East Asian Financial Cooperation and Integration

by

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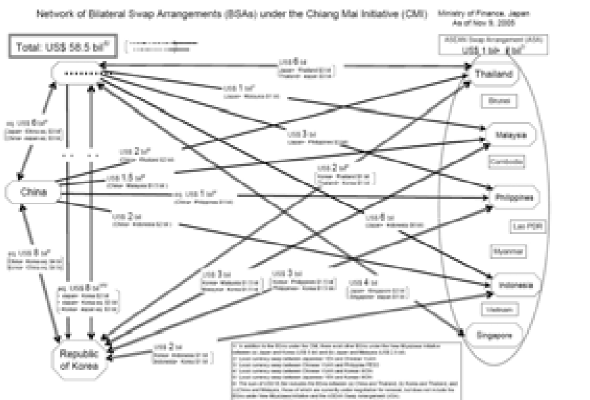
Financial Crisis as Impetus for East Asian Regional Cooperation

- 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)

- A significant outcome of the crisis is the formation of the ASEAN+3 group.
- First concrete regional cooperation initiative of the ASEAN+3 group is the Chiang Mai Initiative (CMI).
- Rationale: Greater foreign exchange liquidity in times of stress may prevent a crisis.
- Expanded ASEAN Swap Agreement and Bilateral Swap Agreement with Plus Three group.
- Bilateral still mostly tied to IMF assistance.
- Recent agreement to increase the amounts and increase the ratio that could be withdrawn independently of an IMF assistant package to 20% from 10% previously.
- 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***, given the diversities and historical baggage in the region. However, actual effectiveness of CMI in its current form is doubtful.
- If CMI had existed before 1997, it would not have made much difference to crisis prevention or management.
- Countries became insolvent. Under CMI, Thailand could have withdrawn about one billion US$ without an IMF program. This is insignificant compared to the size of the problem. Even if amount were much greater, may be the Bank of Thailand would have used up even more resources to defend the currency. Situation could have been much worse.
- Severe limitations: Current amounts not big enough to be significant in cases of insolvencies. Even if it were to be greatly expanded (say by 10 times), does not get round problem that a country will need to implement corrective policies to be able to repay the money, so some form of conditionality will still be needed.

Chiang Mai Initiative (CMI) (3)

- 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.)
- The organization can also become a focal point to coordinate other technical work necessary for future expanded financial cooperation in the region
- Get political commitment to set up such an institution from ASEAN+3 leaders with broad outlines rationale and scope of work. Also, complementary relationships to the IMF can be laid out, with very close coordination at the beginning (as the new organization needs to develop its technical expertise and credibility) and gradually becoming more autonomous (but not completely) of the IMF over time.
- However, it should be clear that having such an organization will not get around the need for conditionalities (although such conditionalities may be more sensitive to the realities in the region).

Asia Bond

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.

Recent Developments

- Domestic bond markets in a number of countries are now quite active. Prior to the crisis, not much domestic bond activities (not much need for governments to borrow, no benchmarks, no liquidity). As a result of the crisis, a steady supple of public sector bonds to recover and clean up from the crisis. Private sector have also benefited. Table shows data from Thailand (Mil. US$)

	Average Daily Trading Value	Total Outstanding Value	Private Outstanding Value
1995	8.4	3,922.4	3,581.3
1996	32.4	5,866.9	5,136.9
1997	13.7	5,389.8	4,226.4
1998	7.2	18,460.9	3,041.8
1999	46.5	28,662.5	4,740.6
2000	136.8	31,611.1	5,225.9
2001	145.6	33,875.6	5,659.6
2002	203.6	38,301.4	6,525.6
2003	254.4	45,681.4	9,093.9
2004	301.3	59,724.3	9,578.7
2005 (10 Months)	397.7	74,607.1	10,547.7

Source: The Thai Bond Market Association.

- However, outstanding private bonds still only about 8% of bank borrowing, so a lot more can be done.

Recent Developments (2)

- EMEAP launched ABF1 in mid-2003. US$ 1 billion investing in US$ bonds issued by sovereign and quasi-sovereign issuers so does not directly address need to recycle to private sector.
- Can be useful if it leads to improved liquidity and benchmarks for regional bonds. This is important if the private sector is to be able to tap into this market more than before. However, to achieve this 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.
- With an eye on addressing the currency mismatch problem, ABF2 was announced in December 2004 with a size of about US$ 2 billion.
- ABF2 has two components: a Pan-Asian Bond Index Fund (PAIF) and a Fund of Bond Funds (FoBF). PAIF invests directly in local currency bonds while the FoBF invests in 8 sub-funds in each EMEAP member countries (except Japan, Australia and New Zealand). All these funds will be passively managed to tract iBoxx ABF indices.
- While PAIF invests in local currency bonds, it is itself denominated in US$ and it is now listed and traded on the Hong Kong Stock Exchange.

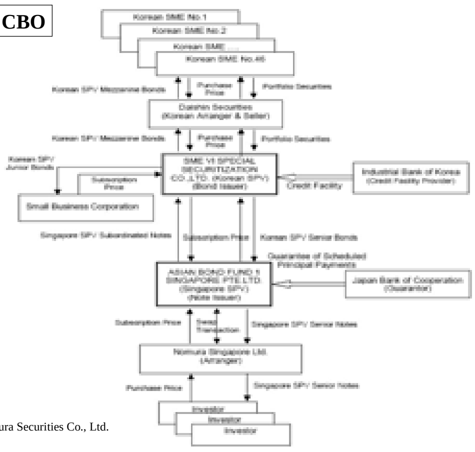
Recent Developments (3)

- Like ABF1, ABF2 only invests in sovereign and quasi-sovereign bonds (although denominated in local currency), so again does not directly address recycling to the private sector.
- However, measures needed to make ABF2 a reality can serve to improve the bond market infrastructure in the region, and 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 become 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.
- Can also help to make investors more adept in dealing with exchange rate risks inherent in PAIF.
- The market should 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.

Recent Developments (4)

- 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.
- This initiative is very promising as it directly addresses the need to recycle to the private sector, particularly the SME's who cannot easily access the international capital markets. Can also develop many variants of this and could be expanded to other countries.
- Currently, need substantial 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.

Future Directions

- Should give priority to initiatives that can lead to more effective recycling to the private sector in a timeframe that is not too long. Already, some countries have reverted to current account deficits and rising short-term foreign debt (like Thailand) and access of the private sector to long-term financing is still very limited.

Short-term External Debt and Current Account: Thailand

	Short-term Ext. Debt		Current Account
	(Mil. US$)	Change	(Mil. US$)
2004		**1,270**	**6,640**
Q1	11,505	601	2,134
Q2	10,464	-1,041	558
Q3	11,449	985	1,179
Q4	12,174	725	2,769
2005		**4,797**	**-5,057**
Q1	14,180	2,006	-1,499
Q2	16,034	1,854	-4,710
Q3	16,971	937	1,153

Source: Bank of Thailand.

Future Directions (2)

- Should take advantage of better functioning domestic bond markets in various countries and try to make it easier for off-shore investors to have access to local currency bonds that are traded in the various domestic bond markets (possibly with some guarantee mechanism for SME's).
- Trading and settlement are still 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.
- Need much more caution in moving toward a truly "Regional" market for local currency bonds.

Future Directions (3)

- Having local currency bonds traded actively in the regional (or global) bond market can be very risky. It is like having 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.
- So far, bond market initiatives in the region have not created a truly regional market for local currency bonds. For example, PAIF invests in local currency bonds, but 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, as the financial markets 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

Future Directions (4)

- Main thrust for the development of the regional bond market should be a market based approached. ABF1 and ABF2 are useful as tools that can promote bond market infrastructures and develop and demonstrate new innovative products. Once the infrastructures are developed and the market has absorbed the new products, then the private sector is highly capable of coming up with even more innovative products that can better tailor to the needs of diverse clients. Of course, 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 currency markets in the region will also be very important for increasing the demand for local currency bonds in the region.
- Investors need 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. 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.
- 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 however not the case for investors from Japan.

Future Directions (5)

- There are no direct exchange markets between the Japanese Yen and many currencies in the region (including the Thai Baht).
- Trading Yen for Baht and vice versa has to go through the dollar. The outcome is that the gap between the buying and selling rates between the Baht and the Yen is more than three times that between the Baht and the US$ and 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.

Baht Exchange Rates: Bangkok

	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.

Sing$ Exchange Rates: Singapore

	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.

- Attracting Japanese investors is very important to developing the regional bond market. To attract Japanese investors to local currency bonds, the Yen needs to become more internationalized, and efficient foreign exchange markets between the Yen and other regional currencies need to be developed. This will need support from the Japanese government in conjunction with the Japanese banks operating in the region.

Regional Monetary Cooperation

- 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.
- However, diverse exchange rate regimes in region 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.

Regional Monetary Cooperation (2)

- There are nevertheless important areas of monetary cooperation for 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 ($, Yen, Euro) or between East Asian currencies and the major currencies. This can affect the global trade imbalances (particularly between the US and East Asia).
- As we all know, most of the foreign reserves in the region are recycled to US$ denominated assets particularly US treasure 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.

Regional Monetary Cooperation (3)

- The above point is about relative exchange rates, and many people worry about possible market volatilities that may emerge. Another related point is equally important and 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.
- US house prices are still increasing strongly. Those in the UK (also Australia) have already begun to slow down.

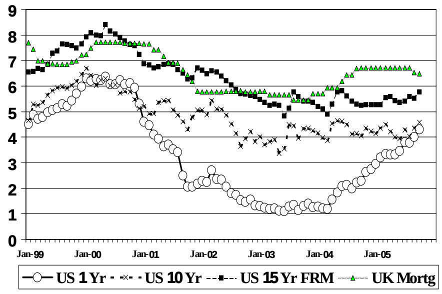
The Economist's house price indices (% change)

	Q3/05	Q2/05	Q1/05	Q3/04	Q2/04	Q1/04	1997-2005
			on a year earlier				
United States	12.0	13.4	12.5	13.0	10.0	8.4	85
Britain	2.4	2.3	5.5	19.3	19.4	16.9	166
Australia	1.0	-0.1	0.4	8.2	12.7	17.9	112

Source: The Economist (various issues)

Regional Monetary Cooperation (4)

- Long-term interest rates (and mortgage rates) in the US have been stubbornly low even as short-term rates have been increasing (UK long rates have risen over the past couple of years).



Regional Monetary Cooperation (5)

- 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.

Regional Monetary Cooperation (6)

- 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 appears 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 central banks do have a significant role to play in shaping the direction of global interest rates, and can help to stabilize possible global financial problems, including real estate bubbles in the US.
- Therefore, 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. In fact, it should be their responsibility to do so. How this can best be done will obviously need a lot more thinking and discussions among the parties concerned.