding through the bond market is now better than before the crisis. However, the total value of outstanding private sector bonds is still only about 8 per cent of the outstanding borrowing of the private sector from commercial banks (in Thailand). Thus, much more can be done to increase the ability of the private sector to raise funds through the bond market, both in improving the domestic regulatory and governance framework and in regional cooperation initiatives.

At the regional level, through the Asian Bond Market Initiative (ABMI) of the ASEAN+3 group and the development of the Asian Bond Funds by the EMEAP group of 11 central banks (comprising Australia, China, Hong Kong SAR, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore, and Thailand), there have been some concrete recent developments that can pave the way to more robust capital markets in the region. However, these are still early steps on the way to fully realizing the goal of an effective long-term capital market that can reduce the risk of a future dependence on short-term foreign borrowing once countries in the region start getting into current account deficits again.

The Asian Bond Fund 1 (ABF1) was launched in June 2003. Approximately U.S.$ 1 billion are gathered from the reserves of these central banks and invested in a basket of liquid U.S. dollar bonds issued by sovereign and quasi-sovereign issuers in major Asian economies (excluding Australia, Japan, and New Zealand). The Bank for International Settlements (BIS), which has managed fixed income portfolios for central banks for many years, is given the ABF1 mandate. The BIS stated that “the ABF is a significant step in fostering regional cooperation in Asia. It will facilitate the reinvestment of a small portion of Asia’s reserves back into the region while at the same time aiding the development of regional capital markets.”

As the ABF1 is invested exclusively in public sector bonds, it does not directly address the need of providing long-term financing to the private sector. The governments whose bonds the ABF1 are invested in do not really need the ABF1 to raise funds either, as they can easily issue their own dollar bonds in the international financial markets. And
given the small size of ABF1 it is unlikely to have any significant impact on bond yields either. Thus, ABF1 is a tiny first step along the path of developing an effective saving recycling mechanism to the private sector in the region.

As ABF1 deals with public sector US$ denominated bonds, it should be viewed as a way to gradually build up benchmarks and liquidity in the regional bond markets so that eventually the private sector can enter this market more easily. Just as the underdevelopment of domestic bond markets before the crisis was an important impediment to the private sector’s ability to raise funds in these markets, an illiquid regional market without adequate benchmarks will also be an important constraint for the private sector. However, if the ABF1 is to be effective in increasing regional bond market liquidity and developing benchmarks then its investment strategy, effective size of the fund, as well as the supply of appropriate bonds from the issuing authorities will have to be consistent with these objectives.

The ABF1 is restricted to US$ denominated bonds so while it may be related (eventually) to improving the ability of the private sector to solve the maturity mismatch problem, it cannot deal with the currency mismatch problem. Subsequent to the currency mismatch problem establishment of the ABF1, attention turned to the currency mismatch problem. The idea is to develop the regional market for local currency bonds which would solve both the maturity and currency mismatch problems.

In December 2004, the EMEAP group of Central Bankers announced launch of the Asian Bond Fund 2 (ABF2). The size of this fund is about US$ 2 billion. As stated in the Press Statement announcing the launch of the fund, “The framework for ABF2 …..comprises two components: a Pan-Asian Bond Index Fund (PAIF) and a Fund of Bond Funds (FoBF). The PAIF is a single bond fund investing in sovereign and quasi-sovereign domestic currency-denominated bonds issued in the eight EMEAP markets. The FoBF is a two-layered structure with a parent fund investing in eight Sub-funds, each of which will invest in sovereign and quasi-sovereign domestic currency-denominated bonds issued in the respective markets of the eight EMEAP economies. The PAIF and eight Sub-funds will be passively managed by private sector fund managers against a Pan-Asian bond index and relevant domestic bond indices for the eight EMEAP markets.” (See structure of ABF2 in Figure 2).
This takes ABF1 another step by investing in local currency bonds in the EMEAP member countries (but excluding Australia, Japan, and New Zealand). However, the PAIF is US$ denominated and is designed as a regional Exchange Traded Fund (ETF). It is now listed on the Hong Kong Stock Exchange and can be traded by investors. Each Sub-funds of the Fund of Bond Funds is also designed to be an ETF to be eventually listed in each domestic stock market. Fund managers for each of the 8 Sub-funds have been appointed.

The interesting feature of the PAIF is that it offers access for investors to a fund backed by a basket of local currency sovereign and quasi-sovereign bonds. Because it emerged from a high profile regional cooperation initiative, it is expected to help raise investor awareness and interest in these types of bonds. The development of ABF2 also led to improvements in the regional bond market infrastructure: The iBoxx ABF indices which the various funds will try to track is a new piece of market infrastructure for Asia. To ensure the success of the ABF2 member countries have also carried out various tax and regulatory reforms to facilitate cross-border investments. These help to make the regional bond markets more attractive.

As with the ABF1, investment of the ABF2 funds is still limited to sovereign and quasi-sovereign bonds (although denominated in local currency). So again it does not directly serve to channel long-term funds to the private sector which is really what the region needs in order to avoid a situation of dependence on short-term foreign borrowing as before the crisis. However, if cooperation among the various countries to develop the ABF2 and also within the framework of the ABMI can improve the bond market infrastructure in the region then this will eventually help the private sector to be able to make more active use of the regional bond markets in the future. Actually, once the regional bond market rules and regulations and other infrastructure are conducive to cross-border investment in the bond markets of the region then the role of the public sector in developing new products for the market can decline. If the PAIF is successful then this kind of instrument can be easily developed by the private sector and actually some private companies already offer their clients similar products.

Apart from helping to accelerate appropriate bond market infrastructure in the region, funds such as the PAIF will benefit the development of the local currency bond market in an indirect way. Because there are exchange rate risks inherent in funds such as the PAIF, investors should become more familiar with how to manage such risks and the market may also develop new derivative products that investors in these bonds can use to
reduce the impacts of currency risks. The availability of better risk management instruments will also help to make local currency private sector bonds more attractive, as investors can more easily hedge against exchange rate losses.

Another very interesting development arises from the cooperation between the Ministry of Finance of Japan and the Ministry of Finance & Economy of the Republic of Korea to promote the development of asset-backed securities markets in Asia. The outcome is the development of a cross-border Yen denominated Korean Collateralized Bond Obligations (“Korean CBO”) that will provide financing to small and medium sized enterprises (“SME”) in Korea. Unlike ABF1 and ABF2, this initiative is directly targeted at the need to develop ways to channel long-term financing to the private sector, particularly the SME’s who may find it difficult to obtain bond financing without government assistances. This is much more in line with what is needed to avoid a situation like prior to the previous crisis than the ABF1 and ABF2 initiatives.

The structure of the Korean CBO is given in Figure 3. Roughly, the Korean CBO provides long-term financing to Korean SME’s who issue Yen denominated notes with guarantees and credit facilities through the involvements of the Small Business Corporation of Korea (SBC), the Industrial Bank of Korea (IBK) and the Japan Bank for International Cooperation (JBIC). The notes issued by the SME’s are in Yen and not in the local currency so they have to take some exchange rate risks. However, this may not be so important if they do business with Japan so they also earn some revenues denominated in Yen or they need to pay Japanese companies in Yen. The scheme can of course be modify so that local SME’s can issue local currency notes, thereby reducing their currency risks. The risks will have to be taken by someone, whether the investor or one or more governments through various guarantee mechanisms, though if there are efficiently functioning currency markets, then the risks can be managed through market instruments.

This kind of innovative scheme has a lot of promise and may be expanded to other countries in the region, particularly those that already have active loan guarantee schemes for SME’s. Of course, in the longer term one should try to make this type of arrangement work with as little public support and subsidy as possible.

4.2.2 Future Directions
There are a lot of on-going work under various working groups as part of the ABMI that should gradually lead to the development of needed infrastructures to support the development of robust bond markets in the region. Those efforts that are more closely related to enhancing the ability of the private sector to raise long-term funding should be given priority. Already some countries in the region are returning to a situation of current account deficit and because access of the private sector to long-term financing is still very limited short-term foreign debt is rising again. For example, Thailand experienced a current account deficit for the first time since the crisis and data in Table 5 shows that Thailand’s short-term foreign debt rose by just about the amount of the current account deficit.

As domestic bond markets are now functioning much better than before the crisis, the potential for private corporations to raise funds in the domestic bond market is much better than before. To increase demand for bonds further, particularly in those countries with saving deficits, what can be done is to make it more easier for off-shore investors to have access to local currency bonds that are traded in the various domestic bond markets. That is, trading and settlement are done in the domestic market, but foreign investors have easy access to invest in these bonds, either directly in individual bonds, or through various instruments or funds that are backed by baskets of bonds (such as in the case of the PAIF). This is already happening but further development of the required infrastructure such as harmonization of market rules and regulations, tax regimes and credit rating standards would promote this further.

One thing that one needs to be careful about in thinking about the development of the market for local currency bonds concerns the development of regional markets for local currency bonds of various countries; for example, a Thai company issuing Baht bond that is then traded in the regional bond market. One needs to be cautious about this as having local currency bonds traded actively in the regional bond market can be very risky. It is like having an active off-shore markets for local currencies (as local currency bonds are settled in local currencies). This is a potentially dangerous source of currency instabilities, as it can provide ammunition for currency speculators. Prior to the crisis, Thailand allowed the off-shore Baht market to become too active, and this was the ammunition that speculators used to attack the Baht and eventually led to the crisis. Thus, after the crisis, Thailand reverted to a tighter control on dealings between financial
institutions and non-resident Baht accounts in order to control the size and activity of the off-shore Baht market along the line that Singapore adopts.

So far, bond market initiatives in the region have not created a truly regional market for local currency bonds. For example, while the PAIF invests in local currency bonds, the PAIF is denominate in US$ and the local bonds that it invests it are cleared and settled in each domestic market. This should be the right approach, particularly as the financial market of the region is still not very robust. As the financial system of countries in the region become stronger, gradual development of regional markets for local currency bonds would become more feasible. An appropriate sequencing is needed in this matter.

In the future, the main thrust for the development of the regional bond market should focus on market based approaches. Initiatives such as the ABF1 and ABF2 are useful as tools that can promote bond market infrastructures and develop and demonstrate new innovative products. However, once the infrastructures are developed and the market has absorbed the new products, then the private sector should be highly capable of coming up with even more innovative products that can better tailor to the needs of diverse clients.

One thing that would be very important to promote the demand for local currency bonds in the region is the development of a deep and well functioning currency markets in the region. This is needed so that investors can have diverse instruments to hedge against currency risks. For funds such as the PAIF, which is denominated in US$ and is backed by local currency bonds, there are numerous instruments that investors can use to reduce their exchange rate risks, in effect combining investing in PAIF with other derivatives to protect against fluctuations in regional currencies vis-à-vis the US dollar. This is because the US dollar is the major international currency with well developed markets between the US dollar and other currencies, whether spot, forward, swaps, NDF etc.

In the region, investors from countries that fix their currency to the US$ can take advantage of the extensive US$ market to minimize their investment risks from instruments denominated in various local currencies. This is not the case for Japan for investment denominated in many of the region’s currencies. There are still no direct markets between the Yen and many regional currencies including the Thai Baht. Exchanges between the Yen and many local currencies have to go through the dollar, making the gap between the buying and selling rates between the Yen and local currencies much higher than the corresponding gap for trading local currencies with the US$. For
example, Table 6 shows the buying and selling gaps between the Baht and various currencies in Bangkok and the Singapore $ and various currencies in Singapore. It can be seen that the relative gap for the Yen is the highest among the major currencies. In Bangkok, the Yen gap is more than three times that for the US$. In Singapore, the Yen gap is more than twice that for the US$. This makes the Yen much more expensive to use as a settlement currency. It also means that there are no direct forward markets between the two currencies so that investors cannot cheaply hedge against currency risks for the Yen vis-à-vis many other regional currencies.

If one wants to make it more attractive for Japanese investors to invest in local currency bonds in the region (and Japanese investors can increase the demand for local currency bonds substantially) then it is very important that the Yen becomes more internationalized and efficient foreign exchange markets between the Yen and other currencies in the region are developed. This will need support from the Japanese government in conjunction with the Japanese banks operating in various countries in the region. It is also very important for supporting greater trade and investment integration in the region (see below).

Another direction that may also be worth exploring in trying to channel more long-term funding to the private sector is to expand the role of multilateral agencies in this regard. In particular, the Asian Development Bank (ADB) could have an expanded role in this and increase fund channeling to private corporations. This has two distinct advantages. As regards borrowing, the ADB has already achieved remarkable reputation and reliability or trustworthiness from investors or owners of funds worldwide. Consequently, the ADB could easily tap more funds to be extended to more private corporations. As regards lending, ADB possesses a widespread network of offices in most member countries. These offices, together with ADB’s favorable recognition, could immediately equip ADB with comprehensive and updated information about promising and reliable targets of lending. At present, the ADB already has two sections (private sector department and office of co-financing) offering some credit facilities and guarantee to private corporations in member countries. What may be pursued in the future is to expand this role of the ADB by, for example, setting up an explicit affiliate called ADB-Private (ADB-P). In addition, this ADB-P could cooperate with East Asian central banks by some means (such as swap arrangements for counterpart funds in local currencies, adoption of viable East Asian Currency Index) so as to facilitate credit extension of ADB-P without incurring excessive
currency risks. A more active and complete exchange market for the Yen with respect to local East Asian currencies as indicated above would also be very helpful in this regard.
4.3 Currency Coordination and Integration

Another rationale for financial cooperation is to support greater trade and investment integration within the region. Intra-regional East Asian trade has been continually increasing. In 2001-2, roughly one third of East Asian’s exports went to East Asia, and 38-42% of their imports came from within the region (Table 7). It is expected that intra-regional trade and investment within East Asia will increase much more in the future. Therefore, it is worth searching for appropriate modes of regional financial cooperation that could help facilitate regional economic integration and reduce vulnerability.

Foreign exchange or currency exposure is a very important issue, as it adds exchange rate risks to the cost of doing business. What remains distressing in East Asia is that even though intra-regional trade has gained increasing momentum as indicated above, most of these trade was still conducted in U.S. dollar. For instance, while only 18-20% of East Asia’s foreign trade in 2001-2 had the U.S. as the destination, roughly 85% of all East Asia trade was denominated in the U.S. dollar. So East Asia was unnecessarily exposed to additional currency risks, which largely hinge on the U.S. economy. Reducing foreign exchange exposure is thus one important aim for regional financial cooperation in East Asia, as the U.S. dollar has moved wildly versus EA currencies since the 1997 crisis (see Table 8).

On the issue of currency coordination, scanning the experience of Europe and the launch of Euro in 1999 may be useful in order to see what options should be pursued and what are their requirements. East Asia can learn many lessons from the European experience about the necessary steps to take for integration and appropriate sequencing. Regional economic integration in Europe has helped EU member achieve a number of “pluses” such as the following. First, market liberalization and the adoption of a common regulatory framework together with less transaction cost due to currency union has broadened the scope of trade and financial flows, resulting in economies of scale as well as higher efficiency. Second, the currency union has acted as a powerful catalyst for productive structural changes in the EU, particularly its financial markets. The euro has become an attractive alternative to the U.S. dollar for international bond issuance, especially in the corporate sector. Equity markets also evolve rapidly. Third, in complying with the euro guidelines, member states have increasingly put into place a
comprehensive set of procedures for policy coordination. There was a remarkable convergence of views on the need to follow prudent macroeconomic policies and implement structural reforms in the markets for goods, labor, and financial products. Fourth, elimination of exchange rate variability reduces the risks, promotes greater international trade while enhancing price stability. Meanwhile, the “minuses” of European integration seem sparse. The only obligated common policies are monetary and exchange rate, while budgetary and structural policies largely remain under the national sovereignty of member countries subject to limits on fiscal deficits.

The similarities and differences between East Asia and Europe can be examined further. Each member country of both regions is not endowed with well-diversified natural resources. They thus have a strong common interest in opening up international trade and finance. Both regions have been hard hit in the nineties by severe economic, currency, and banking crises. They share the same ambition to better control the forces of economic and financial globalization, in order to create a stability-oriented economic and financial system that promotes high and sustainable growth while improving welfare. Both regions have complex modes of society, which put a high price on the need to control the forces of globalization. They seek ways and means to preserve the positive features of complex economic and social models, while retaining the capacity to change in the midst of rapidly evolving circumstances.

However, East Asia and Europe are very different in several respects. Economic diversity is far more pronounced in East Asia, ranging from countries with highly modern economies to others that are still poor and with traditional or rural economic structures. In contrast, the European Union was a much more homogenous economic grouping. According to World Bank data, in 1999 per capita GNP of the richest member (Luxembourg, $38,247) was 2.62 times higher than the poorest member (Greece, $14,595) of the EU. In Asia, the difference amounted to 21.0 times between the richest (Singapore, $27,024) and the poorest (Cambodia, $1,286) (see Table 9). This wider gap in East Asia than in Europe prevailed both before and after the 1997 crisis. Similarly, East Asian countries differed from each other to a larger extent than EU countries regarding trade openness or the proportion of foreign trade to GDP (Table 10). Also East Asian countries are more restrictive than European countries with respect to capital controls (Table 11). Nevertheless, it is unsurprising that East Asian countries often discuss the
possibilities of currency integration within the region, since intra-regional trade has gained growing momentum and reducing exchange rate exposure will definitely facilitate trade. And in the past there have been a number of studies and proposals for an exchange rate arrangement for East Asia, such as the common basket peg of Williamson (1999), the yen block proposal (Kwan, 2001), an East Asian Currency Index (IIMA, 1999) and explorations and analyses concerning a monetary union for East Asia (see Kawai and Takagi (2000) and Fabella (2002) for a review and analyses).

Even though currency integration within the region may seem conceptually attractive, what remains to be examined is its practicality for the East Asian (EA) region. The first question concerns the prevailing macroeconomic features of EA countries. The second question is that if integration is possible, which method (e.g. single currency, snake, etc.) is the most suitable for EA currencies. Macroeconomic temperament of each EA country differs from one another’s drastically. As shown in Table 12, large divergences occur not only on per capita GNP but also on the inflation and interest rate fronts. The average pace of price rise in 1998-2004 went from 0.5% (Singapore) to 2.4% (Thailand) and 16.9% (Indonesia). Meanwhile, average deposit interest rates in 1998-2004 went from 1.6% p.a. (Singapore) to 3.6% (Thailand) and 17.9% (Indonesia). These vast gaps mean contrasting costs of living and make currency union rather impractical, since integrating currencies is equivalent to unifying commodity prices across border.

Regarding economic policies, the discretionary measures that each EA country implemented differ remarkably from one another in terms of both timing and extent. On fiscal measures (Table 13), Thailand, Indonesia, and China scored an average deficit of 2.1% of GDP on the government’s cash balance in 1998-2003, while the Philippines’ government generated far more debts or roughly 39.8% of GDP. Singapore, in contrast, commanded continual fiscal surplus of 7.0% of GDP on average. On the money side, the implemented monetary policies of EA member countries led to big differences in the pace of credit expansion. In 1998-2004 average credit growth ranged from –0.3% in Thailand to 17.9% in Indonesia. The differences in implemented economic policies as mentioned above indicate that currency unification is an extremely difficult task, if possible at all. That is so because linking EA currencies into a common currency or a snake (within a small band) requires that member countries must have roughly the same level of inflation and interest rate. Otherwise, responsible agencies could hardly handle arbitrage.
Furthermore, member countries must have adequate harmony in economic policies, external trade, and growth momentum. But it has already been demonstrated above that these requirements are not satisfied by EA countries.

Although integrating EA currencies is close to impossible, several EA currencies move in consonance with each other to a greater degree than with U.S. dollar. For example, we can use coefficient of variation (CV) or the ratio of standard deviation to mean (in percent) as an index to measure the extent of exchange rate volatility. The following data of CV in 2003-2005 clearly substantiates the above claim. That is, the exchange rate of baht/100 yen was more stable than baht/U.S$ and yen/U.S.$ throughout 2003-2005.

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
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<tbody>
<tr>
<td>Japanese yen/U.S. dollar</td>
<td>3.8</td>
<td>2.5</td>
<td>4.5</td>
</tr>
<tr>
<td>Thai baht/U.S. dollar</td>
<td>2.9</td>
<td>2.4</td>
<td>2.8</td>
</tr>
<tr>
<td>Thai baht/100 Japanese yen</td>
<td>1.7</td>
<td>2.1</td>
<td>2.7</td>
</tr>
</tbody>
</table>

So it may be sensible to tie EA currencies in with each other by some means for specific purposes. For instance, we may theoretically create an East Asian Currency Index (EACI) to be explored as a possible index for some intra-regional transactions. This is something that the ADB is currently initiating as a pilot exercise. This may be helpful in several respects such as the following.

(a) Weeding out non-EA or extraneous exchange rate disturbances.
(b) Preserving policy sovereignty of EA members.
(c) Deleting the requirement that there be enough reserves to back up a snake.
(d) Attaining exchange rates which will help achieve proper resource utilization within the region.

Relative weights of different EA currencies in EACI should vary in accordance with EA members’ volume of intra-regional trade and capital transactions. However, EACI is not to function as another currency. It should function only as a numeraire devised to help equilibrate external positions of EA countries against each other’s in intra-
regional transactions. EACI should help not only in insulating EA countries from non-EA exchange rate disturbances but also in attaining more equilibrium in the market for intra-regional trade.

Related to what was discussed about the need to have efficient instruments for hedging currency risks in the last section, it is very important for the Japanese yen to become more internationalized, and efficient foreign exchange markets between the yen and other regional currencies should be developed (spot and forward markets). This will allow the Yen to play a bigger role as a settlement currency for trade and investment within the region, especially for trade and investment between Japan and other countries in the region. As the Yen’s role increases, other countries may put a higher weight on the Yen in targeting their exchange rate in the future.

4.4 Cooperation to Influence the Global Financial Environment Impacting on the Region

Exchange rate coordination is related to how foreign reserves of various countries in the region are managed. However, foreign reserves management has impacts beyond exchange rates. Presently, East Asian countries hold more than 60% of the world’s foreign reserves and how these reserves are managed and invested have implications for the global financial system, the current global imbalance, and global interest rates.

Presently, most of the current account surplus and foreign reserves in East Asia (particularly the huge amount being held by Japan and China) are recycled to US$ denominated assets particularly US treasury bills and this helps to keep regional currencies low relative to the US$ than otherwise and does not really help to re-balance the trade gaps between the US and the region. One can say that so far this is of mutual benefit, at least to US consumers and the East Asian producers. However, it is not clear how long the financial market can keep on assuming that no major correction will occur and clearly there is a risk of some major adjustment in the future.

The above point is about relative exchange rates, and certainly many people are worried about possible market volatilities that one may end up with. A related point is also very important.. It is about interest rates. How the reserves in East Asia are invested have implications for global interest rates, which in turn affect the global economic system.
The relationship to US interest rates and possible housing bubble in the US is quite important.

Data on average house prices in the US, Britain and Australia show an interesting pattern. Prices have increased rapidly over the last 7-8 years. In Britain and Australia, prices increases have slowed down in 2005 or even declined slightly. In the US, prices are still increasing at double digit rates.

<table>
<thead>
<tr>
<th>The Economist’s house price indices (% change)</th>
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</thead>
<tbody>
<tr>
<td>Q3/05</td>
</tr>
<tr>
<td>United States</td>
</tr>
<tr>
<td>Britain</td>
</tr>
<tr>
<td>Australia</td>
</tr>
</tbody>
</table>

Source: The Economist (various issues)

The price increases are related to changes in long-term interest rates. If one looks at the interest rate trends in the US and UK in Figure 4, there is an interesting pattern. The Figure shows one year and ten year treasure bill rates as well as 15 year fixed rate mortgage in the US as well as UK average mortgage rate. It can be seen that over the past couple of years, short-term rates in the US have been rising quite significantly. This is of course because the Fed tries to cool down possible overheating or even bubbles, particularly in the real estate market, and also because of recent increases in inflation driven by oil price increases. However, it can be seen that US long rates and US mortgage rates (which are more closely tied to long rates) have hardly moved on average. Thus, aggressive increases in Fed funds rate have been unable to affect US long rates and US mortgage rates much and therefore it is very difficult to cool down possible bubbles in the real estate sector that may exist. House prices in the US have therefore continued to increase rapidly and many in the sector expect some form of correction starting in 2006. In the UK the situation is different as mortgage rates have risen over the past couple of years or so and this has helped to cool down rises in house prices.

A suspicion as to why US long rates remain low while the Fed has been aggressively pushing up Fed funds rate is that it is influenced significantly by the investment strategies of East Asian central banks. Of course, it is difficult to get clear
information on this. However, many have this suspicion. But whatever is the case, given that central banks in this part of the world together hold more than 60% of the world’s foreign reserves, it is clear that investment strategies of East Asian central banks can have significant impacts on interest rates and in particularly the yield curve of US treasury bills.

The stubbornly low long term rates in the US could fuel future instability, particularly if there is a bursting of the real estate bubble in the US. It also seems clear that the Fed cannot easily control the yield curve in the US without coordination with major treasure bill purchasers, which means that East Asian central banks need to be more proactive in coordinating with the Fed in influencing interest rates. Thus, East Asian countries do have a significant role to play in shaping the direction of the global financial system, particularly exchange rates and interest rates. They can help to stabilize possible problems, including real estate bubbles in the US. Given the current situation, the ability of the Fed to shape the direction of the global financial system is limited, and to maintain global stability it is time for East Asian countries to play a much more pro-active role. How this can best be done will obviously need a lot more thinking and discussions among the parties concerned.

5. Summary

This paper briefly reviewed the crisis experience that led to various financial cooperation initiatives in the region. A number of rationales for financial cooperation were highlighted. These are to 1) to prevent the recurrence of a crisis; 2) to better manage a crisis whenever it occurs; 3) to Support the Economic Integration of the Region; and 4) to Influence the global financial environment impacting on the region. Various modes of cooperation related to the above rationale were discussed and suggestions made as to the future directions for these modes of cooperation. Modes of cooperation discussed include the Chiang Mai Initiative, the Asia Bond Fund, currency coordination and integration and management of foreign reserves to influence the direction of the global financial system.
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