

# **ASIAN INITIATIVES AT MONETARY AND FINANCIAL INTEGRATION: A CRITICAL REVIEW**

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# RESEARCH PAPERS

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## ASIAN INITIATIVES AT MONETARY AND FINANCIAL INTEGRATION: A CRITICAL REVIEW

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SOUTH CENTRE

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## **ABSTRACT**

Whilst the first steps towards Asian trade cooperation started in the 1970s, it was the Asian Financial Crisis of 1997 that triggered Asian efforts at monetary and financial integration. This paper argues that the conditions for Asian monetary integration are not conducive but that efforts at monetary cooperation should proceed at three fronts – exchange rate cooperation, coordination of capital flows control, and strengthening of regional financial liquidity management as in the Chiang Mai Initiative and regional surveillance. In the area of financial integration, the authors critically review the reasons and performance of regional local currency bond markets. While the advantages of local currency bond markets are well known, the authors highlight the risks and downside, namely foreign exchange volatility, macro-economic instability, non-inclusive financing, and pro-cyclicality. The authors propose attention should be given to other institutional financing structures namely more regional and national long-term credit/development banks that can reduce instability associated with capital markets while addressing the problems of currency and maturity mismatch as well as pro-cyclicality and non-inclusive financing.



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## **INTRODUCTION**

The world is lurching from one financial crisis to another. In 2007 it was the Great Financial Crisis that led to the Great Recession. We were pulled out of the abyss through world-wide massive fiscal pump priming and historic monetary loosening. Little, if any, significant reforms of the international financial architecture, beyond tinkering with Basel III, were introduced; let alone implemented. One of the consequences of these policies of commission and omission is the rolling bubble. The bursting of the financial bubble in the U.S. is followed by the financial bubble in Europe. Banks, particularly European banks, are haemorrhaging from massive sovereign and private loans that were given to the peripheral and semi-peripheral countries of the European Union – Greece, Portugal, Ireland, and even Spain and Italy.

Asia underwent a serious financial crisis in 1997, and the failure of global financial institutions to address the problems prompted Asian countries to work for greater monetary and financial cooperation. Until recently, many in Asia were also proposing Asian monetary and financial integration following the European experience. The problems confronting the European Community give cause for caution and present us an opportunity to learn from the positives and negatives of the European experience and to also take critical stock of the Asian initiatives at monetary and financial integration.

This paper consists of four major sections. The first section provides a brief history of the Asian initiatives at regional cooperation and integration beginning from the 1960s till 2011. The second section examines the objectives and efforts at monetary integration and whether we need monetary cooperation/coordination or integration; the third section deals with similar issues in the area of financial integration, particularly, taking a critical look at the push for development of Asian bond markets. The last section points to some issues in the way forward.

## SECTION I

### BRIEF HISTORY OF ASIAN INITIATIVES AT INTEGRATION

ASEAN (the Association of Southeast Asian Nations) was established in 1967 comprising of Indonesia, Malaysia, Philippines, Singapore and Thailand in the midst of the Vietnam and Cold War. While its avowed objectives as a regional bloc were to “promote economic, social, cultural and educational cooperation”, the political aims, less explicit, were to prevent political disputes between them from developing into armed conflict (Severino, 2009:2) and to act as a bulwark against Communism from expanding into the ASEAN countries following the “domino-theory”, the prevalent belief at that time. In 1976, the ASEAN states started to discuss trade and industrial cooperation issues and formalized economic cooperation.

It was only in 1992 that ASEAN leaders went beyond economic cooperation to talk about economic integration and decided to create AFTA (ASEAN Free Trade Area) and to reduce tariffs on intra-ASEAN trade to between 0 and 5 percent within 15 years. Since then intra-ASEAN trade has grown significantly.

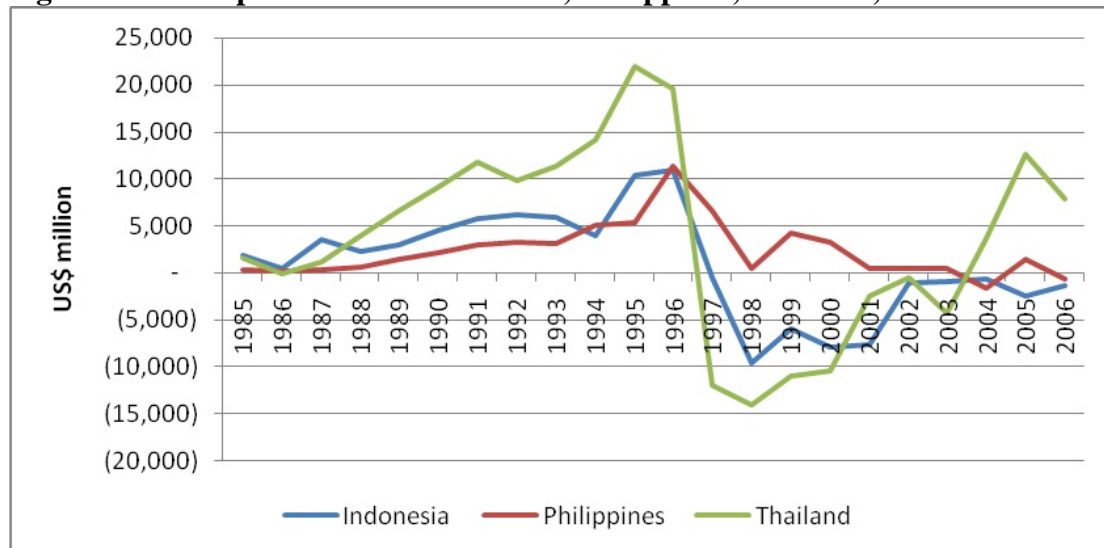
In the same year, Dr. Mahatir, then Prime Minister of Malaysia, proposed to form the East Asia Economic Group (“EAEG”) as a response to the burgeoning European Community and to the plan by the U.S., Canada and Mexico to form the North American Free Trade Agreement (NAFTA). However, the U.S. saw this group as a possible threat to the existence of APEC and their presence in East; hence it objected to the formation of such a group. Japan supported the U.S. position and the formation of EAES never took off (Asami, 2005:4).

Fast-forward thirty years after the formation of ASEAN, the region faced a whole new environment. The ASEAN region now including what were once communist or socialist states of Vietnam, Kampuchea and Laos, have been integrated into the liberalized and globalized world economy and were experiencing an economic boom, fuelled by rising trade and capital inflows. In fact, too much capital was flowing into the region that had only recently liberalized its economic and financial systems and much of the funds were misallocated and flowed into the equity and property markets and also into dubious investment projects (Lim, 2009:12). This was exacerbated by a pegged currency regime and poor supervisory and regulatory financial system; weaknesses that were exploited by speculative funds that broke the dyke when the Thai baht came under attack and crumbled. This set off a contagion effect throughout the rest of Southeast Asia and spreading to parts of Northeast Asia that became known as the Asian Financial Crisis (“AFC”).

## ASIAN FINANCIAL CRISIS TRIGGERED REGIONAL SELF-HELP COOPERATION

During the AFC the currencies of many of these countries depreciated, some by as much as 80% (Indonesia), the banking systems collapsed, non-performing loans rose to as high as 70% (Indonesia) and many banks had to be bailed out or shut down. Some economies shrunk by as much as 10%, many corporations defaulted and became bankrupt, and unemployment soared. Indonesia and Thailand, among the hardest hit, suffered output loss of about 40% of their GDP and the fiscal costs as percentage of GDP were 55% for Indonesia and 35% for Thailand (Caprio, et al., 2003). The net capital outflows from Southeast Asia were massive. See Figure 1. None of these economies could withstand such huge volatility and many tottered on the edge of bankruptcy.

**Figure 1: Net Capital Flows in Indonesia, Philippines, Thailand, 1985-2006**



Source: IMF, International Financial Statistics

## DEFENSIVE OBJECTIVES OF REGIONAL INTEGRATION

The AFC was the catalyst that ignited the call for Asian economic cooperation and integration. The first proposal for regional financial cooperation came from Japan at the G-7/IMF meeting in Hong Kong in September of 1997 where it proposed an Asian Monetary Fund to rescue the ailing economies and offered US\$ 30 million contribution to the five East Asian countries hit by the financial crisis, known as the Miyazawa Plan.<sup>1</sup> This idea was strongly opposed by the United States and the International Monetary Fund (“IMF”) who was already providing rescue packages to Thailand and Indonesia. Many countries were dissatisfied with the

<sup>1</sup> For more details on the Asian Monetary Fund, see Lipsky (2003).

stringent conditions imposed by the IMF rescue packages and in many cases the “cure” exacerbated the ailment.<sup>2</sup> For example, the raising of interest rates not only failed to stem the outflow of funds but pushed many indebted companies into bankruptcy. Dissatisfaction over management of the crisis prompted the Asian leaders to look for their own regional solutions.<sup>3</sup> The first ASEAN+3 meeting was held in December 1997 to explore further regional economic (trade) and financial cooperation.<sup>4</sup>

Thereafter many meetings, forums, groups and agencies were held and established to deal with the issues of greater regional cooperation and integration. For example, the ASEAN Surveillance Process (ASP) was created in February of 1998 during the 2<sup>nd</sup> ASEAN Finance Ministers’ Meeting to carry out peer review and exchange of information. Although the Executives’ Meeting of East Asia Pacific Central Banks (EMEAP) was set up in 1991, its first central banks’ governors’ meeting was only held in 1996 to study financial markets development and the primary functions of central banks (EMEAP Website). Its first important policy was the establishment of the Asian Bond Market Initiative that is discussed in the Section III. The ASEAN+3 Economic Review and Policy Dialogue (ERPD) was formed in 2001. The first meeting of the ERPD involved: assessing global, regional and national economic conditions; monitoring regional capital flows; analyzing macro-economic and financial risks; strengthening banking and financial systems; and providing an Asian voice in international financial forums (Yap, 2007: 13). In 2008, the Asian Financial Stability Dialogue (AFSD) was proposed by the President of the ADB as an early warning and surveillance system for the region’s financial markets (Plummer, 2010:17).

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<sup>2</sup> Malaysia abandoned the IMF advice in December 1997 and the Prime Minister, Dr. Mahatir, implemented his own counter-cyclical policies and capital controls (see Khor, 2011).

<sup>3</sup> Yap (2007:8) argued that “Because of the poor track record in reforming the IFA (international financial architecture), the only viable alternative ... is to reduce their dependence on the current IFA and develop their own regional financial architecture. This was the primary inspiration behind the euro and East Asia is seriously following suit.”

<sup>4</sup> By then ASEAN included ten countries; the original 5 plus Brunei, Kampuchea, Laos, Myanmar and Vietnam. The +3 countries are China, Japan and South Korea.

## **SECTION II**

### **ASIAN MONETARY INTEGRATION OR MONETARY COOPERATION/COORDINATION**

#### **INTRODUCTION**

In the period after the Asian Financial Crisis (AFC), there had been a sprouting of ideas and recommendations for more regional integration in the monetary sector for crisis prevention and reduction of volatilities caused by an unstable global environment. This section deals with issues on monetary integration and regional monetary cooperation. We distinguish regional monetary ‘integration’ from regional ‘cooperation’ or ‘coordination’, although the two of course are closely linked. ‘Integration’ would entail actual institutional integration such as use of the same currency (an Asian Currency or Monetary Unit ACU or AMU) or a strictly complied coordinated exchange rate mechanism for a grouping of countries in East Asia (such as the Exchange Rate Management (ERM) system in Europe from 1979 to the 1990s to be discussed below). Or integration can also involve the setting up of a regional Central Bank that has supervisory and regulatory functions on participating countries. These institutional arrangements would lead to some form of monetary union. Regional cooperation/ coordination, on the other hand, involves common or coordinated regional policies on capital controls, exchange rate arrangements and the setting up of regional funds to assist countries with international liquidity problems.

#### **IS THERE A NEED FOR MONETARY INTEGRATION?**

Is there a case for a regional monetary integration or union for the major countries in East Asia?

One important lesson from the Euro zone crisis is that monetary integration in the form of single currency and roughly uniform interest rate for a group of countries that is too diverse in terms of productivity, wages, trade competitiveness, income levels and trade balances, offer grave dangers especially for the poorer or peripheral economies. The current crisis faced by the European peripheral countries (especially Greece) sprung from detrimental wage and capital account policies implemented by the more developed country (Germany) combined with a worldwide financial crisis (see Akyuz (2011)).

A single currency and a close to uniform interest rate for the region, the lack of exchange rate independence, the lack of monetary and fiscal independence as well as the lack of possible debt workout arrangements for the peripheral countries only served to exacerbate their crises with disastrous consequences.

A paper by Capanelli and Filippini (2009), shows that compared to the EU as of 2007, the economies of ASEAN+3 (China, Korea and Japan) were more heterogeneous in terms of level of GDP and less integrated in terms of trade and investments. A recent paper by Park and Estrada (2010) argues that given the heterogeneity among ASEAN countries, it makes more sense to correct imbalances and detrimental policies of stronger countries and to consolidate the current level of coordinated policies than to broaden or deepen regional integration. The imbalances between exchange rate, inflation and wage policies between China and the other countries seem to be too similar to the current European Union situation to be comfortable going towards monetary union blindly without a careful analysis of the euro crisis.

Cavoli et al (2004) did a survey of literature, based on various measure of financial and monetary integration – such as covered and uncovered interest parity, savings-investment correlations, consumption correlations, and stock market movements. They concluded that East Asian economies are far from being financially integrated. The evidence shows that the more advanced economies – Japan, Hong Kong, Singapore, and Korea seem to be much more integrated financially with the global markets than the lower middle-level countries – Thailand, Indonesia and the Philippines. Malaysia and Taiwan show mixed results. The paper assumed the financial markets of Brunei, Cambodia, Laos, Myanmar and Vietnam to be more segmented and less integrated internationally or regionally. In recent years, though, Vietnam's financial markets had been developing fast and its stock market is getting larger investments from the international financial sector. The lack of financial and monetary integration in East Asia is also shown later in section 3.3 where most portfolio investments in East Asia are coming from outside the region. Although there has been an increase from 2001 to 2007 in the share of East Asian portfolio investments in the same region with Singapore leading the intra-region investments, the share of East Asian portfolio investments in its own region was less than one-third of the total in 2009. China, on the other hand had increased its financial integration more with developed countries than with the developing East Asian economies.

The only thing going for East Asia is the growing trade integration in the area. The East Asian region has become more integrated in the last three decades. Figure 2 gives us the breakdown of exports of major emerging East Asian countries (China, Hong Kong, Indonesia, South Korea, Malaysia, Philippines, Singapore and Thailand) derived from Kim et al (2010). If we do not include Japan as part of the regional East Asian grouping, 40.4% of the export from these eight economies goes to within the eight economies themselves. If Japan is added to the export destination of the eight economies, this goes up to 51.8%. This might be a strong indication of trade integration within the East Asian emerging economies. However, if we look closer at Figure 2, most of the trade is intra-regional trade on intermediate inputs. Only 22.2% of the exports of the eight economies go to the final demand of the eight economies. If Japan is added as part of East Asia, only around a-third of the eight economies' exports go to the final demand of East Asia. Two-thirds of the exports goods produced in the eight economies go to the final demand of the United States, European Union (EU) and the rest of the world.





exchange rate regimes versus those that keep significant controls in their capital account and exchange rate movements. This has resulted in strong real appreciation of the currencies of some countries in the region as well as possible financial bubbles beginning to emerge. The AFC started in exactly this fashion. In addition to this, the trade integration of the region especially with respect to intermediate inputs for exports requires a more stabilized, complementary and less overvalued set of exchange rates in the region especially now at a time of economic slowdown in world economies and world trade. Thus there is a common urgent need for most countries in East Asia to cooperate and coordinate policies in three areas: exchange rate regimes; capital flows; and provision of international liquidity for countries that need them during difficult times.

## **EXCHANGE RATE MECHANISMS**

### **The Asian Currency or Monetary Unit (ACU or AMU)**

Hardly any economist is calling for a move to a single currency system for East Asia in the short run. Even the most optimistic expert would recommend a long run and cautious move towards monetary union. However, the Asian Development Bank (ADB) has done considerable work in possible computations of an ACU or Asian Monetary Unit (AMU) made up of a weighted average of the currencies of the ASEAN+3 region. The uses of the ACU are clear:

- a. It acts as a benchmark for the currencies in East Asia and measures if a country is strong or weak versus the ACU. Using weights based on trade volume and GDP Purchasing Power Parity (PPP) of the countries in ASEAN+3, Ogawa and Shimizu (2011) came up with an Asian Monetary Unit. They then computed the AMU Deviation Indicators (AMU DI) for the currencies of each East Asian country from Jan. 2001 to June 2010. They recommend AMU DI to be a measure of whether a currency is overvalued or undervalued. This system is part of the surveillance system recommended as part of the Chiang Mai Initiative Multilateralization (CMIM) agreement.
- b. Huge AMU DIs can signal large capital inflows (if growing overvaluation is shown) or large capital outflows (if growing devaluation is shown). Although not explicit, the ACU or AMU and a currency's large deviation from the composite measure may signal a beggar-your-neighbor policy of the country under the surveillance mechanism.
- c. Ogawa and Shimzu (2011) also suggest the ACU or AMU can act as the peg for the East Asian currencies or part of the currencies determining the central parity for a managed float system. They showed that by pegging the ASEAN+3 countries' currency to the AMU, the nominal effective exchange rate was stabilized for all the countries.

## **EXCHANGE RATE COORDINATION**

A hard thing to achieve – but at least is being given serious attention to now by the ASEAN+3 countries and ADB -- is exchange rate coordination within the region.

Large swings in capital flows and differences in exchange rate regimes have been causing wild swings in exchange rates in the last two decades. It is urgent that these financial and exchange rate volatilities be tamed for they have caused serious damage to the economies in the region by bringing in capital inflows and currency appreciations during the ‘good’ years - 1993-1996, 2003-2007, and capital flight and currency depreciation during the ‘bad’ years - 1997-98, 2008 to second half of 2009.

The difficulties in coming up with regional cooperation and coordination with the exchange rate regimes of ASEAN+3 are: (1) the exchange rate regimes of the countries are quite heterogeneous ranging from a currency board (fixed exchange rate regime) in Hong Kong to strongly managed floats in China, Malaysia and Taiwan to moderately managed floats in Thailand and Singapore to almost free floating regimes in Korea, Japan, Indonesia and the Philippines; (2) it is hard to tame exchange rates (even managed floats) if capital accounts are relatively open and large swings in short term capital flows abound; (3) to tame the exchange rates of the region from large volatilities during crises periods, a sort of Asian Monetary Fund is needed to provide quick and timely international liquidity to countries under speculative attacks. Thus, part and parcel of exchange rate coordination should be capital control policies and a regional international liquidity fund, which we take up in the next sections.

Table 1 gives us the coefficient of variation<sup>5</sup> of the real effective exchange rates (REER) of the ASEAN5+3 countries plus Hong Kong and Taiwan using the broad indices of the Bank of International Settlement (BIS). The period covers monthly data from Jan. 1994 to Feb. 2012 in the third column and Jan 2000 to Feb. 2012 in the fourth column.

**Table 1: Coefficient of Variation of East Asian Countries: 2010=100**

	Exchange Rate Regime	Jan 1994- Feb 2012	Jan 2000 - Feb 2012
China	Managed float	0.0981	0.0734
Malaysia	Managed float	0.0935	0.0364
Singapore	Managed float	0.0562	0.0493
Thailand	Managed float	0.0990	0.0702
Taiwan	Managed float	0.1181	0.0962
Japan	Free float	0.1366	0.1124
Indonesia	Free float	0.1859	0.1212
Korea	Free float	0.1196	0.1120
Philippines	Free float	0.1141	0.1082
Hong Kong SAR	Currency Board	0.1505	0.1400

Source: Calculated from BIS Broad Indices of Effective Exchange Rate Indices  
<http://www.bis.org/statistics/eer/index.htm>

<sup>5</sup> Coefficient of variation is defined as the standard deviation as a ratio to the mean.

In general, countries with more managed floats (Malaysia, China, Singapore, Thailand, Taiwan) have less volatility than free-floating ones (Indonesia, Korea, the Philippines and Japan) or with fixed exchange rate regimes (Hong Kong). Since they possess large international reserves, these countries should opt for more tightly managed and coordinated floats to prevent wild volatilities in their exchange rate detrimental to their countries and/or their neighbors.

Table 2 gives us the REER of the countries in February of critical years before, during and after the global financial crisis (2001, 2007, 2008, 2009, 2012). The base year is 2010.

The boom in the mid-2000s had differential effects on the Asian economies. China, Hong Kong, Singapore and Taiwan managed to weaken their currencies between 2001 to 2007. Japan also found its currency weakened during this period because of the carry trades.

But the emerging markets – Korea, Thailand, Indonesia and the Philippines -- saw strong capital inflows which significantly strengthened their currencies from 2001 to 2007. Only Malaysia managed to keep its exchange rate stable and slightly weakened. Meanwhile the euro strengthened significantly during this period while the US dollar weakened as the current and fiscal deficits of the US widened.

Table 2 also shows the effects of the global crisis as reflected in the movements of the REERs from Feb. 2007 to Feb. 2009 (the latter date is somewhere near the worst of the global financial crisis), and from Feb. 2009 to Feb. 2012 as Asia (except Japan) recovered from the global recession. The currencies of China and Hong Kong strengthened as China's economic performance outshined everybody else's. The Japanese yen and US dollar also strengthened due to the reversal of the carry trades and a flight to safe havens (dollar, yen and gold) ensued. The emerging markets of Korea, Indonesia, Philippines, Thailand and Malaysia saw their currencies weakened as short-term capital flowed out from these economies because of the global crisis. Korea and Indonesia were especially hit by currency depreciation and Korea had to seek bilateral swaps from the US, China and Japan (see discussion under the Chiang Mai Initiative).

**Table 2: Real Effective Exchange Rate from Feb. 2007 to Feb 2012 (2010=100)**

	Type of Economy	Economic Situation	Feb 2001	Feb 2007	Feb 2008	Feb 2009	Feb 2012
China	Global power	Strong economy	96.87	89.66	94.87	107.29	107.92
Japan	Global power	Hit dby strong recession	116.62	83.19	84.13	105.48	101.37
Hong Kong	Developed economy	Hit by recession-recovery	140.63	106.92	100.36	108.51	100.14
Singapore	Developed economy	Hit by recession-recovery	99.58	91.28	94.59	97.35	107.66
Taiwan	Developed economy	Hit by recession-recovery	129.60	108.04	103.54	97.74	97.84
Korea	Developed economy/emerging market	Hit by recession-recovery	101.82	131.68	118.83	83.60	99.04
Malaysia	Emerging market	Hit by recession-recovery	101.40	99.85	98.80	96.19	101.62
Thailand	Emerging market	Hit by recession-recovery	85.50	95.97	98.25	94.79	97.04
Indonesia	Emerging market	Hit by recession-recovery	66.94	98.02	90.23	79.96	98.44
Philippines	Emerging market	Hit by recession-recovery	84.63	91.80	103.02	99.01	102.49
Euro area	Global power	Hit by strong recession/ debt crisis	88.35	104.49	107.47	106.22	95.04
United States	Global power	Hit by strong recession	123.84	108.37	98.3	110.05	95.53

Source: BIS Broad Indices of Effective Exchange Rate Indices <http://www.bis.org/statistics/eer/index.htm>

As recovery occurs in the current period, strong capital inflows are again pouring into Korea, Malaysia, Indonesia, the Philippines, Thailand and even Singapore, leading to strong currency appreciations in these countries. Meanwhile the euro and US dollar are weakening due to the debt crisis in Europe and the weak economy and very low interest rates in the US.

The above story shows the strong volatilities of the exchange rates and capital flows in a setting of very liberalized capital accounts. Only China, Hong Kong and Taiwan seem to be able to avoid strong appreciation of their currencies in the current period.

### **BASKET, BAND, CRAWL (BBC)**

Akyuz (2009) suggests learning from the European countries' experimentation with the Exchange Rate Mechanism (ERM) and 'snake in the tunnel' system wherein exchange rates, before the adoption of the euro, were anchored on the deutschmark and allowed to move in a narrow band of  $\pm 2.25\%$  of the central parity and loosening the band when the currency is under attack or when faced with international reserves difficulties. He also argues for a BBC system – a basket parity, a band and a crawl in the exchange rate basket peg with the band being relatively narrow. BBC is also recommended by Azis and Puttanapong (2008). Kenen and Meade (2008) seem to espouse a similar basket peg but a more floating exchange rate regime with a wide band around the basket central parity and less interventions<sup>6</sup>. BBC calls for the central parity of a managed float to be a basket of external currencies (the dollar, the euro and the yen, ideally the renminbi too, but the latter is not yet internationally convertible) instead of the current system where most East Asian countries use only the dollar as a peg or central parity. The managed float will involve a band on the central parity of the currency peg (with the countries free to assign different weights to the basket based on their trade pattern). To avoid speculative attacks, the system allows the authorities to devalue or revalue the central parity – the crawling peg system.

Ogawa and Shimzu (2011) recommend that an internal basket of currencies of ASEAN+3 (as in the AMU) be also used as an anchor. But it is not clear how this will be operational since most of the currencies in ASEAN+3 are not internationally convertible.

The idea of BBC is each country will be free to assign weights to the currencies in the external (and, if feasible, internal) basket. Hong Kong will be allowed to retain its currency board, except that the peg will be with the commonly agreed basket of international currencies.

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<sup>6</sup> Kenen and Meade (2008) argues that more uncertainty of the exchange rate movement will be healthy to prevent speculative attacks.

## CAPITAL FLOWS AND COORDINATED POLICIES ON CAPITAL CONTROLS

Another area where Asian cooperation is lacking, but where certain discussions are starting to take place, is in the area of capital controls. With the volatile capital inflows and outflows destabilizing recipient economies, East Asian economies should come up with coordinated policies on capital controls, instead of the unnecessary building up of huge international reserves to stave off freefalls of currency and the depletion of reserves. The need for capital controls on ‘hot money’ – short-term portfolio flows and short-term foreign debts -- stems from: a) during irrational exuberance period, the large short-term capital inflows bring about dangers of asset bubbles, over-lending and overheating of the economy, large and harmful appreciation of the currencies, and dangers of currency and term mismatches; b) During the panic period, they lead to massive outflows that lead to large devaluations, the bursting of speculative bubbles (in the stock and property markets), losses of confidence, foreign exchange reserves losses and may lead financial crises and recessions.

## DIFFERENT MECHANISMS OF CAPITAL CONTROLS

In a landmark paper by Ostry et al (2011), the IMF gave the first hint of a ‘go’ signal for emerging markets to undertake capital controls. But their aversion to capital controls re-emerge with the important clause ‘but with caution and temporary’, as are clear in the following statements:

“[Capital controls may be useful in addressing both macroeconomic and financial stability concerns in the face of inflow surges, but before imposing capital controls, countries need first to exhaust their macroeconomic-cum-exchange-rate policy options.”

“[T]he design of capital controls needs to be tailored to country circumstances. Where inflows raise macro concerns, controls will need to be broad, usually price-based, and temporary (though institutional arrangements to implement controls could be maintained). To address financial-stability concerns, controls could be targeted on the riskiest flows, might include administrative measures, and could be used even against more persistent inflows.” (Ostry et al (2011), p. 4.

The paper came as emerging economies all over the world struggled to impose capital controls on and off due to large portfolio inflows that appreciated their currencies starting late 2009. An important event was on 18 December 2006 when Thailand imposed an unremunerated reserve requirement (URR) on foreign inflows. “All foreign transactions, except those related to trade in goods and services, repatriation of investment abroad by residents and FDI, were required to deposit 30% of foreign exchange with [Bank of Thailand] BOT as an unremunerated reserve requirement (URR). 30% of capital will be refunded after funds have remained within Thailand for a period of one year. If funds are repatriated before one year, only two-third of the amount will be refunded.” (Jongwanich (2011)). This led to a stock

market collapse, forcing the Monetary Authorities to exempt the stock market from the rule. The URR requirement on other foreign investments was slowly removed starting in 2007. Now, the main capital control measures of Thailand are prudential regulations on foreign borrowings by banks and rules and regulations limiting financial institutions from borrowing baht or providing baht to non-residents. Like most East Asian economies suffering strong appreciation in recent periods, rules on foreign exchange outflows by residents and non-residents are being relaxed to offset the massive inflows of capital. Malaysia's main capital control now (outside prudential regulation) is a 10% exit tax on the profits of foreign investments. Indonesia and the Philippines hardly have any effective capital controls outside prudential regulations. Korea just imposed stronger prudential regulation to limit short-term foreign borrowing by financial institutions.

The AFC did lead to significant capital controls on flows going through banks and other financial institutions in the form of stronger prudential regulation and supervision of foreign exchange flows through the banking system.

Some of the prudential rules practiced in East Asia that comprise capital controls are:

- a) Limits or higher capital requirements on loans to unhedged foreign borrowings
- b) Ceilings on foreign derivatives positions
- c) Limits and regulation on short-term foreign debt
- d) Limits on aggregate foreign exchange liabilities
- e) Loan-to-value (LTV) limits on property loans

For capital flows that do not go through financial institutions, capital control measures are more relevant. Portfolio investments by foreigners in equity and debt markets are the biggest components of hot money contributing to strong currency appreciation and asset inflation in many East Asian economies. Among the emerging economies in the world, emerging Asia is absorbing a significant portion in the 2000s (Park and Lee (2011))<sup>7</sup>. Broad-based capital controls to avoid the asset price bubbles include strong measures like the unremunerated reserve requirements or a sizeable 'Chilean' tax.

## **CAPITAL CONTROLS MORE EFFECTIVE ON COORDINATED BASIS**

In July 2011, the ADB sponsored a study of capital controls in Indonesia, Korea, Malaysia and Thailand. The results of the workshop reiterated the Ostry line of possible benefits of capital controls but cautioned using drastic measures as a last resort. Using VAR analysis, Gochoco-Bautista et al (2010) and Jongwanich et al (2011) showed the limited impact of capital controls in Malaysia and Thailand (and more impact due to prudential regulation), and instead proposed liberalizing capital

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<sup>7</sup> Emerging Asia in Park and Lee (2011) paper includes the People's Republic of China; Hong Kong, China; India; Indonesia; the Republic of Korea; Malaysia, the Philippines; Singapore; Taipei, China; Thailand; and Viet Nam.

outflows as being more effective in countering huge capital inflows. However, Akyuz (2009) pointed out liberalizing capital outflows is risky as the policy cannot be reversed instantaneously during periods of panics and massive capital outflows. Also the country has little leverage over capital that has been invested abroad.

VAR analyses are being used without a theory or conceptual framework. The lack of effectiveness of capital controls measures such as URR or the Chilean tax (these include forcing heavy taxation on funds exiting the country in less than a year) is because countries are acting individually and the markets can punish them and so they reverse their policies as was the case in Thailand in 2006.

Similarly, the results of capital controls could have been different if, say, all ASEAN+3 members undertake the same URR policy on portfolio inflows. Since East Asia is the brightest growth area in the world, a coordinated action may not lead to immediate massive outflows from the region. Of course, a better scenario is if all emerging economies agree to impose the same URR on portfolio inflows. But these scenarios are difficult to achieve because of the lack of political will and the reluctance of many countries to limit large inflows of foreign exchange during the 'good' times. Coordination among emerging countries will have to be achieved through strong actions in key institutions such as the UN Department of Economic and Social Affairs (UN DESA), UNCTAD, UNDP, the South Centre and strong leadership from the developing world such as from BRICS (Brazil, Russia, India, China, South Africa).

### **THE CHIANG MAI INITIATIVE MULTILATERALIZATION (CMIM) AGREEMENT**

Perhaps the most hyped-up regional monetary coordination and cooperation for ASEAN+3 is the Chiang Mai Initiative (CMI) that has undergone many changes since it was started in 2000. Most countries in the region had been frustrated after the AFC that there was a lack of initiative to set up a regional fund to prevent another similar crisis.

In May 2000 on the sideline of the Asian Development Bank (ADB) annual general meeting in Chiang Mai, Thailand, Asian leaders agreed to set up bilateral currency swap arrangements among East Asian countries to assist countries that face liquidity crisis. The CMI replaced the idea of the Asian Monetary Fund and the purpose was to "establish a regional financing arrangement to supplement the existing international facilities" (Sussangkarn, 2010:5). This had two components, the ASEAN Swap Arrangement, ("ASA") and the new Bilateral Swap Arrangements ("BSA").

The ASA was set up in 1997 as a short-term liquidity support for member countries facing balance of payment difficulties. The initial size of the facility was only US\$ 100 million and it was never used even during the AFC. The ASA facility was increased to US\$ 1 billion in 2005. The BSA is a new facility available to countries with temporary international liquidity problems in the form of swap of US dollars with the domestic currencies of the borrowing countries in the form of repurchase agreement. The two countries will, after a pre-determined period, return



the original amount of the currencies they swapped with to each other. There was a stipulation in the BSAs that 10% of the agreed amount could be utilized without any linkage to an IMF program for 180 days. The rest can be used only under a current or impending IMF program.

By April 2009, there had been a total of \$90 billion BSAs among the ASEAN+3 economies. The individual bilateral swaps are not big; the biggest would be the currency swap arrangements between Japan and Korea (\$21 billion) and between China and Korea (\$8 billion). Despite the availability of these swap lines, Korea did not use them but obtained a \$30 billion swap line from the US Fed during the recent global financial crisis.

In May 2007, the ASEAN+3 Finance Ministers' Meeting in Kyoto, Japan led to an agreement in principle to convert the BSAs of the CMI into a multi-lateralized self-managed reserves pool governed by a single contractual agreement. Thus was born the idea of the Chiang Mai Initiative Multi-lateralization (CMIM) Agreement. There was little progress until May 2009 when the 12<sup>th</sup> ASEAN+3 Finance Ministers' Meeting in Bali, Indonesia finalized the CMIM arrangement. The Chiang Mai Initiative Multi-lateralization (CMIM) Agreement was signed on 28 December 2009 and took effect on 24 March 2010.

Table 3 shows the contribution of each country to the total pool of funds of CMIM. It also gives the borrowing multipliers. The product of the borrowing multiplier and the country's contribution gives the maximum borrowing of the country. The committed pool of CMIM funds totaled \$120 billion.

**Table 3: CMIM Country Contributions and Borrowing Multipliers**

<b>Country</b>	<b>Contribution (US\$ Billion)</b>	<b>Borrowing Multiplier</b>
Brunei	0.01	5
Cambodia	0.12	5
PRC	34.20	0.5
Hong Kong	4.20	2.5*
Indonesia	4.77	2.5
Japan	38.4	0.5
Korea	19.2	1
Lao PDR	0.03	5
Malaysia	4.77	2.5
Myanmar	0.06	5
Philippines	3.68	2.5
Singapore	4.77	2.5
Thailand	4.77	2.5
Vietnam	1.00	5

\* Hong Kong, China's borrowing is limited to IMF delinked portion because Hong Kong, China is not a member of IMF.

Source: Sussangkarn (2010), p. 9.

The smaller and lower-income countries can borrow up to five times their contribution; the original ASEAN-5 countries can borrow 2.5 times their contribution. Korea can borrow the same amount as its contribution while China and Japan can borrow only half their contribution. Only borrow 20% of their borrowing quota is not subject to IMF conditionality. The rest can be accessed only if the country has or is negotiating an IMF program. Fundamental issues such as review of size of contributions and borrowing multipliers, re-admission rules, expansion of membership and terms of lending will be decided through consensus of the members of the participating countries while lending issues – approving a loan, renewal of loan and default – will be decided by a majority vote.

So far no country has applied for a CMIM funding. This is partly because the initiative was very recent and no country has faced international liquidity problem since mid-2010. In 2009 Korea ran to the US, China and Japan for bilateral swaps when it faced sharp capital outflows partly because the CMIM was not finalized and formalized yet; but most likely, it also shunned the CMIM because of the IMF requirement clause. Singapore was also given a bilateral swap line by the US Fed, together with Korea and Mexico, but actually did not need it. It was just a show by the US Fed that it would support key allies if need be.

But there are basic problems with the CMIM arrangement. First, even though it's a multi-lateralized swap arrangement, what has been multi-lateralized is the process not the facility. In other words, because it is a self-managed pool of reserves, each country reserves the right not to contribute to the specific request of the requesting countries.<sup>8</sup> Second, the amounts that the countries can access are too small, given their contributions. The original idea was that the relatively small amount a country can access from CMIM can be supplemented, once a CMIM loan is approved, as the country can get easier access to funds with the other member countries through bilateral currency swaps. Third, only 20% of the facility requested is free of IMF conditionalities; the remaining facility that is drawn is subject to the usual IMF conditionalities. With the large international reserves of ASEAN5+3, the CMIM agreement, as it is now, is inadequate and far from being the Asian Monetary Fund envisioned during the Asian Financial Crisis.<sup>9</sup>

It is urgent that the CMIM be de-linked from the IMF program because there should be no pro-cyclical conditionalities that the IMF is fond of imposing. Japan is the one fighting to retain the IMF link while China is tacitly acceding to this too. Other countries, such as Malaysia, Thailand and Indonesia, are not so enthusiastic or are actively opposing the IMF link. With such restrictive conditions, countries would prefer to just enter bilateral currency swap arrangements with East Asian or other countries outside the Chiang Mai Initiative.

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<sup>8</sup> Interview with Wei Benhua, the first Director of ASEAN+3 Macroeconomic Research Office (AMRO).

<sup>9</sup> After the completion this paper, the latest development in May 2012 saw the CMIM swap facilities double to \$240 billion, the portion of swap lines not subjected to IMF conditionalities raised progressively to 30% in 2013 and 40% in 2014.

The need to link the CMIM swap arrangements with IMF should be lessened with the setting up of the ASEAN+3 Macroeconomic Research Office (AMRO), which is the surveillance unit of CMIM, officially established in May 2011 and based in Singapore. The two main functions of AMRO are: (i) to conduct and analyze the basic economic and financial conditions of all the member countries and consolidate them into a regional economic report focusing on risks and vulnerability of the countries especially in the financial sector;<sup>10</sup> (ii) to be the secretariat for the reserve pool of CMIM liquidity funds. AMRO is tasked to assist in setting up the covenants for the usage of the funds.

It is important that this office be given the resources and technical personnel that can ensure borrowing countries are properly using the funds. This will hasten the de-linking of the CMIM from an IMF program. Conditionalities for the CMIM international liquidity fund should be much flexible than IMF programs – ensuring no wastage or misuse of the funds, no beggar-your-neighbor policies and ensuring the countries have adequate space for counter-cyclical policies. The other regional monetary cooperation and coordination recommendations in this paper are consistent with this approach.

#### **COSTS OF NOT HAVING REGIONAL COOPERATION ON EXCHANGE RATE COORDINATION, CAPITAL CONTROLS AND AN ASIAN MONETARY FUND**

Table 4 shows the enormous build up of foreign exchange reserves by East Asian countries after the AFC. For the region as a whole, the reserves rose 10 times from \$596 billion (1995) to \$5.5 trillion (2010). Philippines has the smallest amount (\$62 billion) and China the largest (\$2.9 trillion). Why the huge increase and what are the costs?

**Table 4: International Reserves of Major East Asian Countries**

	1995	1995	2000	2000	2005	2005	2010	2010
	US\$ Billion	Import Coverage	US\$ Billion	Import Coverage	US\$ Billion	Import Coverage	US\$ Billion	Import Coverage
China	76	8.3	168.9	9.4	825.6	15.8	2,875.9	26.0
Hong Kong	55.4	N.A	107.6	6.1	124.3	5.0	268.7	7.4
Taiwan	95.9	11.5	111.4	9.7	258	17.3	387.2	18.8
Korea	32.7	3.0	96.2	7.2	210.4	9.8	291.6	8.3
Japan	184.5	7.5	356	12.4	835.5	21.1	1,062.8	20.0
Indonesia	14.8	4.3	29.3	8.7	34.7	6.0	96.2	9.1
Malaysia	23.9	4.0	28.6	4.4	70.2	7.8	106.5	8.2
Philippines	7.8	3.6	15.1	4.2	18.5	4.6	62.4	12.3
Singapore	68.8	6.7	80.2	6.9	116.2	7.1	225.7	8.7
Thailand	36.9	6.3	32.7	6.3	52.1	5.3	172.1	11.5
<b>Total</b>	<b>596.8</b>		<b>1,025.8</b>		<b>2,545.3</b>		<b>5,549.1</b>	

Source: ADB Key Indicators, 2011

<sup>10</sup> Hong Kong was added as a member of CMIM and hence there are 14 members in CMIM; ASEAN+3 plus Hong Kong.

The East Asian economies recovered from the AFC on the back of exports to the U.S. and Europe particularly after the recovery from the dotcom bubble. The current account surpluses (earned reserves) formed the bulk of foreign reserves of most of these countries; though part of the reserves also came from capital inflows (borrowed reserves). Beyond this surge in exports, the desire and need to insure against potential speculative currency attacks also spurred the accumulation of reserves. In fact, the amount of reserves of these East Asian countries far exceeds the 3 to 4 months of import coverage that is conventionally held to be acceptable. See Table 4. A better measure of ability of countries to protect against speculative currency attacks would be the ratio of reserves to short-term foreign debt. Even using this measure, all the East Asian countries have reserves more than twice their short-term foreign debt, except for Hong Kong, Singapore and Japan. See Table 4A. These three countries are financial centers with strong fundamentals and do not need strong reserves to cover short-term debt as most of these are transitory debt that are not really owed by them.

**Table 4A: International Reserves to Short Term Debt Ratio**

	1995	1996	1997	1998	1999	2000	2005	2008	2009	2010
China	3.41	4.24	4.56	8.64	10.43	12.91	5.57	10.44	10.09	
Hong Kong	6.1	4.5	9.0	0.4	0.6	0.9	0.4	0.4	0.5	0.4
Taiwan	4.91	4.98	3.98	5.25	3.53	4.24	3.50	3.76	5.18	
Korea	0.60	0.45	0.32	1.31	1.72	1.94	3.19	1.34	1.81	2.16
Japan							0.82	0.71	0.75	0.59
Indonesia	0.57	0.60	0.53	1.17	1.36	1.35	3.84	2.71	3.54	
Malaysia	2.45	1.40	3.03	5.10	6.26	4.42	6.98	4.08		
Philippines	1.48	1.48	0.74	1.85	3.04	2.74	2.89	5.36	11.06	
Singapore	55.01					1.18	1.40		0.37	
Thailand	0.84	0.81	0.71	1.00	1.49	2.19	3.25	4.58	4.96	

Source: ADB Key Indicators 2011

But the accumulation of international reserves comes at a great cost to these countries. These foreign exchange holdings or assets are earning very little, since they are placed in low-yielding US Treasury notes (at almost zero real interest rate). But their foreign exchange liabilities (foreign commercial debts, equity and bond portfolios owned by foreigners, foreign direct investments) are yielding high returns for the foreign investors. Thus there is a net transfer of income from these countries mainly to the US, European and Japanese foreign investors. Akyuz (2008:25-27) estimated the annual cost at US\$ 50 billion yearly, and Yu (2011) estimates that the average return on foreign direct investments in China is 33% but China's investments in U.S. government securities was 3% - 4%, not counting losses from currency depreciation.

But perhaps more importantly, part of the increases in international reserves comes from the current account – or the gap between savings and investments. For

many of these countries, the gap is positive not because of high or rising savings, but more due to low or declining investments. This is shown in Table 5 where only China, Indonesia and the Philippines saw national savings as percentage of GNP grow over time. The positive savings-investment gap for most countries was caused more by the significant drop in the investment rate after the AFC. A strong exception to this is China whose investments are growing and unprecedentedly high because of its high savings. Another exception is Indonesia, but Indonesia's investments declined after the Asian crisis and only went back to the 1995 level in the last two years<sup>11</sup>. Thus the East Asian countries are under-investing on productive capital and infrastructure. The effect on productive capacity and productivity over time will be substantial, which means that they should be experiencing higher growth now and in the future if they just accumulate less international reserves and place their savings resources more into productive capital.

**Table 5: Gross National Savings and Gross Investments (Domestic Capital Formation) and Savings-Investment Gap, as % of GNP**

	1995	2000	2005	2006	2007	2008	2009	2010
<b>China</b>								
Gross National Savings	38.6	37.2	46.7	48.2	50.9	51.8	51.1	53.3
Gross Domestic Capital Formation	42.6	35.6	41.9	42.7	41.4	43.7	48.2	47.9
S-I	-4.0	1.7	4.8	5.5	9.5	8.1	3.0	5.4
<b>Korea</b>								
Gross National Savings	36.2	32.9	32.3	31.1	31.0	30.5	30.2	32.2
Gross Domestic Capital Formation	37.1	30.7	29.7	29.6	29.4	31.0	26.2	29.1
S-I	-0.8	2.2	2.6	1.6	1.7	-0.5	4.1	3.0
<b>Japan</b>								
Gross National Savings	30.3	27.8	26.7	27.1	27.8	26.2	22.6	23.4
Gross Domestic Capital Formation	28.1	25.1	23.0	23.1	22.9	22.8	19.7	19.7
S-I	2.2	2.7	3.7	4.0	4.9	3.4	3.0	3.7
<b>Indonesia</b>								
Gross National Savings	28.5	27.7	25.2	27.1	25.7	26.8	30.7	32.2
Gross Domestic Capital Formation	32.9	23.6	25.9	26.0	25.8	29.5	31.4	33.5
S-I	-4.4	4.1	-0.7	1.2	-0.1	-2.6	-0.7	-1.2
<b>Malaysia</b>								
Gross National Savings	36.8	41.3	40.1	41.3	40.9	40.6	34.6	37.0
Gross Domestic Capital Formation	45.8	29.2	20.9	21.1	22.0	19.9	14.8	22.2
S-I	-9.0	12.1	19.1	20.2	18.8	20.7	19.8	14.9

<sup>11</sup> Also Indonesia is accumulating its international reserves, not from the current account, but from the capital account.

**Philippines**

Gross National Savings	16.8	28.7	33.3	33.4	33.9	34.3	36.3	39.0
Gross Domestic Capital Formation	21.8	15.2	16.7	14.0	13.5	15.0	12.2	15.1
S-I	-5.0	13.4	16.5	19.4	20.4	19.4	24.1	23.9

**Singapore**

Gross National Savings	50.5	50.5	45.6	49.3	52.1	47.2	47.9	49.5
Gross Domestic Capital Formation	33.1	33.1	21.5	21.8	21.8	31.6	27.0	24.7
S-I	17.5	17.5	24.1	27.5	30.3	15.6	20.9	24.8

**Thailand**

Gross National Savings	35.9	31.5	27.3	29.5	31.9	30.1	28.6	30.4
Gross Domestic Capital Formation	42.8	23.2	33.0	29.5	27.4	30.2	22.1	27.2
S-I	-6.9	8.3	-5.7	0.0	4.5	-0.1	6.5	3.2

Source: Calculated from ADB Key Indicators, 2011.

## **SUMMARY AND THE POLITICAL ECONOMY OF REGIONAL MONETARY COOPERATION IN EAST ASIA**

To summarize, initiatives towards regional monetary cooperation in East Asia is still in a very primitive stage and is facing a quandary given the euro crisis. Centered on initiatives coming from ADB, a lot of effort is being placed in the Asian Currency or Monetary Unit (ACU or AMU). On the recommendations towards exchange rate coordination, the initiatives of moving from the dollar peg to a basket peg in exchange rate coordination initiatives is a proper one. The next struggle is to muster the political will to consider tighter bands around a basket peg of external convertible currencies and allowing crawling pegs on this external basket (the BBC regime).

The CMIM at least got the East Asian countries to commit their resources in a common pool of funds, but it also is not really operational yet. The limited amount a country can borrow and the link of 80% of the borrowing quota to an IMF program makes the facility inferior to a set of bilateral currency swaps de-linked from any IMF program. The setting up and strengthening of AMRO should provide an alternative surveillance mechanism for the CMIM with conditionalities that are more borrower-friendly and counter-cyclical in nature.

There is currently a tug of war between Japan and China on who will be the leader of the regional monetary cooperation initiatives in East Asia. Japan initiated the ACU/ AMU concept, the rise of renminbi as a major regional currency in the future may tilt the balance towards China. Many experts believe that the renminbi may become a convertible currency by 2016, especially since China has undertaken currency swap agreements swapping the renminbi with the currency of the borrowing country. This will then dominate the yen in terms of regional currencies. This is the

most likely reason China scored a victory in May 2011 when, through a suggestion by Malaysian Deputy Finance Minister Lim Siang Chai, Wei Benhua, the former vice-head of China's State Administration of Foreign Exchange, was made the first director of the Singapore based AMRO, which will be the regional financial surveillance body of CMIM. The choice of a Chinese, instead of a Japanese, to be the first head of AMRO shows the balance tilting towards China. China, which was quiet before about an Asian Monetary Unit, suddenly became interested when a high-level group for the ASEAN+3 Research Group surveyed about 1,000 government officials, academics and bankers in the ASEAN+3 countries and found overwhelming backing of creating a regional currency unit to support regional surveillance, although using it as the single currency for the region is still a very long-run prospect. The study recommended the weights used in the regional currency unit to be close to the contribution weight of countries in the CMIM. This will give equal weights to the renminbi and yen. The study also recommended AMRO to be the one to administer this regional currency unit since it is the surveillance unit for CMIM. Since the first director of AMRO is Chinese, this may give the Chinese a temporary edge in the leadership of regional monetary cooperation in East Asia. However, the current agreement is that the head of AMRO would alternate between someone from China and someone from Japan. This means the next director of AMRO next year would be Japanese.

The CMIM is seen as a real ASEAN+3 multi-country initiative but the linking to an IMF program makes the Japanese stand more dominant. Stung by the US rejection of Japan's recommendation of an Asian Monetary Fund during the Asian financial crisis, Japan is making sure CMIM will be approved by the US and the IMF by linking the bulk of the funds to IMF programs. China also tacitly approves the IMF link since it wants a leadership role in the IMF and so did not oppose the linking of IMF programs to the CMIM. Unless the IMF democratizes its powers to developing countries and changes its pro-cyclical and orthodox policies, this reduces the importance and potential effectiveness of the CMIM. There is now a need for a stronger voice given to the ASEAN countries, given the leading roles being played by ADB, China and Japan. More analyses and inputs from the ASEAN countries and Korea would provide a richer variety of possibilities and options aside from the current ones provided by the ADB, China and Japan.

### SECTION III

#### ASIAN EFFORTS AT FINANCIAL INTEGRATION

##### DEVELOPMENTAL OBJECTIVES OF FINANCIAL INTEGRATION

It may be said that the main objective of the CMIM is defensive – to establish a mechanism to provide assistance to countries that face liquidity crisis. In this process, countries should set up surveillance capability to monitor economies for early warning signs of imbalances and to provide the assistance when needed. The objective of financial integration can be seen as more developmental, i.e., how to develop and deepen the financial markets in order to: (a) diversify the financial markets from dependence on the banking sector; (b) minimize or avoid the problems of currency and maturity mismatch arising from short-term loans in the banking sector; (c) recycle the huge amount of foreign surplus from surplus countries in Asia to the deficit countries in the region.

Among the causes of the AFC, a poorly regulated and supervised banking sector was identified as a major factor. After the banking and financial system was liberalized beginning in the 1970s, banks and finance companies began to mushroom in many of these countries, particularly in Indonesia and Thailand. For example, in Indonesia the number of banks doubled in nine years (1988-1997) from 124 to 238; and banking assets to GDP almost quadrupled from 35% to 114% between 1985 and 1997 (Lim, 2009:12). Despite the rhetoric of prudential regulation and better supervision, the reality was far from theory. The problem was aggravated by liberalization of capital flows in these economies. As yields were dismal in the advanced economies, much of international liquidity poured into East Asia seeking for higher yields.

Of the capital flows in the 1970s, other investments, namely bank loans and deposits, figured prominently. During this period, bank syndicated loans were the favorite vehicle for bank lending. Bank assets grew much faster than GDP growth. The problem was compounded by international lending that was both short-term and denominated in foreign currency resulting in the problem of double mismatch, i.e., maturity and currency mismatch. Most of the foreign borrowings in Asia were private rather than public. The practice of pegged or semi-pegged currency system encouraged currency mismatch. Local financial institutions and companies borrowed short-term in US dollar at low interest rates and then lent or invested in local currency projects that had higher yields betting that the currencies will not depreciate. While the going was good, these borrowers reaped substantial profits. But when the crisis broke out, they suffered a double whammy. Not only did funding dry up, the value of their existing loans ballooned from massive local currency depreciation. This led to large-scale defaults and bankruptcies of both financial institutions and corporations.

Compared to the banking sector, the bond markets in these countries, particularly the corporate bond markets, were miniscule. Hence, economists and policy makers started to call for financial sector reforms and development, in



particular promoting the idea of developing and deepening local currency bond markets as a solution to the double mismatch problem, and also as a means to recycle growing regional foreign currency reserves in Asia (Park and Park, 2003). This was also strongly promoted by the ADB.

By 2003, Asian countries had recovered from the ravages of the AFC. Among the lessons learned was the need to strengthen its macro-economic fundamentals including its balance of payment. Hence many countries began to export, helping turn around their current account deficits into surpluses, and accumulating large amount of foreign reserves as a means to insure against future speculative currency attacks.

### **ASIAN BOND MARKET INITIATIVES**

The ASEAN+3 Finance Ministers meeting in 2003 endorsed the Asian Bond Markets Initiative (ABMI) aimed at promoting liquid and efficient bond markets to mobilize Asian savings for Asian investments. Under the ABMI, the ADB has taken a primary role in providing technical studies and in supporting the establishment of regional credit guarantee mechanism, regional clearing and settlement system, introducing new securitized debt instruments, and improving local and possibly regional credit rating systems (Yap, 2007:15). An Asian Bonds Online Website was launched in May 2004.

The Executives' Meeting of East Asian and Pacific Central Banks (EMEAP) is also an active promoter of regional bond markets. It launched the first Asian Bond Fund (ABF1) in June of 2003 harnessing the official reserves of Asian governments. The EMEAP bought US\$ 1 billion of US dollar bonds issued by sovereign and quasi-sovereign institutions in eight EMEAP countries (Japan, Australia and New Zealand were excluded) as a step to promote cooperation among the regional central banks. The success of ABF1 led to the launching of ABF2 in December 2004 and was implemented in April 2005. This time local currency bonds equivalent to US\$ 2 billion were issued by sovereign and quasi-sovereign entities in EMEAP countries. The ABF2 consists of two parts: a Pan-Asia Bond Index Fund investing in local currency denominated bonds; and a Fund of Bond Funds that invests in eight single-market funds (Yap, 2007:15-16; Jang, 2011:14-15).

In May 2008, the 11<sup>th</sup> ASEAN+3 Finance Ministers' Meeting agreed on a new ABMI Roadmap to further the development of regional bond markets to be more accessible to investors and issuers. Four key areas were to be addressed: (i) promoting the issuance of local currency-denominated bonds (supply side); (ii) facilitating the demand for such bonds (demand side); (iii) improving the regulatory framework; and (iv) improving infrastructure for bond markets (ADB BondsOnline Website). A steering group and four task forces were established to implement these objectives. In June 2010, the ASEAN+3 Bond Market Forum (ABMF) met in Tokyo to discuss how best to harmonize regulations and market practices in Asian local currency bond transactions. A regional bond market would entail the development of institutional infrastructures such as harmonization of tax rules, setting common standards for bond issuance, development of cross-border clearing, settlement, payment and depository

systems, and regional credit rating agencies. Most of all, a developed bond market requires free convertibility and free capital flows. As we shall discuss in Section IV, the sine qua non of capital markets is ample market liquidity for individual investors, the ability to buy and sell at an instant, to dip in and out of markets. Much of the discussion on bond markets is predicated on foreign investors from countries with surpluses investing in local bond markets of countries with deficits. Foreign investor will not be encouraged to buy local currency bonds if they do not have ready and full access to local currency, to be able to borrow, buy and sell the currency freely. As many of Asian countries still have restrictions on local currency borrowings and availability, this, as we shall explain later, rather than technical infrastructural issues, is the greatest obstacle to the full development of regional bond markets.

In November 2010, the Credit Guarantee and Investment Facility (CGIF) was set up as a trust fund of the ADB. CGIF will provide guarantee for local currency denominated bonds issued by investment grade companies in the ASEAN+3 countries. These companies are rated by either domestic rating agencies of each country, like RAM in Malaysia, or international rating agencies likely Standard and Poors'. There is as of now no regional rating agency for Asia. CGIF has received capital contributions of US\$ 700 million from ADB (\$130 million), China and Japan (\$200 million each), South Korea (\$100 million) and ASEAN (\$70 million).<sup>12</sup> By providing guarantee, CGIF will assist companies to tap the local bond markets for longer term funding. Initially the business will not be leveraged, i.e., the guarantee will be supported solely by its own capital.<sup>13</sup>

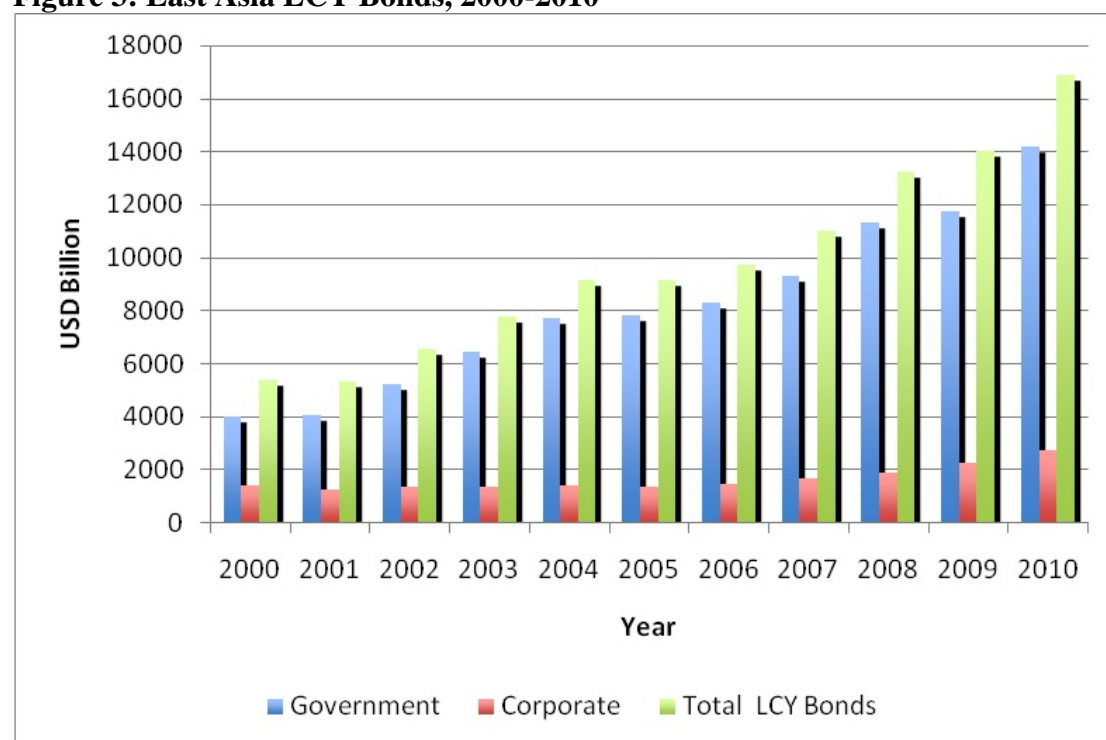
## PERFORMANCE RECORD OF BOND MARKETS

The East Asian local currency (LCY) bond markets have grown substantially over the past 10 years. Figure 3 shows that the size of the LCY bond markets for the eight countries (original ASEAN5 + China + Hong Kong, Korea, Japan) tripled, from US\$ 5.4 trillion in 2000 to US\$ 16.0 trillion in 2010. However, eighty four percent of these bonds are government bonds and only sixteen percent are corporate bonds in 2010. In fact, as a percentage of the total bond markets, the corporate bond market has dropped from 26% in 2000 to 16% in 2010. In other words, the corporate bond markets are still a small fraction of the total LCY bond mark

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<sup>12</sup> Interview with Robert Yeung, consultant to ADB on CGIF.

<sup>13</sup> In the 1990's ADB was a shareholder in Asia Credit, a bond guarantee company, based on the model of typical bond insurers like MBIA and AMBAC. In fact, MBIA was also a shareholder and technical manager of Asia Credit. The operation was highly leveraged as is usual for a bond insurer. During the AFC, the company experienced severe losses as claims mounted against its insured companies that were impaired. Eventually, Asia Credit was wound up suffering major losses.

**Figure 3: East Asia LCY Bonds, 2000-2010**

Source: ADB, AsianBondsOnline Website

Table 6 shows the 2010 distribution of the LCY bond markets by country and by type. Japan, has the largest share, accounting for 69% of the total, followed by China (18%) and South Korea (6.8%). All the other ASEAN+3 countries are at about 1% of the total. However, as a percent of GDP, the bond markets are not insignificant for the smaller countries. In Japan and South Korea, the bond market is at 198% and 110% of GDP respectively, followed by Malaysia (99%), Singapore (76%), Hong Kong (73%), Thailand (67%), China (51%), Philippines (35%) and Indonesia (15%).

**Table 6: East Asian Local Currency Bond Markets, 2010**

2010	Government	Corporate	Total	Government	Corporate	Total	
	% GDP	% GDP	% GDP	US\$ billion	US\$ billion	US\$ billion	% of Total
China	40	11	51	2408	644	3052	18.0%
Hong Kong	39	34	73	87	77	164	1.0%
Indonesia	13	2	15	94	13	107	0.6%
Japan	180	19	198	10609	1113	11723	69.3%
Korea	47	63	110	492	657	1149	6.8%
Malaysia	58	40	99	145	101	247	1.5%
Philippines	31	4	35	64	8	73	0.4%
Singapore	44	32	76	103	76	179	1.1%
Thailand	54	12	67	183	42	225	1.3%
TOTAL				14186	2731	16917	100.0%

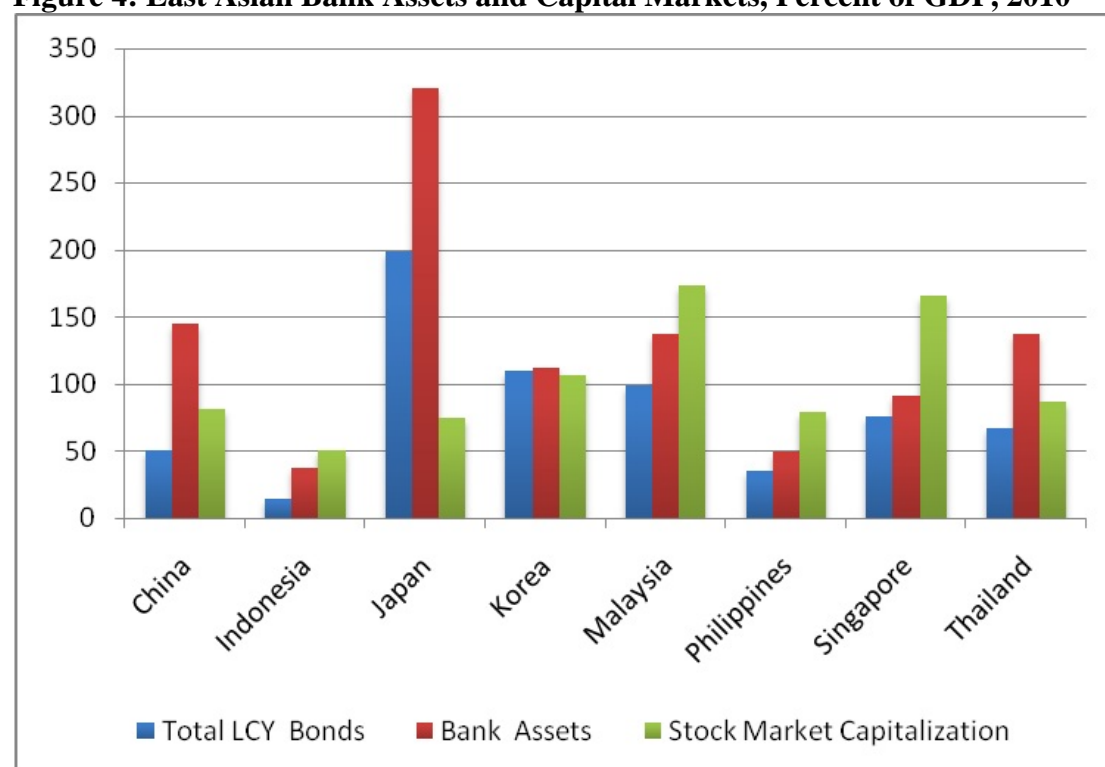
Source: ADB, AsianBondsOnline Website

The government bond market predominates in all these countries. In Japan, the LCY government bond market is 180% of GDP while its LCY corporate bond market is only 19% of GDP. Japan's huge public deficit spending to stimulate growth after the stock market crash of 1990s explains the large government bond market. The governments of Malaysia and Singapore have relatively large government bond markets at 58% and 44% respectively because of their compulsory employees savings schemes that contribute to high levels of national savings. The governments issue bonds to mop up these savings. In the case of Singapore, even though the government enjoys a budget surplus, it issues government bonds to recycle employees' compulsory saving proceeds. The central provident fund holders are paid about 2% to 4% on their savings and the government through its investment arm, the Government Investment Corporation – a sovereign wealth fund - uses the bond proceeds to invest in the international markets with average annual returns of about 6% to 8%. Sterilization of capital inflows is another important reason for issuing government bonds in current account surplus countries like China, Singapore, Malaysia, Thailand and Korea. In Thailand, the high level of government bond is also due to the overhang of debt issued to resolve the banking crisis during the AFC and the fiscal deficits due to populist measures over the last few years.<sup>14</sup>

Figure 4 compares banking assets as a percentage of GDP, to the bond and stock markets (capital markets). Japan has the highest percentage of bank assets to GDP (321%), compared to bond market of 198% and stock market capitalization of 75%. South Korea has the most even distribution between all the three markets, circa 110% of GDP. Malaysia and Singapore have similar distribution; Malaysia's bank assets stood at 137%, bond markets 99% and stock market 173%, while Singapore's distribution is 91%, 76% and 166% respectively. China's bank assets at 145% of GDP are three times its bond markets at 51% and stock market is 81%. Indonesia (37%, 15%, 51%) and the Philippines (50%, 35%, 79%) have low levels of financial markets. Finally Thailand's bank assets at 137% are twice its bond markets (67%) and the stock market size is 87%.

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<sup>14</sup> Correspondence with Pongsak Hoontrakul.

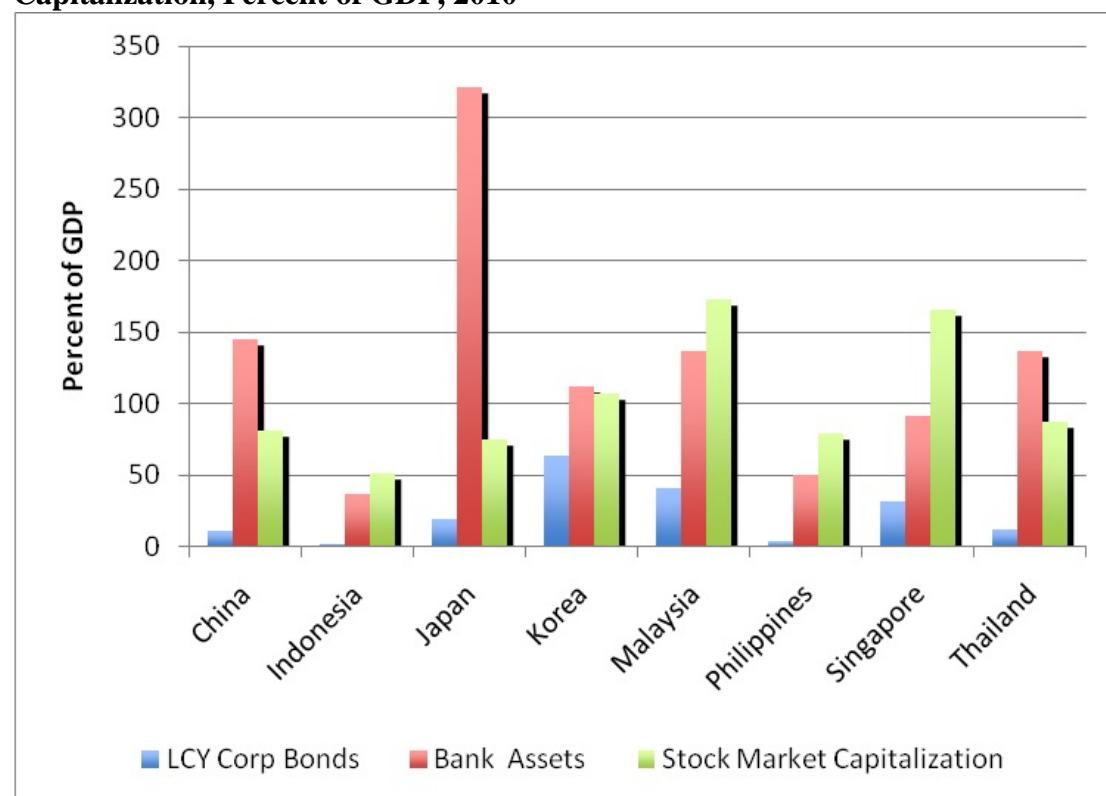
**Figure 4: East Asian Bank Assets and Capital Markets, Percent of GDP, 2010**

Source: ADB, AsianBondsOnline Website; World Bank, World Development Indicators

If one compares only the corporate bond markets size to bank assets for these countries then, they are still undeveloped, even for Japan. Figure 5 shows the relative size of each market for these countries. Korea has the highest percentage of corporate bond markets as percentage of GDP (63%), followed by Malaysia at 49%, Hong Kong 34% and Singapore 32%; Thailand 12%, China 11%, Philippines 4% and Indonesia 2% are trailing far behind. Korea's highly developed corporate bond market supports the country's large conglomerates (chaebols) that have a high need of external funding, while Malaysia's large corporate bond market is explained by the Islamic bond markets (sukuk)<sup>15</sup> that the country is promoting. The sukuk market has been growing at an average annual rate of 20% the past few year and in 2010, it was reported that the sukuk market in Malaysia totaled RM 294 billion (Parker, 2011). Hong Kong and Singapore are developed regional financial markets where the corporate bonds are issued not only for domestic corporations but also for corporations in the region. Japan despite being a developed economy has a very small corporate bond market (19% of GDP) evidencing the historical development and preponderance of indirect financing over direct financing.

<sup>15</sup> Sukuk is a financial certificate issued in accordance with Sharia, Islamic laws that prohibit interest payment. Hence, the issuer sells the certificate to the investor and rents it back for a predetermined rental fee, and also promises to buy it back at a future date at par value. It is the Islamic equivalent of a bond.

**Figure 5 : East Asian LCY Corporate Bond, Bank Assets and Stock Market Capitalization, Percent of GDP, 2010**



Source: Ibid

The following are the main conclusions of the record of Asian bond performance. First, there is a great deal of heterogeneity in the level of bond market development among the ASEAN+3 economies. The plus 3 countries of Japan (69%), China (18%), and Korea (7%) together account for 94% of the total bond markets and the other ASEAN countries together the remaining 6%. Second, government bonds dominate the market making up 84% of it; the remaining 16% are corporate bonds. South Korea is the only country where its corporate bonds exceed 50% of GDP. It is unclear why despite the huge effort to develop LCY corporate bond markets, the record has been rather modest. Third, countries like China, Singapore and Malaysia have relatively high levels of government bonds due to either the need to sterilize the foreign capital inflows and/or the high levels of compulsory saving schemes.

### **A REASSESSMENT OF THE PUSH TO BOND MARKETS DEVELOPMENT**

From a survey of the literature, it seems that many of the economists and policy makers writing about the weaknesses of the Asian financial systems are taking a one-sided view, i.e. extolling the virtues of bond markets (direct financing) and critical of the weakness of banking institutions (intermediated financing). These writers are pushing for the development and deepening of capital markets, particularly

the local currency bond markets, as the best solution to (i) address the problems of currency and maturity mismatch that plagued bank lending in Asia before the AFC; and (ii) recycle the vast Asian savings from surplus countries to finance the region's investments, particularly in deficit countries,

Most of these writers claim, with scant empirical evidence, the many supposed benefits of a well-developed bond market which include: efficient allocation of capital, effective evaluation and monitoring of investment activities, maximization of economic welfare, decreased volatility of capital flows, and reduced vulnerability to financial crises (MAS, 2007:46, 68-9; Park and Park, 2003:10; Bhattacharya, 2011:4-6). Others like Hakkanson (1999) go to the extent of claiming that a well-developed corporate bond market “fosters an efficient corporate financial structure, the presence of rating agencies, a proliferation of financial derivatives, and other means to reduce systemic risk and avoid crises”; and Herring and Chatusripitak (2000) assert that the lack of a well-developed bond market may reduce the efficiency of an economy and may increase vulnerability to a financial crisis (cited in Bhattacharya, 2011:6). We shall examine the validity of some of these claims.

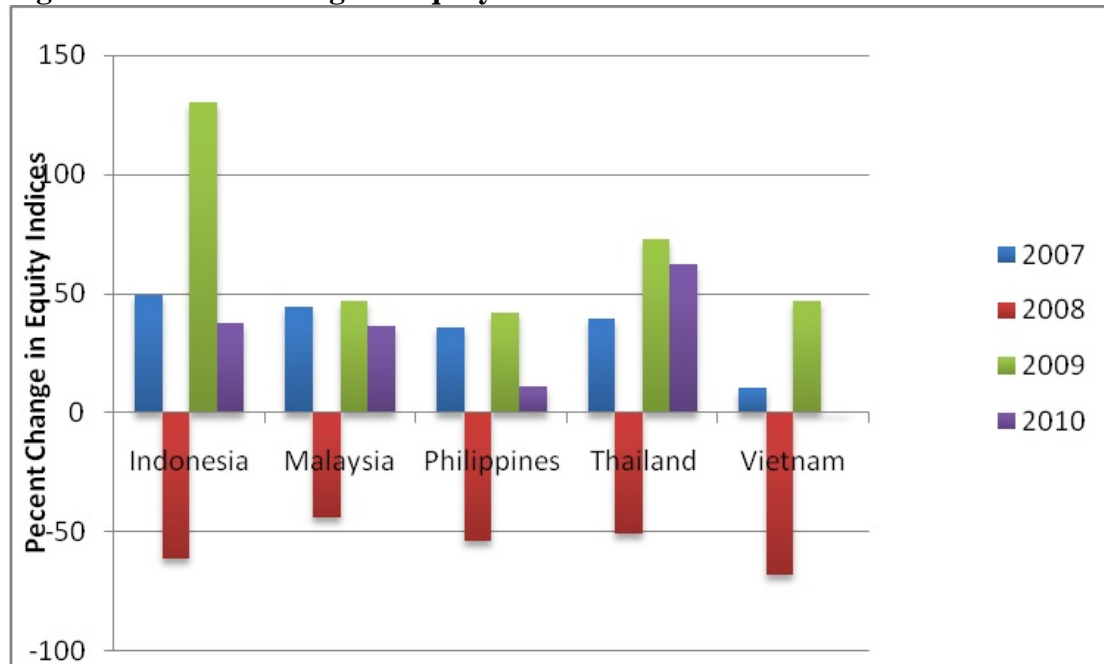
## **LIQUIDITY-STABILITY TRADE-OFF**

Bhattacharya (2011) postulates several hypotheses regarding the determinants of bond market development. Among these is there is a positive relationship between stable exchange rates and bond market development as the former poses low risks to investors and therefore encourage bond market development. However, the trade off between liquidity and financial/economic stability is not addressed. The sine qua non of capital markets is liquidity, the ability to dip in and out of markets, which increases volatility of exchange rates. An ADB article emphasizes this aspect, “Common trading standards would make it faster and cheaper for investors from across the region to **dip in an out of their neighboring markets**” (ADB, 2010. Emphasis added). It is exactly this divergence between the benefits of liquidity to individual investors and the macro-economic costs to the recipient economy, particularly to smaller economies, in terms of vulnerability to volatile capital flows and exchange rate volatility, that has not been addressed among the proponents of bond markets. On the contrary, a typical view can be found in Park and Park (2003:2) where they wrote, “Had there been efficient domestic bond markets, foreign investors locked in bonds could not have left East Asia as banks and other investors hurriedly did.”

Capital markets – the stock and bond markets – are predicated on liquidity for investors. It is this liquidity that causes extreme volatility and instability to smaller emerging market economies. This is particularly true in times of wide spread financial crisis, as was the case with the collapse of Lehman Brothers in the Great Financial Crisis of 2007-09. Despite strong macro-economic fundamentals and healthy corporate balance sheet in Asian economies, foreign capital (stock and bond markets' investors) withdrew massive amount of funds to meet redemption and liquidity problems in their home countries, causing declines in the equity and bond markets of host countries that were greater than the drop in their countries of origin. Figure 6 shows the drop in the stock markets and Figure 7 shows the net portfolio investments flows (stocks and bonds) during the 2007-2009 financial crisis for the

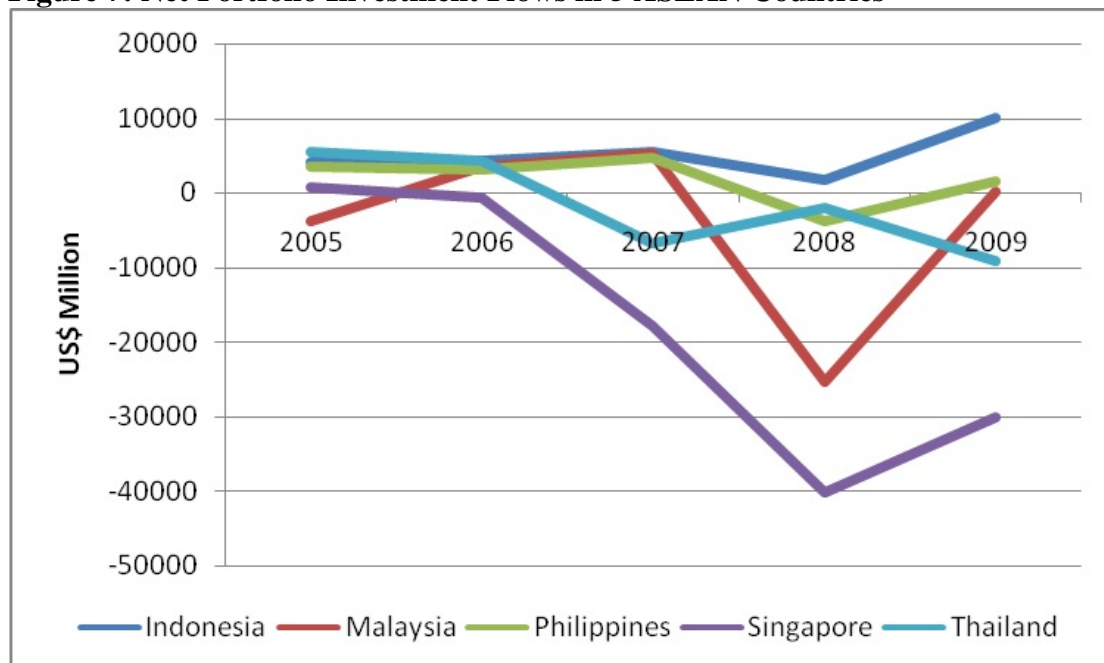
five ASEAN countries. These Asian countries could not sustain such massive capital flight without serious negative effects on their real economy. This is one of the dark sides of capital markets that Keynes talked about and is absent in the literature on bond market development in Asia. To quote him, “...with the development of organized investment markets, a new factor of great importance has entered in, which sometimes facilitates investment but **sometimes add greatly to the instability of the system.**” (Keynes, 1936:150-151. Emphasis added.)

**Figure 6: Percent Change in Equity Indices of Five ASEAN countries**



Source: World Bank Database

**Figure 7: Net Portfolio Investment Flows in 5 ASEAN Countries**



Source: ADB Database



For Keynes, the concept of liquidity applies only to individual investors and not to the investment community as a whole. This is again amply demonstrated in the recent Great Financial Crisis, where not only toxic subprime assets became illiquid when every investor was rushing to exit the door, but even money market funds that are supposedly as liquid as cash became illiquid (Lim and Lim, 2010: Chapter 2).

It is worth quoting at length his insights on the concept and effects of liquidity:

“Of the maxims of orthodox finance none, (sic) surely, is more anti-social than the fetish of liquidity, the doctrine that it is a positive virtue on the part of investment institutions to concentrate their resources upon the holding of “liquid” securities. It forgets that there is no such thing as liquidity of investment for the community as a whole. The social object of skilled investment should be to defeat the dark forces of time and ignorance, which envelop our future. The actual, private object of the most skilled investment to-day is to “beat the gun”... to outwit the crowd, and to pass the bad, or depreciating, half-crown to the other fellow.” (Keynes, 1936:155).

### **CAPITAL MARKETS AS EFFICIENT ALLOCATORS OF RESOURCES?**

It was earlier noted that most writers claim that bond markets are efficient allocators of capital. In a series of meetings held largely by central bankers discussing Asian financial and monetary integration, the case was made that “Financial integration – including the development of a regional bond market – promotes a more efficient allocation of resources, contributes to the efficient price discovery process for financial products, improves access to financial services, and lowers the cost for such services.” (MAS, 2007:46). The experience of the Great Financial Crisis should call into question such strong claims.

Spiegel (2009) is one of the few writers who raised some doubts about conventional wisdom on capital markets. Among the concepts he thinks require reassessment are: the validity of Greenspan’s idea of bond markets as safe spare tire in a financial system; whether the heavy dependence on banks for intermediation is such a bad thing; to what extent the recent growth in demand for Asian bonds was driven by an increase in appetite for risks assets; the extent to which dependence on bond credit rating agencies weakens incentives for creditors and investors to conduct their own due diligence about their borrowers; and the role of securitization and its relationship to the increase in systemic risk exposure and opaqueness.

The assumptions and claims of market efficiency hypothesis have been seriously challenged and its flaws exposed by behavioral economists and more recently by economists who have worked in the financial sector (Cooper, 2008). Do capital markets allocate resources efficiently? What is or are the meaning(s) of efficiency?

Tobin (1984) is among the few who looked critically at the concept of market efficiency. He enumerated four meanings of market efficiency – information-arbitrage efficiency, fundamental-valuation efficiency, full-insurance efficiency in the Arrow-

Debreu sense, and functional efficiency, i.e., the economic functions of financial industry. Functional efficiency relate to the services that should be provided by the financial industry such as "pooling of risks and their allocation to those most able and willing to bear them, a generalized insurance function in the Arrow-Dubreu spirit, the facilitation of transactions by providing mechanisms and networks of payments; the mobilization of saving for investments in physical and human capital, domestic and foreign, private and public, and the allocation of saving to their **more socially productive uses**" (Tobin, 1984:4. Emphasis added.) On all these counts, Tobin concluded that the market is efficient only in the first sense - information-arbitrage efficiency, i.e., "on the average it is not possible to gain from trading on the basis of generally available public information" (Ibid:2). It fails in the second and third senses, and most of all in the fourth sense.<sup>16</sup> He laments that the U.S. are throwing their best resources into financial activities that are remote from the production of goods and services and generate private rewards that are disproportionate to their social productivity (Ibid, 20).

UNCTAD (2009:12) restates the issue more categorically. It says financial markets do a decent job at evaluating all information, and in processing transactions (transactional efficiency); but if they do not contribute to long-run economic growth, they do not provide any social return, and from a regulator's perspective the most relevant criterion to judge efficiency is in terms of social or functional efficiency, i.e. its contribution to stable and long-run economic growth.

Studart (1995-6:284-85) also distinguished between the micro and macro aspects of financial market efficiency. The former refers to processing transactions in technologically sophisticated ways and at lowest costs; the latter refers to how well a financial system expands the use of existing resources of an economy at the minimum costs with the minimum possible increase in financial fragility.

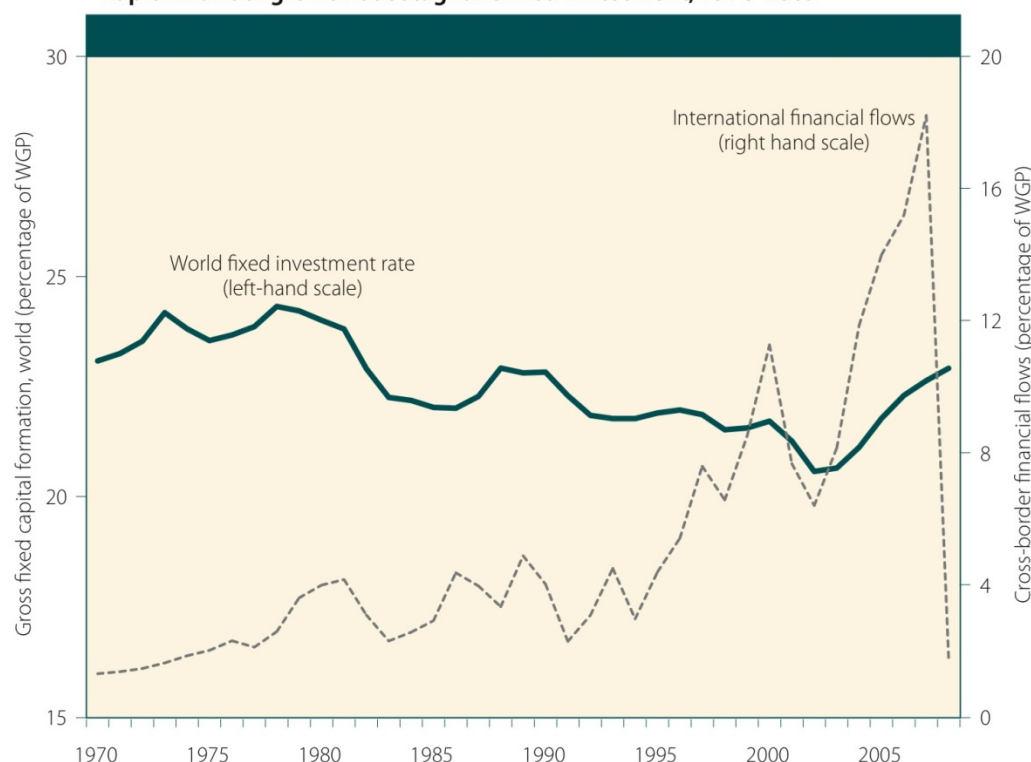
Agenor (2003: 1100, 1109) argues that foreign banks tend to concentrate their lending to larger companies and are biased against small and medium sized companies; hence they do not contribute to an overall increase in allocative efficiency in the financial sector. In the same way, capital markets are conducive only to large companies that are able to enjoy economies of scale and the reduction in cost of funding. Small economies and companies do not have access to such sources of funding and hence do not contribute to allocative efficiency.

Finally several studies have showed that financial deepening alone does not translate into increase in fixed capital investments. Benjamin Friedman wrote that the 1980s was the worst period in terms of fixed investment by businesses who borrowed to pay down equity through mergers and acquisitions, leveraged buy-outs and stock repurchases (cited in Phillips, 2008:40). More recent studies by the United Nations showed that despite rapid financial growth, world fixed investment rate stayed stable over the last forty years (UN. 2010: 104). See Figure 8.

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<sup>16</sup> For Keynes (1936:156), capital markets do not price assets efficiently in terms of reflecting their fundamental value because investors are less interested in discovering the fundamental value of the assets, and more focused on guessing what other investors guess the average price should be. This can be repeated ad infinitum. Modern day technical analysis best exemplifies this phenomenon; it ignores fundamental valuation and only analyzes market trends in terms of mass psychological behavior.

**Figure 8: International Financial Flows and World Fixed Investments**  
**Rapid financial growth but stagnant fixed investment, 1970-2009**



Source: United Nations, 2010.

## ALTERNATIVES IN FINANCING STRUCTURE

Broadly speaking there are two types of financial structure: direct and indirect financing.<sup>17</sup> In direct financing, borrowers directly approach the financial markets, namely bond and stock markets, for external funding. The funding is done without modifying the terms of maturity and the lender or investor is able to shorten his maturity through sale of the asset in the secondary market. Hence a deep and liquid market is paramount for investors. The ability to buy and sell can lead to price instability and in extreme cases to booms and busts. This method of financing is transaction oriented. There is no customer relationship between the borrower and lender or investor. This is the Anglo-American model of financial development where capital markets (stock and bond markets) predominate over bank lending.

In indirect financing, financial institutions, mainly banks, stand as intermediaries between savers and borrowers.<sup>18</sup> The flow of funds from the surplus to deficit units in the economy is intermediated by financing institutions that engage in

<sup>17</sup> Parts of this discussion are based on UNCTAD (2008: 90-91).

<sup>18</sup> Currently there is an on-going debate on whether banks actually act as financial intermediaries, relying on savings or deposits to create credit or whether they can create credit ex-nihilo to finance investments. The former school views central bank reserves requirements as constraining bank lending, while the latter school regards capital, rather than reserves as the main constraint in bank lending.

maturity transformation and take the liquidity risks. In extreme situations a liquidity squeeze can end up as insolvency. In contrast to direct lending that is transaction oriented, the creation of a durable relationship between borrower and lender is important. The German, Japanese and Korean financial systems in the early stages reflected more the indirect financing model.

It was argued that the Asian economies were over reliant on the banking system and the AFC exposed the risks of this system. Even though banks are supposed to be engaged in maturity transformation, in reality in most of these countries, bank lending was short term. Borrowers took both the interest rate risks and the currency risks if they borrowed in foreign currency. This double mismatch was identified as a major factor in the AFC. Consequently, it was argued that the development of bond markets would solve this problem and there was little or no debate on what type or mix of financial structure can best promote stable, long-term economic growth. The experience of Japan and Korea where a subset of banks, known as development banks or long-term credit banks, played a vital role in the industrial development of these economies does not seem to be explored or discussed.

While bond markets represent an alternative financing method that can mobilize large amount of funds directly from the financial markets, they are prone to price volatility and can generate foreign exchange and macro-economic instability particularly if a significant percentage of investments are foreign owned and the host economies are small. Funding through long-term credit banks on the other hand can also achieve the objective of solving the problem of double mismatch with less risks of macro-economic instability. We will briefly examine the Japanese experience in long-term credit banks and some contemporary examples of national and regional development banks.<sup>19</sup>

## **JAPANESE EXPERIENCE IN LONG-TERM LENDING**

It is instructive to look at the role the main banking system, in particular long-term credit banks, played in the rapid industrial development of Japan between the 1950s and the mid 1970s. During this period, the corporate sector was the largest deficit unit and depended mainly on private banks and public financial institutions like postal savings, rather than the capital markets that were underdeveloped, for funding its capital investments. Under the “*kereitsu*” system, corporations had close ties with banks, led by a main bank that would be the primary funder. The close customer relationship was enhanced by cross holdings of shares between banks and the corporations to which they lent. The system was designed to achieve stable, long-term relationship and performance rather than short-term, transactional relationship to maximize profit (Cargill and Royama, 1988: 43-48).

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<sup>19</sup> Traditionally German and Korean banking systems also rely more on bank financing rather than capital markets for growth but are not discussed here for the sake of brevity. A discussion on them can be found in Aoki and Patrick, 1994.

The Japanese banking system is segmented in which different types of banks cater to different market segments. The major classes of banks are city banks, long-term credit banks, trust banks, regional or local banks, foreign banks and other specialized financial institutions providing services to agriculture and small business. The long-term credit banks (LTCBs) and trust banks are the main providers of long-term credit to corporations. While long-term credit banks were started in 1890s, they were briefly abolished during the Allied Occupation and then revived in 1952 with the passage of the Long-Term Credit Bank Law. The major private LTCBs were Industrial Bank of Japan, the Long-Term Credit Bank, and Nippon Credit Bank and they worked closely with the Japanese Development Bank that is government owned and managed. These LTCBs were able to specialize in providing long-term loans to corporations in government targeted industries (iron and steel, coal, electric power and shipping) as well as important manufacturing industries such as chemicals, machinery, cement and textiles, as they enjoyed the privilege to issue long-term bank debentures that was not available to other classes of banks. To mitigate long-term credit risks, the main banks and the LTCBs built up in-depth credit analysis capacity, project evaluation expertise, took collateral for the loans, monitored the performance of the corporations, and maintained special relationships by sending staff to work in the clients' corporation for a certain period or dispatched retiring senior bank managers to become employees of client firms (Packer, 1994; Sunamura, 1994). Through these practices, LTCBs were able to reduce the problem of informational asymmetry that plagued bank lending and focus their energies on the long-term prospects of their clients.<sup>20</sup>

The overall conclusion of the study of the Japanese main bank system edited by Aoki and Patrick (1994) is that despite an undeveloped capital market structure, this system, in conjunction with the government's industrial policy, played a pivotal and effective role in the rapid growth of the Japanese economy after the Second World War. Patrick (1994) wrote, "In the economic and financial environment of the high growth era the main bank system matured and flourished. It represented a successful solution to a key developmental problem: how to finance large industrial enterprises efficiently and effectively" (388); and "The problems and difficulties the Japanese financial system and its banks faced in the 1990s, ... do not undermine the fundamental lessons of the Japanese case" (Ibid:406).

## **EUROPEAN INVESTMENT BANK (EIB)**

The EIB was established in 1958 following the signing of the Treaty of Rome by six countries – Belgium, France, Germany (West), Italy, Luxembourg, Netherlands - to work towards a common market for goods, services, labor and capital flows and a common tariff system. The main function of the EIB was to provide loans to support infrastructure and in particular to compensate the presumed "losers" in the inter-

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<sup>20</sup> No doubt Keynes (1936:160) had this in mind when he wrote, "The spectacle of modern investment markets has sometimes moved me towards the conclusion that to make the purchase of an investment permanent and indissoluble, like marriage, except by reason of death or other grave cause, might be a useful remedy for our contemporary evils. For this would force the investor to direct his mind to the long-term prospects and to those only".

European union.<sup>21</sup> Most of the capital base comes from funds raised in the international capital markets with member countries providing guarantee for the EIB's bonds. The EIB operates independently of the European Community (EC) countries and is based in Luxembourg rather than Brussels. It establishes its own lending objectives rather than serve as a financial tool for the EC's political agenda.

Four years after its establishment, the EIB made its first loans outside the EC and in 1978 it began lending to Spain, Portugal and Greece. In 1988 it began to provide loans to small and medium sized enterprises (SMEs) and other industrial companies. By 1992, the EIB outstripped the World Bank in terms of its lending. By early 2000s EIB shifted its emphasis to fostering innovation, competitiveness and economic growth and provided loans to high technology sector and venture capital.

It also started a subsidiary, the European Investment Fund (EIF), in 1994 that provides indirect equity and debt financing to economic enterprises. For example, on the equity side, the EIF invests in various funds that have equity investments in SMEs. While on the debt financing side, it provides guarantees up to a certain amount to financial institutions that lend to SMES or engage in micro-financing. Another debt instrument product is guaranteeing a certain portion of SME loans that have been securitized. As of 2010, EIF has private equity assets under management of Euro 5.4 billion in 351 funds, and guarantee exposure of Euro 14.7 billion in 193 projects (EIF, 2010). The shareholders of EIF are: EIB 61%, European Commission 30%, and private financial institutions the remaining 9%.

By far, the EIB is the largest of the multi-lateral development banks, almost twice the size of the World Bank. In 2010, its total assets and total loans were Euro 420 billion and Euro 360 billion respectively, compared to the World Bank's at US\$ 283 billion and US\$ 120 billion.

### **BANK OF NORTH DAKOTA (BND)**

It may seem curious why a state-owned bank in North Dakota (BND) would have any relevance to Asia's financial development?

A recent article by Ellen Brown, an attorney, and president of the Public Banking Institute, explained the role BND plays in sustaining North Dakota's healthy economy (Brown, 2011). North Dakota has one of the lowest unemployment rates (circa 3%) in the U.S. since July 2008 (compared to about 9% for the country). It is the only state that enjoys a budget surplus since the financial crisis of 2007/8. It also has the lowest foreclosure as well as credit card default rates. This is not due to all to oil, as Alaska with the about same population and twice the amount of oil has 7.7% unemployment.

The bank was founded in 1919, with US\$2 million in equity, to promote agriculture, industry and commerce. Today its capital base is over US\$ 270 million.

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<sup>21</sup> Much of this discussion can be found in the EIB website.

The bank is unique in that by law all the state's tax revenue are deposited with the state bank, while deposits are also accepted from private citizens (BND website). The bank is not FDIC insured.

The bank partners, rather than compete, with over 100 local banks, helping with capital and liquidity. It provides loans, guarantees, secured and unsecured federal fund lines etc to the local banks. Since 1945, the bank has transferred part of its profits to the state coffers. Over a 15-year period, the bank has contributed more to the state's revenue than oil taxes have. Professor Canova, in comparing the financial situation in California and North Dakota, looked at how the North Dakota state government deposits its tax revenue with the state bank which in turn reinvests part of the funds into productive investments in the state's economy while the state of California deposits its tax revenue in private banks that often lend out-of-state or in speculative investments (cited in Brown, 2011). The performance of BND has prompted California state legislature to approve a feasibility study of starting its own state-owned banks (Brown, 2012).

In short, BND's judicious bank management, without going into speculative investments, and access to credit for the local community has contributed to its success. The bank can boast its total assets climbed from US\$2.3 billion to US\$ 4 billion between 2006 and 2010, a period of financial turmoil for the world; and it not only made profit every year but the profit rose from US\$43 million to US\$62 million over the same period (BND, 2010). The bank's enviable performance can be a lesson to those who argue against the intrinsic inability of state to run an efficient financial institution; efficient not only in the technical sense, but more important in the social efficiency sense that was defined earlier.

## **BRAZILIAN DEVELOPMENT BANK (BNDES)**

The Brazilian Development Bank is a state-owned bank started in 1952 to provide long term financing for the country's economic development. Initially it focused on infrastructure but soon also financed agriculture and dairy, education, health, sanitation, and mass transport. In the 1990s it supported the state's effort in regional decentralization into the less developed regions of the countries and also branched into financing SMEs and micro-enterprises.

The BNDES has grown to become the largest national development bank in the world with total assets of R\$549 billion as of December 2010, shareholders equity of R\$ 66 billion and CAR of 20.5% in September 2011.<sup>22</sup> In 2010 it disbursed R\$ 168 billion of loans, more than the World Bank. In the first nine months of 2011, R\$ 92 billion of loans were disbursed with 41% and 40% going to infrastructure projects and micro and small medium sized enterprises respectively. During the period of global financial crisis (2007 to 2010), the bank's lending rose steadily from R\$ 65 billion to R\$168 billion and its profits from R\$ 7.3 billion to R\$ 9.9 billion; its default rate is 0.12% of total portfolio.

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<sup>22</sup> In 2010, US\$1 = R\$1.75. Most of the information is from BNDES website.

From these various examples, it can be seen that, in contrast to the Anglo-American commercial/investment banking models that imploded and plunged the entire financial and economic system into the worst crisis since the Great Depression, well and prudently managed banking institutions that are focused on long-term funding and stable relationship with clients, not engaged in speculative investments or/and not obsessed with unsustainable rates of return have managed well over the period of the global financial crisis that persists today.

The recent and on-going global financial crisis has brought to the fore once again the contrast between two types of financial system, namely the Anglo-American financial system that is more inclined to capital markets as the major source of financing, and the other model that is more dependent on bank financing as historically was and still is the case in Germany, Japan and Canada.

A recent paper by Bordo et al (2011) analyzed why Canada did not suffer a banking crisis in 2008 or earlier in the 19<sup>th</sup> and 20<sup>th</sup> century, while the U.S. did. They argued that the structure and performance of a financial system is “path dependent”; or to put in another way, is dependent on the historical interplay of political, economic and social forces. In Canada, the federal government could charter nationwide banks, and a few large banks were allowed to function in an oligopolistic but well regulated manner. While this may have the disadvantage of being slow on innovation, it has the advantage of preserving financial stability.<sup>23</sup> There were many instances of bank failures but few that led to bank panics and crisis.

In contrast, banking panics and crises were recurrent in the history of the U.S. since the 1830s. The political struggle between federal and state for the right to charter banks ended in power residing mainly with the states to charter their own banks. Interstate banking was for the most part prohibited. The inability of this fragmented and weak banking system to finance large scale industrial development throughout the country and to move capital across state line created the condition for the development of capital markets where financial instruments (stock and bond markets) can be traded and capital moved freely. Therefore, capital markets and investment banking became equally, if not more, prominent than commercial banking in the U.S. financial system. Despite the greater risks and volatility of this sector, it was not regulated until after the 1930s, even then with a lighter touch. In short, a fragmented and weak banking system co-existing with a largely unregulated investment and shadow banking system created the conditions for financial instability. Sprague’s classic study on *History of Crises Under the National Banking Act* (1910) argued that the “pyramiding of reserves” and heavy reliance on securities markets to finance investments contributed to these panics (cited in Bordo et al. 2011:12).

It is clear that there are costs and benefits associated with each type of financing and they are not mutually exclusive. But the type or mix of financing chosen is dependent on historical and current conditions and also on the objectives of

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<sup>23</sup> The claim that regulated banking is costlier is not supported in the Canadian case. In an earlier study Bordo et al (1994) found Canadian banking costs were not higher than those in the U.S.



development. We should, at all times, keep in mind that the primary role of finance is to serve the real productive sector and not the other way around; and the objectives of development should be to create stable, long-term economic growth that is balanced, employment-creating, equitable and welfare maximizing. Too often means, such as creating a deep and liquid financial market or even the idea of financial integration, are confused for ends. While capital markets instruments are efficient in mobilizing capital to move freely and quickly across borders (assuming free capital flows and minimum regulation), they come at greater social economic costs, i.e., volatility of exchange rates and macro-economic instability.

We have suggested that another way of meeting this objective, as a complement to, not a total substitute for LCY bond markets, is to develop regional or national long-term developmental or credit banks, borrowing elements that are applicable from the countries that have successfully used such institutions to promote economic growth. It is beyond the scope of this chapter to provide a blue print of such institutions. But we can conclude by suggesting several principles guiding such an institution.

## **REGIONAL DEVELOPMENT AND LONG-TERM CREDIT BANKS**

We will not go into detail what such a national or regional development and long term credit bank would look like beyond sketching a broad outline.<sup>24</sup> What would be the main characteristics and advantages of such regional or national long-term credit/development banks?

## **A NEW BUSINESS MODEL**

Many Asian countries are flushed with foreign reserves that are not only not well utilized but also cost ineffective as indicated earlier. These countries should consider setting aside a percentage of the reserves to fund one or several regional development bank(s).<sup>25</sup> As sovereign investors in such an institution, they should: (a) take a long-term view to promote stable economic growth; (b) adopt a purely professional and hands-off approach in the evaluation of credit worthiness of projects and of the social contributions of projects; and (c) they should not follow the market fetish of economic value added (EVA) model that seeks to maximize the rate of return to shareholders at the expense of all other stakeholders. This model of business that is the dominant paradigm is unsustainable and generates considerable social costs (see Lim and Lim, 2010:54-58). The limitations of this business model is beginning to be questioned by not only some business school academics but also by prominent businessmen. In his speech to an international business conference, Ho Kwon Ping,

<sup>24</sup> This topic is dealt in greater detail by Griffith-Jones (2011).

<sup>25</sup> We are used to the idea of having only one multi-lateral development bank in each region, the Asian Development Bank, being the only one in Asia. However, it would not be a bad idea to have some healthy competition among several development banks, not so much in terms of profitability but in terms other social indicators like good governance, employment generation, stable growth etc.

the chairman of the board of trustee of Singapore Management University, advocated a shift from the profit-maximization model of business to a more balanced view of performance that takes account of other stakeholders (Ho, 2011). If some leaders in the private sector are able to see the limits of the EVA business model, governments, as trustees of public interests, should be in the forefront of adopting alternative business models. Here, we propose the concept of socially acceptable rate of return for projects of that are welfare maximizing, financially feasible, ecologically sustainable, and promote long-term growth. These projects should yield positive net present value, but there is no necessity for them to yield maximum profits.

### **GREATER ECONOMIC STABILITY**

These regional long-term credit banks can raise funds in the international bond markets or credit markets and stand as financial intermediaries offering a buffer between the project borrowers and the international bond investors. As long as the projects are financially sound, they would be less affected by direct bond redemption in times of crisis as would be the case if bondholders invested directly in these projects.

### **MORE ANTI-CYCLICAL LENDING**

If banking as an industry is pro-cyclical, bond markets are even more pro-cyclical. The sine qua non of capital markets is liquidity for individual investors, the ability is get in and out quickly. Financial investors are driven by greed and fear; and herding rather than rational behavior predominates. It is easier to go with the crowd even when they are wrong than to go against the crowd. This is particularly true when profitability and financial performance are measured in short term rather than long term. Long-term credit banks that are not driven by profit maximization and short-term performance can afford to take more long-term view and adopt anti-cyclical policies such as building up reserves in good times and lending in difficult times.

### **MORE INCLUSIVE LENDING**

Bond financing is by nature bulky. The overhead costs of issuing bonds are extremely high and hence only large corporations and economies driven by economies of scale are able to access bond financing. Also because of the need for a liquid market, bond markets need to be big; a thin market makes for even greater volatility and instability. In most of the ASEAN+3 economies, small and medium size companies are the main generators of employment and they have no chance accessing bond market. Bank financing on the other hand are more advantageous for and accessible to smaller economies and small and medium size companies that are unable to directly access capital markets.

The obsession to develop capital markets has taken hold even in smaller economies like Kampuchea, Laos, and Vietnam. Table 7 shows the size of the capital markets (bond and stock markets combined) as a percentage of GDP is larger than bank assets in all these countries except for China, Japan and Vietnam.

It also shows the breakdown of capital markets (bonds and stock markets) compared to bank assets as percentage of GDP for these countries.

In many of these countries, the stock market capitalization is more than 70% of the countries' GDP. Singh and Weisse (1998) showed that although development of stock markets has contributed to the growth of large corporations in emerging economies, it has not led to a rise in aggregate savings and investments. What was more likely was a change in the composition of investors' portfolio. Given the size of the capital markets, the flow of funds into and out of these markets make a huge impact on these economies and their contribution to stable, long-term growth is questionable. A recent study by Tatlonghari and Paraiso (2011) on financial deepening and economic growth in ASEAN economies found that there was no significant effect of stock market capitalization on economic growth.

**Table 7: Capital Markets and Bank Assets, 2010**

% of GDP	Total LCY	Stock Market	Total Capital	Bank
2010	Bonds	Capitalization	Markets	Assets
China	51	81	132	145
Indonesia	15	51	66	37
Japan	198	75	273	321
Korea	110	107	217	112
Malaysia	99	173	272	137
Philippines	35	79	114	50
Singapore	76	166	242	91
Thailand	67	87	154	137
Vietnam	15	20	35	123
Hong Kong	73	1208	1281	167

Source: World Bank, World Development Indicators; ABD, AsianBondsOnline Website

## **SECTION 4**

### **WAY FORWARD**

With the rise of China as an economic power, followed by the emergence of India and the ASEAN economies plus the technologically advanced North Asian economies of Japan and South Korea, the twenty first century is sometimes hailed as the Asian century. Despite its economic power, this region is under-represented in international political and economic forum. Furthermore, the region is too heterogeneous in terms of history, culture, economics and politics to be a cohesive unit and they do not speak with one voice in these forums.

European integration and union was initially and primarily driven by political considerations of the major European countries to cooperate rather than compete with each other and to avoid the conflicts that led to two world wars. Asian efforts at integration are driven more by economic and market forces. Over the past two decades, Asia has emerged as the major export powerhouse of the world. Both in terms of trade and finance, Asia is more integrated with the rest of the world than among themselves, although there has been more progress in the field of trade integration than financial integration among the Asian economies.

### **BENEFITS AND COSTS OF INTEGRATION**

Globalization, put simply, is the increasing integration of the world economies through capital, trade, labor and information flows. This process has been aided by deregulation and liberalization of export markets and financial markets. Domestically, financial sector was deregulated, and internationally, capital flows were liberalized. Financial integration is not a one-way street; there are benefits as well as costs. Agenor (2003) has summarized well the benefits and cost of international financial integration. His main conclusions are: financial integration does not result in consumption smoothening or macro-economic stability because of the pro-cyclicality of financial flows; the benefits of capital inflows can be completely offset by large and sudden outflows triggering costly financial crises; penetration of foreign banks may induce transactional efficiencies of domestic banks but there is no evidence of any contribution to a more stable banking system. The choice is not between openness and autarky, but one where national governments should design the right mix of policies to maintain strong macro-economic fundamentals like avoiding real exchange rate misalignment and excessive inflation, limiting fiscal imbalance and external debt, and strengthening financial prudential regulation and supervision. The stronger these fundamentals, the better they are able to manage the vulnerability and volatility associated with openness. He also stressed that given the risks of integration, policy makers should proceed cautiously and have the ability to resort to additional instruments, such as restrictions on short-term capital flows, to prevent excessive

volatility affecting domestic economic stability (Ibid: 1114-5). Stiglitz (2010) tries to provide a theoretical framework for analyzing the optimal degree of financial integration and concludes that full integration is not generally optimal and faced with a choice between two polar regimes, full integration or autarky, the latter may be preferred.

What lessons can we draw from the European experience at integration? It is now clear that monetary integration without fiscal or political integration is fraught with dangers and possibly not workable, particularly if member countries are highly heterogeneous in terms of fiscal discipline and export competitiveness. In the case of Asia, we argue that there is no compelling case for monetary integration, while there is a need for more monetary coordination in the following areas. These countries can work towards a benchmark currency or basket of currencies like an Asian Currency Unit (ACU) for purposes of early warning signals of excessive capital flows, and regional surveillance of whether currencies are over or under valued. What is then needed is better monetary cooperation and coordination in the areas of exchange rate arrangements to avoid or minimize beggar-thy-neighbor policies, coordinated policies on short-term capital flows, and establishment of credible preventive and ameliorative mechanisms to deal with speculative and liquidity crises. Today, the smaller economies of Asia are faced with problems of excessive and volatile capital flows that are threatening their financial and economic stability. Individual countries such as Malaysia and Thailand have instituted temporary capital controls measures at certain periods and have faced tremendous market pressures. These measures would be more effective if they are coordinated. The CMIM initiative is currently the most visible and important step in the area of monetary cooperation. Yet, even this initiative is too small and too tied to IMF conditionality for it to be effective. The leaders of the ASEAN+3 countries must be willing to address these issues outside the conventional, orthodox framework and be willing to sacrifice certain degree of short-term national interest for collective and ultimately national gains. They should learn to speak with one voice and increase their presence in international forum.

In the area of financial integration, the main thrust so far has been to develop and deepen capital markets, in particular, the bond markets as a means to recycle regional savings for regional investments. In diversifying the structure of the financial system, too much emphasis has been placed on deepening capital markets without considering the attendant risks and costs. We argue that there is a trade-off between liquidity of capital markets and financial and economic stability in the host countries. Liquidity is good mainly for investors but brings with it volatility of capital flows with negative macro-economic effects. We suggest that more serious consideration be given to develop a third leg of the financial system, i.e., the establishment of regional and national long-term credit banks that are able avoid the problem of double mismatch while minimizing the costs of speculation, volatility, and instability. We propose that governments use part of their foreign surplus to fund these long-term credit banks, but they should not interfere in the operations of these banks. Just as they would invest in a private corporation and have no say in its day-to-day operations, they should allow these banks to be run in the same manner. The major difference we propose is that these banks do not adopt the economic value added model of business but one that accepts a socially acceptable rate of return. Financial institutions over the past few decades, operating in an environment of deregulation

and liberalization, have made profits that are disproportionate compared to the other sectors in the real economy. This has heightened financial fragility and instability and is not sustainable. On the other hand, several national and regional development banks that have been prudently managed have performed well over this Great Financial Crisis. It is time to explore models of financing and business other than those driven by maximization of shareholders value.

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