Regional Cooperation in Asia after the East Asian Crisis

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The East Asia financial crisis has generated a wide spectrum of analysis as to its cause. During the early days of the crisis, discussions focused on macroeconomic fundamentals and structural problems of the countries in question. That was only natural, as the G7 and IMF were operating under the premise that sound macro-policies and liberalized markets were basically what were required to achieve good economic performance. Moreover, since the collapse of the Soviet Union in the early 1990's, structural reforms to quickly move to an open market economy had been emphasized as appropriate, along with sound macroeconomic management. This initial reaction was derived from what John Williamson termed "the Washington consensus." [1] However, subsequent research revealed that macroeconomic indicators were generally strong amongst crisis-hit East Asian countries, although there was individual country variation. Neither market interest rate spreads nor rating agency forecasts gave prior indications of macroeconomic weakness. Indeed, there was structural weakness in

[1] John Williamson, 1990, "What Washington Means by Policy Reform." in John Williamson (ed.) Latin American Adjustment: How Much Has Happened? Washington D.C., Institute for International Economics.

corporate and national governance, but as it had been there for decades, why it suddenly became a problem in 1997 was hard to explain. The problems of the financial systems of East Asia had existed for many years and yet there were large numbers of countries with weak banking systems which were not hit by crisis. As Barry Bosworth rightly pointed out, “to generate a crisis of the magnitude of East Asia there is a need to link a weak banking system to some other triggering event. It was financial liberalization and the effort to link domestic financial markets to those of other countries. Many countries have encountered difficulties in managing this process of financial market reform.”[2]

Indeed, it was the combination of premature capital liberalization and insufficient financial supervision with the lack of resilient financial markets. With regard to the latter, Donald Tsang, Chief Executive of Hong Kong, then, Financial Secretary, pointed out as early as December 1997, that dual mismatch, currency and maturity mismatch, was one of the major causes of the crisis. Asian high saving had been channeled to dollar assets and returned to Asia as short-term dollar lending. When the lending was quickly withdrawn from East Asia with various triggers, the crisis developed and rapidly deepened. Against this background, Donald Tsang called for the creation of regional debt market. “What Asia lacks, and Europe and the U.S. have, is a deep, liquid and mature debt market where three things can occur. First, governments and corporations can borrow long to invest long, thus eliminating the maturity mismatch inherent in Asia. Second, corporations can issue paper in U.S.-dollar, yen or Euro currencies, with clearing and settlement in Asian times, thus eliminating currency mismatches and developing a truly deep Asian debt market along the lines of Euro-dollar and Euro-yen markets. Third, finance ministers in Asian economies can foster a vibrant debt market with

[2] Barry Bosworth, “Asian Miracle, Crisis and Recovery.” A paper presented at ADBI workshop on Development Paradigms, Dec. 10, 1999.

adequate risk management by investing their reserves in Asia."[3]

At around the same time, Menvyn King, then Deputy Governor and currently Governor of BOE, argued for the creation of what he called "do-it-yourself" lender of last resort[4]. That is the individual accumulation of foreign reserves, or regional pooling of foreign reserves. In view of the difficulties of creating the genuine international lender of last resort, this "middle-way," despite the fact it involves efficiency loss, seemed to him a good second best and politically clever solution.

Another second best solution was temporary capital controls imposed by Malaysian authority on September 2nd, 1998. Although Malaysian controls were effective and worked relatively well, the general perception, today, is the capital controls are the last resort that could be temporarily used at the time of Crisis.

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Developments in Asian financial Markets, since the crisis have reflected lessons learned, then, as pointed by people like Donald Tsang and Menvyn King. That is the creation of Asian bond market and accumulation of foreign reserves and coordinated use of such accumulated reserves.

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[3] "The Asian Debt Market", Asiaweek, Dec. 19, 1997.
[4] Menvyn King, "Reforming the International Financial System: The Middle Way," speech delivered to a session of the Money Marketers at the Federal Reserve Bank of New York, Sep. 9, 1999.

Before going into the details of such developments, let me point out that these moves not only reflect a desire to prevent another crisis but are also the natural outcome of regional integration in trade of FDI.

Trade has been the driving force behind East Asia's "dramatic" economic growth over the last several decades. The nature of the region's trade has been both global and intraregional. The region's growth was initially export-led, which was brought about largely through unilateral liberalization by individual countries in the region. However, regional integration subsequently played a major role in sustaining that growth.

Trade and foreign direct investment (FDI) are closely linked and are the major elements in cross-border production networks organized by multinational corporations. These production networks are at the heart of East Asia's market-driven regional integration. Japanese MNCs were instrumental in initiating the formation of regional production networks although their role in this process has declined in recent years because of the domestic economic downturn in Japan during the 90's and the resulting deterioration in corporate activity. Now, however, China and Korea are emerging to play significant roles in this area. MNCs of both countries are becoming leading sources of FDI in the region.

Intraregional trade among ASEAN plus 3 plus Hong Kong and Taiwan was as high as 54.5% as of the end of 2005 as compared to 43.0% in 1990. This 54.5% compares to 45.0% in NAFTA and 66.2% in EU. Since EU's share has been stable around 65%, ASEAN plus 3 plus Hong Kong and Taiwan share may come close to EU share within a next decade or so.

Thus, the development of East Asia's regional integration has been largely market-driven through trade, FDI, and production networks. However, in recent years an institutional aspect of regional trade integration has begun to develop. This institution-driven integration is in the form of free trade agreements (FTAs) and economic partnership agreements (EPAs). Compared to Europe and North America, FTAs were slow to develop in East Asia for a number of reasons, including the region's historically multilateral approach to trade and the broad diversity of economies in the region. More recently, however, regional interest in forming FTAs has grown.

The proliferation of FTAs in recent years has been attributed to a number of global and regional events and situations, including an uncertain multilateral trading system and increasing regionalism in other parts of the world. Some analysts believe their development is in part a reaction to the Asian crisis. Others believe the rapid growth of FTAs is not politically or crisis related but is in response to trade patterns and production networks in the region.

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Regional financial arrangements in East Asia have started with the Chiang Mai Initiative in May 2000. The initiative has gradually been expanded from bilateral to multilateral framework and in May, 2007, it was agreed among ASEAN plus 3 Finance Ministers to earmark a part of their foreign reserves to a common fund although details have not yet been agreed and reserves are to be managed by individual countries even after the pooling, at least, at the initial stage.

This is a major step too and establishing what we once called Asia Monetary Fund. At the time of the proposal for AMF, in 1999 we were thinking of pooling $100 billion which was a substantial portion of foreign reserves of ASEAN plus 3 at that time. Now it is only 3 to 4 % of foreign reserves and pooling of $100 billion would not be that different. In any ever, I am extremely gratified that it is proceeding along the way we considered 10 years ago.

Initiatives to develop bond markets in East Asia are the most ambitious of the regional financial initiatives ongoing at this time and are the focus of much regional cooperative activity. There are currently several major initiatives sponsored by different regional organizations.

The Asian Development Bank has been instrumental in supporting and assisting bond market development, particularly within the framework of the ASEAN plus 3 ABMI. Furthermore, the latest development in regional bond market development involved the ADB, which launched a US$10 billion Asian Currency Note program in September 2006. Under this scheme, Asian currency bonds can be issued initially in the national capital markets of Singapore and Hong Kong (China), and later on in the markets of Malaysia and Thailand. They can be issued under a single, unified framework with a common set of documents governed by English law. This program is notable because it is the first multi-currency bond platform in the region since the 1997 Asian financial crisis. Furthermore, the program is structured to accommodate other regional markets whenever it is approved by their regulators.

The Asian Currency Note program is a major step toward the development of Asian currency bond markets. However, there is still considerable work to be done in the areas of enhancing the corporate governance of issuers and the development of national and regional market infrastructure. This work includes establishing requirements for disclosure, setting accounting and auditing standards, creating rating agencies, developing depository and clearance systems, and setting up insolvency procedures for defaults. Much of the work in these areas must be done at the national level. However, there is also considerable latitude for regional cooperation in resolving some of these issues, and several initiatives are now being taken within the framework of ASEAN plus 3 Finance Minister Forum.

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Progress in regional economic integration in East Asia has proceeded along a two-pronged path. Regional integration in trade, FDI, and production networks has developed over a longer period of time and at a faster pace than has integration in money and finance. In addition, cooperation in trade and FDI has been primarily market-driven, while financial cooperation has been primarily institution-driven.

Intraregional trade in East Asia has expanded significantly over the last decade or so, and the structure of this trade has evolved as China's role in the region has grown. There have been shifts in the direction of trade, especially among China, Japan, and Korea, as well as changes in the commodity composition of trade from less sophisticated to more sophisticated products, particularly for China.

Trade and finance are closely linked and interact in such a way that each drives the other. This interaction, combined with the rapid expansion of intraregional trade and production networks in East Asia, has increased expectations that financial cooperation will advance more rapidly in the near future.

Although financial and monetary coordination in the region is still in its infancy, this area of regional cooperation has received greater attention in recent years. Granted, this is due in part to reactions to the East Asian crisis and a desire to prevent another crisis; however, many analysts and policymakers in the region are focusing on the expansion of trade and investment and the promotion of growth and development as important goals of regional financial cooperation.

Early production networks in the region were financed largely through bank credit and foreign direct investment. Since the crisis, however, East Asian economies have sought a broader, more diversified financial system to support the continuing innovation required by production networks. Thus, their focus has shifted to equity and bond markets to fulfill this role.

Equity markets are better developed than bond markets in East Asia, but securities markets in general need to be deepened and diversified before they can play a significant role in the regional financial system. The development of bond markets, particularly corporate bond markets, is considered essential to a financial system that can adequately support growing trade and investment. The recognition of this importance has prompted the development of some major regional bond initiatives including the APEC Bond Initiative, the Asian Bond Market Initiative, and the Asian Bond Funds.

Other financial cooperation in the region has focused on policy dialogue and surveillance mechanisms and on regional financing arrangements, such as the Chiang Mai Initiative. The CMI is currently the most prominent and longest-running financial initiative in the region and is important as a liquidity support mechanism.

Finally, the area of regional financial cooperation that has developed the least so far is coordination of exchange rate policies. This area, however, is also receiving increasing attention, albeit in the form of studies and proposals for common exchange rate regimes appropriate for the region. Nevertheless, a recent initiative of the ASEAN plus 3 finance ministers, with the assistance of the ADB, involves joint research into the possible roles of a regional currency unit for East Asia, to be called an Asian Currency Unit (ACU). Although a currency union for East Asia is considered by most to be a prospect for the distant future, there are a variety of steps that regional economies can take now to move gradually toward that goal. While the discussion stage of this process may seem slow with few immediate concrete results, it can lead to solid results in the long term with perhaps fewer missteps along the way.

I would not be surprised to see the emergence of Asian currency within next 40 to 50 years. I have already given the name to the currency. It would be called ASEANA.