13 Asia Pacific regional architecture and financial market integration

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Introduction

The architects of Asia Pacific regional financial integration face a paradox. The region's economies have substantial financial clout – they hold nearly half the world's foreign reserves, account for a third of the world's saving and host nearly a fifth of global foreign direct investment (Table 13.1). Yet they are still addressing the challenges of fragmented financial markets and immature domestic financial systems. Sound and transparent financial institutions and efficient markets are foundation stones of regional financial architecture.

Asia Pacific's financial reforms and integration also have significance beyond the region. It is an increasingly important pole of economic activity. Asia Pacific including Japan accounts for nearly 22 per cent of world GNP and 23 per cent of its trade. Intra-regional trade accounts for a growing share of total trade. But Asia Pacific is still closely tied into the rest of the world economy through global supply chains, through the export markets for its end products and through the world's financial centres that intermediate the region's capital. This integration into the international system has significant benefits. Foreign capital inflows increase domestic investment over what is possible by relying only on domestic savings. Inflows of foreign direct investment (FDI) fan the winds of domestic competition by encouraging rapid technological change and the acquisition of modern management, marketing and other skills.

Yet volatility of exchange rates, interest rates and real economic activity caused by sharp and unanticipated reversals of short-term capital flows can exact high costs. It is the determination to reduce this vulnerability that motivates many in their approaches to regional architecture. As this chapter will argue, however, such approaches need to recognise that while the 1997–98 financial and economic crises revealed flaws in the functioning of the international financial system, they also revealed weaknesses in domestic policies and financial systems. In the intervening period, these sources of vulnerability have been recognised, but the pace of change has slowed as recovery has taken hold.

The purpose of this chapter is to evaluate the issues in financial market integration and regional financial architecture. It discusses two basic building blocks of financial and monetary integration: domestic financial systems (including financial intermediaries and capital market institutions) and exchange rate regimes. The chapter reviews post-crisis financial reforms and analyses the prospects for current initiatives for deeper financial integration. While initiatives to create bond markets attract considerable attention, such initiatives must also be complemented by domestic financial system reforms. Regional financial integration is a major project that will need to be undertaken in stages. The first stage is to build a strong foundation consisting of sound and strong domestic financial systems. Governments must keep their eyes firmly fixed on this primary goal because successful recovery has strengthened the hands of vested interests opposed to necessary reforms and the pace of reform has slowed.

The issues

Domestic financial systems reform

Although the crisis economies have strengthened their domestic financial systems, more than six years after the East Asian crises these are still potential sources of vulnerability. Traditionally bank-dominated, domestic financial systems rely heavily on debt finance. As economies develop and become more complex, diverse and transparent financial systems are necessary for savers and investors to interact with confidence with borrowers and issuers who are unknown to them. Stronger banks and capital market institutions that supply a greater diversity of financial instruments (e.g., bonds and securitised instruments), flows of transparent information, payment and settlement systems, all contribute to deep and liquid financial markets that are better able to withstand external shocks. Stronger supervisory oversight and enforcement of prudential standards, adequate infrastructure, and modern accounting and legal frameworks to promote transparency are also required. At the same time, governments must rely more on market discipline in financial markets to eliminate moral hazard (the traditional expectation has been that if problems occur government bailouts will 'socialise' any losses).

Several constraints also need to be addressed in strengthening domestic systems. These include the lack of trained manpower and independent financial supervisors, and pressures from vested interests to retain existing practices. While there have been improvements since the crises, financial systems in the region still trail best international practice.[1]

Issuers and intermediaries are part of the problem. Many corporations became highly leveraged during the high growth years; they also lacked transparency in financial disclosure and in their corporate governance practices (problems not unique to corporations in the region). Opaque relationships among governments, banks and firms in business groups and family conglomerates marginalised minority shareholders and created asymmetric information problems for investors and lenders. Some firms also borrowed heavily abroad in unhedged foreign currencies. One of the initial consequences of the unanticipated external shocks was a rise in corporate defaults and increase in non-performing loans in financial institutions. But several years later, indicators of corporate health (IMF 2002b) continue to show that although the high average levels of leveraging have declined from their 1997–98 peaks, reliance on short-term debt remains high and relatively stable. By these indicators of leverage, solvency, liquidity and profitability, the East Asian corporate indicators of health are weaker than those in other emerging markets.

Much work is still being done to address the debt overhangs left by the crises. Asset management corporations have had varying success with removing non-performing assets from the books of corporations and banks.[2] Other incentives have encouraged restructuring, including new bankruptcy codes, favourable tax treatment for debt, and negotiations among creditors.[3] But the increased public ownership of banks and corporations in the crisis economies has complicated crisis resolution by signalling the possibility of public-sector bailouts.

Work is also underway to develop capital market institutions. To take one example, in 2001 Thailand's Securities and Exchange Commission (SEC) moved to develop corporate and government bond issues as well as a secondary market. Regulations on the disclosure of private placements of corporate paper were tightened, and requirements for credit ratings of paper were introduced (Bank of Thailand 2003). As the government debt market grew post-crisis (budgetary requirements expanded with the recapitalisation of the financial system) a benchmark was created in 1998 and liquidity in the secondary market increased. Tax obstacles to bond market development were also eased (including the reduction of business taxation of capital gains and personal income taxation of interest income).

The SEC improved infrastructure to facilitate fund raising through the equity markets. While primary listing criteria were relaxed and obstacles to private company restructuring were removed, information disclosure requirements were tightened. Guidelines for foreign investor participation were also changed, and the SEC and Thailand's stock exchange delineated their responsibilities more clearly.

Liberalisation of foreign entry requirements is another channel to recapitalise weak financial institutions, introduce modern financial instruments and provide management and skills training. Both Thailand and South Korea have liberalised entrance requirements, but Thailand's success has been limited by political reluctance; foreign equity participation is regulated although foreign entities receive national treatment with respect to permitted activities. In South Korea foreign institutions have brought significant new sources of competition and modernisation into the financial sector, as well as new sources of capital.

This discussion of domestic reform would be incomplete if foreign participation were seen only as a source of recapitalising weak domestic institutions. Foreign ownership positions in, or 100 per cent ownership of, banks, insurance companies and investment banks, if managed carefully, can make important contributions to reform. Foreign players introduce greater competition, bring new products and technology, provide skills training and require regulators to make rules and standards transparent to ensure compliance.[4]

Among the crisis economies, South Korea seems to have made the most progress in restructuring but much more remains to be done. The OECD's 2002 survey of Korea applauds this progress, but concludes there is still a long way to go before the government allows resources to be reallocated from the failing banks and *chaebol* (conglomerates) to more profitable new enterprises (OECD 2003).

Exchange rate regimes and macroeconomic fundamentals

The second building block is domestic monetary frameworks. Since the crises, managed floating has replaced unsustainable fixed-but-adjustable exchange rate pegs. Among the larger economies, fixed exchange rates are now found only in Hong Kong, China and Malaysia (Table 13.2). Even so, most governments are reluctant to allow exchange rates to float freely, reflecting fears that real and nominal exchange rate volatility will undermine their export-led growth goals. Managed floating has been successful in both Singapore and Taiwan, but for good reason. These economies have large stocks of foreign reserves, disciplined macroeconomic policies, and well-developed, sophisticated and liquid financial systems. In the former crisis economies, immature financial systems, structural problems and debt overhangs make managed floating very risky. Such a practice easily turns into a soft peg, with the associated liability that, by inviting speculation in times of adversity, the risks of crisis are magnified.

Other intermediate exchange rate alternatives, such as basket pegs and regional currency units, have been suggested to provide authorities with more modest combinations of exchange rate stability and monetary policy independence despite capital mobility (Frankel 1999; Ito et al. 1999; Williamson 2000; Ministry of Finance 2000; Bergsten and Park 2002). But in practical terms, such alternatives are complicated. Finding optimal weights for currency baskets is a major technical challenge. Another challenge is to satisfy market participants' demands for transparency. Loose arrangements with wide bands are worth examining, but with open capital markets, these bands are likely to be tested by the markets.

The intermediate option is relevant to China. Its competitors have recently been shrill in their assertions that the yuan is undervalued, by as much as 40 per cent by some claims. Without evaluating the merits of the respective arguments in this debate, China's case illustrates a basic principle relevant to the topic of this chapter. If the yuan is wrongly valued, then appropriate alternative monetary framework choices available to the Chinese authorities are constrained by the immaturity of its financial system. China does not yet have a modern commercial banking system that efficiently intermediates savings into viable credits. The asset positions of most large banks are sufficiently precarious that they need to be recapitalised (and reorganised to improve their ability to evaluate and manage credit). These reforms are necessary prerequisites to permitting the freer play of market forces in the capital and foreign exchange markets. If, as seems likely, the Chinese economy is nevertheless reaching a stage where greater exchange rate flexibility would be in its own long-term interest, gradual moves to an intermediate option would seem to be the most advisable route to take.

In the more advanced economies, such as Singapore, Taiwan and South Korea, which have legacies of low inflation and moderate inflation expectations, inflation targeting and a more flexible exchange rate provides yet another alternative monetary framework. Such a framework requires central bank independence and a low target for inflation (in the 1–3 per cent range). The central bank cannot target the exchange rate, but must allow it to float relatively freely (although Masson et al. 1997 observe that crawling pegs or target zones could, in theory, coexist with an inflation target as long as the target is clear and is given priority in the event of conflict among objectives). Such a framework must include explicit identification of, and commitment to, inflation targets as well.

Since 1997 South Korea has made much of its transition to this regime. The central bank is independent; price stability is the central policy goal; the target and the plan for achieving it, as well as the conduct of policy are transparent; the bank is accountable to the National Assembly; and the exchange rate is relatively flexible.

Regional financial arrangements

In drawing their own lessons from the crises, East Asians recognise the need to remove structural obstacles to the freer play of market forces in their economies, but they argue that these changes cannot realistically be made overnight. More than that, there is a strong sense that the United States and the International Monetary Fund (IMF) cannot be relied upon to handle future crises well. For this reason, there is strong support for the economies in the region to use their financial clout to develop their own capacity to prevent and manage financial crises – and eventually to stabilise intra-regional exchange rates. Further reforms are also called for to the ‘supply’ side of international finance (see, e.g., Park and Bae 2002).

Regional financial arrangements can take several forms, each with a progressively more challenging objective (de Brouwer 2002). One objective is to provide short-term liquidity to bridge temporary balance of payments shortfalls. The IMF does not provide this type of funding, but other central banks can. A second objective is to prevent financial crises. Since many crises develop when external shocks overwhelm weak domestic fundamentals, surveillance is desirable to encourage preventive action. Financial markets, however, can wrongly perceive a weakening of fundamentals. If that is the case, substantial amounts of liquidity may be necessary to head off a crisis and can come from several sources: a country’s own reserves, swap arrangements or IMF lending facilities. A third objective is to resolve a financial crisis once it begins, and this is where the IMF becomes involved with large lending packages.

The appearance of contagion in the East Asian crises (changes in investor sentiment toward an economy with good fundamentals as a result of its neighbour’s or close trading partner’s problems) led to the creation in 1999 of the IMF’s contingent credit line (CCL), as a new lending facility available to such countries to boost their reserves.[5]

The first step toward regional financial arrangements began at the subregional level with the creation of informal currency swap arrangements among the ASEAN economies in 1996–97. These agreements had relatively little effect during the financial crises, but cooperative arrangements took a major leap forward when the idea was expanded and formalised among the ASEAN+3 central banks in May 2000. Financial arrangements negotiated in the Chiang Mai Initiative (CMI) aimed, initially, to address the first and second objectives of bridging balance of payments shortfalls and preventing financial crises. But the CMI is also interpreted by some of its architects, such as Malaysia, as providing, over the longer term, the basis for closer monetary cooperation to achieve exchange rate stability. There is a new determination to map the road to closer monetary cooperation as a basic building block for eventual currency union. This issue is discussed further below.

The CMI includes ASEAN+3 central bank governors and finance ministers who have agreed to bilateral swap arrangements among central banks in the three Northeast Asian economies (China, Korea and Japan) and those in the Southeast Asian economies. These arrangements are part of a network of bilateral swap arrangements that will supplement the foreign exchange reserves of the Southeast Asian countries with those of China, Korea and Japan.

In 2001–02 Japan finalised swap arrangements with China, South Korea, Malaysia, the Philippines and Thailand that will permit borrowers to draw 10 per cent of their allowance without conditions; beyond that amount IMF conditionality applies. Since then, South Korea and China have finalised similar agreements.[6] In relation to total foreign exchange reserves held in the region, the amounts are still modest. But in relation to IMF quotas, their significance increases. Henning (2002) estimates the total for bilateral swaps plus the ASEAN swap arrangement was US$25.5 billion as of 31 December 2001. IMF quotas totalled another US$10.1 billion. Within the established framework these amounts can be changed quite easily; that is, upward in the event of a real or threatened crisis.

Throughout these negotiations, a key issue was what conditions would be imposed on borrowers and how they would be applied. Initial reluctance to impose any conditions reflected traditional preferences for non-interference in domestic policies. But Northeast Asians were not about to see their resources used without appropriate policy adjustments by borrowers. Eventually conditionality arrangements were agreed that ensure consistency with IMF conditionality.[7]

International experience (e.g., in the Group of Seven) indicates that potentially powerful incentives for good domestic policy can be supplied by intergovernmental forums for cooperation. In East Asia the Manila Framework Group (MFG) filled the policy vacuum left in the wake of the 1997–98 crises. The central bank forum, the

Executives’ Meeting of East Asia and Pacific (EMEAP), has also undertaken effective technical cooperation since 1997 (Table 13.2).

Several information exchange and cooperation processes have emerged in the region since 1998, including the ASEAN Surveillance Unit (ASU) and the Asian Development Banks’ Regional Monitoring Unit (RMU). ASEAN+3 bureaucrats have also debated, but could not agree to, a proposal to create an independent group to carry out objective analysis on which surveillance and peer pressure might be based (PECC 2002).

In summary, it is still unclear if and when governments might accept constructive criticism and peer pressure from other members about their domestic financial and economic policies and economic performance. Some ASEAN governments do have reservations, but much will depend on the Chinese government’s willingness to engage in such processes.

Regional architecture: future issues and their implications

Strengthening regional institutions

The ambiguity of the CMI’s long-term objectives noted above raises questions about whether a financing mechanism could provide the basis for the much-deeper monetary cooperation that is necessary to stabilise intra-regional exchange rates and to pave the way for a regional currency unit or currency. Such a sequence is a reasonable one. Economic analysis and European experience, however, suggest caution about the difficulties of execution.

Economic analysis suggests that certain optimal conditions are necessary for a common currency arrangement to be sustainable. Differing economic and financial conditions among participating countries can lead to internal tension and conflict if there are differing adjustments, such as monetary and exchange rate changes, to aggregate supply or demand shocks. Studies comparing the East Asian economies with optimal currency area criteria suggest that certain crucial conditions necessary for smooth adjustment to external shocks do not yet exist. Eichengreen and Bayoumi (1996) conclude that the standard criteria for the adoption of a common monetary policy fit East Asia about as well as for Western Europe. Kohsaka (2000) makes a similar determination.[8] Eichengreen and Bayoumi (1996) also carry out a cost–benefit calculus in which they observe that intra-regional trade and investment have grown to relatively high levels, adjustment to shocks is relatively quick, and supply and demand disturbances are small and symmetric by European standards. These findings imply that East Asia's small open economies would benefit from a reduction in exchange rate uncertainty. On the other hand, domestic financial systems are not yet mature, there is a political tolerance of ambiguous policy goals, and clear determined political leadership is lacking. Taken together, these three factors pose non-negligible risks that a common basket peg, for example, would suffer the unfortunate fate of the Mexican crawling peg in 1994.

European experience demonstrates that achieving supranational institutions, monetary union and a single currency as goals requires significant and prolonged political leadership and many compromises. Political commitment and leadership and common institutions are essential elements of the architecture. In effect, some modicum of domestic autonomy must be traded for meaningful surveillance in the group. The review of the existing mechanisms for policy dialogue (Table 13.2) is hopeful, but not conclusive. Between 1956 and 2002, a variety of financial forums were created in the Asia Pacific region, with varying mandates and memberships. Almost without exception, however, these mandates are limited to 'soft' forms of cooperation and information exchange that do not begin to approach the deeper ('harder') cooperation that is required for meaningful policy monitoring and policy bargaining.

Still, a cooperative process has begun, even though it is difficult to see the basis for the objective of deeper monetary integration. The East Asian Vision Group (EAVG 2001) report to ASEAN+3 leaders in 2001 expressed ambition about the possibility of East Asia evolving into a common currency area ('if and when economic, political, social and other linkages develop to a point where tighter forms of monetary integration become feasible'). A subsequent report of the East Asia Study Group on implementing the recommendations (EASG 2002) backed away, acknowledging the pursuit of a 'closely coordinated regional exchange rate mechanism consistent with both financial stability and economic development' and recommending 'further study with high priority', but observing that:

> Presently, it may not be possible for the financial authorities in the region to come up with firm rules, but frequent consultation among regional authorities and some coordinated actions in both monetary and foreign exchange areas can be sought. (EASG 2001, paragraph 138)

Eichengreen (2002) systematically evaluates the viability of a common basket peg using several criteria: the credibility of participants' commitments to defend the exchange rate regime, their flexibility to allow adjustments when needed, the existence of a mechanism to coordinate adjustments, and adequate financial support.

Credibility requires political commitment sufficient to sacrifice domestic policy autonomy to sustain exchange rate stability in a world of mobile capital. Flexibility requires a cooperative mechanism to bring about necessary adjustments in a timely way. The CMI is not yet, but conceivably could become, a mechanism to coordinate adjustments among governments willing to participate. Finally, the CMI is a potential source of financial support, but the liquidity available to individual countries is small unless countries pool a portion of their reserves. This they are unlikely to do unless a robust surveillance mechanism exists that can prevent crises and manage them when they occur. Each criterion, to be met in a credible way, requires willingness by governments to give up some degree of sovereignty to a cooperative mechanism that is capable of forcing countries with weak currencies or fundamentals to adjust their policies. It is difficult to disagree with Eichengreen's conclusion that deeper monetary and exchange rate cooperation is not the right project for East Asia at the present time.

Some of the rhetoric in the region in 2003 implied that two tracks to deeper integration are possible: capital market development, particularly bond markets, and deeper cooperation on strengthening financial markets and institutions. Such a distinction is artificial; essentially these tracks are complementary. Bond market development ultimately depends on strong and sound domestic financial systems. Domestic financial systems can be strengthened, but without the development of capital markets they will remain immature, unnecessarily restricting the choice, and raising the risks and costs, of external finance available to rapidly growing firms. While these developments are complements, it is useful to examine them separately.

Developing Asian bond markets

Successful development of a regional bond market would confer advantages on issuers and investors throughout the region. But these advantages would only accrue over time.

An Asian bond is one issued by Asian borrowers (governments, corporations and financial institutions) in the region for sale in the respective issuing countries and denominated in foreign currencies. Investors in these bonds would come from anywhere in the world. Bond markets already exist in Tokyo, Hong Kong and Singapore but these markets lack depth and liquidity and, owing to capital account and other restrictions, are not accessible to most borrowers in the region. Korea's recent deregulation of capital market activities has permitted foreigners to issue bonds denominated in won and other currencies, but few issuers have yet taken advantage of this market.

The advantages of a regional bond market lie mainly in the efficiency gains that would accrue to the region's borrowers. As the recent crises underlined, the problem of double mismatches of currencies and maturities must be resolved. A logical response is to make local currency instruments more readily available. Asian bonds would provide safer and (perhaps) cheaper sources of finance. The market would also intermediate more of the region's savings within the region. In the past, Asian savers have been risk averse, investing their savings in riskless assets available in the world's money centres, in part because they have not had ready access to risk-management technologies and to information needed to make informed choices.

Park and Bae (2002) examine the depth of financial ties among the Asia Pacific economies compared to their ties with the rest of the world. They find stronger ties with the advanced countries than with one another. One of the main reasons they identify is that non-regional financial institutions dominate the capital markets because of their technical superiority to penetrate the markets. The gap between local and foreign technology and expertise is large. Indeed these authors suggest the gap will be difficult to close because of the implied need for a rapid and costly build-up of human capital and the ‘backbone’ infrastructures of information and telecommunications services, regulatory oversight and modern governance practices.

The other advantage of a regional bond market is that it would be a building block to global markets. More plentiful opportunities for bond finance would reduce reliance on banks and provide superior risk-management options to investors and a superior diversification for institutional investors. More sophisticated and diversified financial markets with longer-term instruments would not only attract more global investors but also enhance the capabilities of the region’s issuers and investors to participate in global markets.

What are some of the main elements in a road map that would make this possible? As Park and Park (2003) point out, the first step is for governments to undertake sufficient domestic financial liberalisation to allow the issuance of bonds in foreign currencies. Another step is to permit competition among domestic bond markets as a stimulus to modernisation and change. A third step is to create the essential infrastructure of payment and settlement systems. Government would also have to cooperate in the development of legal, regulatory and accounting infrastructures to support bond markets. Cross-border infrastructure, such as a single securities depository for the region, is one example. Regional credit agencies, cross-border securities borrowing and lending and credit-enhancement mechanisms, as well as credit guarantee agencies would also be necessary.

Some activity in these directions was begun in 2003. On the demand side, for example, EMEAP central banks established an Asian Bond Fund to invest in US dollar bonds issued by Asian governments. This activity may be diversified into local currency bonds in future. On the supply side, the Asian Development Bank’s bond initiative is working toward creating well-functioning and efficient local currency bond markets. But progress is slow and the sizes of these initiatives are modest.

For local currency markets to grow Asia Pacific central banks will have to relax restrictions on the use of their currencies, which in turn implies less monetary policy control. Unless this reluctance to see their currencies held by foreigners is overcome Asian bonds have to be denominated in one of the three major international currencies, or in the currencies of the region's international financial centres.

In summary, in order to create regional bond markets of significance governments should consider strengthening and liberalising domestic financial systems and cooperating in encouraging appropriate but essential regional infrastructural support.

Cooperating to encourage domestic financial reform

It is imperative for the region's governments to create incentives to step up the pace and deepening of domestic financial reforms. Such cooperation would also serve as a stepping stone to future cooperation on monetary issues. Weaknesses in bank-centered financial systems need to be corrected by training and appropriately rewarding bank supervisors and by training bank staff in modern banking practices. Yet more than six years after the crises, no region-wide evaluation of domestic reforms against best-practice benchmarks has been made available. Many domestic reforms have been initiated, but the remaining gaps in implementation need to be identified and addressed. What do we know about the competitiveness of the region's banking sectors? What do we know about governments' progress in regulatory and supervisory reforms? What is the state of banks' ability to evaluate and monitor risks? Are the weaknesses being addressed? What are the most effective methods that have been employed for achieving these objectives? Can these be identified and disseminated? Claessens and Glaessner (1998) made an early attempt at such monitoring. Table 13.4 provides a summary of comparative openness in financial services as an example of what is possible.

Deeper cooperation is needed for another reason as well. As competition increases among the region's financial institutions, regulatory authorities will have to coordinate among themselves or lose capital market activity to those jurisdictions with the least-onerous rules and standards. Diverse tax and regulatory regimes will therefore need to be harmonised to reduce obstacles to intra-regional cross-border capital flows.

Eichengreen (2002) argues that deeper cooperation should be supported by an institution. He proposes the creation of an Asian financial institute on the ASEAN+3 platform to provide reserves-management, clearing and settlement services to member central banks along the lines those provided by the Bank for International Settlements, as well as a venue for the negotiation of regional agreements on standards for information disclosure, capital adequacy, and so on, that would best reflect circumstances in the region.

The functions Eichengreen specifies foreshadow the need for common infrastructure for regional markets. One can also envisage such a platform performing other functions as well, such as analysing progress on domestic reforms and providing training and technical assistance, as well as being a place for policy dialogue among the public sector, market participants and others. Whether or not one agrees with the details of Eichengreen's institutional proposal, it raises the compelling and important question of how much deeper Asia Pacific cooperation can become without more institutionalisation. At present, independent empirical enquiry is the only way to identify and assess reform across the region.

CMI institutionalisation suggests two other issues. One is CMI membership. At present there is no accession clause in the bilateral swap agreements and therefore no mechanism to admit other countries as members. In theory, any country willing to provide a swap line with at least two-thirds of the existing membership could be allowed to join. Alternatively, members that have 'financial capacity', measured by reserves or capacity to borrow, could also be allowed to join. The second issue is the CMI's capacity and mandate. The mechanism has developed to this point with the implicit premise that it is possible to deepen cooperation without institutionalisation. There is no secretariat, not even one that rotates among member governments.[9] Nor is there an independent surveillance mechanism that could carry out the objective analysis of members' policies and performance that is essential for peer monitoring. Could peer monitoring be initiated with the practical focus on encouraging (and evaluating) the strengthening of domestic financial systems? If so, experience could then provide the basis for the more controversial monitoring of fiscal and monetary policies that will be necessary for deeper monetary cooperation (or to prevent the onset of a future crisis).

Regional or global institutions?

A related architectural issue is the relative roles of regional and global institutions. International experience shows that the central objective of cooperative financial institutions and arrangements is to preserve and enhance financial stability. How best to achieve this aim? It is clear that there is a role for regional financial arrangements, but the degree of interdependence among open economies is such that a global financing capacity (i.e., the IMF) is critically important. If funding is to be provided to head off a crisis, appropriate conditions are required to ensure remediation of real or perceived underlying problems and to prevent or minimise contagion. An adequate level of knowledge and understanding is also required of domestic financial systems and their particular characteristics.

The IMF's ability to marshal large amounts of support in the face of cross-regional contagion is unique. It is the world's expert in managing crises after they have occurred, facilitating debt write-down and imposing conditionality. But, as stressed earlier, the IMF is widely seen in the region to have imposed inappropriate conditions in the crisis countries because it lacked sufficient flexibility and adequate levels of local knowledge. Seven years after the East Asian crises, the depth and persistence of support for a regional self-help capacity should not underestimated. But there is also a widespread perception that regional financial cooperation is complementary to, rather than a substitute for, the IMF.

Indeed, there is a place for a regional financial institution in East Asia. A regional institution can draw more readily on local knowledge in developing appropriate conditions. In theory, it is more likely to be able to marshal peer pressure from close neighbours to bring about adjustments that will prevent crises; however, the longstanding commitment to consensus in ASEAN would have to be overcome for this to be true in the future. Alternatively, non-ASEAN members must be relied upon for such peer pressure. Those countries closest to a troubled neighbour are also more likely to muster support for a financial rescue package, a factor that is especially true given East Asia's large foreign reserves. Finally, a credible regional mechanism is more likely to be able to prevent contagion within the region.

A basic principle of global and regional financial arrangements is that they be complements, not substitutes. Their goals and operations should also be consistent to prevent arbitrage and such distortions as moral hazard. Henning (2002) summarises the history of the IMF's relations with regional financial arrangements, from the European Payments Union to the North American Framework Agreement. He notes that despite this history, no standards or criteria for evaluating regional arrangements have been developed or applied. Indeed, in the absence of a definition of 'complementarity', there are no guidelines to evaluate proposals such as the Asian monetary fund idea when it appeared in 1997. To address this issue, he proposes the creation of a financial equivalent of GATT Article XXIV that would provide agreed principles of regionalism as criteria for guiding and evaluating regional arrangements.

Mechanisms are also required on the supply side of global capital markets to reduce the dangers of volatility by changing incentive structures for the institutions that supply short-term capital flows and for their official overseers. Dobson and Hufbauer (2001) identified the suppliers of short-term capital as 200 very large financial institutions in ten OECD countries. The work of the Financial Stability Forum and the Basel Committee on Banking Supervision notwithstanding, coordination among the financial regulators in these countries needs to be stepped up and these very large global financial institutions need closer monitoring and better coordination among regulators to reduce herding and concentration of risk. This route, they argue, represents a better allocation of government effort to crisis prevention. The only other alternative is to improve the instruments for crisis management through the arduous and lengthy legislative process required to change the IMF Articles needed for a sovereign debt restructuring mechanism (to allow a country breathing space to restructure its debts if these become unsustainable). For the time being, however, governments have decided to take the latter route, as the recent study of the proposed sovereign debt restructuring mechanism demonstrates (IMF 2002c).

The roles of the plus three and the United States

A final dimension of regional financial architecture is the roles of and relationships among the 'plus 3' – China, South Korea and Japan – and the United States. Stable relationships among China, Japan and the United States will be necessary if regional institutions are not to be submerged by geopolitical issues. Since the 1997–98 crises, support from the ‘plus three’ in Northeast Asia has been key to the CMI initiative. Despite old antagonisms, leaders of the three economies have demonstrated their commitments to cooperate on regional issues. But the depth of such cooperation is limited. South Korea played a major role in leading the East Asian Vision Group, but its ambitions seem not to have been carried through in the East Asia Study Group. China and Japan must provide the leadership to CMI, but they have differing interests in and strategies for East Asian integration. China seems to be more interested in ASEAN than in deeper integration with South Korea and Japan. It remains to be seen whether the China–ASEAN FTA will be accompanied by a Chinese willingness to expand the bilateral swaps with ASEAN, favouring a “One-plus-ASEAN” rather than ASEAN+3. These strains and uncertainty about China’s commitment to a credible surveillance mechanism will in turn affect the credibility of the CMI as a platform for deeper cooperation.

China is playing an increasing regional leadership role as its economy develops. The Chinese authorities managed successfully through the East Asian crises and they are perceived to have correctly resisted pressures to devalue the yuan at the time. China has demonstrated its ability to implement major domestic structural changes. It is now a major destination for regional exports. But its persistent internal economic imbalances could have a negative impact on its neighbours. The state-owned enterprises’ continuing business and fiscal problems have frustrated attempts to create a modern commercial banking system. Asset-management companies created to work out the non-performing loans of the four large state-owned policy banks are themselves in trouble. The magnitude of bad loans has continued to be very large. These problems in the financial system constrain China’s options for introducing more flexibility into its exchange rate regime, despite strong external pressures in 2003 to do so. China’s persistent challenges in balancing economic reform and its social consequences could spill over into the region. The most obvious channel for spillover is through trade. If the authorities are unable to stabilise aggregate demand growth without abrupt quantitative restrictions, imports from its neighbours could suffer disruptions. Since China is now the region's engine of growth, such disruption could be significant. The other channel is financial. China is also a magnet for FDI from the region; to the extent these investments create excess capacity, the drying up of profits could produce negative spillovers. Furthermore, if China were to decide to adjust its monetary framework, any misstep that produced abrupt exchange rate movement would likely cause negative consequences in the banking system that could spill over to the neighbours.

The United States, distracted since September 11 by homeland security and fighting a war, has shifted its views of the region and its individual economies. Foreign economic policy is now driven by the security imperative of whether countries are 'with us or with the terrorists' (President Bush speaking to Congress, 20 September 2001). Initiatives promoting regional integration and financial institution building are more likely to be evaluated in terms of their alignment with these security interests than was the case in the past.

Conclusion

Regional financial architecture is already an important part of the evolving Asia Pacific economic order. While the current enthusiasm for regional bond markets to aid capital market development is creating momentum, the more difficult and fundamental task of domestic financial system reform is lagging in the face of restored economic growth. As argued earlier in this chapter, domestic reform and capital market development are complements, not substitutes. Successful bond markets will thrive in sound and strong financial markets. Stronger domestic markets that continue to rely on bank-dominated finance will remain immature and will restrict the choices for external finance available to rapidly growing corporations, restrict the options for managing risk and raise the cost for borrowers over what would be available in more mature financial systems.

Domestic financial reform provides the foundation for the much-touted long-term goal of deeper monetary integration in the region. It is the first milestone on a very ambitious (but ultimately attainable) route that requires new processes and institutions to be built in stages. Yet this first milestone has not been reached, in part because successful recovery has strengthened the hands of vested interests resisting reform.

The next step is clear. Incentives are required to reward progress and discourage foot dragging on domestic reform, through peer pressure. The Manila Framework Group tried to play that role in the immediate aftermath of the crises. But it has since been superseded, at least for the members of ASEAN and CMI, by their own cooperative forums for leaders, finance ministers and central bank governors. These arrangements are important to educate policymakers and the general public about the merits of closer cooperation and of the endgame of deeper monetary integration in the region. But here too progress on creating an incentive system for reform is slow; the existing mechanisms are not yet seen as credible forums where governments engage in objective analysis, monitoring and peer pressure for good policies that both serve national interests and prevent future crises. Membership is also incomplete, with important economies in the region not yet included.

Future developments will depend rather heavily on the Chinese government's support for the CMI's objectives, processes and membership. In the long run, deeper monetary cooperation will need to build on success in these earlier, more practical initiatives. Deep links in factor and product markets are necessary for deeper monetary cooperation, and close cooperation is required for convergence, as the European project demonstrated in the 1980s and 1990s. Too early an effort may divert resources from the reform process that is argued for in this chapter.

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[1] See Dobson and Jacquet (1998); Claessens et al. (2001).

[2] Indonesia's centralised asset-management companies do not seem to have achieved their goals of expediting bank and corporate restructuring. Malaysia has been more successful, helped by a strong bankruptcy regime. Thailand has used a decentralised framework that has not been regarded as very successful, in part because of a weak institutional framework (accounting and legal rules, capital positions of banks and ownership links).

[3] Thailand, Korea and Malaysia have each developed procedures whereby majority accords among creditors can be used to force all creditors into debt restructurings; Indonesia has moved more slowly in this direction.

[4] The benefits of foreign entry are not undisputed. Some argue that foreign banks 'cherry pick' the most desirable markets and customers. Others argue that their methods for evaluating credit risk can have undesirable consequences for industrial structures. The empirical evidence tends to confirm the greater efficiency of foreign-owned banks, their beneficial impacts on competition and evidence of their stabilising impact on, and long-term commitment to, local markets once they have entered (see IMF 2000a: Chapter VI and Annex II).

[5] No country signed up, however, because of the negative signal that entry or exit might send to the markets (e.g., if a country had to exit because it no longer qualified owing to deteriorating fundamentals), thereby exacerbating the possibility of a loss of confidence and a crisis.

[6] By the end of 2003 both Japan and China had finalised bilateral swap arrangements with all major ASEAN economies.

[7] See Henning (2002) for calculations illustrating this point.

[8] See Bergsten and Park (2002) for a survey of the issues and a proposal for a regional monetary arrangement.

[9] Even the informal Group of Seven (G7) finance ministers and central bank governors rotate the secretariat functions according to the country hosting the current year's leaders' summit.

Table 13.1 East Asia: Economic and demographic indicators, 2001

	I. 2001 Share of world: GDP[1]	Population[1]	Trade[2]	Inward FDI stock[3]	Foreign reserves less gold[4]	Savings[1]	II. Foreign reserves less gold 2001 ($US billion)
Japan	13.56	2.07	6.04	0.73	18.49	20.13	314.43
China	3.70	20.72	4.09	5.77	10.09	6.36	171.56
S. Korea	1.34	0.77	2.34	0.68	4.80	2.11	81.76
Hong Kong	0.51	0.11	3.14	6.60	5.20	0.73	88.44
Taiwan	0.97	0.36	1.84	0.46	5.72	–	97.24
Thailand	0.36	0.99	1.02	0.41	1.51	0.61	25.74
Indonesia	0.46	3.37	0.71	0.83	1.27	0.52	21.68
Philippines	0.22	1.25	0.51	0.20	0.62	0.18	10.69
Singapore	0.29	0.05	1.90	1.52	3.52	0.67	59.97
Malaysia	0.27	0.38	1.30	0.77	1.42	0.51	24.24
Vietnam	0.10	1.27	0.24	0.23	0.17	0.09	2.92
Laos	0.005	0.08	0.007	0.008	0.01	0.01	0.10
Cambodia	0.009	0.20	0.02	0.02	0.03	0.00	0.47
Myanmar	0.84	0.73	0.04	0.05	0.01	–	0.32
Total	21.74	32.38	23.25	18.34	52.91	31.92	899.60

Notes:
1. Source:*World Development Report 2000/01;* exceptions are Taiwan and Myanmar where source is Asian Development Bank *Key Indicators,2000.*
2 Trade is defined as exports plus imports.
3 Inward FDI stock is the value of the share of capital and reserves (including retained profits) attributable to the parent enterprise, plus the net indebtedness of affiliates to the parent enterprise. The values are presented at historical cost, reflecting prices at the time when the investment was made.
4 Total reserves less gold is defined to include the monetary authorities' holding of special drawing rights, reserve position in the IMF and foreign exchange.

Sources**:** World Bank, ***World Development Report 2003***; Asian Development Bank, ***Key Indicators 2002***; UNCTAD, World Investment Report, IMF, International Financial Statistics.

Table 13.2 Regional forums for financial cooperation, East Asia, 2002

Forum	Year founded	Membership	Mandate
SEANZA (Southeast Asia, New Zealand, Australia)	1956	British Commonwealth central bank governors	Contact among banking supervisors in the region
ASEAN (Association of Southeast Asian Nations; 10 members)	1967	Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam	Economic development, security
SEACEN (Southeast Asian Central Banks; 11 members)	1982	Indonesia, Korea, Malaysia, Myanmar, Mongolia, Nepal, Philippines, Singapore, Sri Lanka, Thailand, Taiwan	Cooperative research, training (runs a research and training centre)
APEC (Asia Pacific Economic Cooperation forum; 21 members)	1989	Pacific Asia, North and South America	Finance ministers cooperate on stabilising capital flows, development of capital markets
EMEAP (Executives' Meeting of East Asia and Pacific; 11 central banks)	1991	Australia, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, Philippines, Singapore, Thailand	Information exchange and cooperation on: payment and settlement systems, financial markets, banking supervision
Four Markets Group (finance ministry and central bank officials)	1992	Australia, Hong Kong, Japan and Singapore	Specialised cooperation on financial market functioning and regulation
Manila Framework Group (14 APEC members)	1997	Finance and central bank officials	Enhanced economic and technical cooperation following the crises on financing, surveillance and technical cooperation
ASEAN Surveillance Process	1998	ASEAN membership	Information exchange; early warning and peer review; monitoring global developments
ASEAN+3	2000	ASEAN economies plus China, Japan and South Korea	Strengthen economic policy dialogues and cooperation using Asian Development Bank Regional Monitoring Unit

Sources: Ito (2002); de Brouwer (2002).

Table 13.3 Exchange rate arrangements in East Asia, 1997 and 1999

Economy	1997	1999	Notes
China	Peg	Peg	Plus capital controls
Hong Kong	Peg	Peg	Currency board
Indonesia	Intermediate	Managed float	
Malaysia	Intermediate	Peg	Partial capital controls since 1997
Philippines	Intermediate	Managed float	
Singapore	Intermediate	Managed float	
South Korea	Intermediate	Managed float	
Thailand	Intermediate	Managed float	Peg 1970–97
Taiwan	Intermediate	Managed float	

Source: Fischer (2001); IMF *Exchange arrangements and exchange restrictions;* various years.

Table 13.4 An index of openness in financial services, 1997

	Banking		**Securities**		**Insurance**	
	Commitment	Practice	Commitment	Practice	Commitment	Practice
Hong Kong	4.20	4.75	4.00	4.40	4.40	4.00
Indonesia	3.15	3.20	3.50	3.00	3.10	2.60
South Korea	1.10	1.70	1.70	2.10	1.20	2.60
Malaysia	2.40	2.40	2.50	2.50	2.10	2.10
Philippines	2.80	3.35	2.40	2.40	2.90	2.80
Singapore	2.25	2.50	2.70	2.70	4.10	4.10
Thailand	2.95	2.85	2.00	2.00	2.80	2.80
India	2.70	2.25	2.50	2.10	1.00	1.00
Average	2.69	2.88	2.66	2.65	2.70	2.75

Note: 1= most closed, 5 = most open

Source: Claessens and Glaessner (1998).