Growing reserves and regional financial cooperation: East Asia ten years after the crash

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Monetary Regionalism in East Asia

- Main reason for change: Asia suffered traumatic financial crisis in 1997

- Entire region affected by unexpected financial and economic crisis – no warnings provided

- IMF did not provide first-class crisis management – liquidity too late, unacceptable conditionality

- Ever since the countries in the region search for new ways to stabilize their financial markets

Financial Cooperation in East Asia

- East (incl. Southeast Asia) – the world‘s fastest growing region
- Growth is fuelled by economic integration – both trade and investment are at unprecedented levels
- Yet: Institutions of economic integration weak compared to Europe
- Trade integration primarily driven by bilateral trade agreements, limited cooperation in monetary affairs, unresolved leadership issues

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Monetary Regionalism in East Asia

- Progress and potential of East Asian integration
- Main questions: How do the countries in the region cooperate? What are the effects of that cooperation for the international financial architecture?
- Can integration proceed without the leadership issue being resolved?
- Monetary regionalism and the potential for a single Asian currency – The Euro as a model for Asia?
- But first: The costs of ever-growing foreign reserves

Reserves in East Asia

- Obvious expression of new era: Asian central banks accumulate reserves
- Martin Feldstein in 1998: Build-up reserves as a defence strategy
- China – more than1000 bn $
- South Korea – 216 bn $ (tenfold since 1997)
- Singapore – 129 bn $, greater than China’s reserves in 1997

Foreign Reserves 1997 to 2005 in billion US-$

	1997	1998	1999	2000	2001	2002	2003	2004	2005
All Developing Countries	701	700	727	817	914	1,093	1,418	1871	2335
Asia without Japan	249	274	307	321	380	497	670	934	1181
America w/o USA/Can	170	153	143	156	159	161	196	221	249

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The cost of foreign reserves

- Foreign reserves have a low return
- Estimate: not more than 5 % in real terms
- Investment, e.g. in education, infrastructure generates higher returns: ~5%
- Consequently: developing countries pay a lot for the insurance - in 2005 over $ 120 billion
- Comparison: ODA in 2005: $ 50 billion

The cost of foreign reserves

- Some banks generate higher returns: Government of Singapore Investment Corporation (GIC): 9.5 percent
- Reserve management: Part of the “financial defence force” of Singapore (Kok Song, GIC)
- Countries react to the lack of reform in Washington
- Does East Asia need the IMF anymore?
- The region insures itself against another crisis

The cost of foreign reserves

- Level of reserves of all developing countries in 2004: ~ 30 percent of GDP
- Industrialised countries: ~ 5 percent of GDP, steady since the 1950s
- Reserve accumulation: reflection of lack of proposals from the IMF on last-resort-lending
- CCL – introduced after the Asian crisis – failed
- New Proposal: Reserve Augmentation Line (RAL) equally disappointing
- Main weakness of both CCL and RAL: No guaranteed access to liquidity in a crisis

Monetary Regionalism in East Asia

- Four goals of monetary regionalism: First, avoidance of (severe) financial crises

- Second: Regional management of financial crises – rather than returning to the International Monetary Fund

- Third: Provision of efficient, well-functioning financial markets that match highest standards of efficiency

- Fourth: facilitate trade in goods and services by providing stable monetary conditions

Monetary Regionalism - Sequencing

- Conventional integration: Trade first, finance follows
- Proposal: Turn sequencing around: finance first, markets for goods and services integrated later
- First step: regional pooling of reserves, followed by regional exchange-rate regime, an economic and monetary union and finally a political union
- Another proposal (Yunjong Wang): Limited cooperation in liquidity assistance, monitoring and exchange-rate stabilization

Monetary Regionalism – Chiang Mai Initiative

- In 1997, Japanese proposal for an Asian Monetary Fund – rejected by the IMF, USA, China

- 2000 – Chiang Mai Initiative: Bilateral swap agreements (local currency against international currency), ASEAN +3 countries

- Cautious endeavor – modest sums agreed

- But: Starting point for monetary integration from very low levels – ASEAN finance ministers never met before 1997

Monetary Regionalism – Chiang Mai Initiative

- In 2005: Bilateral swaps turned into multilateral fund, sums available doubled to ~ 80 bn dollar

- But: project remains vague and ambiguous, no operational structure, no monitoring mechanism

- Goals unclear: Nucleus of monetary regionalism? Or limited to liquidity provision?

- Also: Conflict between China and Japan over future course, Japan wants monitoring mechanisms to secure repayment, China opposed

Monetary Regionalism – Monitoring

- Before 1997 no joint monitoring, today: Monitoring and surveillance as part of the regional policy dialogue building trust
- Unclear: Monitoring with sanctions or without?
- With sanctions difficult – institutional environment does not exist (no equivalent to the European Commission, European Court of Justice, Parliament)
- Also: Monitoring not sufficient to avoid financial crises

Monetary Regionalism – Bond markets

- Before 1997, regional bond markets weak
- Since: development of regional bond markets to keep the region’s savings in Asia and to enable financing without currency risk
- Advantages: Developed (deep) bond markets provide both greater choice and enhanced stability
- Change: regional bond markets result in reduced business for New York and London

Monetary Regionalism – Bond markets

- Several efforts to strengthen bond markets: e.g. ASEAN+3 – Asian Bond Market Initiative (ABMI)
- With Australia and NZ: Executives' Meeting of East Asia and Pacific Central Banks (EMEAP)
- Japan initiated EMEAP in 1991, growing importance since 2000 – Washington has been excluded
- Two-stage process: Asian bond fund 1 and 2 – first dollar denominated, second in local currency

Monetary Regionalism – Exchange rates

- Conventional debate: Is Asia an optimum currency area – OCA?
- Cost benefit analysis with a trade-off between micro-economic efficiency and macroeconomic flexibility
- Eichengreen and Bayoumi: Asia as suitable for currency union as Europe
- Main question: Is there the same political will to integrate and to partially give-up sovereignty?

Monetary Regionalism – Exchange rates

- After the Asian crisis: Intensive debate about the appropriate exchange rate mechanisms
- IMF pushed the bipolar view: Either hard pegs or a free float - But: A free float is not an option for many developing countries, cost of hedging too high
- Indirectly: The IWF forces countries to build up reserves - Governments know: No support from the Fund for fixed exchange rate regimes

Monetary Regionalism – Exchange rates

- Several options discussed in report: anchors, baskets and other concepts to enhance exchange rate stability
- Identified as plausible: Intra-regional exchange rate mechanism à la European Monetary System
- Question: As internal anchor the yen or the yuan?
- Yen suffers from high government debt (170 of GDP), volatile exchange rate vis-à-vis the dollar
- Yuan suffers from fragile financial sector and lack of convertibility

Monetary Regionalism – Alternatives

- Back to the rivalry question: Will China or will Japan lead East Asia?
- If leadership issue unsolved: Competing regimes
- China might consider a Greater Chinese currency union, with China, Hong Kong and Taiwan
- For Japan, such a (currently unlikely) scenario would be worrying – the creation of a competitor to dollar and euro without Japanese participation

Monetary Regionalism – Conclusion

- Since 1997, a remarkable shift in financial co-operation in East and Southeast Asia
- Two distinct developments: Both a new emphasis on national measures (reserves) and regional co-operation in finance
- Asia dissociates itself from Western institutions (IMF) and demonstrates a skeptical view regarding the stability of financial markets