

**East Asian Economic
Cooperation and Integration:
Japan's Perspective**

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1. Introduction

Movements toward regional economic and monetary integration has been accelerating in East Asia. On the trade front, various FTAs have been proposed and negotiated. The Japan-Singapore “FTA plus” treaty has been completed and implemented. This is the first FTA for Japan. The Korean government has concluded a negotiation of its first FTA with Chile, to be ratified by the Parliament. In the area of financial cooperation, the Chiang Mai Initiative has solidified the grouping called ASEAN plus Three—Ten ASEAN countries and Japan, China, and Korea. The network of swap agreements has been built to complement IMF resources, should another crisis hits the region.

Japan's interest in regional financial cooperation has recently grown for four reasons. First, intra-regional trade and investment is increasing. The region has become a natural candidate for an economic area with common interest in trade deepening and in the exchange rate stabilization. Second, the experience of the Asian currency crisis that was highly contagious has shown that the Asia and Japan have been “on the same boat.” Their strong trade and financial linkages mean that one country's financial difficulties affect others quite easily. Preventing a financial crisis in one country, if possible, is of others' interest. Moreover, the less-than-perfect performance of IMF in managing various stages of the Asian currency crisis, 1997-98, has given an interest in building a regional framework that is substitutable or complement to IMF. Third, success in economic and currency integration in Europe shows that it is indeed possible for a region to unify the currency. Of course, there are many steps before monetary union. But, Europe clearly shows a model for a group of advanced and middle-income emerging market economies to integrate real economies and financial markets. Fourth, there is a fear factor. Asia may be left behind in rush toward

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regionalism. The EU is poised to expand to the east and the NAFTA may be expanded to the Free Trade Area of the Americas (FTAA). Fragmented Asia may suffer in any trade negotiations or trade wars as each of the Asian economies may be dwarfed by the expanded Euro Area or the “dollarized” Americas.

Once the worst of the currency crisis was over, a movement toward economic integration restarted. In May 2000, the Chiang Mai Initiative (CMI), to build a network of swap agreements in the region to help the hard currency liquidity in need was agreed. The grouping for CMI is “ASEAN plus Three” countries, namely Japan, China, and Korea. The CMI has been negotiated and built up to a multilateral swap agreement among the ASEAN ten countries and a network of bilateral swap agreements between one of the Three and one of the advanced or middle-income ASEAN countries (original five).

Economic integration and cooperation on the trade and investment front has become accelerated too. Japan has implemented its first FTA with Singapore, and started negotiations with Korea, Malaysia, Thailand, and the Philippines, as well as Mexico. China has proposed a FTA with ASEAN, and has already implemented “early harvest” with ASEAN countries.

The rest of this paper is organized as follows. Section 2 reviews the reason that the regional cooperation has become so popular in the second half of the 1990s. The groupings and mandate of the existing regional forums are also summarized. Section 3 considers the four major topics of cooperative frameworks: FTA, CMI, Currency regime, and Asian bonds. Section 4 concludes the paper.

2. Rationale for Regional Financial Cooperation

It had been proposed in several different forms that countries should cooperate each other in averting a financial crisis. The central banks typically have large foreign reserves, and they can pool them to lend to each other. Preventing a crisis in one country is of interest to neighbors, since a crisis tends to spread to neighboring countries with strong financial ties, directly and indirectly.

The proposal of economic affiliation under the proposal of East Asian Economic Caucus (EAEC) was proposed in the early 1990s, but opposed by the United States and never materialized. The proposal of the Asian Monetary Fund (AMF), after the Thai devaluation, but before the Korean and Indonesian crisis, was opposed by the United States and China in 1997 and never materialized².

² The proposal of the Asian Monetary Fund (AMF) could have been a defining moment in the history of financial integration in Asia. Instead, it became a source of controversy

During the Asian crisis of 1997, several factors contributed to the growing sense of regionalism. First, the crisis spread to neighboring countries from Thailand quite quickly. Reasons for the “contagion” have been debated, but most economists agree on at least two factors: institutional investors’ decision to put Asian in one basket; and negative spillovers through a trade linkage.

When a crisis occurs, it works as a “wake-up call” for institutional investors. They start looking for weak countries to look out for who’s-next. Investors start withdrawing funds from countries they think vulnerable and similar to the initial crisis country. This happened in the Mexican crisis as well as the Thailand crisis. Moreover, sometimes mutual funds are organized by geographical grouping. For example, when Thailand falls into a crisis, shareholders may want to cash out, so perceived by fund managers. Fund managers sell equities and bonds in the fund to fatten cash reserves. Therefore, securities and currencies in the fund will be sold and negative pressures on bonds, stocks, and currencies will result of the rest of the region. This is a contagion process through investors.

Contagion can be caused by trade link. When Thailand goes into a serious crisis, demand for goods—some of them imports—will decrease. Those countries that export to Thailand will suffer from declined aggregate demand. This may be amplified as spillovers go into a spiral of aggregate declines.

From these reasons, contagion occurred. The exchange rates of Asian currencies declined together from July 1997 to January 1998, although degree of correlation varies from one country to another. The sense of “we are on the same boat” was enhanced greatly.

Contagion occurred in the Mexican crisis of 1994-95. Pressure was applied to Argentinean and Brazilian markets. However, contagion was stopped before it caused devaluation in other countries, thanks to IMF program to Argentina in March 1995. In the case of Asia, IMF policies were not effective in stopping a crisis. Some think that the IMF policies even aggravated the downturn of the economies in some countries. For the Thai crisis, the IMF arranged a “package” of US\$17.2 billion, in which IMF contributed US\$4, and Japan also US\$4, with the rest came from the World Bank, ADB,

in the following three years, putting fetters on any regional effort toward financial cooperation. Although elements of the AMF proposal were quite sensible, the package was presented without coordination among Asian countries. It was quickly painted as a substitute for IMF, as a challenge to global institutions, and as an inward-looking framework for mutual “self-help” without tough economic reform.

and group of Asian countries. Countries like Korea, China, and others contributed US\$1 billion dollars each. It was notable that the United States or any European countries contributed to IMF package. These developments contributed to a notion that Asian countries should help each other in preventing and managing crisis. The regional self-help is important.

Japan provided financial assistance, that is, short-term and long-term loans through Japan Export-Import Bank, of its own under the new Miyazawa initiative from 1998. This alleviated some acute credit crunch due to banking crisis in the aftermath of the currency crisis.

In 1999, the Euro was introduced. This was the last major step in the long history of European economic integration. This stimulated the interest in regional integration among Asian countries. As the EU has succeeded in deep integration, and the NAFTA seems to be expanded to an entire Americas (FTAA), the Asia seems to be hopelessly fragmented. The newly revived interest in regionalism in Asia has been fueled by defensive considerations.

The failed attempt to launch WTO rounds in Seattle also put some pressure toward regional initiatives. Although a new round was launched two years later in Doha, now the regional FTAs are considered to be building bloc rather than a stumbling bloc.

There are many forums and framework for financial cooperation in the region. The following table summarizes the functions and status of the major grouping in the region.

Table 1: Regional surveillance Fora in Asia

Grouping	Structure	Focuses	Mandate
<p>Manila Framework Group (MFG) Established in 1997</p>	<p>The group of Finance and Central bank officials from 14 member countries (Australia, Brunei Darussalam, Canada, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore, Thailand, and the United States of America), and senior representatives from IMF, WB, ADB, BIS</p>	<p>macro-economic policies of crisis-affected economies in the region, exchange rate developments and their implications for monetary policies in the region (6th Meeting in March 2000)</p> <p>streaming of IMF facilities, strengthening the international financial system, including the work of IMF, G-20, FSF (8th Meeting in March 2001)</p>	<p>Finance and Central Bank Deputies Agreement at the meeting in Manila In Nov 1997 as follows</p> <p>This framework includes the following initiatives;</p> <p>(a) a mechanism for regional surveillance to complement global surveillance by IMF, (b) enhanced economic and technical cooperation particularly in strengthening domestic financial systems and regulatory capacities, (c) measures to strengthen the IMF's capacity to respond to financial crisis (d) a cooperative financing arrangement that would supplement IMF resources</p>

Grouping	Structure	Focuses	Mandate
<p>APEC (Asia-Pacific Economic Co-operation) Established in 1989</p>	<p>Led by Heads of Governments, finance ministers (initially Foreign Affairs and Trade Ministers) of 21 countries (Australia, Brunei Darussalam, Canada, Chile, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, Mexico, New Zealand, Papua New Guinea, Peru, the Philippines, Russia, Singapore, Taiwan, Thailand, the United States of America, and Viet Nam)</p>	<p>Macroeconomic issues and exchange rate issues, freer and stable flows of capital, private sector participation in infrastructure development, and the development of financial and capital markets</p>	<p>Leaders' Declaration in Vancouver in Nov 1997 (This is the first time to touch upon the regional surveillance)strongly endorse the framework agreed to in Manila as a constructive step to enhance cooperation to promote financial stability; enhanced regional surveillance; intensified economic and technical cooperation to improve domestic financial systems and regulatory capacities....</p> <p>Memorandum to APEC Leaders in Sep 1999 Ministers reaffirmed the value of peer surveillance within APEC economies and the benefits to be derived from greater co-operative efforts at the micro level, particularly in financial and capital markets</p>

Grouping	Structure	Focuses	Mandate
<p>ASEAN (Association of South East Asian Nation) Established in 1967</p>	<p>The association of 10 member countries (Indonesia, Malaysia, the Philippines, Singapore, Thailand, Brunei Darussalam, Vietnam, Laos, Myanmar, Cambodia)</p>	<p>The objective range from free trade to environmental protection, social, cultural and scientific development</p>	
<p>ASEAN Surveillance Process Established in 1998</p>	<p>The institutional bodies consists of ASEAN Finance Ministers Meeting (AFMM), ASEAN Select Committee and ASEAN Central Bank Forum</p>	<p>Monitoring and analyzing macroeconomic situation and developments, and any other specific areas including structural and sectoral issues Enhancing surveillance work, relevant sector and international organizations within and outside ASEAN may be consulted</p>	<p>Terms of Understanding in 1998 1.exchanging information and discussing economic and financial development... 2.providing an early warning system and peer review process to enhance macroeconomic stability and financial system. 3.highlighting possible policy options and encouraging early unilateral or collective actions to prevent a crisis... 4.monitoring and discussing global economic and financial developments...</p>

Grouping	Structure	Focuses	Mandate
<p>ASEAN (Association of South East Asian Nation) plus 3 Established in 2000 (based on “Joint Statement on East Asia Cooperation” issued by the ASEAN+3 Leaders at their Informal Meeting in 1999)</p>	<p>Led by Finance Ministers of ASEAN, China, Japan, and Korea</p>	<p>Enhancing policy dialogues and regional cooperation activities, particularly in the areas of regional self-help and support mechanism, international financial reform and short-term capital flows monitoring, Exchanging data on capital flows bilaterally among member countries on a voluntary basis</p>	<p>The joint Ministerial Statement of the ASEAN+3 Finance Ministers Meeting in Chiang Mai in May 2000 ...we agreed to strengthen our policy cooperation activities in, among others, the area of capital flows monitoring, self-help and support mechanism and international financial reforms...</p> <p>The joint Ministerial Statement of the ASEAN+3 Finance Ministers Meeting in Honolulu in May 2001 ...we agreed to update the capital flows situation in each member country and to exchange data on capital flows bilaterally among member countries on a voluntary basis...</p>

Grouping	Structure	Focuses	Mandate
<p>EMEAP (the Executives' Meeting of East Asia and Pacific Central Banks) Established in 1991</p>	<p>A cooperative organization of central banks and monetary authorities of 11 economies: Australia, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore, and Thailand</p>	<p>Exchanging the information in the areas of banking supervision and monetary policy, foreign exchange policy and operational issues (3WG on Payment and Settlement Systems, Financial Markets, Banking Supervision) Reporting on the Regional Foreign Exchange Markets Monitoring and Exchange Rate Regimes</p>	<p>Governors' unanimous agreements at the meeting in July 1997 that a closer cooperation and coordination among EMEAP members is necessary and important to enhance financial stability and market development in Asia Pacific region.</p>
<p>SEACEN (South East Asian Central Banks) Established in 1982</p>	<p>A organization of central banks of 11 Economies: Indonesia, Korea, Malaysia, Myanmar, Mongolia, Nepal, the Philippines, Singapore, Sri Lanka, Thailand, Taiwan</p>	<p>Facilitating co-operation in research studies and training program relating to the policy and operational aspects of central banking</p>	<p>The objectives of The SEACEN Research and Training Centre established as a legal entity to promote a better understanding of the financial, monetary, banking and economic development matters...</p>
<p>SEANZA (South East Asia, New Zealand, Australia) Established in 1956</p>	<p>A regional policy forum of central bank governors from British Commonwealth countries in Asia Pacific region</p>	<p>Providing training course for central Bank staffs and forum of Banking Supervisors in order to exchange information on issues and problems of common interest.</p>	<p>The objective of The SEANZA Forum of Banking Supervisors established as an offshoot to provide a means for banking supervisors from the region to establish contact with each other....</p>

Grouping	Structure	Focuses	Mandate
<p>BIS Asian Consultative Council Established 2001</p>	<p>The council within BIS, comprising the Governors of the BIS member Central Banks in the Asia/Pacific region (The secretariat are provided by the BIS Representative Office for Asia and the Pacific in Hong Kong.)</p>	<p>Providing a vehicle for communication between the Asian and Pacific members of the BIS and the Board and Management on matters of interest and concern to the Asian central banking community</p>	
<p>IOSCO Asia Pacific Regional Committee (IOSCO APRC) (IOSCO: International Organization of Securities Commissions, Established 1976)</p>	<p>One of the four Regional committees of IOSCO (a world-wide forum for securities regulators) consists of Australia, Bangladesh, China, Hong Kong, India, Indonesia, Japan, Korea, Kyrgyz Republic, New Zealand, Pakistan, Papua New Guinea, the Philippines, Singapore, Sri Lanka, Taiwan, Thailand, Viet Nam and Malaysia (2002)</p>	<p>Regional co-operation in the regulation of the capital markets, particularly focusing on the enhancement of co-operation, mutual assistance and information-sharing in the enforcement of illegal securities activities. Formulating a regional approach in combating these illegal operations, which have affected investors in the region</p>	<p>APRC will consider its regional multilateral Memorandum of Understanding, aimed at enhancing information sharing as well as cross-border co-operation and multiple jurisdiction surveillance and enforcement functions. (2002) (IOSCO established a Special Project Team on co-operation, which is developing an IOSCO-wide multilateral MOU)</p>
Notes: Author's summary			

3. Further Integration in Four Fronts

3.1. FTA

Traditionally, Japan had maintained a strong commitment for multilateral trade negotiations under the GATT/WTO (World Trade Organization) regime, and hesitated to join any regional trading or political arrangement, such as EAEC. In the 1990s, formation of the NAFTA and EU have change the view of the Japanese politicians and bureaucrats. The disadvantage of being left out from major regional groupings have become obvious toward the end of the 1990s.³ Moreover, the financial crisis in the East Asia had made it clear that there exists a regional interest to form a common trade and financial strategies. However, it has been difficult to organize any trade grouping in Asia, for historical and political reasons. The APEC has been the first to publish the target of free trade as the Bogor goal. However, it did not have any enforceable agreement or political leadership. Common interests among the diverse APEC members are difficult to find. The ASEAN Free Trade Agreement, AFTA, has also pushing free trade among ten members.

Sometime in 2000-2001, Japan's trade policy has shifted from hesitation to promotion of regional arrangements. On the financial side, the Chiang Mai Initiative was agreed among the ASEAN plus Three (ASEAN+3), and this grouping has quickly become a preferred grouping for the regional integration.

Considering the importance of the East Asian countries as markets of the made-in-Japan products and also as a production base for Japanese multinational companies,⁴ Japan has good reasons to assist and cooperate with the regional economy. Since Japan has lowered the tariffs of most of the products under the past GATT rounds, the average tariff rate of Japan is quite low. Major restraints on Japan's imports, both in the form of quota or tariffs, remain only in the agricultural sectors. Although most of the agricultural products are freely imported—and the ratio of “domestically produced calorie” is lowest—but the remaining products have strong political backing for protection.

Japan's first FTA was negotiated with Singapore. Japan negotiated a FTA-plus agreement—Japan Singapore Economic Partnership Agreement (JSEPA)—with

³ In response to the stagnation in the domestic consumption, Japan gradually increased export dependency in the 1990s, mainly through East Asian market. The share of Japan's export to East Asia was 29.8% in 1990, but it went up to 40.4% in 2000.

⁴ According to METI's survey, the profit rate of Japanese subsidiaries in Asia has doubled that in the U.S, exceeding 17.2% in amount (about 1 trillion Yen) in 2001. However, it was seriously changed by the crisis from 1998-99.

Singapore in 2001 and the treaty took effects in 2002. Since Singapore has little productions in the agricultural sector, it was thought to be easy for Japan to conclude the treaty. Since the average rate of tariffs of Singapore has been very low, the main point of the treaty was The main point of the JSEPA was to expand the cooperative arrangements beyond traditional trade area into services and movement of people. Although the expansion was limited, the JSEPA removed any doubt on the will of Japan to pursue regional arrangement.

Korea has been always the first priority country of FTA for Japan, for the geographical proximity and strong trade relationship. However, for various reasons, the negotiation did not start. Korea maintained tariff and nontariff barriers to Japanese goods until the currency crisis and its resolution. The opening of the Korean markets to Japanese goods (especially autos) and culture has been proceeding slowly in the last five years. Korea has been reluctant to go for a regional arrangement in the past. But, Korea also negotiated an FTA with Chile. Japan and Korea agreed to start negotiation in December 2003.

China has become very enthusiastic to ASEAN plus Three process, both in the trade and financial fronts. China has proposed an FTA with ASEAN and agreed to conclude negotiation by 2010. The so-called early harvest in liberalizing agricultural imports to China was implemented in 2003.

Japanese businesses have complained bitterly about the discrimination that they suffer in Mexico. Since Mexico is a member of NAFTA and also has a bilateral FTA with EU, the US and European manufacturing subsidiaries in Mexico enjoys free imports of parts from parent companies. Also, US and European companies can export finished goods to Mexico without tariffs. Japanese companies are subject to high tariffs. The Japanese business pushed the government to negotiate an FTA with Mexico. The negotiation came close to a conclusion when President Fox came to Japan in December 2003. However, pork and orange juice became the last stumbling block, and the negotiation broke down. This shows how strong the agricultural lobby in Japan. In terms of population, agriculture has only 5%, but it has a power to stop FTAs.

Japanese approach to ASEAN in the area of FTA has been influenced by the overture of China to ASEAN. Since ASEAN has been a primary area for Japanese corporations to invest in the last two decades, the economic integration with ASEAN is important for Japan. Goods and parts moving freely around the ASEAN countries and between Japan and ASEAN is important for Japan. On the one hand, Japan proposed an FTA with ASEAN countries, one year behind the Chinese schedule. On the other

hand, Japan is pursuing negotiations of bilateral FTAs with Thailand, Malaysia, and the Philippines. After the breakdown of the Japan-Mexico FTA negotiation, Japan's prospects of FTA with Asian countries are not so good.

Tabel 2: Timeline of the Japanese FTA

	Study	Negotiation	Signed
Singapore	Concluded	Concluded, 2001	2002:1
Mexico	Concluded	2002:11-	Soon?
Korea	Concluded	2002:12-	2004?
Thailand, Philippines, Malaysia	Concluded	2002:12-	2005?
Asean	?	2005?	2012?
Asean+3	?	?	?

3.2. CMI

The right form of financial regional architecture has been a focus of discussion ever since the Asian currency crisis started in July 1997. The idea of complementing the IMF was dubbed as the Asian Monetary Fund. At the time of the Mexican and Thailand crisis, the IMF lending to a crisis country was limited to the amount of five times of the quota of the country—this is called an access limit. The access limit made it necessary to form a “IMF package” with a regional power—the United States in the case of the Mexican crisis and Japan in the case of the Asian crisis. The Asian Monetary Fund did not materialize when it was opposed by the IMF, the United States, and China in September 1997. The problem of access limit was partially eased at the level of the IMF decision making, by the introduction of the Supplemental Reserve Facility (SRF), that was used for Korea in December 1997. The global discussion also took a direction of emphasizing the role of creditors—the discussion is called private sector involvement (PSI)—rather than lending ever large amount to a crisis country. (See Ito (2003a).)

In May 2000, Japan took another leadership in forming ASEAN plus Three group to start negotiating foreign exchange swap agreements—the Chiang Mai Initiative. This aims at the cooperation among the 13 countries, with a network of arrangements for sudden foreign currency needs. The ASEAN countries had had a multilateral swap agreement among themselves. The size was expanded by five-fold, and became a 1 billion dollar facility. Japan started to negotiate a swap agreement with four middle income countries—Thailand, the Philippines, Malaysia—in the ASEAN, and concluded by March 2003. China and Korea, respectively, negotiated with these five countries. Japan and Singapore also concluded a swap agreement in 2003. Bilaterals among the three, namely Japan-China, China-Korea, and Japan-Korea, have been concluded, too. See Table 1 for details.⁵ Negotiations to complete the matrix is under way.⁶

⁵ This is the sum of all BSAs, including the amount that Japan committed under the New Miyazawa Initiative—a total of US\$7.5 billion, or US\$5 billion with South Korea and US\$2.5 billion with Malaysia—, except that two-way BSAs are doubled for calculation purposes. Excluding the amount committed under the New Miyazawa Initiative, the total sum is US\$31.5 billion.

⁶ While Indonesia has proposed BSAs with China and South Korea, actual negotiations have yet to begin.

**Table 3. Progress on swap arrangement under the Chiang Mai Initiative
(as of end-March 2003)**

BSAs	Currencies	Conclusion Dates	Size
Japan-South Korea	USD-Won	July 4, 2001	US\$ 7 billion ^a (1-way)
Japan-Thailand	USD-Baht	July 30, 2001	US\$ 3 billion (1-way)
Japan-Philippines	USD-Peso	August 27, 2001	US\$ 3 billion (1-way)
Japan-Malaysia	USD-Ringgit	October 5, 2001	US\$ 3.5 billion ^b (1-way)
China-Thailand	USD-Baht	December 6, 2001	US\$ 2 billion (1-way)
Japan-China	Yen-Renminbi	March 28, 2002	US\$ 3 billion ^c (2-way)
China-South Korea	Renminbi-Won	June 24, 2002	US\$ 2 billion ^c (2-way)
South Korea-Thailand	USD-Won or USD-Baht	June 25, 2002	US\$ 1 billion (2-way)
South Korea-Malaysia	Won-Ringgit	July 26, 2002	US\$ 1 billion ^c (2-way)
South Korea-Philippines	Won-Peso	August 9, 2002	US\$ 1 billion ^c (2-way)
China-Malaysia	USD-Ringgit	October 9, 2002	US\$ 1.5 billion (1-way)
Japan-Indonesia	USD-Rupiah	February 17, 2003	US\$ 1.5 billion (1-way)
Japan-Singapore	Concluded in 2003		
China-Philippines	Under negotiation		
China-Indonesia	Under negotiation		
South Korea-Indonesia	Under negotiation		

Notes: (a) The amount includes US\$5 billion committed under the New Miyazawa Initiative.

(b) The amount includes US\$2.5 billion committed under the New Miyazawa Initiative.

(c) The amounts are US dollar equivalents.

According to the general agreement of the Chiang Mai Initiative, a country can borrow

hard currency collateralized by domestic currencies with government guarantees. The swap will be extended up to 90 days and, renewable up to seven times, is aimed at an arrangement. The interest rate is equivalent to the LIBOR plus 150 basis points for the first drawing and first renewal. The premium of 50 basis points will be added every two renewals, subject to a maximum of 300 basis points.

Up to 10 percent of bilateral support can be released immediately, but the rest is subject to a condition that a country will obtain an IMF program. In this sense, the CMI is complementing the IMF. The linkage to IMF is necessary given that CMI itself does not have a secretariat or an independent surveillance function to prevent a moral hazard problem. The CMI will be reviewed in May 2004.

3.3. Currency Regime⁷

One of the lessons from the Asian Currency Crises is the danger of the *de facto* dollar peg adopted by the Asian economies that had extensive trade and investment relationship with countries other than the United States.ⁱ When the yen appreciated vis-à-vis the US dollar, the Asian economies enjoyed the boom, or a bubble in some cases, due to increased exports. But, when the yen depreciated, the Asian economies tended to experience a recession, or a burst bubble. The experience of the Asian boom and bust in the 1990s, along with the yen-dollar exchange rate fluctuation, is a stark reminder of risk of the fixed exchange rate regime.

An obvious solution for this problem is to increase flexibility of the exchange rate. If the baht had appreciated during the yen appreciation phase of the 1993-95, the extent of overheating in Thailand might have been limited; and if the baht had depreciated along with the yen in 1996-97, then the decline in exports could have been mitigated. This kind of exchange rate flexibility can be achieved by a flexible exchange rate regime which keeps the real effective exchange rate relatively stable.

An insight here is that an emerging market economy, which exports to the United States and Japan, is well advised to consider managed exchange rate regimes, in order to avoid excessive volatility of the real effective exchange rate. The questions to be considered include how to determine a reference rate as an appropriate real effective exchange rate and how much fluctuation is excessive.

The optimality of the exchange rate regime is defined as the one that minimizes the fluctuation of the trade balances,ⁱⁱ when the yen-dollar exchange rate fluctuates. Ito, Ogawa, and Sasaki (1998) proposed how to calculate the optimal weights when the

⁷ This section draws on Ogawa and Ito (2002).

emerging market economy exports to Japan and the United States only. The optimal weights were calibrated with some assumptions on the demand elasticities and export shares. Ogawa and Ito (2002) extend the Ito, Ogawa, and Sasaki model to include a neighboring emerging market as well as Japan and the United States. A typical Asian economy exports about one-third to the United States and one-third to Japan, and the rest to countries in the Asian region (and EU). Therefore, to simplify, we consider the case that country A (B, respectively) exports to the United States, Japan, and country B (A, respectively). Therefore, the real effective exchange rate calculation includes the currency of neighboring country.

Ogawa and Ito (2002) considers how the optimal weights may depend on what the neighboring country is adopting as weights. In the extreme case, if country A is adopting the dollar peg, country B should adopt the dollar peg; and if country B is adopting the dollar peg, then country A should adopt the dollar peg. Namely, the dollar peg is a Nash equilibrium. However, if country A is using a currency basket which mirrors the export shares, adjusted for demand elasticities, then country B should adopt a (similar) currency basket; and if country B is using a currency basket, then country A should adopt a currency basket. This trade-weighted currency basket is also a Nash equilibrium.

Although the paper is motivated by the recent Asian experiences, the application is not limited to Asia. Results obtained in this paper are relevant to any developing countries with a trading structure with export destinations including different currency areas.

Which of the Nash equilibria is chosen depends on the inertia as well as rational calculation. If countries can coordinate, then they should choose the best among Nash equilibria. This process of choosing the optimal Nash equilibrium can be regarded as a regional currency arrangement. Coordination failure could occur if a country has some obstacles for coordination from political or social obstacles against breaking inertia. What this paper shows is that coordinate managed float by the two countries would increase the stability in the trade balance fluctuations.

3.4. Asian Bonds⁸

Three of the many lessons from the currency crisis have been discussed much but not used to make changes in the real world yet. First, it was found important to reduce vulnerability is to avoid the “double mismatch” problem, namely currency and maturity

⁸ This section is drawn from Ito (2003b).

mismatches of borrowers in emerging market companies. Borrow short in the US dollar and lend long in the local currency is dangerous. Second, to avoid over-reliance on the banking sector is important, since the “twin crisis”, that is, a simultaneous currency and banking crisis, is quite damaging to the economy. Third, to avoid the dollar peg is important both from the viewpoint of maintaining price competitiveness of imports and of discouraging too much short-term capital inflows.

In order to reduce reliance on the banking system, to promote bond financing is important. If the government and corporations can issue bonds for long-term projects, then they can reduce borrowing from banks. Banks also benefit from avoiding maturity mismatch. One of the problem is that the bond market in an emerging market countries in Asia has not been developed in terms of the market institutions. The bond market in emerging market may benefit from broadening the market to the region, since inviting foreign investors will deepen the market. However, in order to lure investors into the bond market, transparency may have to be enhanced. Therefore, it is desirable to establish a region-wide bond market.

Asian bonds have been proposed, most prominently in several speeches by Prime Minister Thaksin of Thailand. The Asian bond has become a focal point for regional financial cooperation after the Chiang Mai Initiative. Below, I will review what has been done and propose a particular form of Asian bonds.

Asian bonds are bonds issued by Asian institutions (government, corporations, and financial institutions), denominated in an Asian currency, and sold, traded, and settled in an Asian financial center (Tokyo, Singapore, and Hong Kong). Investors are expected to be mainly regional (Japan, Singapore, Hong Kong, in particular), but others are welcome.

In order to solve the double mismatch problem, it is essential that Asian bonds are issued in a local currency, or a basket of local currencies. By issuing bonds in local currency, the governments or corporations will be freed from possible problem of acute dollar liquidity shortage, unless maturities are bunched in particular months. Major trading center should be regional so that settlement and clearance should be done in real time. Delivery vs. Payment (DvP) can be done if regional central banks extend real time gross settlement facility to financial centers and settlement and clearance facility is developed in regional financial centers.

Investors are known to have “home bias”, that is, investors’ portfolio is heavily biased toward domestic securities. Many possible reasons, including avoiding currency risk, familiarity, etc, have been presented. There may be “regional bias” in that investors may be attracted toward securities issued by countries in the region, second to

domestic securities. The currencies in the region are more correlated than other currencies, and familiarity of regional companies and currencies are high. That is the reason to think that major investors into Asian bonds are Asian investors.

The central banks in the region (EMEAP)⁹ have announced that they will contribute US\$1 billion to the Asian Bond Fund (ABF), managed by the BIS, in order to invest in dollar-denominated bonds issued by Asian issuers, namely Yankee bonds.¹⁰ The central banks will set aside a certain portion of their foreign reserves (estimated to be more than 1 trillion US dollars) to invest in ABF. Eligible securities are those issued by governments and quasi-governments.

This is a good step toward an eventual development of the Asian Bond market. However, this proposal does not fit perfectly in what was envisioned as Asian bonds. First, the use of the U.S. dollar, presumed in the current version of ABF, does not contribute to the financial and monetary stability of the region. Second, under the current version of ABF, the monetary authorities buy and hold the Asian bond fund as foreign exchanges, so the secondary market of Asian bonds would not develop. Third, the ABF is contributed from central banks, but foreign reserves are strictly regulated on their eligible securities. Due to the regulation, the market size of bonds that can be invested by the ABF will be limited.

It has been proposed that the fiscal authorities of Japan, Korea, and Thailand, and any other willing Asian countries, should jointly establish the Asian Bond Corporation (ABC) in offshore market (Tokyo, Hong Kong, or Singapore). The ABC will purchase sovereign bonds (later, corporate bonds and asset backed securities) of the participating countries, issued in the respective local market and denominated in the yen, won, and baht. The ABC's asset side is composed of a basket of bonds in different currency denominations and different coupon rates. The ABC bond, on the liability side of the ABC, is backed by the market value of the bonds on the asset side. Hence, pricing of ABC bonds in the secondary market should reflect the value of the underlying assets.

For example, we recommend that the ABC initially purchase Japanese, Korean, and Thai government bonds with value-weights of 50-30-20, respectively. Then the pricing of ABC bond reflects both the exchange rate fluctuations of the yen, won, and baht, as well as the interest rate movements in the three countries. With respect to currency risk, the ABC bonds show a feature of a basket currency, namely a weighted

⁹ EMEAP (Executives' Meeting of East Asia-Pacific Central Banks) members consist of central banks of Australia, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore, and Thailand.

¹⁰ See <http://www.boj.or.jp/en/about/03/un0306a.htm> for the announcement.

average of the three currencies. The coupon interest rate of the ABC bond will be a weighted average of the underlying bonds.

It is likely that many investors find ABC bonds attractive. Investors have to take some currency and credit risk to receive some extra returns. But risks have to be transparent, fair, and diversified. (The Japanese investors currently receive only 0.8% yield from holding Japanese bonds, but some of them are eager to purchase Australian-dollar-denominated bonds yielding 5%, reflecting currency and credit risk. They may be attracted to an ABC bond yielding 3%, with lower currency risk.) The role of ABC is to bundle bonds from diversified sources, so that a reasonable tradeoff point in the risk-return curve will be offered in a transparent manner. The regional investors who pursue higher returns without increasing too much of risk will regard bonds issued by the ABC as just such financial instruments.

If credit risk of participating bonds makes ABC bonds unattractive to risk-averse bond investors in the region, the partial guarantee may be offered by a credit enhancement agency. When corporate bonds and asset backed securities (ABS) are bundled into a ABC corporate bond, credit enhancement or separating into senior bonds and junior bonds may help widen the customer base. If currency risk, even as a weighted average, is not desirable for some home-biased investors, swap into local currencies may be offered by the ABC, or its foreign exchange swap partners.

The ABC sovereign bonds will not assume any major risk, because the value and coupon payments of assets and liability matches all the time. It should behave like a currency board or a mutual fund. The ABC helps create the Asian bond secondary market. The ABC encourages the issues of bonds in the region. The ABC sovereign bond should give the benchmark for the ABC corporate bonds and ABC-ABS bonds.

In comparison to the ABF proposal, the ABC proposal has several advantages. The ABC promotes local currency bond issues, while the ABF in the current version invests in the dollar-denominated bonds only. The ABC will bundle them as a basket currency bond for investors. My proposal of the ABC bonds promotes the secondary market by issuing the ABC bonds, while ABF does not. In the sense the central banks in the ABF are a buyer-investor, while the ABC is an issuer as well as a buyer. In this sense, the two proposals are quite complementary, while the ABC is based on market participants and principles. The ABC has no limit in what kind of securities to invest in, while the ABF is limited to sovereign and quasi-sovereign bonds. If another crisis comes, then the foreign reserves may have to be sold to help stabilize the currency, then the monetary policy has to sell Asian bonds, aggravating the crisis by depressing the bond market. This kind of procyclicality is something to be avoided in institutional

design. The ABC proposal does not have such a deficiency.

4. Future Directions and Challenges

Further deepening in trade and financial cooperation is expected in the East Asian region. Unresolved questions and tentative answers are as follows:

- (1) Grouping. An appropriate grouping for economic integration is still unclear, although China and Japan seem to be comfortable with the ASEAN plus Three grouping. China will object to have Taiwan as an independent member. Some ASEAN countries may object to include Australia and New Zealand, although bilateral FTAs may be extended to them.
- (2) Regional or bilateral FTA. AFTA is moving slowly toward an free trade area. China is pursuing a regional FTA with ASEAN. Japan has both a regional FTA initiative and a network of bilateral FTAs. In the end, ASEAN plus Three FTAs will become a target, but there seem to be a movement that bilateral FTAs are faster and will become building blocks for the future. FTAs in East Asia is not obstructing the WTO process. It would be at least as clean as NAFTA or EU.
- (3) Financial Cooperation Beyond CMI. The network of CMI will be almost complete among the northeast Three and the original ASEAN five. The challenge here is what is next. Whether financial cooperation in the region should move toward an arrangement more independent from the IMF and any other global institutions is an interesting question. Asian Bond initiative is clearly a right path toward an environment that is less affected by external and internal shocks.
- (4) Exchange Rate Regime. When the region (say, ASEAN plus Three) become deeply integrated, a strong incentive will emerge to pursue stability among the exchange rates in the region. Most likely, the basket currency will be formed to give an anchor to the regional currencies. Currencies in the region will limit volatility inside the basket but float together against outside currencies, just like a snake or ECU arrangements in Europe in the 1980s. Whether the yen will be inside the basket or outside the basket will be an interesting question, both from political and economic points of view.

The progress toward true economic integration has just begun, and many important decisions have to be made in the next several years before the level of economic integration becomes deep enough to talk about the exchange rate stability among the member countries. However, the path that European countries have traveled is well recognized by Asian countries, and there seems to be a political movement toward them

as well as economic rationale.

(END)

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