CHALLENGES FOR CURRENCY COOPERATION IN EAST ASIA

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Synopsis (Summary and Conclusion)

The defects of the current international financial system are creating tremendous distortions in the economies of East Asia. For the time being, most of the developing countries in East Asia have no choice but to adopt some sort of a flexible, wider band exchange rate system (crawling band) while resorting to capital control when necessary, in order to avoid the recurrence of an Asian currency crisis.

Japan's approach to building a stable international financial system in East Asia has gone through several stages since the late 1970s. Though the latest approach of setting up the Asian Bond Fund is a step in the right direction, the ABF has severe limitations in reducing the risks for the developing countries in Asia. The ABF needs to be replaced by the Asian Bond Corporation (ABC) in order to develop an international capital market in Asia and to use the region's abundant savings to finance the growth of Asia. In the process of expanding the activities of the ABC, Asia can adopt the notional common currency based on a basket of major currencies. That notional currency will pave the way toward introducing the Asian common currency, which can be the ultimate goal for economic cooperation and integration in East Asia.

In the meantime, while enhancing currency cooperation, East Asia needs a lender of last resort in order to keep its economy from collapsing by another currency attack. Japan has been trying to play that role and is poised to take that responsibility as the largest and the most developed economy in the region.

International capital markets and a truly international currency are supported by numerous institutions and intellectual framework. Asia is yet to build those institutions. To help build those institutions, we in East Asia need to establish a new international research institution which would coordinate the strenuous intellectual efforts needed for building institutions that bolster the international capital market in Asia. The envisaged new institute can be dubbed the Asian Monetary Institute, AMI.

THE CURRENT STATE OF THE INTERNATIONAL FINANCIAL SYSTEM

Recurrence of the Twin Deficits

With the war in Iraq likely to be longer lasting and more expensive than anticipated by the Bush Administration, the United States began to run twin deficits again: a budget deficit of the federal government and a current account deficit of the whole country. The twin deficits that existed during the peak of the Cold War under the Reagan Administration have come back again in the 21st century; it

is likely that the Bush twin deficits will also linger on in the years ahead.

The net international debt of the United States, $2.6 trillion, some 25% of U.S. GDP at the end of 2002, is already huge. This huge debt has made fund managers feel dizzy on the prospects of the U.S. economy. On top of this debt, the United States is likely to need continued massive borrowing from overseas, because the current account deficit may well reach $500 billion in 2003 as a result of the long occupation of Iraq by U.S. armed forces. This new outlook has made global investors nervous about the sustainability of the American war on terror from the financial side.

In order to alleviate the concerns and anxieties of the investment community, the United States needs to do something to keep its reliance on foreign capital inflow from becoming even greater. That means the United States had better reduce its current account deficit. That need is probably the most important underlying factor behind the American demand to revalue the Japanese yen and the Chinese yuan, a demand that came onto the international political scene after the American armed forces occupied Baghdad in May 2003.

While Japan has yielded to U.S. pressure and abandoned the tacitly held target since 2002 (of keeping its currency below 115 yen to the dollar) and allowed the yen to rise since August 2003, China chose to resist the U.S. pressure at least for some time.

From the Japanese view point, the request for a higher yen and lower dollar for financing the endless American war is not a new experience. As Table 1 shows, it happened during the Vietnam War and resulted in the Smithsonian Agreement of December 1971 (with the yen going from 360 to 308 per dollar) and then the floating rate system in March 1973. In the final stages of the Cold War, the United States recorded twin deficits and we had the Plaza Accord and the Louvre Accord; the yen moved up from 221 per dollar (1985 average) to 128 (1988 average). In fact, the demand for the devaluation of the U.S. dollar (up-valuation of the Japanese yen) during a large-scale American war is a déjà vu for the Japanese business community.

Table 1: Twin Deficits Redux

Percent of GDP

	Vietnam War			Cold War			War on Terror		
	Year	Budget Balance	Current Account	Year	Budget Balance	Current Account	Year	Budget Balance	Current Account
				1981	-2.6	+0.2	2001	+1.3	-3.9
				1982	-4.0	-0.2	2002	-1.5	-5.6
	1968	-2.9	+0.1	1983	-6.0	-1.1	2003	-4?	-6?
	1969	+0.3	0	1984	-4.8	-2.4	2004	-5?	?
	1970	-0.3	0.2	1985	-5.1	-2.8			
	1971	-2.1	-0.1	1986	-5.0	-3.3			
	1972	-2.0	-0.5	1987	-3.2	-3.4			
	1973	-1.1	+0.5	1988	-3.1	-2.4			
Currency	Fixed→Smithsonian→		Float	Float			Float		
Yen/$ (ann. avg.)	360→308			221→128			121.58→108.13		(11/19/03)

Source: Statistical Appendix to the *Economic Report of the President 2003* and www.bea.gov/bea/di/home/bop.htmT, and *Statistical Abstract 2003*, compiled by the Japanese Government Cabinet Office.

Vulnerable Dollar

However, the current round of currency revaluation is different from the past experiences in several aspects: 1) the war on terror is creating a direct threat to the United States homeland, quite unlike the Vietnam War and Cold War; 2) the balance of payments and the international investment position of the United States have deteriorated sharply and the position of the U.S. dollar has come to be seen as quite vulnerable by global investors, and 3) the U.S. pressure on foreign currencies is placed not only on the Japanese yen but also on the Chinese renminbi and other Asian currencies.

The U.S. reliance on foreign capital for financing its twin deficits (the federal budget and the current account) has come close to a dangerous point. On 5 November 2003, the U.S. Treasury Securities held by foreign monetary authorities under the custody of the New York Federal Reserve Bank reached $1.002 trillion, topping the one-trillion-dollar mark for the first time in history.[1] One trillion dollars is some 32% of the marketable U.S. Treasury Securities outstanding at the end of 2002.[2] If a sell-off of U.S. government IOUs by foreigners should happen, the exchange rate of the dollar could fall precipitously and U.S. government financing could be in jeopardy.

The Normal State of International Capital Flow

Currently, the United States, the richest and most advanced country in many ways, is borrowing money from less rich countries to keep its economy going. This is not the normal state of capital flow in the world of international finance.

As a rule, money should be flowing from the developed countries to the less developed ones. This is because in the developed countries, the investment opportunities at home are small compared to the saving (surplus money for investment) available at home. Generally speaking, the rate of return on investment in developed countries is lower at home than abroad. The less developed countries need more money for investment in infrastructure projects and importation of capital goods. The demand for investment funds usually exceeds the supply of surplus funds (saving) available at home where income is low. These tight demand and supply conditions of money usually result in higher interest rates in the developing countries than in the developed countries. The household sector in developing countries does not have much surplus because of its relatively low income. In order to realize their high growth potential, the less developed countries borrow money from the more developed ones.

There are rich historic examples for this natural flow of capital from the more developed countries to the less developed. In the 19th century, railroad construction across the vast continent of North America was financed by British investors, the richest country of that age. American money in turn helped the reconstruction of war-ravaged Europe after World War II. Japan used loans from the World Bank (mostly American money in those days) to build its Shinkansen (bullet train lines) in the post WWII era.

The role of international finance is to facilitate this natural flow of funds from the developed to the developing. The Bretton Woods system built after WWII played that positive role. In order to let the international financial system function smoothly, the exchange rate between currencies must be stable; the volume and the direction of capital flow should be predictable. The Bretton Woods system of fixed exchange rates and capital controls made exchange rates and capital flows stable and predictable.

The current system of international finance that has existed for the past thirty years does not satisfy those conditions. Because the floating rate system and unregulated international capital flows do not meet those requirements, the current system has caused much damage already.

Problems of the Current System

Japan’s former vice Minister of Finance for international finance, Toyoo Gyoten, points to the negative

impact of the floating exchange rate system on the world economy as seen in table 2.[3] Comparing growth rates under the fixed and floating exchange rate systems, it is clear that the volatility and unpredictability of the exchange rate contributed to the poor economic growth and trade performance under the floating-rate system. Mr. Gyoten maintains that the current exchange rate system is a "non-system", an emergency measure taken because there was no alternative at that moment but never intended as a sustainable international financial system. In 1973, reform in the international financial system for building a stable exchange rate system was recognized as the most urgent task. Though quite a few international conferences were held on this subject, nothing substantial has been done since then.

Table 2: Negative Impact of the Floating Exchange Rate System

percent

		Economic growth rate	Inflation rate	Export growth rate	Import growth rate
1960-73	Fixed-rate system	4.8	4.3	8.8	9.3
1973-87	Floating-rate system	2.6	6.8	4.2	3.7

Source: Volcker and Gyoten, 'Changing Fortunes' p. 304, New York: Times Books.

Because the current floating-rate system has lasted for more than thirty years, many people might regard it as the natural state of the international financial system. It is not. Despite its longevity, the floating-rate system is a defective system in need of major reform.

Many European leaders share this highly skeptical view of the current floating-rate system. For instance, Helmut Schmidt, former Prime Minister of Germany made the following statement, in criticizing the current floating-rate system.

> Though common understanding has not been reached today, when such understanding is reached, the EU will play an important role in establishing the new international system for regulation and control. I will not be surprised if an attempt is made for restoring the fixed exchange rate system.[4]

The world economy has suffered from this defective floating-exchange rate non-system since 1973. Europe has managed to minimize its disruptive effects by creating the euro through regional currency cooperation; Asian countries moved more slowly toward regional currency cooperation. Asia paid dearly for its delay in currency cooperation in the disastrous currency crisis of 1997-98.

The 1997 Capital Account Crisis

The Asian currency crisis of 1997-98 was, in essence, a capital account crisis caused by the defective

international financial system of floating exchange rates and unrestricted international flows of capital. Table 3 shows the problem clearly. The five crisis-struck countries of Asia (Korea, Indonesia, Malaysia, Thailand, and the Philippines) ran a combined current account deficit of $54.6 billion in 1996, one year before the crisis.

Table 3: Balance of Payments in Crisis Countries

	1995		1996		1997		1998		1999	
	Billion US$	% of GDP	Billion US$	% of GDP	Billion US$	% of GDP	Billion US$	% of GDP	Billion US$	% of GDP
Current account	-41.0	-4.06	-54.6	-5.03	-26.3	-4.12	58.5	7.7	43.2	5.03
Capital account	81.5	8.07	100.6	9.27	28.8	4.52	-0.5	-0.07	-1.2	-0.14
Direct equity	15.9	1.57	19.7	1.82	3.6	0.56	8.5	1.12	18.7	2.18
Portfolio equity	11.0	1.09	13.9	1.28	-3.2	-0.5	2.1	0.28	4.5	0.52
Comm. bank credit	53.2	5.27	65.3	6.02	-25.6	-4.01	-35.0	-4.61	-18.8	-2.19
Nonbank credit	9.9	0.98	18.2	1.68	21.0	3.29	-1.7	-0.22	-4.6	-0.54
Official flows	2.5	0.25	-2.6	-0.24	29.9	4.69	27.8	3.66	3.5	0.41
Errors & omissions	-26.5	-2.62	-26.8	-2.47	-35.0	-5.49	-16.9	-2.22	-14.9	-1.74
Reserve (-increase)	-14.0	-1.39	-19.3	-1.78	32.5	5.1	-41.1	-5.41	-27.0	-3.14

Note: The crisis countries are Indonesia, Korea, Malaysia, Philippines, and Thailand.
Source: Masaru Yoshitomi and ADBI staff, *Post-Crisis Development Paradigms in Asia*, p. 69 2003 Tokyo: Asian Development Bank Institute.

Under the traditional system of fixed exchange rates and limited capital flows, foreign loans were not readily available and it was not easy for a country to devalue its currency to improve its balance of payments. According to those traditional rules of the game, if a county ran a current account deficit for too long, that country could soon run into difficulty in making payments for the loans from overseas. However, with the liberalization of the capital market in most developing countries, those constraints on the current account deficit that a country can incur seem to have been removed. Even if a country's current account has been in deficit for many years, it would not run into balance of payment difficulties, as long as the inflow of foreign capital is larger than the current account deficit.[5]

That was exactly the case in East Asia before the currency crisis. In 1996, the combined capital account of the five countries had a surplus of $100.6 billion, with commercial bank credit of $65.3 billion being the important bulk in the capital inflow. Because the current account deficit ($54.6 billion.) was more than offset by the incoming bank loans ($65.3 billion), the result was some surplus in the overall balance. With the conditions in the international balance of payments appearing secure on the surface, those countries were growing fast. The rate of return on investment (or bank loans) was relatively high.

This pattern of economic growth (using imported capital goods for equipment investment and infrastructure-building at home financed by the inflow of money from foreign countries) seemed to work well for East Asia so long as the foreign capital kept flowing into the region, based on the expectation of continued high growth.

However, when the speculative bubble of development projects in Thailand's real estate sector burst, there was a major turn around. Mr. Yoshitomi, former director of the Asian Development Bank Institute, analyzes the turnaround in an illustrious way.

> While the business cycle downturn and the fallout from the bursting of the asset bubbles reduced capital inflows, investors in the spring of 1997 launched a speculative attack. The Bank of Thailand fended off the attack. However, it faced renewed pressure in the summer as Thai exporters delayed converting exports earnings into baht and Thai banks and corporations scrambled to sell baht to cover their short-term dollar loans (Lauridsen 1998). The Bank of Thailand abandoned its peg on 1 July 1997. The currency initially fell and then tumbled further when IMF and the US Treasury encouraged the central bank to reveal to market participants that much of its reserve was tied up in swap contracts.
>
> Contagion spread to neighboring countries. These countries had current account deficits lower than Thailand (around 4% of GDP), budget surpluses, low inflation, and persistently high economic growth. Nevertheless investors who before 1997 had eagerly flocked to Asian markets suddenly pulled out. This break in investor confidence is evident in the sudden reversal of capital flows.[6]

There was a dramatic swing in capital flows: inflow of $100.6 billion in 1996 turned to outflow of $0.5 billion in 1998, a net swing of $101.1 billion (table 3). Exchange rates of those five Asian countries plunged (table 4). In the case of Indonesia, the rupiah fell to less than one-quarter of its previous value in two years (from 2,342.3 to 10,013.6) . Capital was withdrawn and a massive sell-off of the currencies took place. In order to stave off a balance of payments crisis, those countries had to cut spending to reduce imports and push hard to promote exports. As a result of heroic efforts to tighten fiscal and monetary policy, the current account balance of the five crisis-struck countries turned into a surplus in 1998. Thus, the currency crisis was overcome through strenuous efforts and enormous pain.

Table 4: Plunge in Nominal Exchange Rates

(local currency per US dollar)

	1996	1997	1998
Korea (won)	804.8	951.3	1,398.9
Indonesia (rupiah)	2,342.3	2,909.4	10,013.6
Malaysia (ringgit)	2.5	2.8	3.9
Philippines (peso)	26.2	29.5	40.9
Thailand (baht)	25.3	31.4	41.4

Source: International Monetary Fund.

The Asian currency crisis of 1997-98 was a result of the defective international financial system. Even so, developing countries must still utilize foreign capital in order to grow, and this need makes them vulnerable to the instability in international financial system. The problems in the international financial system are still with us today in the early 21st century; they haunt all Asian countries including Japan and China, the two countries in the region that were not hit by the crisis in 1997-98.

Current Distortions and the Mounting Pressure for Reform

By the end of September 2003, the foreign exchange reserves of the major Asian countries amounted to somewhere between 15% (Japan) and 99% (Singapore) of each country's GDP (table 5). The traditional theory of the international currency system usually assumes that foreign exchange reserves equivalent to some two to three months' of a country's import bill should be sufficient. Based on this premise, for a country with total imports amounting to 30% of GDP, the sufficient amount of foreign exchange reserve would be less than 10% of its GDP ($30 \times 3/12 = 7.5$).

Today, all the East Asian countries hold foreign exchange reserves far in excess of what is needed to conduct import business smoothly (table 5). Moreover, although the level of foreign exchange reserves is already high, the East Asian countries are still hoarding foreign exchange. In 2002, the Asian countries had current account surpluses ranging between 1.6% of GDP (Korea) and 21.5% (Singapore). The drastic change in the current account from deficit to surplus that occurred in the aftermath of the Asian currency crisis of 1997-98 is still maintained. A surplus in the current account is likely to cause upward pressure on a country's exchange rate.

Table 5: Amassing Foreign Exchange Reserves in Asia

	Foreign exchange reserves/GDP, % Q2 2003	Current Account/GDP, % 2002	Current Account/GDP, % 1996
China	31	+2.9	+0.9
Korea	28	+1.6	-4.7
Taiwan	22	+5.4	+4.0
Singapore	62	+21.5	+15.4
Thailand	28	+6.0	-7.9
Malaysia	44	+7.7	-5.0
Indonesia	72	+4.3	-3.4
Philippines	22	+5.4	-4.7
Japan	14	+2.7	+1.4

Source: www.imf.org/external/np/tre/sdr/drates/8101.htm and *China Statistical Year Book 2002.*

The reason for the piling up of exchange reserves is that those Asian countries want to defend their currencies against speculative buying. The central banks of Asian countries bought dollars and sold their country's currency in the exchange market in order to keep it from rising too fast. The monetary authorities hold these dollars not in cash but in the form of the U.S. Treasury Securities. U.S. Treasury Securities constitute most of the foreign exchange reserves of each country. In an economic sense, this purchase of Treasury Securities is an unconditional lending of money to the U.S. government by foreign governments.

In their effort to defend their currency from attack, those Asian developing countries with low income levels are lending money to the much-higher-income United States without placing any condition on how the money should be spent. The money lent to the United States (through operations in the foreign exchange market and recorded as increases in the foreign exchange reserve of each county) is used by the U.S. government to finance a domestic budget deficit that is swelling due to the high cost of "the war on terror".

This is the irony of the international financial system today. A typical example is Malaysia, with a per capita income in 2002 of $3,879 compared to $37,233 in the United States. The average U.S. citizen's income is almost 10 times that of the average Malaysian's, and yet, Malaysia is lending almost 44% of its national income to the U.S. government. Muslims, who constitute the majority (60%) of the 25 million Malaysians, do not support America's war on terror, and Malaysia's long-time leader until October 2003, Mahathir Mohamad, has been bitterly critical of American foreign policy toward the Islamic world. However, rich America can spend the money from poor Malaysia to pay the

cost of war in Iraq and in Afghanistan. The Malaysian government has no control over this unintended result of its own ringgit-defending operations.

There was no major currency crisis in Asia in 2003 with a visible economic disruption equivalent to the one that occurred in 1997. However, beneath the calm surface, the seeds of crisis are growing and the pressures for a major currency realignment are mounting.

Impending Tasks for Asia

We in East Asia conduct almost half of our international trade among ourselves. The ratio of intra-regional trade in East Asian was 47% in 2002. Instead of relying on the U.S. dollar, East Asians had better create our own regional currency and use that common currency for trade and investment within our region. This will substantially reduce the currency risks. The U.S. dollar is a currency outside East Asia, and the heavy debt and the huge current account deficit of the United States can make the dollar quite unstable under the current system of floating exchange rates and free capital flows.

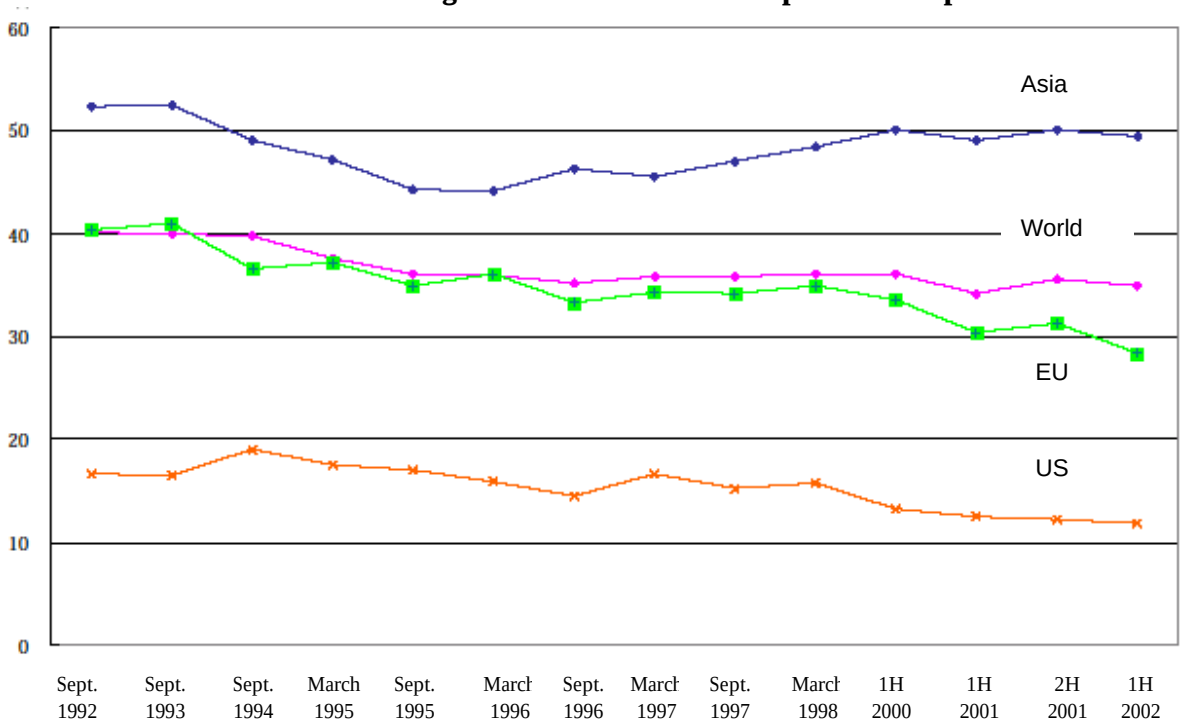
JAPAN'S APPROACH TO BUILDING A STABLE CURRENCY SYSTEM

Since the late 1970s, Japan has been trying to make the economies of East Asia less vulnerable to erratic movements in the foreign exchange market, because a stable financial system in Asia will benefit Japanese exporting companies and will help Japan's major trading partners in Asia. In the first stage in the 1980s, Japan tried to make the yen itself an international currency (table 6). The percentage of Japan's exports to East Asia denominated in Japanese yen has risen from some 45% in 1995 to 50% in 2002 (table 7).

Table 6: Japan's Approach to Currency Stability for Asia

International use of yen	1980s
Asian Monetary Fund	1997
Chiang Mai Initiative	1999
Asian Bond Fund	2003

Table 7: Percentage of Yen Denominated Exports from Japan



Source: http://www.mof.go.jp/singikai/kokusaika/siryou/a140912/aa.pdf.

Though the percentage for Asia is higher than the yen-denominated share of Japan's exports to the other regions of the world, 50% is not a particularly high number. We can observe that the promotion of the international use of the yen outside Japan was mildly successful. In the second stage, in the late 1990s, Japan launched the so-called Miyazawa Initiative and came out with the specific proposal, to establish the Asian Monetary Fund. The AMF did not materialize because of opposition by the United States. It is a chagrin that Japan could not use its enormous financial resources during the Asian financial crisis of 1997-98 (table 8).

Table 8: Asian Monetary Fund and the Miyazawa Initiative

Asian Monetary Fund	Miyazawa Initiative
First proposed at the September 1997 IMF meeting in Hong Kong. Strongly opposed by the United States	Proposed in 1998 $30 billion aid to countries affected by the Asian currency and economic crisis Medium- to long-term loan program ($15 billion) • to help rebuild the economies-countries immediately by delivering a large amount of money speedily. • Yen loans provided by Japan's OECF (Overseas Economic Cooperation Fund) and Export Import Bank became important ingredient Short-term financing program for trade ($15 billion) • contingency short-term loan to support trade • nothing to do with the foreign exchange market intervention for currency stabilization. 7

THE ASIAN BOND FUND AND ITS LIMITATIONS

In May 1999, the Finance Ministers of the ASEAN member countries plus Japan, China, and South Korea , the so-called ASEAN-plus-three or APT, agreed to build a network of swapping agreements for the foreign exchange reserves of member countries. This network of agreements is usually called the Chiang Mai Initiative, CMI, because the Finance Ministers meeting was held in Chiang Mai, Thailand. Bolstered by the success of the CMI, in June 2003 the APT members took another step forward by establishing the Asian Bond Fund, ABF, a regional investment fund investing in bonds denominated in U.S. dollars (table 9).

Table 9: Asian Bond Fund

Launched:	June 2003
Functions:	• to use $1 billion collected from central banks • to invest in dollar-denominated public bond in Asia, passively
Limitations:	• currency mismatch persists • no active trading nor deepening market • no investment in corporate bonds or securitized assets; little private sector benefit

Eleven central banks in East Asia agreed to establish the Asia Bond Fund, collecting a total of $1 billion from the member central banks. The Bank of Japan is to contribute $100 million to the Asia Bond Fund. The Fund will invest in bonds issued by the public sectors of the eight countries and regions in East Asia, including Japan, China, Korea, Hong Kong, Indonesia, and Thailand . Though this initial step is too mild to have any significant effect, it is still a step in the right direction. Taking

the step toward developing an international bond market in East Asia will facilitate currency stability and economic growth in the region.

Nevertheless, the Asian Bond Fund has severe limitations and is in need of major improvements. In its current form, the ABF has at least three problems. One is that it can invest only in U.S. dollar-denominated securities. As a result, the ABF cannot resolve an insolvency crisis of a bond issuer when a sharp fall of a local Asian currency occurs, such as befell the Thai baht and the Korean won in 1997 (currency mismatch). The second limitation of the ABF is the different maturity structures between borrowers and lenders. Local borrowers in Asia tend to use the money for long-term investments to build factories while foreign lenders are short-term oriented. When business conditions become difficult, foreign banks will withdraw funds, making it difficult for the local business to survive (maturity mismatch).

The last problem is the passive investment policy to be adopted by the ABF. Just buying and holding bonds till maturity will not result in deepening and activating the bond market in Asia. The ABF is to be managed by the BIS, Bank for International Settlement, in Basel, Switzerland, the association of global central banks. Instead of leaving the important business of investing to these conservative and bureaucratic central bankers, we need participation from the private sector. This can be called an investment policy mismatch. We must let investment bankers, institutional investors, and individuals in Asia buy and sell, take risks, and make losses and profits. Let a hundred risk takers come and let them prosper or lose! That is the way to develop an international capital market in the region.

THE NEED FOR ASIAN BOND CORPORATION AND ITS FUNCTIONS

In order to overcome these limitations, Professor Taketoshi Ito of Tokyo University proposes establishing a new entity that can be called the Asian Bond Corporation, or ABC.[8] As Prof. Ito puts it: “The Asia Bond Corporation will use its assets, i.e., the bonds purchased, as collateral to issue an “ABC Bond” which has a characteristic of being denominated in the basket of collateralized securities held by the corporation” (table 10).

Table 10: Asian Bond Corporation Proposal

- Proposed by Prof Ito et al.
- Purchase bond issued in local currencies (eliminate currency mismatch)
- Use as collateral to issue ABC bonds
- Investors in ABC bonds earn higher returns with less exchange risk (reduce maturity mismatch)

For example, suppose the ABC were to issue a batch of bonds backed by a purchase of government bonds—50% Japanese, 30% Korean, and 20% Thai government bonds. The new bond issued by the ABC would, in effect, be denominated in a basket currency comprised of 50% yen, 30% won, and 20% baht. For Japanese investors, the currency risk would be smaller than that on assets denominated in dollars or in euros, because the won and the baht fluctuate more closely with the yen than do the dollar or the euro.

"On the other hand," according to Ito, "as half of the component to set the rate of return of the bond would consist of domestic interest rates of Korea and Thailand, the effective yield would be higher than that of the Japanese government bond. The feature would also make it attractive for Japanese investors. This means while reducing fluctuation risks by creating a virtual basket currency, higher rate of return could be expected than investing in securities with high credit standing. This sort of instrument, if made easily accessible, should appeal to Japanese investors" (See note 11). At the end of 2003, the interest rate on ordinary bank deposits in Japan was an incredibly low 0.001%, extremely close to zero. For Japanese depositors, any mixing with the interest rates of neighboring countries is very attractive. Those new bonds based on a basket of Asian currencies would sell out in Japan almost instantaneously.

An Asian Currency Unit

The policy-deliberating community in Japan and Asia sees the formation of the Asian Bond Corporation as part of a grand design for regional currency cooperation culminating in an Asian currency unit, or ACU. The current thinking expressed at several conferences held in 2002 and 2003 and in papers from many East Asian countries submitted to those conferences contemplates the gradual expansion of the operation of the Asian Bond Corporation over the years. As the ABC moves forward, introduction of the Asian currency unit would become more feasible. The basket of

currencies for the ACU (probably initially consisting of the dollar, the euro, and the yen) could gradually include more local East Asian currencies and reduce the weight of currencies from outside the region. As each member country's economy grows and becomes more stable, the income gap among member countries will be reduced and the convertibility of some local currencies could be achieved. At that stage, the composition of the ACU could be altered by sharply reducing the weight of the outside currencies and increasing that of Asian ones.[9]

Toward an Asian Capital Market

The ASEM Finance Ministers' Meeting in early July 2003 stressed the importance of deepening the Asian bond market and expanding the capital base of the Asia Bond Fund. In order to invigorate the Asian bond market, another bold initiative seems to be called for. As Prof. Ito puts it, "the scheme to introduce the Asian Bond Corporation should be pursued."[10] In September 2003, at the Meeting of APEC (Asia Pacific Economic Cooperation) Finance Ministers, Prime Minister Thaksin of Thailand stressed that an Asian bond market would "provide a rational option as a savings instrument for us in order to ensure that the wealth of Asia and the Pacific is used to create greater prosperity for the region."[11]

It is in the common interest of East Asian countries to promote regional financial cooperation. By establishing something like the Asian Bond Corporation, the abundant domestic household saving in Asia can be used for financing growth locally, not for financing a war outside the region. By eventually establishing a regional common currency such as the ACU, trade and investment can grow more smoothly as the economic activity in the region becomes less vulnerable to the volatile fluctuations of outside currencies such as the U.S. dollar.

LENDER OF LAST RESORT

As East Asia moves toward building a stable international currency and capital market, it must encounter a lot of risks along the way. Many of these risks will be insurmountable for developing countries even after the establishment of the Asian Bond Corporation and the Asian Capital Market.

The daily flow of capital in the international markets is up to one trillion dollars a day. A country can use its foreign exchange reserve to defend its currency against speculative attacks. In the

Asian crisis of 1997-98, the swing in the capital account from surplus to deficit was well more than one year's import bill, several times the equivalent of three month's of imports that countries were urged to hold in foreign exchange reserves in the days of the fixed exchange rate.[12]

East Asian countries are likely to encounter many new difficulties that could cause global investors to change their perception of the region and trigger attacks on Asian currencies. No developing country in Asia can have sufficient foreign exchange reserves to persevere in such attacks. Neither the International Monetary Fund nor the World Bank can provide in a timely fashion enough liquidity to the developing countries in Asia in such a contingency.

Provision of international liquidity for controlling future capital crises must be done in a massive and timely fashion. A lender of last resort should emerge on the regional level rather than on a global one. It is natural and reasonable for a regional power to become the lender of the resort and exert the needed political and economic leadership. In the East Asia region, Japan can play that role.

In the North American continent it is natural for the United States to be the lender of last resort. The United States rescued Mexico because of that country's strategic interest for the US. It will also play a similar role when another economic crisis erupts elsewhere in the Americas, if the strategic interests of the United States are involved. In Europe, the European Central Bank could face similar challenges in the future, under the mandate given by the European Union.

As we move forward toward closer economic integration and currency cooperation, East Asian countries had better bear in mind that the region needs not only the ABC, a capital market, and the forward-looking idea of a common currency, but also a lender of last resort to protect ourselves in contingencies.

TASKS FOR THE ASIAN MONETARY INSTITUTE

The policy issues of international finance can appear too technical, and some expertise might be needed to understand the policy challenges and explain them in plain English. What is more important is not the expertise itself but the greater common understanding of Asian financial affairs by the policy community and the general public in East Asia. We need more exchange of views on the practical steps and more collaboration to disseminate information on international finance in East Asia.

The time could be ripe for establishing something like an Asian Monetary Institute to pool the brainpowers and ideas in East Asia to study policy, encourage discussion, and make proposals (table 11).

Table 11: Functions of the Asian Monetary Institute

- Provide intellectual infrastructure for APT cooperation (data, conferences, etc.)
- Study and make proposals for financial cooperation
- Educate public and disseminate information
- Hub of a network

Institutions and Intellectual Infrastructure

The analysis heretofore has focused on currency collaboration and capital markets in Asia. There is no question that we should concentrate our discussion and dialogue on the clearly defined, specific, urgent task of facilitating currency collaboration and capital market development. We should bear in mind that we will encounter other broader, related, and difficult issues along the way. Building a capital market requires not only money, computer hardware/software, and traders that conduct transactions. In order to issue and trade bonds, we need rating agencies; companies must make financial statements based on certain accounting standards; we need a legal infrastructure (law, court, lawyers) in order to specify rules and settle business disputes. The role of companies in capital markets may not be limited to profit-making alone. Corporate governance is defined by the society's expectations about the behavior of private companies. Accounting standards also contribute to the foundation of the capital market. Without them, managers could treat companies as their private property under the pressures to show quarterly profits, and disaffected shareholders could flee, destroying the better part of Asia's fledging capitalism.

Europeans have bred and are endeared to their version of a "social market economy" as opposed to American-type capitalism. The draft of the first European constitution to be adopted in the next several years clearly stipulates that the European Union is a social market economy (Article 3, "The Union's objectives"). A well-developed set of institutions and intellectual infrastructure bolster Europeans' assertion of their own market economy system. For Asians to envisage and grope toward

an Asian capital market that has a global scope and size, they need to put in place those institutions and intellectual infrastructure that make a global financial market function smoothly. We should not underestimate the strength of the Anglo-American capital markets and the institutions that bolster those markets.

Lesson from Business in China

One typical example within my knowledge illustrates Asia's weakness in the institutional framework that facilitates capital market transactions. An American lawyer friend of mine visited mainland China several times during 2002 to write a memorandum of understanding (MOU) on the far-ranging business cooperation between a major Japanese manufacturing corporation and an important Chinese manufacturing corporation located in inland China. The Japanese and Chinese corporations agreed to help each other for the expansion of their business in China, and they needed a legal document to underwrite the nature of their cooperation. But, the Japanese side did not trust the Chinese legal system at all and neither did the Chinese side trust the Japanese one. Hence, the two parties inserted a clause in the contract, which effectively said, "when a dispute or a serious question arises as to the implementation of the contract, it will be resolved in an American court". Since any dispute was to be settled under the American legal system, an American law firm had to be involved and become a co-signatory to the contract. That is the reason why the American lawyer became involved in a deal between two Asian corporations.

Many large Japanese corporations that are strong enough to penetrate the Chinese market already have a presence in the United States, and they have already retained American law firms. The net result is that the deeper major Japanese corporations penetrate into the Chinese market, the more prosperous some American law firms will become. This is a typical example of the weakness in Asia's market institutional infrastructure.

The Soft Side of the Economy

At present, Japan has comparative advantages in many industries in the manufacturing sector. Japanese companies can produce higher quality products with lower prices. There is no question that in the years ahead many countries in Asia will follow Japan, create their own technology, and

out-perform Japan and the rest of the world in the manufacturing sector.

It is one thing to excel and establish a de facto global standard in manufacturing, however, and quite another to create institutions and build intellectual infrastructure to meet the various needs of market transactions. The software side of the capital market, so to speak, is different from the hardware side. Creation of an international capital market in Asia requires supporting institutions that all players can use and participate in. This is the area that the countries of Asia must strive strenuously to build together.

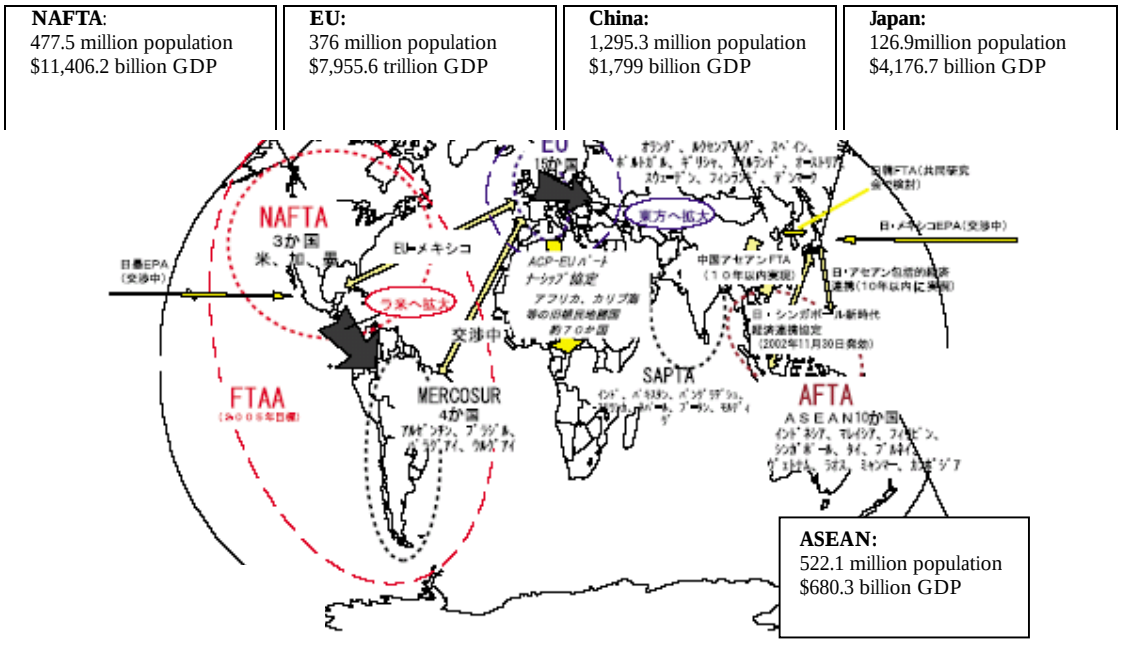
The envisaged Asian Monetary Institute would cover a wide range of activities and serve a large and diverse population as well. Table 12 compares the world's three major economic regions in terms of currency, population, and GDP while table 13 is a more graphical comparison of regional economic arrangements.

Table 12: APT in Perspective

	Number of members	Currency	Population (million)	GDP ($ billion)
APT	13	US$, ¥, local	1,991	5,896.9
NAFTA	3	US$	478	11,405.2
EU	15	€	376	7,955.6

Source: METI, *White Paper on Trade 2003.*

Table 13: Major Regional Economic Arrangements, REAs



Source: METI, *White Paper on Trade 2003*, http://www.meti.go.jp/report/whitepaper/index.html.

The trend in the twenty-first century is for people and countries within a geographic region to band together in regional economic arrangements (REAs) to withstand the rough wave of globalization and at the same time to promote globalization and efficiency within the region. The potential of East Asia, with the largest population and the highest economic growth rate of any REA, is tremendous. Intra-regional investment and trade are already high and they are rising, but the capital market and currency side of cooperation in the region is yet to be developed. We must build the institutions and create the intellectual infrastructure to support regional financial and monetary cooperation. The task is surely daunting. But do not wince. We have come a long way. We still have a long way to go. Let us move forward step by step through regional cooperation by and for East Asia.

ADDENDUM: SOME LESSONS FROM EUROPE

Europe's experience with regional currency cooperation holds some lessons for East Asia. The common currency, the euro, was officially introduced in January 1999 and the actual bills and coins began to circulate in 2002, putting Europe at the forefront of regional currency cooperation. It should be noted, however, that it took more than 30 years for Europe to create and use a common currency. The road to the euro was bumpy and uphill and there were moments when Europe's incessant search for a stable, common regional currency appeared to be almost collapsing.

Werner Report and the Snake

As early as 1969 member countries of the European Economic Community first agreed to a concrete plan of monetary cooperation . In 1971 the so-called Werner Report on monetary union came out, and based on the Report, the EEC's Council of Ministers adopted a resolution which declared the establishment of an economic and monetary union as the political goal.

In 1972, the "snake in the tunnel" system was adopted. It included the original six members of the EC as well as the UK, Ireland, Denmark, Sweden, and Norway. Under the snake system, member countries' exchange rates could fluctuate within plus or minus 2.25 percent. However, due to the

continuous international financial instability in the early 1970s, first the UK, and then France, Italy, and Sweden left the snake cooperation. With the departure of those important countries, the snake lost much of its significance.

European Monetary System

In 1979 through a French-German initiative, the snake was replaced by the European Monetary System (EMS) although the UK and Norway stayed out of the EMS. The new EMS maintained the parity band of plus or minus 2.25% , and the participating countries were obliged to intervene in the exchange market to keep their currencies within the band. In reality, the strong German mark was the anchor currency and the Bundesbank often intervened in the market in favor of the other central banks with weaker currency.

Delors Report

In 1988, again through French-German cooperation, it was agreed to set up a committee to prepare a report to reinvigorate the drive for further regional currency cooperation. The result was the Delors Report which outlined a three-stage development plan for an enhanced economic and monetary union. The first stage was from July 1, 1990, and the Maastricht Treaty, ratified in 1992, provided the legal basis. Denmark voted against the Maastricht Treaty and the French referendum on the Treaty passed by a very thin majority. It was this weak support and hesitation of many Europeans toward further currency cooperation that triggered the speculation on major European currencies in 1992-93. As a result, in August 1993 the band of currency fluctuation was widened to 15%, stemming off the attack on the EMS. The first stage narrowly survived.

European Monetary Institute

Despite those setbacks, Europe moved to the second stage of monetary union in January 1994 with the establishment of the European Monetary Institute (EMI). The EMI was to monitor the public budget of the member countries whose budget deficits were to be kept within 3% of their GDP.

European Monetary Union

In December 1996, the European Council, the gathering of the heads of the European countries, decided that the monetary union should move to the third stage, by replacing the EMI with the EMU,

European Monetary Union, in January 1999 and should fix the exchange rate among the member countries permanently and unalterably. The new currency was named the euro. Three years later, the euro was introduced as an actual currency for daily use.

Optimum Currency Area and Political Will

Many observers attribute the success of the euro to two factors: 1) the political determination to pursue European integration as the utmost national priority project, and 2) the benefit of introducing the euro outweighed the economic and political costs. The benefit of the euro is calculated to be a cost-saving of "0.3 to 0.4% of GDP for EMU countries,"[13] and the elimination of exchange rate uncertainties among the EMU countries has created better conditions for business. Important on the cost side is the loss of independent monetary policy by individual countries; in the event of an asymmetric shock hitting only one country, the cost of adjustment could be considerable without a country-specific monetary policy tool to mitigate the shock.

In economic theory, as articulated by Mundell, the area in which the benefit of currency union is greater than the cost is called the optimum currency area.[14] Compared with East Asia, the EU is more homogeneous in terms of income level, political system, culture, and shared history. Those conditions made currency cooperation in Europe easier. Asia could learn from Europe that the road to monetary union was fraught with risks and animosities even under conditions favoring currency cooperation. Political will, practical compromise, and real economic benefits seem to have been the most important factors that made the euro project an eventual success.

Notes

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