Prospects for Regional Financial Cooperation in East Asia

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Good afternoon, ladies and gentlemen,

It is my great honor and pleasure to have this opportunity to speak at this distinguished symposium. I would like to express my appreciation to the government of Japan and ABAC Japan for co-hosting this event.

I. Introduction

More than five years have already passed since the Asian financial crisis. Most of the crisis-hit countries have shown rapid and remarkable progress in recovery thanks to far-reaching and painful structural reform efforts. However, when we consider the nature of the Asian financial crisis in depth, we cannot rule out the possibility of another similar crisis in the region. After the outbreak of the crisis, policy makers of Asian countries have come to realize that strengthening monetary and financial cooperation in the region would be one of the most important factors to prevent a recurrence of a similar crisis and efficiently deal with the repercussions. In this regard, various efforts have been made to achieve the goal of enhancing regional financial cooperation.

The Japanese government took the first step by proposing the creation of Asian

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Monetary Fund (AMF) in September 1997, even though the proposal was turned down owing to the opposition by the U.S., EU and the IMF. The idea of a regional financial arrangement gained momentum in May 2000, when 10 members of ASEAN and three Northeast Asian economies, namely, Korea, PRC and Japan, announced the Chiang Mai Initiative (CMI) on regional financial cooperation. Although the CMI swap arrangements, which established regional financial mechanisms to supplement existing international facilities, have been designed and implemented to strengthen the self-help and support functions in the East Asian economies, the CMI is still an incomplete backup facility, which may not adequately eliminate the smoldering vulnerabilities that may lead to a possible future crisis.

The ASEAN+3 finance ministers, who met in Honolulu on May 2001, agreed to review the principles of the CMI, and in particular, the swap arrangements, in three years. At that time, the ASEAN+3 may decide to maintain, amend or abolish the current arrangements.

In this regard, I believe that today's gathering is a timely and valuable opportunity for facilitating and exchanging the views and ideas of business leaders, high-level policy makers and eminent scholars on various issues concerning regional financial cooperation. Today, I would like to share with you my personal views on several issues relating to regional financial cooperation, particularly focusing on the current process of and future prospects for CMI. And at the end of my presentation, I would like to briefly touch upon the issues surrounding the development of Asian bond market, which have recently drawn extensive interest and discussion in this region.

II. Lessons Learned from the Asian Financial Crisis

Before looking at the specific issues on CMI, I would like to briefly consider the lessons we have learned in 1997 and 1998, in conjunction with the need for regional financial cooperation.

First, it is now widely accepted that the 1997/1998 Asian crisis was a capital account crisis, distinct from a conventional current account crisis that is often caused by weak macroeconomic fundamentals. A massive short-term capital flowed into the region induced by large interest rate differentials between the local currency and the dollar, under sound macroeconomic conditions. However, this situation was suddenly reversed, triggered by a cyclical domestic economic downturn and change in market perception. Such a large swing in the capital account, amounting to 15-20 per cent of GDP in crisis hit economies in one year, led to an international liquidity crisis and a domestic banking crisis. Such crises were marked by major deterioration in financial institutions and corporations' balance sheets, which was caused by serious maturity and currency mismatches, also known as the double mismatch problem.

Relating to the possibility of another financial crisis in the region, we must keep in mind that this double mismatch problem is more or less inherent in the financial markets of emerging economies. Poor corporate governance, inappropriate financial regulations and inadequate monitoring of the financial sector will all contribute to exacerbating maturity mismatches, namely, borrowing short and lending long on risky investments. Also, it is not expected that the region would be able to solve its own structural problems in a relatively quick manner. Taking into account all these factors, there is no guarantee that there will not be another crisis.

Second, the Asian crisis was highly contagious in the region not only through the usual trade and financial channels but also through the investors' herd behavior. The world and regional economy have fast become globalized and integrated not only due to the liberalization of capital accounts and financial markets, but also due to the development of fast and efficient information and communication technology. Global financial integration could have a negative impact on economies with higher exchange rate volatility and greater vulnerability to external financial shocks and contagion as revealed in the recent financial crisis. Global finance also limits the scope of policymakers in pursuing macroeconomic policies in their own countries. In this context, national and international policies have to be complemented by regional responses.

Third, many Asian countries have had high levels of savings. However, because of weak domestic and regional capital markets, these savings were not placed in domestic long-term investments. The savings deposited in local banks in the region have been invested in international financial centers and were returned back to the region mainly in the form of short-term bank loans and stocks investments, i.e. risky assets. Such flow of funds has caused maturity and currency mismatches, thereby, increasing the region's vulnerabilities to the fluctuations in international capital movements. Against these backdrops, the development of bond markets in Asia has been viewed as a major challenge left for the region to tackle collaboratively, in order to prevent a recurrence of financial crises and attain sustainable economic development.

Lastly, there was a lack of sufficient and prompt liquidity support from inside and outside the region in the early stage of the crisis, as well as a lack of self-help mechanisms. Although the IMF strengthened its capacity to act as an international lender of last resort, the IMF's financial resources were not sufficient to handle all the financial crises around the world, and its surveillance mechanism was not sufficient to prevent the crisis in Asia. For this reason, many countries in the region proposed or supported the establishment of regional financial arrangements that will function as a regional lender of last resort facility to complement the efforts of the IMF.

III. Progress toward Regional Financial Cooperation

After having suffered from the painful economic crisis in 1997/1998, many countries in East Asia realized the need for monetary and financial cooperation in the region in order to prevent a recurrence of a similar crisis in the future. Efforts to promote regional cooperation have been taking shape as a consequence of the "Asian Monetary Fund (AMF) proposal," the "Manila Framework," and the "Chiang Mai Initiative (CMI)." These efforts focused on two components, i.e. resource provision mechanisms and information exchange and surveillance processes.

In September 1997, Japan proposed the creation of an "Asian Monetary Fund" (AMF), as a framework for financial cooperation and policy coordination in the region. The AMF would be considered independent of the IMF and would allot a certain quota to each participating country. Initially, the AMF aimed to raise US$50-

60 billion through contributions from participating countries and another US$50 billion through the contribution of the Japanese government. It was to start operating some time in 1997, and make up for where IMF activities were lacking, such as regional surveillance. However, this idea of establishing an AMF was turned down in November 1997, owing to the opposition by the United States and the IMF on the ground that such an arrangement would lead to moral hazard problems and unnecessarily duplicate IMF's activities.

In November 1997, a framework to strengthen regional cooperation to achieve financial and currency stabilization in Asia, called Manila Framework, was announced in a meeting of finance ministers and central bankers from 14 Asia-pacific countries, who had gathered in Manila to discuss additional responses to the Asian financial crisis. The Manila Framework included the following four initiatives. First, the group meets twice a year and brings together deputies of finance ministries and central banks to discuss macroeconomic policies, foreign exchange policies, and appropriate financial systems of each membership nation.

In October 1998, the Japanese government proposed a framework called "A New Initiative to Overcome the Asian Currency Crisis," also known as the New Miyazawa Initiative. The initiative was to provide a package of support totaling US$30 billion. Of the total amount, US$15 billion would be made available for medium to long-term financial needs of Asian countries in achieving economic recovery, and another US$15 billion would be set aside to support their short-term capital needs, which may arise in the process of implementing economic reform. In fact, there was a demand for such funding from Asian countries in order to support corporate debt restructuring, strengthen social safety nets, stimulate the economy, and address the credit crunch. The United States and the IMF supported this initiative, owing to its bilateral nature, compared with the previous proposal that attempted to achieve cooperation on a multilateral basis. The new initiative also focused on assisting Asian countries affected by the crisis in overcoming their economic difficulties and contributing to the stability of international financial markets.

The efforts to establish regional financial arrangements gained momentum in May 2000, when the Asian+3 finance ministers agreed to expand the existing network of swap arrangements to include all ASEAN countries. Also, China, Japan, and Korea were designated, in particular, to better prevent future financial crises by helping the central banks of other countries in the region. The Plan, called the Chiang Mai Initiative (CMI), is considered a major step toward strengthening financial cooperation among the East Asian countries. The rationale of the CMI is to strengthen the self-help and support mechanisms in East Asian economies by establishing a regional financing arrangement to supplement existing international facilities.

IV. CMI: Overview and Inherent Drawbacks

The CMI was announced by the ASEAN plus Three (China, Japan, Korea) Finance Ministers in May 2000, not as an alternative to the IMF, as was the original AMF proposal, but rather as a complement to financial multilateralism. After the meeting in Chiang Mai, the deputies and working-level officials from the finance ministries and central banks continued to discuss the expansion of the ASEAN Swap Arrangements (ASA) and introduction of a network of bilateral swap agreements (BSAs).

In 1977, five ASEAN countries (Indonesia, Malaysia, Philippines, Singapore, and Thailand) agreed to establish the ASA to provide short-term swap facilities to members facing temporary liquidity or balance of payments problems. In November 2000, the ASA was expanded to cover all ASEAN members and the total amount of holdings was increased from $200 million to $1 billion. Under the ASA, not only the US dollar but the yen and the euro are also available. The euro, yen and euro LIBOR interest rates are used as the base rates for swap transactions. The contributions from participating countries are divided into two groups based on their ability to pay. The maximum withdrawal amount by each participating member remains limited to twice their committed amount under the ASA. The swap transactions have a maturity not exceeding 6 months, and are subject to rollover for a period of less than 6 months.

Up to now, the ASA was activated on five occasions, by Indonesia in 1979, Malaysia in 1980, Thailand in 1980, and the Philippines in 1981 and 1992, but not activated during the crisis of 1997-98. The ASA is limited in their possible contribution to future crises. ASA's major drawbacks include: first, the amount to be granted to a swap-requesting country shall be provided by the other members in equal shares. Second, creditors can opt out of the arrangements. Third, renewal of an outstanding swap is blocked by an application by a second country for activation. Fourth, the facility is small relative to the trade and capital flows within the region. If an ASEAN member cannot find a country to extend a significant amount of credit, it should link the ASA to global liquidity facilities, or further expand the ASA to include China, Japan and Korea.

In broad terms, the CMI is a type of an expansion of the ASA, aimed at providing countries facing the possibility of a liquidity shortage with additional short-term hard currencies. It encompasses all ASEAN countries, as well as China, Japan and Korea. This expansion of the ASA is the first step in putting the CMI into effect, which envisages that hard currency lines of credit will be made available to the member countries. In addition to the expansion, the three Northeast Asian countries - PRC, Japan, and Korea - have simultaneously been in discussions aimed at establishing a bilateral swap arrangement (BSA) among them.

The Network of BSA is a facility that provides short-term liquidity assistance in the form of swaps in U.S. dollars, with the domestic currencies of participating countries.[1] The maximum amount that can be drawn under each BSA is to be determined through bilateral negotiations. The BSA is complementary to the IMF's assistance in that countries drawing from the facility are required to accept an IMF program for macroeconomic and structural adjustment. The BSA, however, allows an automatic disbursement of up to 10 percent of the maximum amount of drawing without any linkage to an IMF program or conditionality. It should be noted that from the beginning of the CMI, some participating countries opposed the idea of linking the CMI with the IMF conditionalities and have proposed to increase the limit gradually and also to abolish the IMF linkage after a period of time.

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[1] The exceptions are the Japan-PRC and Korea-PRC BSAs, which would swap the yen for renminbi a nd won for renminbi, respectively.

Since the ASEAN+3 summit meeting in November 2000, Japan, China and Korea have been negotiating BSAs with each other and with the ASEAN countries. So far, Japan has taken the most active stance by concluding six agreements thus far and is currently negotiating one more agreement. Korea also has concluded five agreements. PRC has concluded four agreements and the negotiations with the Philippines have been completed. From the beginning, Singapore and Brunei have shown little interest because they believed that the BSAs with other ASEAN countries actually will be one-way arrangements. Indonesia has also not shown strong interest as it has been preoccupied with its domestic economic and political issues and managing huge foreign debts. At present, the total amount of BSAs covering all 13 countries is estimated to be around US$ 32billion.

Bilateral Swap Agreements under the CMI

(as of March 31, 2003)

Countries	Conclusion Dates	Amount (US$ billion)	Currencies
Japan-Korea	4 July 2001	2	Dollar-won
Japan-Thailand	30 July 2001	3	Dollar-baht
Japan-Philippines	27 August 2001	3	Dollar-peso
Japan-Malaysia	5 October 2001	1	Dollar-ringit
PRC-Thailand	6 December 2001	2	Dollar-baht
Japan-PRC	28 March 2002	3	Yen-renminbi
PRC-Korea	24 June 2002	2	Renminbi-won
Korea-Thailand	25 June 2002	1	Dollar-baht or dollar-won
Korea-Malaysia	26 July 2002	1	Dollar-ringgit or dollar-won
Korea-Philippines	9 August 2002	1	Dollar-peso or dollar-won
Japan-Singapore	In progress		
PRC-Malaysia	9 October 2002	2	Dollar-ringgit
PRC-Philippines	Negotiation completed	1	Dollar-peso
Japan-Indonesia	17 February 2003	3	Dollar-rupiah

Although the CMI marked the first major step toward strengthening regional financial cooperation and has significantly developed during the past three years, the current system is too weak to be able to work as a credible and effective system of defens e against future financial crises.

For any financial arrangement to be effective in preventing financial crisis and providing financial assistance for such purpose, some broad principles need to be incorporated. First, the credit lines need to be large enough to generate confidence in private capital markets and repel speculative attacks, as well as involve a sufficient number of countries to avoid potential problems of covariance and allow the pooling risks. Nonetheless, it remains an open issue as to what can be considered sufficiently large. Second, the availability of resources should be flexible enough to be disbursed quickly. Speed is of the essence in a crisis. Third, access to such liquidity needs to be separated from the detailed negotiation of conditionality that would prejudice quick dispersal. Fourth, a policy of “prohibitively high” or “time escalating” interest rates for ex ante lending facilities does not solve the moral hazard problem at the creditor or investor level. The way to limit investor moral hazard would be to have the private sector to share in the burden of bailouts.

However, the CMI is far from sufficiently satisfying these principles. Most importantly, it is doubtful whether any country encountering short-term liquidity problem could quickly draw sufficient funds from the BSAs. Currently, only 10 percent of the total amount can be provided without linkage to an IMF program or conditionality. And any support even within the 10 percent drawing, which is not linked to the IMF conditionality, could be refused by the creditor countries. The creditor nations are willing to provide swaps only when they can assess and be certain that the borrowing countries are victims of speculative attacks. Considering the required amount of time necessary for assessing the swap-requesting country’s problems, frequent and regular assessments of the economic health of the participating countries are required for the effective functioning of the CMI. In this regard, the CMI cannot be viable without independent monitoring and surveillance system.

Another serious problem is that the swaps must supplement existing international financial facilities and specifically those of the IMF. As a condition for drawing most of the funds through the swaps, the borrower must have completed, or be nearing completion on, its agreement with the IMF. Also many people raise questions on the credibility and effectiveness of the CMI as a preventive means to a future crisis, because th e total number of BSAs is limited and the maximum swap amounts, which any individual country can draw, is small. However, as long as the CMI is simply a financial resource supplementary to the IMF, the total amount of liquidity under CMI does not have to be sufficient enough to meet the potential needs, as the participating countries can always rely first on the financial resources provided by the IMF (Wang, 2001).

In addition, under the CMI framework, common policy objectives toward economic integration are not clear. Joint effort for crisis prevention in the region is ambiguous as the policy objective toward promoting economic integration in the region. Also, there is no clear vision on the scope and modality of financial cooperation through the CMI. In comparison with the European facilities, the CMI has had a different motivation from the outset. The European facilities were created with the purpose of stabilizing exchange rates through a coordinated exchange rate mechanism. The CMI started with high capital mobility and flexible exchange rates, although some members of ASEAN+3 have maintained relatively fixed exchange rate regimes. Even now, the CMI does not presume any manifest exchange rate coordination.

Finally, no driving forces for integration like Franco-German nexus in European integration exist. The rivalry between China and Japan remains an obstacle in creating greater cooperation. The two countries have not agreed on a number of operational issues, including the surveillance mechanism. For example, as a minimum condition for expanding the CMI, Japan would demand the creation of an effective surveillance mechanism for the region in which it can exercise influence commensurate with its financial contribution. However, China may feel that it cannot play the second fiddle to Japan in any regional organization in East Asia. This concern appears to be the most serious roadblock to further the development of the CMI. China seems to put more emphasis on the economic integration with ASEAN, South Asia and Central Asia. Also, there are some unconfirmed suspicions that Japan may engage in the discussion of regional economic cooperation to maintain its leadership role rather than purely economic reasons.

V. Future Issues of CMI: Establishment of Monitoring and Surveillance Mechanism and De-linking IMF Conditionality

Given the abovementioned drawbacks, future cooperation should be pursued in many areas, for the CMI to function as a credible and effective mechanism of defense against future speculative attacks. Here I would like to concentration on two issues, the establishment of a surveillance unit and de-linking IMF conditionality.

First of all, the most important precondition for effective functioning of the CMI is the institutionalization of an independent surveillance unit. Surveillance processes in the region have already existed since 1998. The original ASEAN surveillance Process was set up in October 1998, and later expanded into the ASEAN+3 surveillance Process as the leaders of ASEAN invited the PRC, Japan and Korea to join them. However, as Wang and Woo (2002) identified, the current surveillance process is inadequate to meet the demands of the CMI. First, presently, the countries have wide discretion over the contents of their reports, which cause difficulties in making comparison of situations across economies for many important issues. Therefore, the surveillance process needs to specify the precise content of the information to be exchanged. Second, the current process does not effectively signal the potential risks early enough for the required individual or collective policy response to take place. Emerging problems are not sufficiently addressed mainly because discussions at the ASEAN+3 meetings tend to focus on recent economic developments of member countries on a voluntary basis. Third, in light of the inadequacies in information exchange and peer review, the ASEAN+3 surveillance process has not helped to improve the regulation, supervision, and integration of the financial markets of the member countries.

Under the CMI in particular, because the swap funds can be disbursed only with the consent of swap-providing countries, the latter need to formulate their own assessments about the swap-requesting country. To ensure quick disbursement to fight against speculative attacks and possible contagion, and to avoid bailing out countries that mismanaged their economies, it is necessary for the CMI to enhance the existing ASEAN+3 Surveillance Process by pre-qualifying members for assistance. In order to accomplish this goal, an independent ASEAN+3 surveillance unit must be established immediately. In addition, the member countries should supply not only usual macroeconomic information and capital flows, but also diverse information relating to social and economic resilience.

Then, the ASEAN+3 policy dialogue process should discuss the issues identified by the surveillance report, and make specific policy recommendations to member countries. As the policy recommendations are not binding, but only strongly encouraged, it is essential that the policy recommendations agreed upon by member countries be made public, thereby reinforcing peer pressure through monitoring in the marketplace. The countries that do not comply with these recommendations would hence be pressured by market discipline. In order to increase the peer pressure effect in order that the surveillance recommendations are taken more seriously, the surveillance report should also include the progress of the implementation of recommended policy changes in a separate section. (Yoshitomi, 2003)

At the ADB annual meeting in Honolulu on May 9, 2001, the ASEAN+3 finance ministers agreed to organize a study group to produce a blueprint for an effective mechanism of policy dialogues and economic reviews for the CMI operations. Japan and Malaysia were chosen as the co-chairs to lead the group. The study group met in Kuala Lumpur November 22, 2001 to discuss the report on possible modalities of surveillance prepared by Bank Negara Malaysia and Japan’s Ministry of Finance. However, the member countries could not reach an agreement on the surveillance issues, agreeing only to institutionalizing the ASEAN+3 meetings of deputies for informal policy reviews and dialogues. Notwithstanding the continued negotiations for additional BSAs and also the surveillance system, the future prospects of the CMI do not seem promising unless the deadlock over some of the pending issues on surveillance is broken.

As an another issue, ASEAN+3 swap arrangements need to be de-linked from a member country’s participation in the IMF supported adjustment program in the long run. If the CMI develops into an independent regional financial arrangement from the IMF, the question of the conditions under which those swaps can be made available logically arises. In other words, it should be decided whether the CMI arrangement could be supported by a surveillance mechanism based on peer reviews and pressure instead of formal policy conditionalities.

According to Park and Wang (2003), economic policy dialogues and peer monitoring may not provide an institutional framework that can minimize the moral hazard problem. Peer pressure may not be effective in rectifying the moral hazard related to liquidity assistance and may have to be supplemented by surveillance and conditionalities attached to the liquidity provision. An independent financial arrangement from the IMF arrangement should be designed to discipline the borrowers to adhere to sound macroeconomic and financial policies by imposing conditionalities. On the other hand, peer pressure may be an effective means of achieving the objective of economic policy coordination among members. The surveillance and policy coordination may have a double-decker structure in policy formation and implementation.

VI. Fostering Regional Bond Markets

In response to the Asian financial crisis of 1997, many countries in Asia as well as international financial forums have intensified their efforts to develop bond markets in the region. This reflected a clear recognition that excessive dependence on bank-intermediated financing and huge foreign-currency denominated short-term financing had been one of the major causes of the Asian financial crisis. Development of a bond market is crucial in preventing another crisis in the region, since it can mitigate maturity mismatch and reduce heavy dependence on the banking sector.

Recently, to plough the huge amounts of capital accumulated in Asia directly back into the region has become another important policy issue for those countries within the region. Since the financial crisis, Asian countries have accumulated substantial foreign exchange reserves, reflecting a surge in exports and high personal savings. However, most of the accumulated reserves have been first invested in the developed markets, including the U.S. and Europe, and later recycled back to the region in a form of risky assets, such as equities and foreign direct investments.

Among the structural impediments to ploughing Asian savings back into the region, the credit quality gap between the low credit rating of issuers and the minimum credit requirement of investors, and currency risks inherent in cross-border flow of capital are the two most significant.

Under this recognition, Korea proposed to undertake a full-scale discussion on the ways to develop a regional capital market under ASEAN+3 Finance Ministers' Meeting at the Informal ASEAN+3 Finance and Central Bank Deputies' Meeting (AFDM+3)3rd Meeting on 13 November 2002. After this proposal was accepted, the ASEAN+3 informal session was held in Chiang Mai on 17 December 2002. At the informal session, Japan presented a comprehensive approach to foster bond markets in Asia, "Asian Bond Markets Initiative (ABMI)".

On 28 February 2003, an informal session of the ASEAN+3 Finance and Central Bank Deputies on fostering bond markets in Asia was held in Tokyo. At this session, Japan proposed the Asian Bond Markets Initiative (ABMI) again. Korea made a proposal for fostering an Asian Bond Market by using Securitization and credit guarantees. Thailand proposed creating securitized debt instruments that can be called "Asian Bond" and the establishment of an Asian Credit Guarantee Facility. Singapore also proposed the establishment of an Asian Credit Rating Board. In addition, the member countries agreed to organize two groups of volunteers, one for studying proposals on the schemes for creating new securitized debt instruments, and the other for promoting the use of guarantee mechanisms as credit enhancement for bond issuance.

The first joint meeting of the voluntary working groups was held in Seoul on April 4, 2003. The meeting was co-chaired by Korea and Thailand, and participants discussed new schemes for securitized debt instruments and credit guarantee mechanisms. Also, participants agreed to produce a progress report based on their discussion at the meeting and submit it to the ASEAN+3 Finance and Central Bank Deputies' Meeting (AFDM+3) and the ASEAN+3 Finance Ministers' Meeting (AFMM+3) for the acknowledgement.

The development of bond market is an important policy issue in Asia. With this in mind, monetary and financial cooperation focusing on mechanisms for liquidity provision and surveillance are not enough to prevent a recurrence of financial crises in the region by themselves. In addition, when we take into account many political and operational conflicts among member countries, further promising results from CMI are not expected any time soon. Therefore, regional financial cooperation in the future should also be pursued in developing regional bond market, in addition to assisting short-term financial liquidity to countries facing crisis.

VII. Conclusion

I strongly believe that sharing lessons, experiences and ideas among business leaders, policy makers and scholars will contribute to enhancing cooperation among Asian countries, which will eventually lead to greater stability in the region. I hope that this symposium provide such an opportunity, and contribute to preventing recurrence of financial crisis and attaining sustainable economic growth in the region.

Thank you for your kind attention.