Directions of East Asian Regional Financial Cooperation

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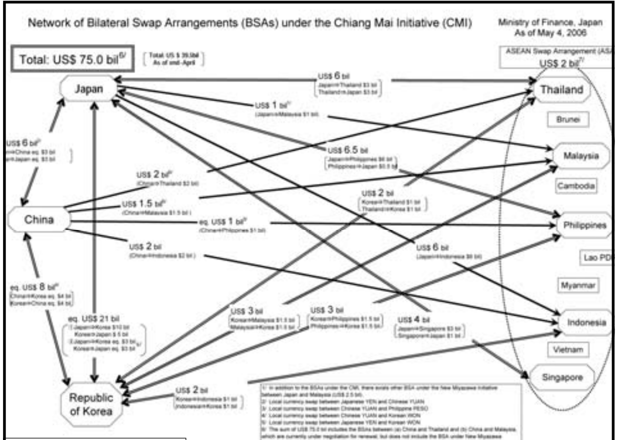
Financial Crisis as Impetus for East Asian Regional Cooperation

- Policy errors and various lessons learned from the crisis provided the impetus for financial cooperation in the region. The rationales for cooperation are to prevent a future crisis and also to manage a crisis better if one were to occur. In addition, monetary cooperation can also lead to greater influence for East Asian economies on the direction of the global financial system. Also, as intra-regional trade and investment increase in importance, greater regional financial integration are needed to support the economic integration process.
- Some concrete progress in financial cooperation but not anywhere close to fulfilling the rationales.
- This presentation will address three main issues as follows: 1) the Chiang Mai Initiative; 2) Asian Bond Market Initiative; and 3) Regional Monetary Cooperation.

Chiang Mai Initiative (CMI)

- Formation of the ASEAN+3 group after the crisis (not possible before the crisis). First concrete regional cooperation initiative of the ASEAN+3 group is the Chiang Mai Initiative (CMI).
- Swap Agreements for Foreign Reserves.
- Still mostly tied to IMF assistance.
- Current status in next slide.



Source: Ministry of Finance, Japan.

Chiang Mai Initiative (CMI) (2)

- CMI can be regarded as a ***very significant symbolic initiative***. However, actual effectiveness of CMI in its current form is doubtful.
- Current amounts not big enough to be significant in cases of crisis.
- To make CMI more meaningful two key steps are necessary.
- First, the swap arrangements should be multilateralized and the amounts expanded.
- Second, a regional monetary organization should be set up to coordinate the funding mechanism. (Goes back to the Asian Monetary Fund idea.)
- However, conditionality will still be needed to turn around a country in crisis.

Asia Bond Market Development

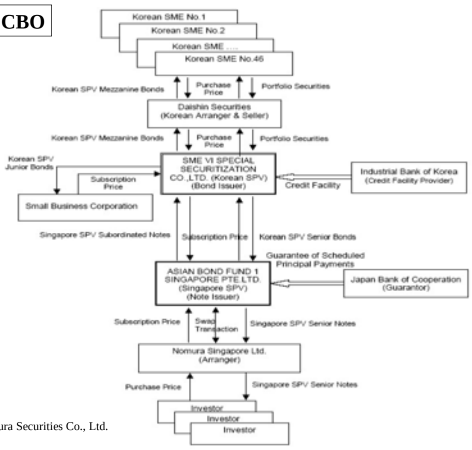
Rationale

- Excessive reliance on short-term foreign debt by the countries that became insolvent and had to seek IMF assistance.
- Lack of adequate long-term financing, private sector in deficit countries had to rely on foreign bank borrowing (from OECD banks). Due to Basel Capital Accord provisioning requirements, most of these lending were be short-term.
- Double mismatch (maturity and also currency).
- Rapid built up of short-term external debt. Yet the region as a whole had a large saving surplus. These were not recycled for long-term financing in the region.
- The key need is from the Private Sector. Governments and the public sector were able to tap long-term financing and arrange appropriate currency and maturity mix, whether from bilateral or multilateral channels or in the domestic and foreign capital markets.

Asia Bond Market Development (2)

- Domestic bond markets in a number of countries are now quite active so more potential to raise funds by issuing long-term bonds.
- Asian Bond Fund 1 (ABF1) launched mid-2003 ($ 1 billion) and ABF2 launched December 2004 ($ 2 billion)
- ABF1 invests in $ bonds issued by East Asian governments, while ABF2 invests in local currency government bonds. So still does not provide funding to private sector.
- These initiatives can nevertheless by useful. They can lead to improved liquidity and benchmarks for regional bonds and they also involve a lot of regional cooperation to improve the bond market infrastructure of the region. This will eventually help the private sector to be able to make more active use of the regional bond markets in the future.
- Another very interesting development arose from the cooperation between the Ministry of Finance of Japan and the Ministry of Finance & Economy of the Republic of Korea. This led to 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.
- Currently, still need support from public institutions (the Small Business Corporation of Korea, the Industrial Bank of Korea and the Japan Bank for International Cooperation) in the form of guarantees and credit enhancement, but possibly less direct support may be required in the future as the market becomes more used to this type of product.

Korean CBO



Source: Nomura Securities Co., Ltd.

Asia Bond Market Development (3)

- Main thrust for the development of the regional bond market should be a market based approached. Effective Asian bond markets will require a lot more infrastructures (being developed under the Asian Bond Market Initiative, ABMI) such as regional credit rating, harmonization of rules, regulations and taxes, settlement and clearing mechanisms etc.
- The development of deep and well functioning <u>currency markets</u> in the region will also be very important for increasing the demand for local currency bonds in the region. For example, Japanese investors need to be able to hedge against exchange rate risks if they invest in local currency debt instruments in other countries in the region (eg. Thailand). However there are no direct markets between Yen and many currencies, so ability to hedge is very limited.

<u>Baht Exchange Rates: Bangkok</u>

	Selling	Buying	Gap
US Dollar	**41.12**	**40.97**	**0.37%**
Euro	48.94	48.46	0.99%
British Pound Sterling	71.09	70.56	0.75%
Swiss Franc	31.47	31.16	0.99%
Japanese Yen (100)	**35.15**	**34.74**	**1.18%**
Singapore Dollar	24.79	24.54	1.05%
Hong Kong Dollar	5.31	5.28	0.58%

Source: Siam Commercial Bank, 30/12/05.

<u>Sing$ Exchange Rates: Singapore</u>

	Selling	Buying	Gap
US Dollar	**1.673**	**1.659**	**0.84%**
Euro	1.985	1.960	1.28%
British Pound Sterling	2.889	2.854	1.23%
Swiss Franc	1.280	1.257	1.83%
Japanese Yen (100)	**1.428**	**1.400**	**2.00%**
Hong Kong Dollar	0.217	0.213	1.92%

Source: UOB, Singapore, 30/12/05.

Currency Coordination and Integration

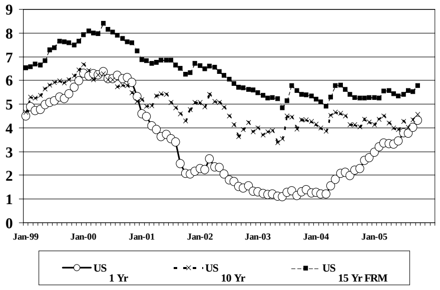
- As intra-regional trade and investment increase in importance, more attention is being paid to regional monetary cooperation and integration to facilitate intra-regional trade and investment.
- Much discussions about regional exchange rate coordination or arrangements, e.g. common basket, Yen block, East Asian Currency Index and monetary union.
- Clearly, greater stabilities of regional currencies are important for closer economic integration of the region. Reduce exchange rate risks, whether for trade or investment.
- While East Asia can learn a lot from the European experience on monetary integration, there are still major differences. East Asian economies are much more diverse than European economies, whether in terms of levels of development or in terms of economic characteristics. In addition, diverse exchange rate regimes in East Asia and vastly different development needs and political agendas mean that the region is a long way off from being able to move to anything close to a monetary union.
- Even adopting some form of a fixed exchange rate system for the region's currencies would be inappropriate. In Thailand, the crisis occurred precisely because the country used up almost all its reserves to try to defend the fixed exchange rate. With managed float there is a lot more flexibility.
- Costs of exchange rate volatilities can be reduced by developing efficient currency markets in the region so that traders and investors have access to a range of products for hedging against exchange rate risks. This is particularly important for Yen related transactions as already indicated.

Cooperation to Influence the Global Financial Environment Impacting on the Region

- There are nevertheless important areas of monetary cooperation for the region, particularly to increase the region's influence on the global financial environment impacting on the region.
- As the major holder of foreign exchange reserves in the world (more than 60%), how East Asian countries manage these reserves has major implications for the global financial system. East Asian countries need to be more proactive in this regard.
- How these huge reserves are being invested can affect currency movements, whether among the major global currencies ($, Yen, Euro) or between East Asian currencies and the major currencies. This can affect the global trade imbalances (particularly between the US and East Asia).
- Another equally important point is about interest rates. How the reserves in East Asia are invested have implications for global interest rates, which in turn affect the global financial system. The relationship to US interest rates and possible housing bubble in the US is quite important.

Cooperation to Influence the Global Financial Environment Impacting on the Region (2)

- Long-term interest rates (and mortgage rates) in the US have been stubbornly low even as short-term rates have been increasing.



Cooperation to Influence the Global Financial Environment Impacting on the Region (3)

- While the Fed has been pushing up short-term rates in the attempt to try to cool down possible overheating or even bubbles, particularly in the real estate market, and recent increases in inflation, it can be seen that long rates have hardly moved. Thus, aggressive increases in Fed funds rate have been unable to affect long rates and mortgage rates much and therefore it is very difficult to cool down possible bubbles in the real estate sector that may exist.
- It is thought that low long-term rates relate to the investment strategies of central banks in this part of the world as they together hold more than 60% of the world foreign reserves. Whether this is true or not, there's no denying 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.
- East Asian central banks need to play a much more proactive role. Rather than just investing the reserves under their control, they should seriously think about using the resources under their control to influence the direction, and implicitly the stability, of the global financial system. As the Fed can no longer shape the direction of the global financial market by itself, it is the responsibility of East Asian central banks to help in this task. How this can best be done will obviously need a lot more thinking and discussions among the parties concerned.