

**Intra-regional Exchange Rate Stability  
and  
Prevention of Financial Crisis in East Asia**

**August 2006**

**Institute for International Monetary Affairs**

## **Background and Objectives:**

There is a growing risk of cross-border financial contagion in an environment of high capital mobility. Financial instability in one country can quickly spread to neighboring countries, causing severe economic disruptions. The risk of contagion becomes particularly larger in a region where economic interdependence becomes stronger. The contagious nature of financial instability suggests that there will be a strong case for region-wide cooperation in financial and macroeconomic policies in East Asia with its rising degree of economic integration.

The Chiang Mai Initiative (CMI) and the Asian Bond Markets Initiative (ABMI)/Asian Bond Fund (ABF) are promoted in order to enhance financial and monetary integration and prevent financial crisis in the East Asian region. Furthermore, ideas of an Asian Currency Basket and Asian Currency Unit for intra-regional exchange rate stability also have been proposed as mid- and long-term objective for the region.

Under those circumstances, The Working Group (WG) for financial cooperation was established in January 2006. The WG examined the nature and causes of financial instability in the context of the East Asian economy and seeks to identify areas where regional cooperation is important to achieve financial stability across the region, based on current movements in financial and trade integration in the region.

Then, the WG discussed and compiled opinions and views among the WG members for enhancing “Intra-regional Exchange Rate Stability and Preventing Financial Crisis in East Asia.” for which purpose members of the WG met in Tokyo on June 30, 2006. The discussions held during the meeting on the topics outlined in this paper, have resulted in the seven policy recommendations which can be found at the end of this report.

The Working Group has noted the statement by the ASEAN+3 leaders at the 9<sup>th</sup> annual meeting held in December 2005, who declared that they would prepare a second Joint Statement on East Asia Cooperation on the tenth anniversary of ASEAN+3 process in 2007. The WG has also noted the achievements of the Research Group which has been working under the ASEAN+3 Finance Ministers Meeting since 2003 to explore ways to further strengthen financial cooperation and promote financial stability in the region. The WG will seek further measures based on these achievements as well.

Members of the WG are as follows:

Mr. Tadahiro Asami, Managing Director, Institute for International Monetary Affairs (Leader)

Dr. Takatoshi Ito, Professor, The University of Tokyo (Co-Leader)

Dr. Eiji Ogawa, Professor, Hitotsubashi University

Dr. Tetsuji Murase, Professor, Kyoto University

Dr. Junko Shimizu, Researcher, Assistant Professor, Meikai University

Mr. Naoyoshi Kinukawa, Director, Economic Research Department, Institute for International Monetary Affairs

Mr. Yozo Nishimura, Senior Economist, Economic Research Department, Institute for International Monetary Affairs

Mr. Kenichiro Matsui, Lead Economist, Economic Research Department, Institute for International Monetary Affairs

## Table of Contents

Background and Objectives: .....	1
Chapter 1: The nature and causes of financial instability .....	4
1-1. What are the causes of financial instability? .....	4
1-2. Why does financial instability tend to induce deep recession? .....	6
1-3. Why is financial instability contagious?.....	6
1-4. How does promoting trade impact regional financial integration? .....	7
Chapter 2: Policy implications for regional cooperation .....	9
2-1. Why is strengthening the regulatory framework important for financial stability?.....	9
2-2. How can an appropriate supervisory framework be established in the country?.....	10
2-3. How should capital account liberalization be executed?.....	11
2-4. How important is a regional monitoring system of cross-border capital flows for the prevention of contagion? .....	12
Chapter 3: Macroeconomic and exchange rate policy coordination.....	12
3-1. Should the governments in East Asia establish a region-wide coordination mechanism?.....	12
3-2. Why is the macro economic surveillance important?.....	13
3-3. Why should we need a regional coordination policy of exchange rate regimes in East Asia? .....	14
3-4. What are the objectives for a common currency basket system in East Asia?..	14
3-5. Regional monetary units and a common currency basket .....	16
3-6. Steps toward a common currency basket .....	16
3-7. The use of an AMU as a deviation indicator .....	18
3-8. The creation of a Core AMU .....	18
3-9. Recent progress of initiatives under the ASEAN+3 Framework .....	19
3-10. How can a roadmap be created for financial and monetary integration in the region for the medium to long term? .....	20
Policy Recommendations.....	24
Appendix: Initiatives under the ASEAN+3 Framework.....	30

## **Chapter 1: The nature and causes of financial instability**

### **1-1. What are the causes of financial instability?**

We have learned quite a number of lessons from the Asian crisis of 1997-1998. Considering the nature and causes of financial instability, the following consensus has emerged from the large source of literature on the Asian currency crisis.

First, about the causes of financial instability, many researchers have pointed out that the crisis occurred due to the combination of weakness in macro fundamentals and unstable capital flows. Weak macro fundamentals include not only slow growth rate, high unemployment rate, and relatively high inflation rate, but also financial and institutional vulnerability. Several Asian countries before the crisis had developed the so-called double mismatch problem: on the one hand, a currency mismatch, and on the other hand a maturity mismatch. Many Asian banks borrowed dollars from foreign lenders in short term loans and lent long-term loans in their own currency. When foreign lenders asked Asian banks to repay (by not rolling over loans), these banks could not come up with the dollars in time. Weakness of balance sheet was one of the major causes of financial instability.

Second, a lack of transparency in terms of government data and private sector balance sheets made investors form overly optimistic expectations about the growth potential of these countries, thus lending to these banks and firms without assessing their risks properly. The borrowers also borrowed without calculating their own ability to repay in the future. Over-lending flooded the domestic financial markets with liquidity, resulting in over heating and in some cases causing a bubble in the asset market. That was also one of the major causes of financial instability. These aspects of financial markets were exposed when the capital flows reversed their direction. Triggered by circumstances which varied from country to country, investors suddenly became aware of those vulnerabilities and decided to withdraw their funds and investments very quickly. This resulted in very acute currency pressures.

Third, the exchange rate regimes contribute to enhance the vulnerability. Before the currency crisis, the Asian countries had adopted a de facto dollar peg. Although, the declared exchange rate regime was not necessarily a dollar peg. For example, Thailand had declared their exchange rate regime as a basket system, but since the dollar weight in their basket was in fact estimated to be more than 90 percent, it was de facto a dollar peg. The dollar peg, on the one hand, encouraged capital flows into the country, which resulted in the over-heating as mentioned above, and on the other hand it allowed their export competitiveness to be affected by the movement of the cross rate (the baht-yen rate). Therefore financial instabilities were caused by the combination of the exchange rate policy and domestic policy.

Eichengreen and Hausmann (1999)<sup>1</sup> referred to the phenomenon where many emerging countries could not borrow abroad in their own currency and could not borrow in local currency at long maturities, as the “Original Sin”. They show that countries with the Original Sin, mainly Latin American countries, exhibit greater output and capital flow volatility, lower credit rating, and limited ability to manage an independent monetary policy. These situations are similar to pre-crisis East Asian countries. However, we do not suppose that the Original Sin necessarily applies to East Asian countries. They could not borrow from foreigners in local currencies, but they might not have made an effort to do so, since they were not aware of a problem on the currency denomination of foreign borrowing.

Once selling pressure on the exchange market rose and currencies started to depreciate, it had profound effects on the Asian emerging market economies. The effects were not only financial but real. First the depreciation affected the balance sheet of financial institutions and corporations. Since they borrowed in US dollar and lent in domestic currencies or invested in plants and machineries for the long term, they could not come up with repayments. Therefore the corporations started to stop payments to banks and banks had to endure non-performing loans on their balance sheets. That resulted in the stalling of

---

<sup>1</sup> Eichengreen, Barry, and Ricardo Hausmann, “Exchange Rates and Financial Fragility”, in *New Challenges for Monetary Policy*, a symposium sponsored by the Federal Reserve Bank of Kansas City, 1999

further bank credits in other sectors. Also, due to the collapse in asset prices, as a reaction to the overheating economies mentioned above, investors, entrepreneurs, and households in those countries lost confidence in the future prospects of the economy. So spending in consumptions and investments suddenly went down and a recession started.

### **1-2. Why does financial instability tend to induce deep recession?**

The depreciation of the currency was supposed to help the exports to grow. However, that process, as a natural remedy of depreciation, did not work in time.

First, the currency depreciation was so rapid that the corporations could not take advantage of price competitiveness. We know that it takes time for exporters to adjust their pricing policy and to increase the volume of the exports in order to exploit the stronger competitiveness because it takes time to reach the destination of export market, and to advertise and distribute goods. So currency depreciation by 50 percent in three months did not enable exporters to increase their exports in time to help the economy.

Second, exporters in some cases could not get the export-credit from banks because banks had already developed non-performing loans and could not get credit lines with corresponding banks in major financial centers. Thus, local banks in those countries lost their credibility in international markets and therefore letters of credit issued by those banks were not acceptable. So a simple recession became a deep recession very quickly. In some countries, the economic recession resulted in political instability and that aggravated the economic chaos.

### **1-3. Why is financial instability contagious?**

Also notable in the Asian currency crisis was the phenomenon of contagion. The Asian currency crisis started from Thailand which adopted a floating exchange rate system on July 2, 1997.

At first, depreciation was most notable in Thailand and then it affected neighboring countries, such as the Philippines, Malaysia, and Indonesia. Soon all the currencies in the region started to depreciate. The Hong Kong Dollar underwent a large pressure on the exchange and stock markets at the end of October. The Korean won was relatively robust against depreciation pressure until November 1997, but it eventually started to depreciate very sharply. By December 1997, the Chinese Renminbi and the Hong Kong dollar were the only currencies which could maintain the dollar peg.

There are several hypotheses on why the contagion was so widespread in Asia. The first hypothesis is the investors' sudden awareness of the risk in the region. The so-called wake-up call hypothesis states that the crisis in one country in the region prompted investors to reassess risks of other countries in the same region, thus discovering similar financial weakness in neighboring countries.

The second hypothesis of contagion goes through trade links. Depreciation in Thailand made Thai exports more competitive against neighboring countries. As a result, the neighboring countries, such as Singapore, Malaysia and Indonesia, let their currencies depreciate so that they would not lose their competitiveness in export. This is the mild version of competitive devaluation.

The third hypothesis is the so-called common creditor hypothesis. Many Japanese banks and Western banks providing loans to several Asian countries started to withdraw funds from these countries to make up for the losses in the troubled country when companies and banks in that country became non-performing in the eyes of Japanese and Western banks. In this hypothesis, the contagion is not limited to the same region. In some cases, the losses in Asia prompted banks and investment banks to withdraw funds from Brazil and Russia. It is debatable which hypothesis is most relevant in Asia. It is most likely that these three hypotheses reinforced each other and contributed to deepening of the crisis in Asian.

#### **1-4. How does promoting trade impact regional financial integration?**

In the trade-linked hypothesis of contagion, trade and financial relationships are closely linked together. The more integrated the trading relationship is, the more sensitive becomes the financial market. Therefore, cooperation in financial markets should proceed with cooperation in trade relationships.

In the experiences of regional cooperation in other part of the world, we tend to see that trade integration precedes the financial integration. At first, a free trade area (FTA) or a customs union (CU) is developed. Then, goods and services and human capital start to move freely across the border in the FTA/CU region. Such movements need a stability of exchange rates in the free trade area or customs union.

In Asia, the existing free trade area among ten ASEAN countries is called AFTA, and progress has been made towards creating a zero tariff area. East Asia has been vigorously promoting economic integration in recent years. China started negotiating with ASEAN countries on early harvest (early implementation of part of goods and services) for agricultural goods.

In 2005, there were some major developments in FTA and Economic Partnership Agreement (EPA) talks between Japan and Asian countries: In April, Japan and ASEAN also launched formal negotiations on the ASEAN-Japan Comprehensive EPA. In July, Japan and Indonesia launched their formal negotiations for Japan-Indonesia EPA. In September, Japan and Thailand EPA confirmed that agreement in principle has been reached on major elements of the Japan-Thailand EPA. In July 2006, Japan-Malaysia EPA was entered into force.

However, trade and investment, particularly foreign direct investment, in these ten countries are not yet freely flowing across the border for various reasons. The trade relationship between Japan and ASEAN countries, or China and ASEAN countries, are in the process of being liberalized. FTAs in East Asia in recent years also include investment liberalization, trade and investment facilitation, as well as economic and technical cooperation. These alliances will be expected to promote foreign direct investment (FDI) and economic and technical co-operation in the future.

It may take at least several years to achieve a genuine free trade area in East Asia. Financial cooperation including exchange rate cooperation cannot be completed without liberalizing trade and investment. If a tariff barrier is abolished due to bilateral free trade talks between East Asian countries that might make both trade volumes and capital flows relatively larger, resulting in greater volatility and risks in the financial markets. Therefore, it is very important to encourage trade integration in parallel with financial integration.

## **Chapter 2: Policy implications for regional cooperation**

### **2-1. Why is strengthening the regulatory framework important for financial stability?**

In designing a robust financial market in the region, it is very important to think of a regulatory framework in the region. Of course, the regulatory framework has to start with the domestic market. Each country has to strengthen their regulation and supervision of financial institutions including banks, securities firms and insurance firms. To build robust financial institutions is a crucial step to avoid another crisis in the region.

However, in parallel with making a regulatory framework in each country stronger, it is important to cooperate and harmonize regulatory frameworks in the region as a whole. For example, when banks operate in another country, the supervision of the foreign branch primarily rests on the host supervisor. So the authority of the home country has to trust the host country supervisor. The home country supervisor also has to make sure that the foreign branches of their banks are not treated unfairly by the host country supervisor. Therefore, making regulations and supervision standards harmonized, if not standardized, is a very important step for smooth financial transactions in the region.<sup>2</sup>

---

<sup>2</sup> In the EU as a general rule, home supervisors are responsible for solvency risks, while host supervisors for liquidity risks of EU-based banks.

## **2-2. How can an appropriate supervisory framework be established in the country?**

There are several different models for financial supervision in one country. The first model is an FSA (Financial Supervisory Authority) model like U.K., Japan and Korea. The integrated, unified supervisory agency is established independent from the central bank or the fiscal branch of the government. They collect experts on financial supervision, design and implement regulations as well as examine financial institutions.

Another model is financial supervision by a central bank. This is the case in many continental European countries, and Thailand and Indonesia in Asia. Financial supervision by a central bank is efficient for developing countries where resources are scarce. But it often invites a conflict of interest when central banks would like to protect financial institutions from failing. The challenge, therefore, is how to make an arms-length supervision framework within the central bank. The trend at least among advanced countries is to establish FSA so that a problem of the conflict of interest would not arise in crucial times of financial distress.

When financial institutions are weak, it is not appropriate to liberalize external financial transactions. Any distortion and weakness in the domestic market will be magnified rather than rectified, if the capital, especially short-term capital, flows into the country. Therefore, the timing for opening capital accounts would be dependent upon the strength of domestic financial institutions and the fiscal and supervisory framework. In this regard, it is very important that the financial authorities in the region exchange information and cooperate in developing, harmonizing, and standardizing financial supervision. The better supervised and the more harmonized, the better the region will be able to allocate capital to the most productive areas and industries in the region. That would promote faster growth and robust economies in the region.

Up until now the regional financial cooperation efforts have been guided by the ASEAN+3 Finance Ministers' Meeting. However, seeing how the central banks in the region make important contributions towards maintaining a stable exchange rate regime, financial supervision, and regional financial cooperation, their active participation in the

cooperation process is indispensable. It is thus important for the central bank governors to participate in the Finance Ministers' Meeting as regular members.

### **2-3. How should capital account liberalization be executed?**

There were some problems with the capital account liberalization in East Asian countries.

For example, in the case of pre-crisis Thailand, the magnitude of short-term capital inflows via the Bangkok International Banking Facility (BIBF) was very large. As a result, excess liquidity swelled in domestic markets, and it adversely affected the monetary policy management and foreign exchange market stability due to the "impossible trinity" (the impossibility of simultaneously realizing capital liberalization, a fixed exchange rate, and monetary policy autonomy).

As another example, Korea adopted a totally opposite sequenced capital liberalization program, which brought the Korean economy in deep crisis. The most serious sequencing problem that the Korean government created in the pre-crisis period was that they liberalized short-term financing through the banking sector too prematurely.

These lessons teach us that in designing capital account liberalization including currency convertibility, it is very important to consider the proper sequencing. Liberalization usually begins with the current account, i.e., trade and trade-related financial transactions. Liberalization of financial and monetary transactions usually starts with the liberalization of domestic transactions, later moving to cross-border transactions. The process then moves from the current account to the capital account, which usually starts with inward foreign direct investment (FDI). From FDI, the liberalization process will move gradually on to securities and long-term capital transactions, while finally arriving at the liberalization of short-term capital flows. Capital account liberalization could contribute to regional financial integration, however, so particular attention should be paid to the proper sequencing of liberalization which is dependent upon the stage of economic development and financial infrastructure.

#### **2-4. How important is a regional monitoring system of cross-border capital flows for the prevention of contagion?**

The financial investments by foreigners help domestic institutions to increase their funds in order to lend to domestic companies as well as putting pressure on better governance on domestic financial institutions. In order to promote foreign direct investment into a country, it is better to remove restriction on foreign ownership and foreign investment into manufacturing and service industries in general, even though increasing investment may not be as essential in Asian countries as other regions, because domestic saving is already relatively large in Asia. When liberalization proceeds not only in long-term investments but also in short-term investments, it is important to develop a monitoring system for short-term cross-border investments, because they may become a source of unstable capital flows. When foreign funds are attracted to high-yielding bonds or high-yielding bank deposits without careful assessment of risks, those investments may reverse their direction very quickly.

So ideally, who is investing in what financial instruments is important information for financial regulatory agencies. In particular, information on speculative positions (short selling of the local currencies against buying of the foreign currencies) may be important variables to monitor. However, such information is sometimes very difficult to obtain. It is very important for central banks and supervisory agencies to keep monitoring large short-term capital flows across borders by asking not only domestic financial institutions but also foreign authorities. Therefore, to reap the benefits from liberalized capital flows without developing financial crisis, the authorities should make domestic financial institutions strong and robust, and sequence financial liberalization appropriately, and then keep monitoring capital flows after completing liberalization.

### **Chapter 3: Macroeconomic and exchange rate policy coordination**

#### **3-1. Should the governments in East Asia establish a region-wide coordination mechanism?**

Even with strong financial institutions and harmonized regulatory framework including monitoring short-term capital flows across borders, there may be the case that the private sector capital flows still exceed the official resources for stability. It is very important in such circumstance that the authorities in the region coordinate so that they can cooperate and fight against unstable capital flows.

If a country experiences liquidity shortage of foreign currencies, not because of their macro fundamentals but because of a sudden reversal of foreign capital flows, it may be desirable for authorities in the region to cooperate by lending each other foreign currencies. The CMI, which is essentially a network of bilateral swaps for foreign hard currencies, is such a mechanism that helps those countries in a liquidity type crisis.

### **3-2. Why is the macro economic surveillance important?**

In order to design and maintain such a mutual assistance framework, it is very important to carry out macro economic and financial surveillance during tranquil times as well.

When countries in the region as well as the international financial institutions are confident in the strength of macro economic fundamentals and of financial institutions, they should be able to lend, with massive liquidity, to a country under speculative pressure. Since currency pressure develops very suddenly, the surveillance has to be conducted on a regular basis, at least annually, if not quarterly.

Models of surveillance in fact are Article 4 consultations by the IMF, and economic survey by the OECD, as well as structural consultations by the World Bank, the ADB and other international financial institutions. The governments in the region may be able to cooperate and have frank discussions based on those publicly available international surveillance products. Since the authorities in the region have more information than the aforementioned international financial institutions, sometime confidential, about trade and financial transactions among neighboring countries in the region, they should be able to be more informed about the vulnerabilities and risks of neighboring countries. They should be more vocal and frank, at least in closed door meetings, and propose

constructive steps to avoid crises. Countries in the region have self interest in exercising mutual surveillance, because if one country falls in crisis, it may affect other countries in the region, sometimes very severely.

### **3-3. Why should we need a regional coordination policy of exchange rate regimes in East Asia?**

In order to carry out effective cooperation and mutual surveillance, it is very important to harmonize and disclose macro economic and financial data, and to have frequent consultations with each other. One of the surveillance items is the exchange rate regime. The Asian financial crisis taught us that the dollar-peg is not the most desirable exchange rate regime in the region. Regarding the intra-regional trade linkages, the average of intra-regional trade weights (in terms of the sum of imports plus exports) of ASEAN +3 countries increased from 48.7 percent in 2000 to 51.0 percent in 2004. Especially, the average of intra-regional import weights has steadily increased to 57.9 percent in 2004.

As the intra-regional trade ratio in East Asia is now close to that in the European Union, the internal stability of exchange rates in the region is very important for growth and stability in the region as the experiences of the EU shows. Therefore, some mechanism to keep bilateral exchange rates stable among the East Asian countries is desirable.

### **3-4. What are the objectives for a common currency basket system in East Asia?**

In view of the increasing degree of real economic integration in the region, and especially the region-wide FTA that is expected to take shape in the coming decade, the objective of a regional exchange rate arrangement should be the exchange rate stability of ASEAN+3 currencies.

There are basically three options (with some variations) in securing regional monetary stability; (a) a currency peg system to a single major currency like the US dollar or euro, (b) a peg system to individual baskets of G3 currencies or currencies in the region, and

(c) a monetary system with a common basket of G3 currencies or currencies in the region as a central instrument for exchange rate coordination.

(a) a currency peg system to a single major currency

In addition to the risk the Asian crisis taught us as a lesson, pegging to the US dollar or euro has the major defect of ignoring the diversity of trading partners of economies in the region. This would make such a system more unstable than otherwise due to diverging impacts on economic competitiveness caused by fluctuations of the reference currency.

(b) a peg system to individual currency baskets

The Singapore dollar has been pegged to a currency basket, whose composition has not been disclosed. The shift of the Chinese renminbi and Malaysian ringgit from the dollar peg to a managed floating system with reference to a currency basket may support advocates of individual currency baskets. This system may be adopted during a transitional period as part of a learning process towards a common basket system. One should keep in mind, however, that this system remains subject to the so-called “failure of coordination,” which endangers the regional monetary stability in the end.

(c) A common basket system, or a system with a common basket of G3 currencies or currencies in the region as a central instrument for exchange rate coordination

A regional monetary system using a common currency basket as a central instrument for exchange rate coordination is the third option, which is worth further studies in detail. There should be basically four sub-options (with their variations) in accordance with combinations of (i) a basket of G3 currencies or a basket of regional Asian currencies, and (ii) a grid formula after the EMS model or a peg formula of a hub-and-spokes type. The alternatives under (ii) need careful study, which is beyond the research scope of this paper for the moment. The paper, therefore, focuses upon the issues related to (i) above.

Under a common basket system of G3 currencies, the Asian countries can use the value of the basket against major currencies outside the region as a reference and coordinate their policies so that their exchange rates do not deviate from the common reference point too much. In this way, the countries can achieve internal stability, basically by joint

floating against the outside currencies. There remain several questions concerning how to implement such a common basket system including reserve management and intervention policy.

Under a common basket system of regional Asian currencies, which consist of convertible currencies including the yen, member countries are required to coordinate macroeconomic policies closely each other, and to fulfill certain conditions, which include sound macro-economic management such as inflation, fiscal balance and government debt, capital account liberalization. The required degree of conditions may differ according to the structure of the monetary system with a common basket (a grid formula or a peg formula).

### **3-5. Regional monetary units and a common currency basket**

In reference to regional monetary units, finance ministers of ASEAN+3 countries agreed to pursue study on creating regional monetary units at the ASEAN+3 Finance Ministers' Meeting in May 2006 (Hyderabad, India). And also the Finance Ministers of China, Japan and Korea (Trilateral Finance Ministers' Meeting) noted the importance of sharing a long-term vision for financial integration in the region and agreed on further study of related issues, including the usefulness of regional currency units, through the ASEAN+3 Finance Ministers' Process.

Our proposal of a common currency basket in this report is in line with the agreement on exploring further study on regional monetary units under the ASEAN+3 Finance Ministers' Process.

### **3-6. Steps toward a common currency basket**

Since the yen is the only fully convertible major currency in the region, the role of the yen is very important in assisting a country in distress at the time of crisis as well as providing bilateral networks of liquidity, even during tranquil time. In the long run, the Asian region may follow the footsteps of the European Union and achieve a common

currency in several decades. However, the countries should start with a modest step by implementing a currency basket system with a band and see how it helps to achieve growth and stability in the region.

As a first step, we propose that the ASEAN +3 countries will make use of a common basket value composed of all their currencies as a surveillance index without changing their exchange rate systems. Currency convertibility is not necessary for each currency. There are many discussions with reference to the appropriate currency composition for a common currency basket. It is especially a controversial point whether the Japanese yen should be included in a common currency basket. From the standpoint of a common currency basket as a surveillance index, it is desirable that the Japanese yen should be included.

At the second stage, we propose to start using a Core AMU currency basket that would be a weighted average of main currencies with convertibility in the region. We emphasize that convertibility is necessary to be a Core AMU composition currencies at the second stage, since it ensures confidence in the basket.

Only after the institutional harmonization and development of effective financial supervision in the region, more steps toward common currencies should be pursued. Still, convertibility will be indispensable to join in a common currency basket if we pursue a strong role for the common currency basket with regard to implementing commitments such as bilateral stabilization method or coordinated intervention.

Currently, most East Asian currencies are traded under some restrictions or controls in their currency transactions, while their liquidity in foreign exchange markets is not sufficient except for some core group currencies. Accordingly, in order to compose a common currency basket in East Asia, whichever way we choose, it is necessary to wait for more countries to achieve further economic developments to start a common currency basket with a core group of currencies.

### **3-7. The use of an AMU as a deviation indicator**

As a new surveillance criterion, Ogawa and Shimizu (2005)<sup>3</sup> propose the creation of an Asian Monetary Unit (AMU) and AMU Deviation Indicators for East Asian currencies as one of the research products of RIETI (Research Institute of Economy, Trade and Industry). These should contribute to the coordination of exchange rate policies in East Asia, thereby enhancing the monetary authorities' surveillance capabilities. The AMU is calculated as a weighted average of East Asian currencies according to the method used to calculate the European Currency Unit (ECU), which unit was adopted by EU countries under the European Monetary System (EMS) prior to the introduction of the euro. Currency convertibility is not necessary for the component currencies. The AMU Deviation Indicators for each East Asian currency are measured to show the degree of deviation from the Benchmark Rate for each of the East Asian currencies in terms of the AMU.

Nominal AMU Deviation Indicators are provided on a daily basis and Real AMU Deviation Indicators, which are adjusted for differences in inflation, are provided on a monthly basis. The Real AMU Deviation Indicators are more appropriate for conducting surveillance on the effects of changes in exchange rates on the real economy, while the Nominal AMU Deviation Indicators are more useful for monitoring day-to-day deviations from the AMU. The data of AMU and both AMU Deviation Indicators are available on the website of RIETI (<http://www.rieti.go.jp/users/amu/en/index.html>).

### **3-8. The creation of a Core AMU**

A Core AMU can be created, when major currencies in the region realize their convertibility in the sense that residents as well as nonresidents have an access directly or indirectly to the foreign exchange and money markets of the currency. There are two categories of a Core AMU, an official one and a private one. An official Core AMU is used for the purpose of a unit of account (numeraire) among monetary authorities in a

---

<sup>3</sup> Ogawa, Eiji, and Junko Shimizu, "[A Deviation Measurement for Coordinated Exchange Rate Policies in East Asia](#)", RIETI Discussion Paper Series 05-E-017, 2005

regional system for exchange rate coordination. A private Core AMU can be used as an investment and funding instruments, among others, by the private sector.

The composition or the share of component currencies of an official Core AMU should be decided by taking into account such factors as GDP, trade volume and capital markets. The composition can be politically a sensitive issue, and a clear principle needs to be formulated among parties concerned.

As to the composition of a private Core AMU, it can be fixed freely by private agents according to the objective of creation. Theoretically it may be so, however the European experience of a private ECU and other composite currencies teaches us the importance of the confidence and marketability (including liquidity) of a private ECU (or Core AMU) for its sustained development. The existence of an official ECU (or Core AMU) with the same composition of currencies as a private ECU (or Core AMU) enhanced the confidence of the latter substantially among market participants.

Thus, a study on regional currency units for East Asia should include a study on the European experience as well.

### **3-9. Recent progress of initiatives under the ASEAN+3 Framework**

The monetary authorities of East Asian countries have been strengthening regional monetary cooperation since the Asian currency crisis of 1997. Such monetary cooperation after the crisis resulted in the CMI in May 2000, which was established by the ASEAN + 3 (Japan, South Korea, and China) as a network of bilateral and multilateral swap arrangements to deal with a currency crisis in member countries. Under the CMI, the monetary authorities should conduct surveillance to prevent a currency crisis in the future.

At the ASEAN+3 Finance Ministers ' Meeting in May 2006 (Hyderabad, India), finance ministers agreed to successfully complete the strengthening of the regional liquidity support network (also known as the Second Phase of the CMI Review), which was initiated at the Jeju ASEAN+3 Finance Ministers' Meeting in 2004. The following

substantial progress of the CMI has been made: (1) collective decision-making procedure for the swap activation was adopted, (2) to explore the ways for further strengthening surveillance capacity in East Asia, the Group of Experts (GOE) and the Technical Working Group on Economic and Financial Monitoring (ETWG) would be launched, (3) the total swap size has now reached US\$75.0 billion, almost doubled from a year ago.

Finance ministers agreed to task the Deputies to set up a “new task force” to further study various possible options towards an advanced framework of the regional liquidity support arrangement (CMI multilateralization or Post-CMI).

Regarding the Network of Bilateral Swap Agreements (BSAs) under the CMI, the total amount of BSA as of May 4, 2006 became US\$75.0 billion. BSAs were concluded among: China, Indonesia, Japan, the Republic of Korea, Malaysia, the Philippines, Singapore, and Thailand.

Regarding the Asian Bond Market Initiative, at ASEAN+3 Finance Ministers’ Meeting in May 2006 (Hyderabad, India), finance ministers noted that concrete progress had been made in the area of (i) local currency-denominated bonds issued by various international and foreign institutions, and (ii) local currency-denominated bonds issued through securitization. Ministers agreed that the study on the issuance of the asset-backed Asian currency-basket bonds and cross-border local currency bonds would contribute to the further development. Also, ministers recognized a noticeable progress made in discussions on the market infrastructure including Asian Bond Standards. Technical assistance should be continued to overcome weaknesses identified in the regular self-assessment and information sharing exercises.

### **3-10. An Illustration as to how a roadmap can be created for financial and monetary integration in the region for the medium to long term**

We hereby assume that a political consensus will be reached for founding a regional currency system in ten years around 2015 under the framework of ASEAN +3. Then, from a medium to long-term perspective, we can divide the time span between 1999,

when the First Joint Statement on East Asia Cooperation of ASEAN+3 Heads of State/Government was signed in Manila, and 2015 into three stages according to the progress towards a regional monetary arrangement. The first stage started in 1999 and will finish in 2007, when the Second Joint Statement is due in December of the same year. The first stage can be regarded as a period to consolidate regional monetary cooperation in itself. The second stage will cover the period from 2008 until 2011 or 2012, which should be a period to strengthen and complete regional monetary cooperation in terms of preventing and managing a possible currency and financial crisis. The third stage, which we consider to be a preparatory period to address consensus building on a regional monetary system, will be expected to conclude by around 2015, leading, if an agreement is reached, further to a stage of implementation.

In view of intensified financial cooperation in coming years, a permanent secretariat, which should be composed by high-level experts including the staff of monetary authorities, central banks from member states, and some independent economists should be set up, in order to discuss a broad range of essential topics as mentioned so far in the paper. Experts at the permanent secretariat will keep close contact with related governmental offices of member countries in preparing important proposals, and bring up an agenda at the ASEAN+3 Finance Ministers' Meeting. Experts at the secretariat will be engaged in their designated assignments on the basis of personal trust, and countries in the region will share information through the secretariat to their mutual benefit. Institutionalization of this mutual surveillance would be a crucial step for developing financial integration in East Asia.

Furthermore, while designing a roadmap for regional monetary and financial integration, we should not lose sight of what is happening outside the region as well. One global concern that is important to the East Asian regional integration effort is the so-called global imbalance that involves the current account deficit of the United States and current account surplus countries in East Asia as well as oil producing countries, which is the other end of the spectrum of the US current account deficit issue. It is generally viewed that the US current account deficit may not be sustainable in the long run, and therefore

solutions need to be found for the medium and long-term, while avoiding a hard-landing scenario.

As agreed at the spring International Monetary and Financial Committee (IMFC) meeting this year, a multilateral dialogue on the global imbalances will be carried out in the near future among the United States, the EU and representatives from the current account surplus countries such as China, Japan, and Saudi Arabia under a surveillance framework to be established by the IMF. It is expected that these countries will eventually reach an agreement on a set of macro economic policy measures to resolve the difficult global imbalances and to mitigate the adverse impact that any possible adjustment may have on the regional exchange rate regime as a whole. It is important to note that the issue is not a short-term, but a medium to long-term issue.

The combination of the fixed exchange rate regime (or heavy managed floating regime) coupled with current account surpluses in China, Malaysia, and other Asian economies resulted in large accumulations of foreign exchange reserves. The concerned authorities will pay careful attention to the management of the accumulated foreign exchange reserves, since the issue involves not only adjustment to exchange rates, but also modification to the exchange rate mechanism of the international monetary system. A change in foreign exchange reserve policy is a very delicate and significant issue for the authorities in East Asia, since it involves not only monetary issues, but also political issues. Therefore, a comprehensive approach rather than a piece meal approach is required in carrying out policy formation on foreign exchange reserves.

### Illustrative Roadmap for a regional monetary arrangement

	<b>Monetary &amp; financial crisis management</b> CMI, Solidifying financial system ERPD & Designing new framework &current new framework	<b>Exchange rate stability of regional currencies</b> <b>Permanent Secretariat:</b> surveillance etc	Designing and planning ACU and regional monetary arrangements	Note
<p><b>1999</b> <b>First stage:</b> Consolidation of monetary cooperation</p> <p><b>2007</b> <b>Second stage:</b> Strengthening &amp; completing cooperation</p> <p><b>2011-12</b> <b>Third stage:</b> Consensus building for a regional monetary system</p> <p><b>around 2015</b></p>		<p>Establishing a permanent secretariat: Enhancing surveillance, discussion by experts on regional monetary arrangements</p>	<p>Theoretical AMU as a divergence index, issue of AMU denominated bond</p> <p>Discussion on, preparation for a regional monetary system</p> <p>Agreement on a regional monetary system (Creation of Core AMU)</p> 	<p>The 1<sup>st</sup> Joint Statement of ASEAN+3</p> <p>10<sup>th</sup> anniversary of ASEAN+3, &amp; the 2<sup>nd</sup> Joint Statement</p> <p>Significant Progress in FTA • EPA network</p>

## **Policy Recommendations**

### **NEAT Working Group meeting in Tokyo**

The NEAT working group (the WG) met in Tokyo on June 30, 2006, and discussed “Intra-regional Exchange Rate Stability and Prevention of Financial Crisis in East Asia”.

At the 9<sup>th</sup> annual meeting held in December 2005, the ASEAN+3 leaders declared that they would prepare a second Joint Statement on East Asia Cooperation on the tenth anniversary of ASEAN+3 process in 2007, to consolidate existing cooperation and to set forth the future direction for the cooperation and East Asia community building.

As a response to the ASEAN+3 declaration from the viewpoint of private sector think-tanks, the WG confirmed that it is important to further strengthen regional financial cooperation based upon achievements up to now, such as the Chiang Mai Initiative (CMI), Asian Bond Markets Initiative (ABMI), Asian Bond Fund (ABF), and the surveillance mechanism to enhance financial and monetary integration. With regard to the future direction of financial cooperation, the WG reached a broad consensus that the most important long-term objective for financial cooperation is to establish a stable exchange rate mechanism in East Asia. This objective is essential for East Asia where economic interdependence through trade and investment has progressed and is expected to increase further, with the eventual creation of a free trade area within ASEAN+3. A stable exchange rate mechanism is also indispensable to maintain sound and sustainable economic growth, while avoiding financial instability which may lead to financial crisis in the environment of high capital mobility in East Asia.

Through meaningful and fruitful discussions on the current situation of financial integration and the nature and causes of financial instability as discussed in this paper, the WG has reached an agreement to present the following seven policy recommendations to the NEAT annual conference to be held in Kuala Lumpur on August 22-23 this year.

### **Recommendations:**

#### **1. Study on a currency basket**

One of the lessons learned from the Asian financial crisis of 1997-98 was that the exchange rate regime of a de facto dollar peg, which the Asian countries had adopted before the crisis, combined with inappropriate macro economic policy, was one of the

causes of financial instability. As suggested in the ASEAN+3 Finance Ministers' meeting in May this year, we are of the opinion that a major study on regional currency units should be conducted jointly by the official as well as the private sector. Based upon studies and proposals by academics, the study should focus on various regional currency units, with a view to eventually establishing a common currency basket system in the region, thus avoiding the problems arising from a dollar peg. It will be a long and difficult but most challenging task to reach a consensus on a common currency basket in East Asia, where the development stages of the economies are highly diversified. A joint study between the public and private sectors on the subject will provide an opportunity to explore the most suitable exchange rate mechanism for East Asia, while deepening the understanding of the general public on this complex subject.

There are several options available for a common currency basket, such as a currency basket composed of G3 currencies (the US dollar, euro and yen), a basket of regional currencies, a mixture of the two, or other variations. Among these options, a common currency basket composed of regional currencies is considered most suitable to achieve intra-regional exchange rate stability in East Asia, where economic inter-dependence has deepened. Such a basket system is also expected to keep trade competitiveness relatively stable, and to lessen the volatility of capital flows in the region, thus promoting economic integration.

## **2. Capital account liberalization and currency convertibility**

It is desirable that each currency composing the common currency basket will meet certain conditions in order to ensure confidence in the basket. The conditions may include, among others, sound macro-economic indicators, such as inflation, fiscal balance and government debt, capital account liberalization, and currency convertibility. Each government in the region should, therefore, in addition to maintaining sound macro-economic management, carefully study the pros and cons of gradually liberalizing capital accounts, while also establishing currency convertibility. In view of the experience of the Asian financial crisis, it is important to carefully evaluate the impact that capital account liberalization and currency convertibility may have on the domestic monetary and financial markets.

In designing capital account liberalization and currency convertibility, it is very important to consider the proper sequencing. Liberalization usually begins with the current account, i.e., trade and trade-related financial transactions. Liberalization of financial and monetary transactions usually starts with the liberalization of domestic transactions, later moving to cross-border transactions. The process then moves from the current account to the capital account, which usually starts with inward foreign direct investment (FDI). From FDI, the liberalization process will move gradually on to securities and long-term capital transactions, while finally arriving at the liberalization of short-term capital flows. The capacity building of financial institutions and businesses in the region will help to expedite the process. Capital account liberalization could contribute to regional financial integration, however, so particular attention should be paid to the proper sequencing of liberalization which is dependent upon the stage of economic development.

### **3. Surveillance**

The WG felt that, although remarkable progress has been made in regional financial cooperation, development of a regional surveillance mechanism should be more vigorously enhanced. A proper surveillance mechanism through the strengthening of the ERPD (Economic Review and Policy Management) process under the CMI should be promoted. In order to establish a stable exchange rate mechanism in the region in the long run, it is indispensable for the regional governments to exchange information on capital flows in order to deepen coordination in macro-economic and exchange rate policies. In order to expedite and streamline this regional surveillance mechanism, it is essential to establish a permanent secretariat in the ASEAN+3. The permanent secretariat should be composed of experts from monetary authorities, central banks, and independent economists.

### **4. The European experience**

European experiences in regional financial integration in the past several decades provide useful lessons for East Asia. They include, among others, creation of a common basket called the European Currency Unit (ECU), the importance of creating a surveillance system and maintaining currency convertibility. Therefore, a study on the

regional currency units for East Asia should include a study of the European experiences as practical lessons for East Asia

## **5. Roadmap towards a regional exchange rate regime**

It is always useful for governments in the region to review the progress which has been achieved, and to draw a roadmap for the medium and long-term so that member governments will make concerted efforts towards regional financial cooperation. The prospective permanent secretariat for the ASEAN+3 should draw a roadmap from time to time that will be used for its consultations with the member countries in order to design the roadmap for the long-term process towards an eventual common currency basket system in East Asia.

## **6. Central bank governors**

Since the central banks in the region contribute important initiatives and functions towards maintaining a stable exchange rate regime, financial supervision, and regional financial cooperation, their active participation in the cooperation process is indispensable. As regional financial cooperation has been guided by the ASEAN+3 Finance Ministers meeting, it is recommended that central bank governors should participate in the meeting as regular members.

## **7. Global imbalances**

It is generally viewed that the US current account deficit may not be sustainable in the long run, therefore solutions need to be found for the medium and long-term, while avoiding a hard-landing scenario. It is expected that a multilateral dialogue among the United States, the EU and representative countries from the current account surplus countries, such as China, Japan, and Saudi Arabia, led by the IMF, will be held in the near future. Such a framework of dialogue should be strengthened in order to find a way to solve global imbalances, and to mitigate the adverse impact that any possible adjustment may have on the regional exchange rate regime as a whole.

**(Attachment)**

**List of Participants in NEAT Working Group Meeting in Tokyo on June 30, 2006**

(Countries in Alphabetical Order)

- Brunei** Mr. SUHAIMI Haji Ali  
Lecturer, The University of Brunei Darussalam
- China** Prof. XU Mingqi  
Deputy Director, the Institute of World Economy  
The Shanghai Academy of Social Sciences
- Korea** Prof. LEE Choong Lyol  
Korea University
- Laos** Dr. Akhom PRASEUTH  
Head of Exchange Rate Policies, Bank of Lao PDR
- Malaysia** Mr. HUZAIME Hamid  
Deputy Secretary-General, NEAT Malaysia
- Myanmar** Mr. Thiha SAW  
Deputy Secretary  
Myanmar Institute of Strategic and International Studies  
(Myanmar ISIS), Ministry of Foreign Affairs
- Philippines** Dr. Melanie MILO  
Senior Research Fellow and NEAT Country Coordinator  
Philippine Institute for Development Studies
- Singapore** Dr. TAN Kim Song  
Practice Associate Professor of Economics  
Singapore Management University
- Vietnam** Ms. Nguyen Hai YEN  
Lecturer at the Faculty of International Economics  
Institute for International Relations

**Japan**

Mr. Tadahiro ASAMI (Leader)  
Managing Director, Institute for International Monetary Affairs

Dr. Takatoshi ITO (Co-Leader)  
Professor, Graduate School of Economics, The Tokyo University

Dr. Eiji OGAWA  
Professor, Graduate School of Commerce and Management  
Hitotsubashi University

Dr. Tetsuji MURASE  
Professor, The International Center, Kyoto University

Dr. Junko SHIMIZU  
Assistant Professor, Meikai University

Mr. Hajime SHINOHARA  
Advisor, Institute for International Monetary Affairs

Mr. Naoyoshi KINUKAWA  
Director, Economic Research Department  
Institute for International Monetary Affairs

Mr. Yozo NISHIMURA  
Senior Economist, Economic Research Department  
Institute for International Monetary Affairs

Mr. Kenichiro MATSUI  
Lead Economist, Economic Research Department  
Institute for International Monetary Affairs

Ms. Catharina E. KOOPS  
Visiting researcher, Institute for International Monetary Affairs

Ms. Miyuki FUJII  
Senior Officer, Researcher Assistant,  
The Japan Forum on International Relations, Inc.

## **Appendix: Initiatives under the ASEAN+3 Framework**

[1. Chiang Mai Initiative \(CMI\)](#)

[2. Economic Review and Policy Dialogue \(ERPD\)](#)

[3. Asian Bond Markets Initiative \(ABMI\)](#)

[4. ASEAN+3 Research Group](#)

[5. Monitoring of Short-Term Capital Flow](#)

1. [Chiang Mai Initiative \(CMI\)](#)

### **Objective**

The Chiang Mai Initiative aims to create a network of bilateral swap arrangements (BSAs) among ASEAN+3 countries to address short-term liquidity difficulties in the region and to supplement the existing international financial arrangements.

### **Background**

After the Asian financial crisis, East Asian countries shared the need to promote regional financial cooperation. At the ASEAN+3 Summit in November 1999, ASEAN+3 leaders agreed to enhance “self-help and support mechanisms in East Asia” through the ASEAN+3 framework. At the ASEAN+3 Finance Ministers’ Meeting in May 2000, finance ministers agreed to promote the Chiang Mai Initiative to establish a regional financial arrangement to supplement the existing international facilities.

November 1999:

The 3rd ASEAN+3 Summit (Manila, the Philippines)

- Leaders agreed to enhance “ self-help and support mechanisms in East Asia. ”

May 2000:

The 2nd ASEAN+3 Finance Ministers' Meeting (Chiang Mai, Thailand)

- Finance ministers agreed to promote the Chiang Mai Initiative.

May 2004:

The 4th ASEAN+3 Finance Ministers' Meetings in May 2004 (Jeju, Korea)

- Finance ministers agreed to explore the ways of enhancing its effectiveness of CMI.

May 2005:

The 8th ASEAN+3 Finance Ministers' Meeting in May 2005 (Istanbul, Turkey)

- Finance ministers agreed to take the following measures to enhance the effectiveness of the CMI: (1) integration and enhancement of ASEAN+3 economic surveillance into the CMI framework, (2) clear - defining of the swap activation process and the adoption of a collective decision-making mechanism, (3) significant increase in the size of swaps, and (4) improvement of the drawdown mechanism.

#### **Network of BSAs under the CMI (as of May 4, 2006, figure in next page)**

Total amount: US\$75.0 billion (16 arrangements)

BSAs were concluded among: China, Indonesia, Japan, the Republic of Korea, Malaysia, the Philippines, Singapore, and Thailand.

#### **Recent Progress**

At the ASEAN+3 Finance Ministers' Meeting in May 2006 (Hyderabad, India), finance ministers agreed to successfully complete the strengthening of the regional liquidity support network (also known as " the Second Phase of the CMI Review " ), which was initiated at the Jeju ASEAN+3 Finance Ministers' Meeting 2004. Following substantial progress of the CMI has been made: (1) collective decision-making procedure for the swap activation was adopted, (2) To explore the ways for further strengthening surveillance capacity in East Asia, the Group of Experts (GOE) and the Technical Working Group on Economic and Financial Monitoring (ETWG) would be launched, (3) the total swap size has now reached US\$75.0 billion, almost doubled from a year ago.

Finance ministers agreed to task the Deputies to set up a “new task force” to further study various possible options towards an advanced framework of the regional liquidity support arrangement (CMI multilateralization or Post-CMI).

## 2. [Economic Review and Policy Dialogue \(ERPD\)](#)

### **Objective**

Effective economic review and policy dialogue would contribute to the prevention of financial crises through the early detection of irregularities and the swift implementation of remedial policy actions. It will also lay a foundation for providing immediate assistance, such as the CMI, in the event of a crisis.

ASEAN+3 countries have been conducting Economic Review and Policy Dialogue (ERPD) at the Ministers’ level annually and at the Deputies’ level twice a year to discuss economic and financial developments in the region.

### **Recent Progress**

At the ASEAN+3 Finance Ministers’ Meeting in May 2006 (Hyderabad, India), finance ministers agreed to launch the Group of Experts (GOE) and the Technical Working Group on Economic and Financial Monitoring (ETWG) to explore the ways for further strengthening surveillance capacity in East Asia.

## 3. [Asian Bond Markets Initiative \(ABMI\)](#)

### **Objective**

The Asian Bond Markets Initiative aims to develop efficient and liquid bond markets in Asia, enabling better utilization of Asian savings for Asian investments. Activities of the ABMI focus on the following two areas: (1) facilitating access to the market through a wider variety of issuers and (2) enhancing market infrastructure to foster bond markets in Asia.

### **Recent Progress**

- Issuance of Korean Collateralized Bond Obligations (CBO) (“Pan-Asia Bond”) with

guarantee by the Japan Bank for International Cooperation (JBIC) and the Industrial Bank of Korea (IBK).

- Issuance of baht-denominated bonds by Japanese subsidiaries in Thailand, Malaysia and Indonesia with a partial credit guarantee from the JBIC and Nippon Export and Investment Insurance (NEXI).
- Issuance of local currency-denominated bonds by the Japan Bank for International Cooperation (JBIC), World Bank, Asian Development Bank (ADB) and the International Finance Corporation (IFC) in Malaysia, Thailand, China, and the Philippines.
- Information dissemination through [the Asian Bonds Online Website \(ABW\)](#) at the ADB.

At ASEAN+3 Finance Ministers' Meeting in May 2006 (Hyderabad, India), finance ministers noted that concrete progress had been made in the area of (i) local currency-denominated bonds issued by various international and foreign institutions, (ii) local currency-denominated bonds issued through securitization. Ministers agreed that the study on the issuance of the asset-backed Asian currency-basket bonds and cross-border local currency bonds would contribute to the further development. Also, ministers recognized a noticeable progress made in discussions on the market infrastructure including Asian Bond Standards. Technical assistance should be continued to overcome weaknesses identified in the regular self-assessment and information sharing exercises.

#### 4. [ASEAN+3 Research Group](#)

##### **Objective**

The ASEAN+3 Research Group was proposed by Japan at the Informal ASEAN+3 Finance and Central Bank Deputies' Meeting in November 2002, and agreed among ASEAN+3 in August 2003. The Research Group aims to explore the ways to further strengthen financial cooperation and promote financial stability in the region by soliciting academic input from researchers and research institutes in ASEAN+3 countries.

##### **Research Themes**

In 2006/07:

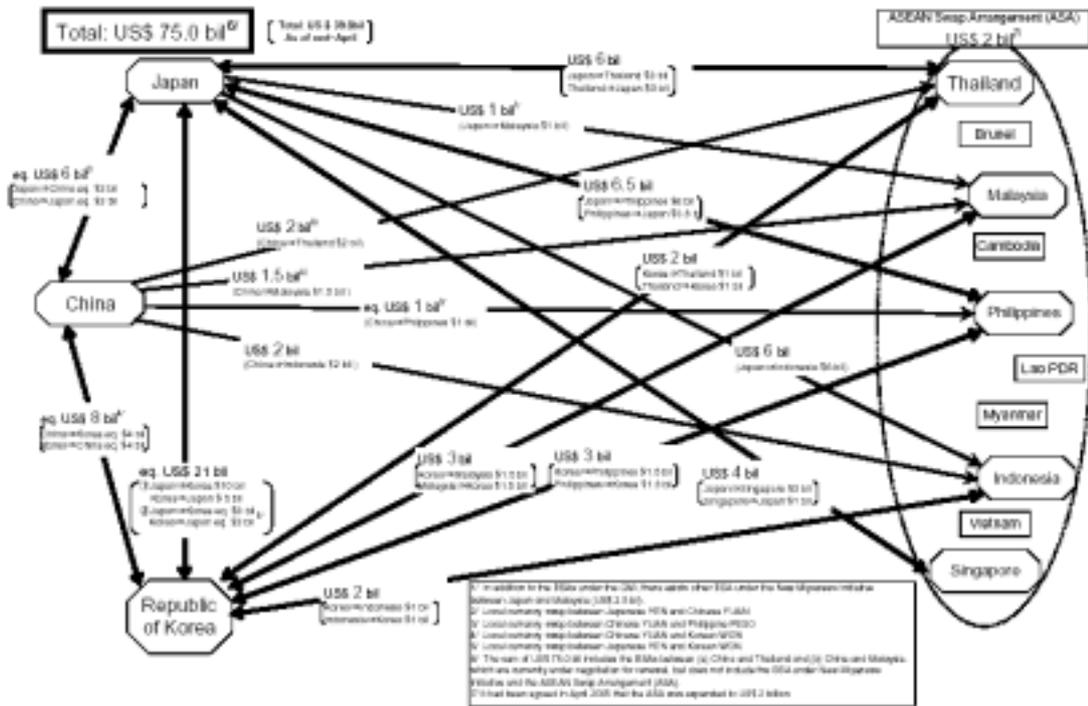
- (1) Toward Greater Financial Stability in the Asia Region: Exploring Steps to Create Regional Monetary Units
- (2) Financial Conglomeration in the East Asian Region: Recent Trends and Implications for Regional Financial Market Development

#### 5. [Monitoring of Short-Term Capital Flow](#)

At the ASEAN+3 Finance Ministers' Meeting in May 2001 (Honolulu, USA), finance ministers agreed to exchange data on capital flows bilaterally among ASEAN+3 on a voluntary basis to facilitate effective policy dialogue. Japan has been exchanging data with the Republic of Korea, the Philippines, Thailand, Indonesia, and Viet Nam.

Network of Bilateral Swap Arrangements (BSAs) under the Chiang Mai Initiative (CMI)

Ministry of Finance, Japan  
As of May 4, 2006



## The Joint Ministerial Statement of the 8<sup>th</sup> ASEAN+3 Finance Ministers' Meeting 4 May 2005, Istanbul, Turkey

### Introduction

- 1 . We, the Finance Ministers of ASEAN, China, Japan and the Republic of Korea (ASEAN+3), convened our eighth meeting in Istanbul, Turkey under the chairmanship of H.E. Chansy Phosikham, Minister of Finance of Lao PDR.
- 2 . We exchanged views on recent economic and financial developments and policies, and reviewed the progress of regional financial cooperation, including the Chiang Mai Initiative, the Asian Bond Markets Initiative, and the ASEAN+3 Research Group.

### Recent Economic and Financial Developments in the Region

- 3 . We were pleased to note the region's strong economic growth last year. Despite the softening of external demand, it was expected that the region would post still solid, though somewhat moderated, growth this year.
- 4 . To sustain the economic growth of the region particularly against the potential risks of persistently high oil prices and global imbalances, we reiterated our commitment to implement structural reforms as well as to take appropriate macroeconomic policy measures including policies to promote domestic demand-driven growth.

### Strengthening East Asia Financial Cooperation

- 5 . On the **Chiang Mai Initiative (CMI)**, we reaffirmed our resolution to strengthen our self-help and support mechanism in East Asia by making the CMI a more effective and disciplined framework. As a basic principle for the review, we agreed to firmly maintain the CMI's two core objectives, namely, (1) to address short-term liquidity difficulties in the region and (2) to supplement the existing international financial arrangements.
- 6 . Taking into account (i) the improvement in our economic and financial situations and (ii) the advancement in our various initiatives for regional financial cooperation, such as regional surveillance and the Asian Bond Markets Initiative, as well as reflecting the existing vulnerabilities in the global financial markets, we agreed upon the following measures to enhance the effectiveness of the CMI as a self-help and support mechanism:
  - (I) **Integration and enhancement of ASEAN+3 economic surveillance** into the CMI framework to enable early detection of irregularities and swift remedial policy actions, with a view to developing effective regional surveillance capabilities that complements the current undertaking by the International Financial Institutions (IFIs);

- (II) **Clear-defining of the swap activation process and the adoption of a collective decision-making mechanism** of the current network of bilateral swap arrangements (BSA) as a first step of multilateralization so that the relevant BSAs would be activated collectively and promptly in case of emergency; and
  - (III) **Significant increase in the size of swaps.** The size of the BSAs should be increased by (i) increasing the amount of existing bilateral commitment, (ii) concluding new BSAs, for example, among ASEAN countries, and (iii) transforming one-way BSAs to two-way BSAs. Member countries favored an enhancement of up to 100% increase of the existing individual arrangements while noting that the size could be flexibly decided by bilateral negotiations. In this context, the ASEAN Swap Arrangement has been doubled from US\$ 1 Billion to US\$ 2 billion.
  - (IV) **Improving the drawdown mechanism.** The size of swaps that could be withdrawn without the IMF-supported program would be increased from the current 10% to 20% in order to better cope with sudden market irregularities while the current framework to complement the international financial arrangements and other disciplined conditions would be firmly maintained.
- 7 . To further enhance the CMI's effectiveness, we tasked the Deputies to study the various possible routes towards multilateralizing the CMI.
  - 8 . On the **Asian Bond Markets Initiative (ABMI)**, we were pleased with the concrete progress made to date, in particular the positive measures implemented in line with the aspiration of this Initiative. The notable achievements since our last meeting are summarized in the ABMI progress report (to be uploaded to the Asian Bonds Online Website (ABW) <sup>1</sup>). The East Asian local currency bond markets have grown rapidly, and some structural improvements have been observed such as stretching of the government bond yield curves and diversification of instruments and issuer base.
  - 9 . To further contribute to the development of deeper and more liquid regional bond markets that would assist in the efficient allocation of the large pool of savings in Asia to finance productive investment in the region, we will continue and expedite our efforts in undertaking a wide variety of studies and implementing various effective measures under the ABMI working groups.
  - 10 . Embracing the initial success, we will introduce a roadmap that proposes gathering and sharing information in an integrated manner on bond market development and on our related efforts with the regular self-assessment conducted by member countries. The possible issuance of Asian currency-basket bonds could be explored under the auspices of the roadmap. We also agreed to embark the study of Asian Bond Standards to explore the development of international bond markets in Asia through tailoring necessary infrastructure and setting the procedure entrusted by global issuers and investors. We acknowledged the merits of embracing the voluntary "practical alternatives" for withholding tax treatment on bond holdings in promoting liquidity and cross-border trading in the region.

- 11 . On the **ASEAN+3 Research Group**, we acknowledged the usefulness of the findings and recommendations of the studies on economic surveillance, economic and financial integration in the region, regional financial architecture, and private sector development, which contributed to our better understanding of closer financial cooperation in the region. We also endorsed three research areas for 2005-06 that will collectively look at capital flow liberalization and institutional arrangements; capital market development including fostering asset management industry; and policy coordination forward in the region.

#### **Asia's Representation in the IMF**

- 12 . We called for an urgent review of the quota of the Asian countries in the IMF to properly reflect the current realities and their relative positions in the world economy. This would strengthen the mutual understanding between Asia and the IFIs.

#### **Others**

- 13 . We thanked the ADB for its continued support for ASEAN+3 initiatives and welcomed the Bank's new focus on regional economic integration. We also expressed our appreciation to the governments of Lao PDR and Turkey for the excellent arrangements.
- 14 . We agreed to meet in Hyderabad, India in 2006.

---

<http://asianbondsonline.adb.org>

<sup>2</sup>To be disseminated through the websites of the ASEAN Secretariat, the ADB, and member countries where available.

## The Joint Ministerial Statement of the 9<sup>th</sup> ASEAN+3 Finance Ministers' Meeting 4 May 2006, Hyderabad, India

### Introduction

- 1 . We, the Finance Ministers of the ASEAN, China, Japan, and Korea (ASEAN+3), convened our ninth meeting in Hyderabad, India, under the chairmanship of Senior Minister Keat Chhon, Minister of Economy and Finance of the Kingdom of Cambodia.
- 2 . We exchanged views on regional economic and financial developments and policies. We also reviewed the progress of regional financial cooperation processes, including the Chiang Mai Initiative, the Asian Bond Markets Initiative, and the ASEAN+3 Research Group, and explored ways to further enhance regional cooperation.

### Recent Economic and Financial Developments in the Region

- 3 . We were pleased to note that East Asia had maintained a strong growth momentum and that the overall economic outlook remained bright in 2006, as assessed by our own peer review mechanism, "Economic Review and Policy Dialogue (ERPD)," as well as International Financial Institutions (IFIs). Nevertheless, we shared a view that there were a number of potential downside risks such as persistently high oil prices, widening global imbalances, upward global interest rates trend, and potentially adverse effect of avian flu pandemics.
- 4 . We acknowledged the deepening economic interdependence and increasing financial market openness in the region. In order to achieve sustainable economic growth in East Asia, we underscored the importance of implementing appropriate macroeconomic policy mix and accelerating economic structural reforms. We also agreed to further strengthen the cooperation in policy development to cope with such potential risks. In particular, given the recent spike of oil prices, we strongly urged for swift actions both on the demand and supply side to stabilize the oil market and underscored the need for enhancing dialogue between oil producing and consuming countries to improve market information and transparency.

### Strengthening East Asia Financial Cooperation

- 5 . On the **Chiang Mai Initiative (CMI)**, substantial progress has continued to be made. In particular, the strengthening of the regional liquidity support network (also known as "the Second Phase of the CMI Review"), which was initiated at the Jeju ASEAN+3 Finance Ministers' Meeting 2004, had been successfully completed, as explained below. Here, we reaffirmed to firmly maintain the CMI's two core objectives, namely, (1) to address short-term liquidity difficulties in the region and (2) to supplement the existing international financial arrangements.

- (i) **Collective decision-making procedure for the swap activation was adopted.** All Swap Providing Countries can simultaneously and promptly provide liquidity support to any parties involved in bilateral swap arrangements (BSA) at times of emergency;
  - (ii) **To explore the ways for further strengthening surveillance capacity in East Asia, the Group of Experts (GOE) and the Technical Working Group on Economic and Financial Monitoring (ETWG) would be launched.** The GOE, composed of several regional professional experts, would serve as an independent economic assessment vehicle for this region. The ETWG would play an important role in developing and spreading the Early Warning System to facilitate early detection of irregularities.
  - (iii) **The total swap size has now reached US\$75.0 billion, almost doubled from a year ago.** Nine BSAs have been revised since last year to enhance the effectiveness of CMI reflecting the Istanbul Agreement.
- 6 . Looking ahead, we tasked the Deputies to set up a “new task force” to further study various possible options towards an advanced framework of the regional liquidity support arrangement (CMI multilateralization or Post-CMI), based upon their exploration during the past year. Moreover, we instructed the Deputies to enhance the regional surveillance capacities.
- 7 . On the **Asian Bond Markets Initiative (ABMI)**, we noted that concrete progress had been made as indicated by the fact the size of the local currency bond market in the region has more than quadrupled since 1997. Following the issuance of Pan-Asia Bond in 2004, the achievements included (i) local currency-denominated bonds issued by various international and foreign institutions such as Baht-denominated bonds, Peso-denominated bonds, Renminbi-denominated bonds (Panda Bond), and Ringgit-denominated bonds; and (ii) local currency-denominated bonds issued through securitization. We believed that the study on the issuance of the asset-backed Asian currency-basket bonds and cross-border local currency bonds would contribute to further development.
- 8 . We recognized a noticeable progress made in discussions on the market infrastructure, including regional credit guarantee and investment mechanism, settlement system, credit ratings, and the Asian Bond Standards. We agreed that the on-going discussions should be further expedited to promote development of an international bond market in the region. We concurred that technical assistance should be continued to overcome weaknesses identified in the regular self-assessment and information sharing exercises.
- 9 . On the **ASEAN+3 Research Group**, we acknowledged the usefulness of the input from researchers and research institutes in the region. The research reports for 2005-2006 will be disseminated through the websites of the ASEAN Secretariat, the ADB, and member countries where available. We endorsed two research topics for 2006-07: “Toward greater

financial stability in the Asian region: Exploring steps to create regional monetary units” (led by a Japanese research institute) and “Financial conglomeration in the East Asian region: Recent trends and implications for regional financial market development” (led by a Korean research institute).

### **ASEAN+3 and the International Financial Institutions (IFIs)**

- 10 . In order to ensure the credibility and legitimacy of the Bretton Woods Institutions in the rapidly changing global economy, we emphasized the importance of an ad hoc quota increase for significantly under-represented countries in the IMF. We called upon its Managing Director to work with the IMFC and Executive Board to come forward with concrete proposals for agreement at the upcoming IMF and World Bank Annual Meetings in Singapore. We agreed that we would play active roles in the IMF policy-making and support its activities.
- 11 . We appreciated the IFIs such as the ADB and IMF for their continued efforts to support ASEAN+3 initiatives related to the regional surveillance activities. We heard the presentation by the ADB President, Mr. Haruhiko Kuroda, on the economic outlook for the region. We also welcomed the ADB’s ongoing works on the regional bond market development.

### **Others**

- 12 . We expressed our appreciation to governments of the Kingdom of Cambodia and the Republic of Korea for the excellent arrangements as the co-chairs of the ASEAN+3 Finance Ministers’ Process. We also thanked government of the Republic of India for its hospitality and kind cooperation.
- 13 . We agreed to meet in Kyoto, Japan, in 2007. The Kingdom of Thailand and the People’s Republic of China would co-chair the ASEAN+3 Finance Ministers’ Process in 2007.

**Joint Message**  
**The 6th Trilateral (China, Japan and Korea)**  
**Finance Ministers' Meeting**  
**May 4<sup>th</sup>, 2006, Hyderabad, India**

- 1 . We, the Finance Ministers of China, Japan and Korea, held our 6<sup>th</sup> meeting in Hyderabad, India, and exchanged views on the regional economic prospects, regional financial cooperation, and ways to improve our representation in the International Financial Institutions (IFIs).
- 2 . Through meaningful and fruitful discussions, we have made considerable progress in the cooperation among the three countries as the following:
  - 2-1. We noted that the prospects of three countries' economic growth for 2006 are positive because of the strong demand in the region and continued robust growth of the world economy although the continuous high oil price and an upward trend of the interest rates in the world may pose a major risk to the regional economy.
  - 2-2. We agreed that the regional financial cooperation within the ASEAN+3 is going toward a favorable direction. We welcomed the completion of the CMI review, which started in the 2004 ASEAN+3 Finance Ministers' Meeting in Jeju. We also agreed to make continuous efforts to seek the possibility to further enhance the regional financial cooperation beyond the CMI, including exploring the ways of achieving multilateralisation of the CMI (a new framework or post-CMI). We also reaffirmed our strong commitment to promote other regional cooperation projects such as the Asian Bond Markets Initiative (ABMI) etc. We noted the importance of sharing a long-term vision for financial integration in the region; we agreed on further study of related issues, including the usefulness of regional currency units, through the ASEAN+3 Finance Ministers' Process.
  - 2-3. Furthermore, we recognized the need to strengthen our roles in achieving global as well as regional sustainable growth and financial market stability. We acknowledged the importance of addressing the issue of significant under-representation of the countries whose current economic strength and the relative position in the global economy are not properly reflected in the IFIs and ensuring its legitimacy. We also emphasized the importance of an ad hoc quota increase in IMF, and called upon its Managing Director to work with the IMFC and Executive Board to come forward with concrete proposals for agreement at the next IMF and World Bank Annual Meetings in Singapore. On our side, we will strengthen our participation in the IMF activities.
- 3 . Based on our strenuous efforts thus far and the success of this meeting, we agreed to continue our meeting for closer policy dialogue among the three countries.