New Impetus for Institution Building for East Asian Financial Cooperation

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Main Topics

- 1997 Crisis as Impetus for East Asian Financial Cooperation
- Sub-prime Impacts on East Asia
- Policy Responses and Growth Rebalancing
- New Impetus for Institution Building for East Asian Financial Cooperation

1997 Crisis as Impetus for East Asian Financial Cooperation

1997 Crisis as Impetus for East Asian Financial Cooperation

- The 1997 financial crisis provided an important impetus for financial cooperation within the region.
- Prior to the crisis, the East Asian region as a whole was financially strong, with a combined current account surplus (saving surplus) of about $100-150 billion per year and a combined foreign reserves of about $600 billion.
- However, most of the surplus were invested outside the region, and deficit countries within the region, such as Thailand, Indonesia and South Korea, had to rely on short-term foreign borrowing. The ratio of short-term foreign debt to official reserves in these countries reached more than 100% prior to the crisis.
- This was a fundamental reason that precipitated the crisis, particularly after Thailand used up almost its entire foreign reserves in a futile attempt to defend the currency.

1997 Crisis as Impetus for East Asian Financial Cooperation (2)

- Thailand, Indonesia and South Korea had to ask for IMF assistance, and had to implement harsh and controversial policies under IMF conditionality.
- Given the region's pre-crisis overall financial strength, countries in the region felt that with better financial cooperation, the crisis could have been avoided. Also that much of IMF conditionalities were too far reaching (such as structural reforms and privatization) and lacked understanding of the region's socio-cultural context.
- This led to the formation of the ASEAN+3 group (ASEAN plus China, Japan and South Korea), a group that was hard to envisage prior to the crisis because of historical tensions between some countries in the group.
- Various cooperation measures were initiated. The rationales for cooperation were to help countries in the region prevent a future crisis and also manage a crisis better if one were to occur.

1997 Crisis as Impetus for East Asian Financial Cooperation (3)

- First concrete regional cooperation initiative of the ASEAN+3 group was the Chiang Mai Initiative (CMI).
- Rationale: Greater foreign exchange liquidity in times of stress may prevent a crisis and may lead to “better” crisis resolution.
- CMI involved an expanded ASEAN Swap Agreement and Bilateral Swap Agreements with Plus Three group.
- Bilateral still mostly tied to IMF assistance (given arguments of possible moral hazard).
- Amounts of swaps later increased and the ratio that could be withdrawn independently of an IMF assistant package increased to 20% from a level of 10% initially.
- Latest total amounts of the swaps was $ 90 billion..

1997 Crisis as Impetus for East Asian Financial Cooperation (4)

- Prior to the CMI, there was also the proposal by Japan to set up an Asian Monetary Fund (AMF).
- This was shot down from both within and outside the region. The proposal was too radical at that time. Not enough informal discussions were carried out inside the region to gain a consensus. Parties outside the region attacked the proposal mainly on grounds of moral hazards and likely undermining of the IMF.
- The AMF proposal was quickly abandoned, though countries in the region still felt that some self-help mechanism needed to be developed, and this led to the CMI. The CMI link to the IMF was a compromise to get round the moral hazard issue.

1997 Crisis as Impetus for East Asian Financial Cooperation (5)

- There were also initiatives to develop the Asian Bond Markets; the Asian Bond Funds 1 and 2, and the Asian Bond Market Initiatives (ABMI).
- The rationale was to recycle East Asian saving surplus into long-term funding within the region. This should help to solve problems of “maturity mismatches” and “currency mismatches” associated with the region’s external borrowing prior to the crisis.
- Once the ASEAN+3 group became institutionalized, new cooperation initiatives were also developed to feed into the process. This led to various free trade agreements, mostly with ASEAN as the hub (by default, as it has remained difficult to conclude free trade agreements among ASEAN’s trading partners).
- As the momentum of regional cooperation increased, other countries wanted to join the process. Now there is the so-called “East Asian Summit” with India, Australia and New Zealand joining the ASEAN+3 group to become the ASEAN+6 group.

Limitations

- While CMI can be regarded as a ***very significant symbolic initiative***, given the diversities and historical frictions in the region, the actual effectiveness of CMI has always been doubtful. Series of swaps are very cumbersome to implement, size still not very large, no clear coordinating mechanism, and the scheme is still mostly tied to the IMF, an organization that has lost a lot of its credibility in much of East Asia.
- CMI needed to 1) become multilateralized, 2) increase in size, 3) de-link from the IMF, and 4) operated by a coordinating organization.
- As countries in the region relied more and more on the export engine in the post crisis period, experienced current account surpluses and accumulated more and more foreign reserves, it appeared that the need for foreign exchange liquidity support declined. So progress on extending the CMI became very slow. Formal agreement on the multilateralization of the CMI (self-managed reserve pooling) was only reached in 2007 and total size (US$ 120 billion) and contribution quotas for each country earlier this year. Operating mechanism still to be finalized. Setting up of a coordinating organization still to be agreed upon.

CMIM Contributions, Multipliers, and Rules

<table>
<tr><th>Country</th><th colspan="2">Contribution (USD Billion)</th><th>Borrowing Multiplier</th></tr>
<tr><td>Brunei</td><td colspan="2">0.03</td><td>5</td></tr>
<tr><td>Cambodia</td><td colspan="2">0.12</td><td>5</td></tr>
<tr><td rowspan="2">China</td><td rowspan="2">38.4</td><td>China (exclude Hong Kong, China) 34.2</td><td>0.5</td></tr>
<tr><td>Hong Kong, China 4.2</td><td>2.5*</td></tr>
<tr><td>Indonesia</td><td colspan="2">4.77</td><td>2.5</td></tr>
<tr><td>Japan</td><td colspan="2">38.4</td><td>0.5</td></tr>
<tr><td>Korea</td><td colspan="2">19.2</td><td>1</td></tr>
<tr><td>Lao PDR</td><td colspan="2">0.03</td><td>5</td></tr>
<tr><td>Malaysia</td><td colspan="2">4.77</td><td>2.5</td></tr>
<tr><td>Myanmar</td><td colspan="2">0.06</td><td>5</td></tr>
<tr><td>Philippines</td><td colspan="2">3.68</td><td>2.5</td></tr>
<tr><td>Singapore</td><td colspan="2">4.77</td><td>2.5</td></tr>
<tr><td>Thailand</td><td colspan="2">4.77</td><td>2.5</td></tr>
<tr><td>Vietnam</td><td colspan="2">1.00</td><td>5</td></tr>
</table>

*Hong Kong, China's borrowing is limited to IMF de-linked portion because Hong Kong, China is not a member of the IMF

	Issues	Rule of Decision-Making
Fundamental Issues	Review (size, contribution, and borrowing multiples), Re-admission, Membership, Terms of Lending, etc	Consensus
Lending Issues	Lending -- Renewal, Default	Majority

Limitations (2)

- Also still a long way to go to develop effective regional fund recycling for long-term financing of the private sector. Most of the initiatives up to now have focused on investing in public sector bonds.
- Also episodes of large capital inflows have led to currency appreciations, affecting export competitiveness and led to the introduction of capital control measures in Thailand in December 2006. This had negative impacts on the development of Thailand's bond market at that time.
- Although much progress on regional free trade agreements, the region still relied a lot on final demand from outside the region, particularly the United States. Possibility of "decoupling" has been shown to be wrong by the huge indirect impacts of the sub-prime crisis on the region's exports. This is now a major problem for most economies in the region.

Sub-prime Impacts on East Asia

Sub-prime Impacts on East Asia

- Direct exposure of East Asian financial systems to sub-prime assets were relatively limited.
- In Thailand, one small bank had to be re-capitalized because of exposures to CDO's.
- Financial institutions in East Asia learned from the 1997 financial crisis, so they tended to be more risk averse than the western financial institutions. Low direct exposure was also probably a reflection of the so-called "underdeveloped" financial system in most of Asian Emerging Markets, which has turned out to be a good thing.

- However, stock markets have been severely affected in line with the global trends.

Stock Markets Affected Substantially

Stock Market Indices

	(2007 Peak)	End Jan. 2009	Change
Dow	14,164.53	8,000.86	-43.5%
S&P 500	1,565.15	825.88	-47.2%
FTSE 100	6,732.40	4,149.64	-38.4%
Australia	6,828.70	3,540.70	-48.1%
Tokyo	17,458.98	7,994.05	-54.2%
S.Korea	2,062.92	1,162.11	-43.7%
Shanghai	6,395.76	2,089.90	-67.3%
Taiwan	9,809.88	4,247.97	-56.7%
Hong Kong	31,638.22	13,278.21	-58.0%
Indonesia	2,810.96	1,332.67	-52.6%
Malaysia	1,445.03	884.45	-38.8%
Philippines	3,873.50	1,825.09	-52.9%
Singapore	3,831.19	1,746.47	-54.4%
Thailand	915.03	437.69	-52.2%
Vietnam	1,167.36	303.21	-74.0%

Source: Bloomberg.

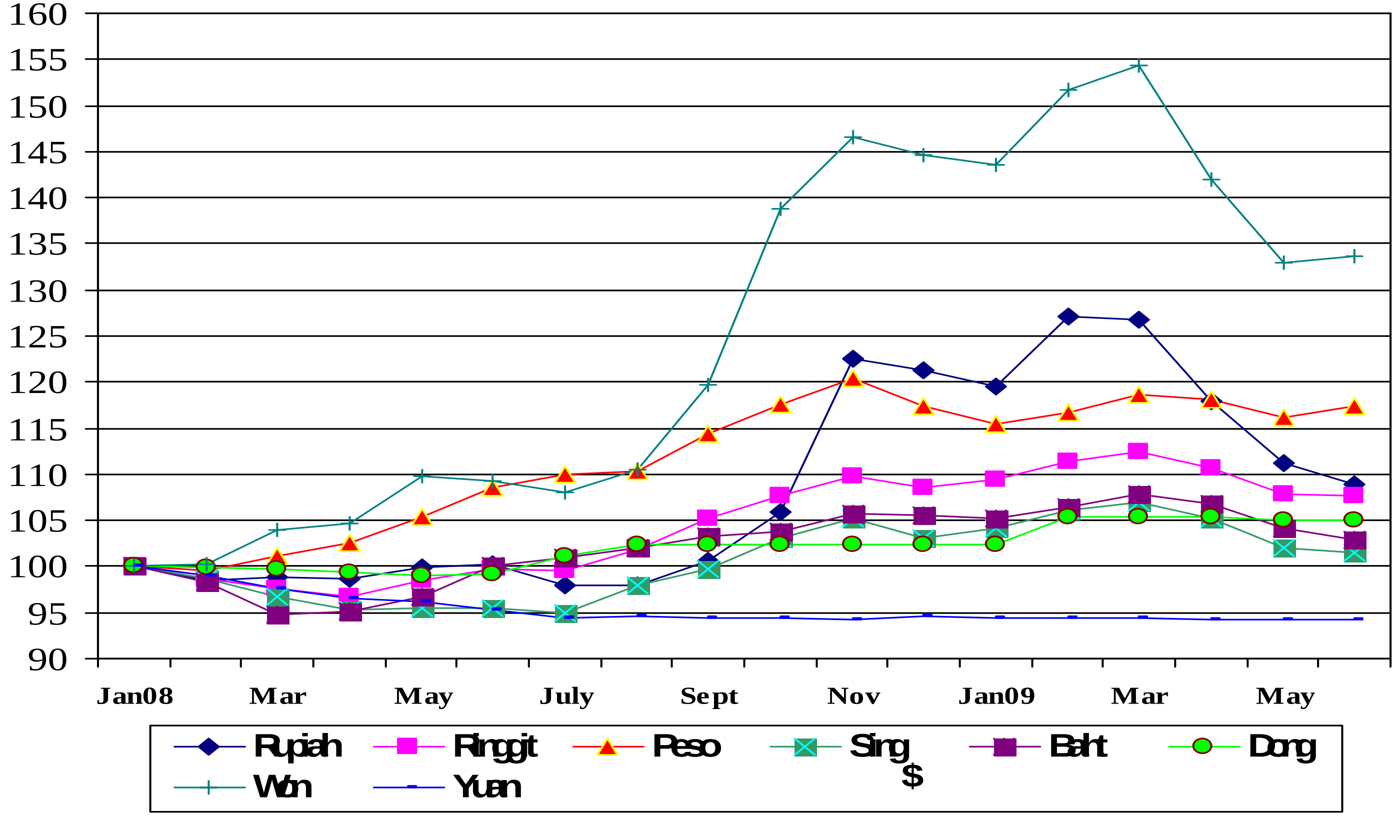
Sub-prime Impacts on East Asia (2)

- Liquidity constraints in the West led to asset liquidation in emerging markets and large capital outflows. This led to foreign exchange liquidity problem for some economies (reserves need to cover short-term debt as well other contingent liabilities). Some exchange rates weakened considerably, particular the Korea Won.
- South Korea and Singapore had to arrange swap lines (US$ 30 billion each) with the US Federal Reserves to ease US$ liquidity problems.
- There were some signs of banking stress signified for example by the announcement of blanket bank deposit guarantees by Malaysia and Singapore on October 16, 2008. The implementation of the Thai Deposit Insurance Act has also been postponed.
- However, the problems created by capital outflows were mostly reasonably well contained and there have been signs of increasing capital inflows, with recent increases in stock indices and strengthening pressures on many of the region’s currencies.

Sub-prime Impacts on East Asia (3)

- Significant currency depreciation for some economies, particularly South Korea. Also US$ liquidity problems. Situation now under control.

Exchange Rate Indices (from January 2008)



Source: Various Central Banks.

Adequacy of Foreign Reserves

- Need to back up short-term contingent liabilities.

	(1)	(2)	(3)	(4)	(5)
	FX Reserves (Bil. US$)	Short-term Debt (by remaining maturity)	Foreign Holdings of Stocks	Foreign Holdings of Bonds	Ratio of (1) to (2)+(3)+(4)
South Korea	201.7	191.1	111.0	27.0	61.3%
Indonesia	50.9	33.2	18.0	7.1	87.3%
Malaysia	91.3	42.4	22.3	11.8	119.3%
Philippines	39.6	14.3	11.6	0.6	149.4%
Thailand	112.3	35.1	30.7	1.7	166.4%

Source: Johanna Chua, “Asia Macro Views: Asia – Reassessing FX Reserve Adequacy”, February 23, 2009, Citgroup, quoted in Table 2 of Huang Yiping, “Strategies for Asian Exchange Rate Policy Cooperation”, paper presented at the conference on “Asian Economic Integration: Financial and Macroeconomic Issues”, organized by the East Asia Bureau of Economic Research, ANU, the Institute of World Politics and Economics, CASS, and the Institute of Asia-Pacific Studies, CASS, 14-15 May 2009, Beijing, China.

Sub-prime Impacts on East Asia (4)

- Crash of the export engine.

Export Growth (Nominal US$)						
	2006	2007	2008H1	2008Q3	2008Q4	2009Q1
Indonesia	14.4%	20.5%	28.0%	26.9%	-16.3%	-31.8%
Malaysia	14.0%	9.6%	9.0%	21.4%	-13.0%	-28.8%
Philippines	18.9%	7.1%	4.1%	4.2%	-21.8%	-35.6%
Singapore	18.4%	10.1%	2.8%	14.5%	-15.5%	-38.3%
Thailand	18.7%	17.0%	23.3%	28.4%	-9.4%	-19.9%
Viet Nam	22.1%	22.2%	31.8%	44.8%	6.7%	2.4%
China	27.2%	25.7%	21.8%	23.1%	4.4%	-19.7%

Source: Official Sources.

Sub-prime Impacts on East Asia (5)

- Importance of Intra-regional Components Trade in East Asia but high dependence on outside markets for final products.

Intra-East Asia Trade Shares

	2005-2007 Average		1994-1995 Average	
	Parts and Components	Final Products	Parts and Components	Final Products
Machinery	62.6%	38.5%	55.5%	42.9%
ICT Products	68.5%	34.4%	59.8%	36.4%
Electrical Goods	68.4%	67.4%	60.1%	58.8%
Motor Vehicles	44.0%	16.9%	42.5%	22.5%

Source: Table 3 in Athukorala, Prema-chandra and Archanun Kohpaiboon: “Intra-Regional Trade in East Asia: The Decoupling Fallacy, Crisis, and Policy Challenges”, Paper presented at the Conference on Global Financial and Economic Crisis: Impact, Lessons and Growth Rebalancing, Asian Development Bank Institute, Tokyo, 22-23 April 2009.

Sub-prime Impacts on East Asia (6)

- GDP growth has turned highly negative for some economies. Slowdowns evident for others (though China's growth has been boosted recently by fiscal injections).

YoY GDP Growth (%)						
	2006	2007	2008H1	2008Q3	2008Q4	2009Q1
Indonesia	5.5	6.3	6.4	6.1	5.2	4.4
Malaysia	5.9	5.7	6.7	4.7	0.1	-6.2
Philippines	5.4	7.3	4.6	4.6	4.2	0.4
Singapore	9.4	7.7	4.5	-0.6	-12.5	-10.1
Thailand	5.1	4.8	5.6	3.9	-4.2	-7.1
Vietnam	8.2	8.5	6.5	6.6	5.7	3.1
China	11.1	11.9	10.4	9.9	7.0	6.1

Source: Official Sources.

Policy Responses and Growth Rebalancing

Policy Responses and Growth Rebalancing

- Current crisis likely to be much more difficult to deal with than 1997 crisis. Hits at the very model of East Asian export-led growth. Apart from short-terms measure to shore up the economy under global recession, East Asia needs to depend less on the export engine, particularly from markets outside the region, and rebalance the growth path to be more dependent on domestic demand. This is not easy and cannot be achieve quickly.
- Most of the current policy responses involve fiscal injections (particularly direct transfers to individuals and households) and monetary easing. Both of these are necessary, but have limitations. If global recovery comes quickly then fiscal injections in the short-term can make way for other natural growth engines without serious fiscal burden. However, if the recovery drags out, like in the post 1997 case in Thailand, then depending on fiscal injections as the main source of growth will mean that larger and larger fiscal injections will be need each year, and it is easy to run into problems of large public debt.

Policy Responses and Growth Rebalancing (2)

- Even though Thailand started from a strong fiscal position with a public debt to GDP ratio of less than 38% before the sub-prime crisis, this has already jumped by 5% to 43% in just six months or so, and the situation can easily ballooned.
- Monetary easing also has limitations. Interest rates are mostly already very low so there is not much room for additional cuts. Furthermore, the major problem for the private sector, particularly SME's, is not <u>the cost of credit</u> (interest rate), but rather <u>access to credit</u>, as banks become doubtful of their credit worthiness so they face credit rationing.
- This is like in post 1997 when banks had difficulty finding good clients so ended up with excess liquidity and became major buyers of the large amount of government bonds that financed the crisis clean-up cost. Meanwhile the private sector were credit constrained for many years. The global financial outlook under the current sub-prime crisis is likely to be similar.

Policy Responses and Growth Rebalancing (3)

- In the medium term, it would be wishful thinking for East Asia to expect as much from the export engine as in the past. Export will still be important, but a serious growth rebalancing strategy will be needed.
- Public investment can be an important growth driver in the medium term. Thailand has a large number of mega-projects in the pipe line, and many of these should be implemented over the next several years.
- However, it is not entirely clear that an investment led growth strategy can be sustainable. If the investment is not excessive, then it should be sustainable. But then the generated growth may not be that high. If investment becomes excessive, then there is a danger of large adverse impacts on the current account and external stability.
- There is also a danger of a bubble, like prior to the 1997 crisis. So management of an appropriately level of public investment will be important. The quality of these investment will be equally important. Thailand has gone through phases of wasteful and inefficient mega project investments in the past, whether purely public sector projects or those given out as concessions to the private sector. This is again a very important issue needing carefully planning and monitoring.

Policy Responses and Growth Rebalancing (4)

- Apart from domestic strategies for growth rebalancing, there are also strategies at the regional level.
- Regional investment initiatives, particularly on Infrastructures, such as Japan's recent "Growth Initiative towards Doubling the Size of Asia's Economy" involving infrastructure and industrial development, increased ODA loans and involvement of the private sector.
- Regional infrastructure development can be linked to development of new regional growth poles, such as, for example, the Greater Mekong Sub-region (GMS) involving, southern parts of China, Lao PDR, Vietnam, Myanmar, Thailand and Cambodia. Other sub-regional growth poles can also be developed.
- Regional cooperation can also extend to joint development of new industries with growth potential, such as for example on the environment or alternative energy.
- More generally, push ahead with deeper trade and investment integration in the East Asia Summit group. This will increase trade (particularly in final products) and investment within the region and create more robust intra-regional growth drivers.

New Impetus for Institution Building for East Asian Financial Cooperation

Institution Building for Financial Cooperation

- It was worrying that financial regional arrangements, particularly CMI, did not play any role in assisting liquidity constrained countries, such as South Korea and Singapore. Instead countries went to the US Federal Reserves. There was a danger that CMI was becoming irrelevant.
- However, this seemed to have given the ASEAN+3 group a new impetus for financial cooperation.
- The contributions for each country in the multilateral CMI or CMIM has been a sensitive issue, particularly among the +3 countries (China, Japan and South Korea). Because of the new impetus, this was finally agreed at the 12th ASEAN+3 Finance Ministers' Meeting in Bali on 3 May 2009. The borrowing multiplier for each country was also agreed.
- The CMIM is planned to be implemented by the end of 2009. Officials have been tasked to work out the operational details and implementation plan, particularly the legal documents that will govern the CMIM.

Institution Building for Financial Cooperation (2)

- To make the CMIM fully effective a number of implementation steps are suggested.
- First, the mechanism must be de-linked from the IMF. Given experiences with the IMF during the 1997/98 crisis, no government of any country that went through an IMF program at that time can survive if it takes the country into another IMF program. This will prevent countries in the region from making use of the CMIM. Instead, they will resort to various central bank swap arrangements, with the US or other regional central banks. This will by pass the CMIM and make the initiative useless.
- (De-linking should be agreed at the policy level, but with appropriate sequencing. A coordinating organization needs to be set up (more on this below), its capabilities and credibility developed over a few years. For this, the IMF can provide capacity building support, so while the CMIM facility is de-linked from IMF conditionality, the CMIM institution still works closely with the IMF.)

Institution Building for Financial Cooperation (3)

- Second, the CMIM borrowing quota may not be enough if a country gets into serious problem. It should be possible to supplement the CMIM borrowing with additional contributions from countries in the group, such as for example country contributions to the IMF package during the 1997/98 crisis (most of the $17.2 billion package for Thailand came from country contributions).
- Third, instead of just borrowing from the CMIM, it should also be possible for countries to arrange swap facilities with the CMIM in a similar way as central bank swaps. This will make it much more flexible and quicker to use CMIM in situations of short-term liquidity shortages.
- Fourth, expansion to the other members of the East Asian Summit not yet included in the CMIM (India, Australia and New Zealand) should be quickly explored and implemented.

Institution Building for Financial Cooperation (4)

- Finally, and most importantly, an organization to coordinate and operate the CMIM needs to be set up. To be effective, the CMIM needs full time professional staff to provide substantive inputs to the member countries on areas such as surveillance, implementing mechanism, and developments of other areas of financial cooperation, which may over time extend to regional financial regulatory frameworks, capital market development as well as greater regional financial integration.
- CMIM Coordinating Organization (CCO) can have close institutional links to the IMF in the initial stages (as was indicated earlier) as the organization develops the expertise and credibility. The IMF can have a key role in capacity building.

Institution Building for Financial Cooperation (5)

- It should also be noted that outside of Europe a regional monetary organization is nothing new. In fact, there is already an AMF in the form of the Arab Monetary Fund. This was set up by the Economic Council of the League of Arab States in 1976, with the aim of assisting member countries in eliminating payments and trade restrictions, in achieving exchange rate stability, in developing capital markets, and in correcting payments imbalances through the extension of short- and medium-term loans; the coordination of monetary policies of member countries; and the liberalization and promotion of trade and payments, as well as the encouragement of capital flows among member countries.
- Another regional monetary organization is the Latin American Reserve Fund (LARF). The LARF was established in 1991 as the successor to the Andean Reserve Fund (ARF). The aims are to assist in correcting payments imbalances through loans with terms of up to four years and guarantees extended to members, to coordinate their monetary, exchange, and financial policies and to promote the liberalization of trade and payments in the Andean sub-region.

Institution Building for Financial Cooperation (6)

- However, important to understand that CCO is not simply performing a similar role as the IMF at the regional level. It's role extends to supporting financial cooperation and integration process of the region. It should also carry out activities in the common interest of the region. For example, East Asia is a major investor of foreign reserves assets. This can have large impacts on the global financial system, such as on exchange rates and interest rates. At the same time, what happens in the investment destinations have impacts on the safety and returns on these investments. Thus, the CCO should provide inputs to the member countries on these issues, including the state and direction of the global financial markets affected by and affecting East Asia's financial investment, impacts of various investment strategies, as well as carry out economic surveillance of the investment destinations.

Institution Building for Financial Cooperation (7)

- The CCO will be an important part of the reform of the International Financial Architecture. Current institutions have proven time and again to be inadequate in foreseeing and preventing major crises, whether in developing or in advanced economies. Simply reforming the existing institutions is unlikely to be very effective, as there are too many diverse and conflicting interests. New regional institutions with more focused objectives can contribute to future global financial stability.
- Apart from pushing on the CMIM front there are also other areas of financial cooperation that can assist the region both in the short-term and in the longer-term.
- Some countries may have fiscal constraints to deal with the short-term impacts of the crisis. Regional initiative can provide fiscal assistances to these countries. Currently, Japan has scaled up ODA loans to Asian countries in response to the sub-prime crisis. This is very helpful. Other donor countries should follow, even though their own fiscal positions have been harmed by the crisis.

Institution Building for Financial Cooperation (8)

- Financing of new growth drivers, such as infrastructure investment, is another important financial cooperation area. Recent agreement to increase the capital of the ADB will be helpful. Further development of the Asian Bond Market will also make it easier for countries to raise funds from within the region.
- Initiatives to set up an Infrastructure Fund have been under discussion in East Asia for a couple of years. No concrete proposal has yet been developed, but it is timely now to seriously explore this initiative at the East Asia level.

Institution Building for Financial Cooperation (9)

- Finally, it is clear that the trend of greater economic integration in East Asia will continue, and probably more rapidly now as a result of the sub-prime crisis. This makes the need for more and more financial cooperation and integration to facilitate and support the economic integration process greater than ever.
- Of course, moving toward something like an EU model will take a very long time, but there are many areas of financial cooperation that will also be very important to the region's economic integration process. For example, an issue such as the development of deeper and more efficient currency markets within the region is directly linked to trades and investment. It is also related to the promotion of a greater use of the region's currencies in intra-regional transactions, and this may extend to the global level.
- This and many other areas of financial cooperation need technical inputs from full time professionals. This kind of support has been lacking under the current ASEAN+3 process, making it very slow and cumbersome. This is why an organization such as the CCO will be extremely valuable for the future financial cooperation and integration process within the region.

Thank You