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

Heribert Dieter

German Institute for International and Security Affairs, Berlin
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
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 than 1000 bn $

- South Korea – 216 bn $ (tenfold since 1997)

- Singapore – 129 bn $, greater than China’s reserves in 1997
## Foreign Reserves 1997 to 2005 in billion US-$

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>All Developing Countries</td>
<td>701</td>
<td>700</td>
<td>727</td>
<td>817</td>
<td>914</td>
<td>1,093</td>
<td>1,418</td>
<td>1871</td>
<td>2335</td>
</tr>
<tr>
<td>Asia without Japan</td>
<td>249</td>
<td>274</td>
<td>307</td>
<td>321</td>
<td>380</td>
<td>497</td>
<td>670</td>
<td>934</td>
<td>1181</td>
</tr>
<tr>
<td>America w/o USA/Can</td>
<td>170</td>
<td>153</td>
<td>143</td>
<td>156</td>
<td>159</td>
<td>161</td>
<td>196</td>
<td>221</td>
<td>249</td>
</tr>
</tbody>
</table>
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