



# Prospects for Regional Financial and Monetary Integration in East Asia

Yung Chul Park and Doo Yong Yang

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**Kyung Tae Lee**  
**President**

# **Prospects for Regional Financial and Monetary Integration in East Asia**

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## Executive Summary

The financial crisis that erupted in 1997 changed the region's confidence in such a progress and in consequence gave a strong impetus to searching for a regional mechanism that could forestall future crises. This search has been gathering momentum and opening the door to possibly significant policy-led integration in East Asia. The adoption and implementation of the CMI and ABMI could be counted as a major step toward strengthening the financial and monetary cooperation in East Asia.

The CMI initiated as a supplementary liquidity facility based on bilateral swap arrangement. However, it has been criticized from the beginning as being too small in volume and too fragmented in its decision making process to deal with possible financial crisis in the region. IMF conditionality and the lack of a regional surveillance mechanism also provide a great concern of the effectiveness for the CMI. Reflecting those concerns, ASEAN+3 Financial Minister's Meeting made some progress. The ministers agreed to increase the size of the bilateral swap arrangements among from \$39.5 billion to \$79 billion. They also decided to increase the ceiling for liquidity supports without any IMF supports to 20% from the current 10%. Furthermore, the FMM reached a decision that the CMI would be developed as a multilateral decision-making process rather than bilateral one. Despite current development in the CMI, it is quite suspicious that the CMI can fully handle in a case of full-fledged crisis in the region.

One of important economic cooperation in the region is monetary cooperation or common exchange rate arrangement. It is, of course, long-term perspective, and therefore it seem not to reach any short-term or medium term agreement on this issue. The discussion includes the choice of a common currency and a collective exchange rate regime during the transition period that could facilitate monetary integration in the region.

In promoting the ABMI, the priority of cooperation among the ASEAN+3 members would be to resuscitate the financial reform enacted by most East Asian economies after the 1997-98 financial crises. Deregulation and opening of the domestic capital market with the

construction of the requisite market supporting infrastructure will overtime create domestic demand for foreign financial instruments and encourage domestic borrowers to seek the capital markets of other countries for financing. These developments- particularly deregulation of cross border trading and investment in financial instruments denominated in different currencies- which will establish the foundation of efficient regional capital markets, should precede the creation of regional capital markets.

East Asia enjoys the latecomer's advantage in promoting financial and monetary integration as it can learn from the European experience. But the success of its integration efforts will in no small measure depend on the support of the US and EU. In the end, the western countries will have to decide whether the regional financial arrangements in EastAsia will contribute to global stability and welfare. And the European experience suggests that they are likely to do so. It would therefore be in the US and European interest to support the expansion and consolidation of the CMI insofar as financial deepening and integration in East Asia supports an orderly globalization of the world economy.

JEL: F36, F42, F53

Key Word: monetary cooperation, regional financial arrangement, East Asia

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# Table of Contents

<b>Executive Summary</b> .....	3
<b>I. Introduction</b> .....	9
<b>II. Financial Market Liberalization and Integration</b> .....	11
1. Benefits of Financial Integration .....	11
2. Regional or Global Financial Integration? .....	13
3. Financial Integration and Monetary Unification .....	15
<b>III. Capital Flows in Asia</b> .....	19
1. Trends and Characteristics of Capital Flows in Asia .....	20
2. Stylized Facts on Capital Flows in the APEC region .....	24
3. Freer and More Stable Capital Movements .....	34
4. Policy Implications .....	38
<b>IV. Financial Globalization and Real (Trade) Regionalization</b>	40
<b>V. Economic Rationale for a Regional Financial Arrangement in East Asia</b> .....	46
1. Regional Financial Arrangements: Stumbling Blocks? .....	46
2. Trade Integration and Stability of Bilateral Exchange Rates .....	47
3. IMF and Capital Account Crisis Management .....	49
4. Limited and Slow Progress in International Financial Reform .....	53
5. Accumulating Reserves: a War Chest or Insurance? .....	54
6. Regional Financial Arrangements: Prone to Moral Hazard? .....	59
<b>VI. Recent Developments in the Chiang Mai Initiative (CMI)</b> .....	62
1. The Background of the Chiang Mai Initiative .....	62
2. Structure and Status of the CMI .....	65
3. Strengthening the CMI .....	68

<b>VII. The Asian Bond Market Initiative (ABMI)</b> .....	72
1. Objectives and Structure .....	72
2. Rationale and Need .....	76
<b>VIII. Exchange Rate Policy Coordination for Monetary Unification</b> .....	80
1. East Asian Monetary System (EAMS) .....	81
2. Pegging to Currency Baskets .....	82
3. The Asian Currency Unit (ACU): What is it and what will it do? .....	83
4. China's New Exchange Rate Regime and Growing Need for exchange rate policy coordination .....	94
<b>IX. Barriers to Financial Cooperation and Integration</b> .....	101
1. Institutional Constraints .....	101
2. Leadership Issue .....	105
<b>X. Concluding Remarks</b> .....	112
<b>Appendix.</b>	
1. The Joint Ministerial Statement of the 8th ASEAN+3 Finance Ministers' Meeting 4 May 2005, Istanbul, Turkey .....	115
2. Joint Message The 5th Trilateral (China, Japan and the Republic of Korea) Finance Ministers' Meeting .....	119
3. Report of the Review of the Chiang Mai Initiative-Ways of Enhancing Its Effectiveness .....	121
4. Progress Report of the Asian Bond Markets Initiative (ABMI) .....	158
5. Chairman's Statement of the First East Asia Summit Kuala Lumpur, 14 December 2005 .....	218
6. Chairman's Statement of the Ninth ASEAN Plus Three Summit Kuala Lumpur, 12 December 2005 .....	221
7. Kuala Lumpur Declaration on the ASEAN Plus Three Summit Kuala Lumpur, 12 December 2005 .....	224
<b>References</b> .....	230

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## Tables

Table III-1. Foreign Reserves in East Asian Economies .....	23
Table III-2. Coefficients of Volatility of Capital Flows in APEC .....	27
Table III-3. Regional Distribution of Portfolio Investment .....	30
Table III-4. Trade Volumes among APEC regions .....	31
Table III-5. Flows of Workers Remittances .....	33
Table III-6. Restrictions on Capital Flows in APEC .....	36
Table IV-1. Geographic Division .....	40
Table IV-2. Regional Distribution of Portfolio Investment (%) .....	41
Table IV-3. Export Flows among Regional Specification .....	43
Table IV-4. CT Index for Asia .....	44
Table IV-5. CT Index for Europe .....	44
Table IV-6. CT Index for Latin America .....	45
Table IV-7. CT Index for North America .....	45
Table V-1A. Trade Share in East Asian Countries (export) .....	48
Table V-1B. Trade Share in East Asian Countries (import) .....	48
Table V-2A. International Reserve of East Asia, 1999-2005 .....	55
Table V-2B. Current Account Surpluses .....	56
Table V-3. Ratios of Foreign Exchange Reserves to Short-term External Debt and GDP .....	58
Table VI-1. Progress on the Chiang Mai Initiative .....	67
Table VII-1. Net Overseas Portfolio Investments of Asian Economies .....	73
Table VIII-1. Amounts and Weightings of ECU Currencies .....	86
Table VIII-2. Trade Weights of East Asian Economies .....	98
Table IX-1. Free Trade Agreements in East Asia .....	103

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## Figures

Figure III-1. Patterns of Capital Inflows in Asian Economies .....	21
Figure III-2. Patterns of Capital Outflows in Asian Economies .....	22
Figure III-3. Trends of Current Account in Asia .....	23
Figure III-4. FDI Inflows by Region .....	24
Figure III-5. FDI Inflows into Asia .....	25
Figure III-6. FDI Outflow .....	26
Figure III-7. Portfolio Investment of APEC Economies .....	28
Figure III-8. Workers Remittances of APEC Economies .....	32
Figure VIII-1A. Real Effective Exchange Rate .....	96
Figure VIII-1B. Real Effective Exchange Rate (ASEAN 4) .....	96

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# I. Introduction

The 1997 Asian financial crisis has set in motion two interrelated financial developments in East Asia. Most of the East Asian countries including the crisis-hit ones have increased the pace and scope of domestic financial reform to liberalize and open their financial markets and also to improve soundness, corporate governance, and risk management at financial institutions. The other development is the regional movement for financial cooperation and integration that has culminated in the Chiang Mai Initiative (CMI) and Asian Bond Market Development Initiative (ABMI).

Before the Asian financial crisis broke out in 1997, few would have seriously argued for the creation of a system of regional financial cooperation in East Asia. To many a market-led integration process was desirable and in fact was taking root in East Asia. The financial crisis that erupted in 1997 changed the region's confidence in such a progress and in consequence gave a strong impetus to searching for a regional mechanism that could forestall future crises. This search has been gathering momentum and opening the door to possibly significant policy-led integration in East Asia (Bergsten 2000 and Henning 2002). Bergsten noted that East Asia might be on the brink of a historic evolution, as Europe was half a century ago.

After the 1997-98 financial crises, there has been a rising sense of East Asian identity. When the proposal to create an Asian Monetary Fund (AMF) was shot down, the leaders of ASEAN responded by inviting China, Korea and Japan to join in an effort to seek economic cooperation in the region. The ASEAN+3 summits in November 1999 released a "Joint Statement on East Asian Cooperation" that covers a wide range of possible areas for regional cooperation. Recognizing the need to establish regional financial arrangements to supplement the existing international facilities, the finance ministers of ASEAN+3 at their meeting in Chiang Mai, Thailand, in May 2000 agreed to strengthen the existing cooperative frameworks in the region through the "Chiang Mai Initiative (CMI)". The CMI has been followed by another regional initiative for developing and integrating bond markets of individual

## 10 Prospects for Regional Financial and Monetary Integration in East Asia

countries into a large unified regional market, which is known as the Asian Bond Market Development Initiative (ABMI).

The purpose of this paper is to examine the current process and future prospects for regional financial and monetary cooperation in East Asia. Section II analyzes benefits of financial liberalization and conditions for regional and global financial integration. Section III discusses capital flows in Asia. This is followed in section IV a theoretical as well as empirical examination of the causality between financial globalization and regional trade integration in East Asia. Section V discusses economic rationale for a regional financial arrangement in East Asia. Recent developments in the Chiang Mai Initiative and Asian Bond Market Initiative are reviewed in sections **IV** and **V**. Section **VI** is devoted to an analysis of the scope and modality of exchange rate policy coordination for monetary integration in East Asia. Section **VII** addresses major barriers to financial cooperation and integration in East Asia. Concluding remarks are in a final section.

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## II. Financial Market Liberalization and Integration

### 1. Benefits of Financial Integration

The theoretical literature suggests many direct and indirect channels through which financial market liberalization and opening could help improve allocative efficiency, assimilate new foreign technology-mostly through FDI inflows-and stimulate growth in emerging market economies.<sup>1)</sup>

In theory, integration with international financial markets enhances growth potential and eases the burden of adjustment to external shocks in emerging economies. An increase in capital mobility between the north and south, for instance, allows a high rate of investment and hence a high rate of growth in capital-poor emerging market economies while offering a higher rate of return on capital to capital-rich advanced countries. In a financially open economy, domestic residents can diversify their asset portfolios to include those issued by foreign firms and financial institutions in addition to domestic ones. The increased ability to diversify risk allows firms in emerging market economies to reduce the cost of capital adjusted for risk and hence to invest more than otherwise.

When it is integrated with the international capital market, an emerging market economy could relieve its external deficit as well as unemployment that reflects its internal imbalance. For example, an adverse supply shock to a given industry of the economy may require shifts in labor and capital to other industries. After all adjustments have been made within the country including a fall in factor prices, some factors of production are likely to remain unemployed when the capital account is closed. However, deregulated and open domestic capital markets in theory can facilitate migration of the unemployed capital to other countries, thereby mitigating the burden of adjustment through changes in factor prices and employment. That is, real capital mobility can be a partial substitute for price-wage flexibility.

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1) Prasad, Rogoff, Wei, and Kose (2003) identify seven such channels.

## 12 Prospects for Regional Financial and Monetary Integration in East Asia

Financial capital can move freely and quickly across the border in the absence of capital account control, but installed capital such as plants and equipment is not mobile in the short run at least. Firms in a country that sustain an adverse demand or supply shock may be able to close plants quickly, but it may take months or years to move production facilities to or to create new ones in other countries.<sup>2)</sup> As a result, in the short-run, real capital mobility is low and only in the long run it could ease difficulties of adjustment to demand and supply shocks. In the absence of price and wage flexibility, an adverse supply shock such as an oil price increase may therefore result in a deficit on the current account in addition to both an increase in unemployment and a decrease in factor prices. Emerging market economies with a better access to both regional and global capital markets will find it easier and less costly to borrow to finance their current account deficits. External borrowing could make the real adjustment unnecessary if the deficit is transitory and hence reversible.<sup>3)</sup> Even when the deficit is permanent, the borrowing allows spreading the cost of adjustment of consumption spending over time.

Through the risk diversification of portfolio investments, an emerging market economy could share some of the loss resulting from an adverse supply shock with other countries to the extent that it holds claims on their outputs. This means that together with the access to international capital markets this diversification of country specific risks allows smoothing out fluctuations in consumption that the shock would cause. The amount of the loss that could be shared will increase, if this country holds diversified portfolios of bonds and equities of those countries with different structural characteristics and with lower business cycle correlations of macroeconomic variables.

There are other potential advantages associated with financial market integration. As Prasad, Rogoff, Wei, and Kose (2003) point out; financial market integration promotes specialization in production,

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- 2) However, some of the investment planned by these firms may be relocated to other countries in a relatively short period of time in the form of foreign direct investment in response to the adverse shock, a possibility that is rather limited in a controlled capital account regime.
  - 3) If the deficit reflects changes in economic fundamentals instead, external borrowing would simply mask the imbalances that require real sector adjustments.

improves efficiency in the financial intermediation industry, encourages better economic policies, and has the effect of signaling the commitment to liberalization. How significant are these gains in reality? Most of the empirical studies on financial market integration do not find the presence of these positive effects. Although their rates of return on capital are in general higher than those of advanced countries, many East Asian countries have been net capital exporters for a long time and more so since the 1997 crisis. Prasad et al. also show that financial integration is neither a necessary nor a sufficient condition for sustaining a high growth rate unless capital receiving countries have developed an institutional capacity to achieve efficient allocation of foreign capital.

Nor do they find any evidence that emerging economies can expect better consumption smoothing through integration into global financial markets. In fact, volatility of consumption relative to output increased in the emerging market economies during the 1990s- the heyday of financial integration. Prasad et al. argue that this volatility will decrease once the emerging market economies develop their capacity of absorbing foreign capital. However, it will take long periods of time for many emerging market economies to improve human capital, governance, and efficiency and stability of the financial system that determine their absorptive capacity. By the time they have developed the capacity, they may not need any capital inflows from advanced economies.

## **2. Regional or Global Financial Integration?**

A large number of WTO members participate in one or more regional trade arrangements (RTAs). Some 250 RTAs have been notified to the WTO up to the end of 2002. If those RTAs under negotiation or discussion are concluded, the WTO predicts that the total number of RTAs in force would approach 300 by the end of 2005. In contrast to the proliferation of RTAs, there have been only a few regional financial arrangements. In fact, the EU is the only RTA that has succeeded in achieving financial and monetary integration. The NAFTA, which is the second most important RTA, has no agreement on, or plan for financial and monetary integration among, the three members.

There is general consensus that economic liberalization in emerging market economies should begin with trade liberalization to be followed by deregulation of domestic financial markets before lifting restrictions

## 14 Prospects for Regional Financial and Monetary Integration in East Asia

on capital account transactions and on entry of foreign financial institutions. This sequencing strategy implies that countries would go through the process of financial market integration before adopting a common currency: that is, creation of a CCA would take place at the last stage of full economic integration in any region or a group of countries.

Following this order of economic liberalization, one might argue that countries that are party to any RTA will move to integrate financially among themselves once they complete trade liberalization and integration. With this expected transition, following the progress in regional trade integration in many part of the world economy, a large number of new regional financial arrangements (RFAs) may emerge in the future. But given the mixed evidence on the effects of financial integration on growth and financial markets stability, it is an open question whether many emerging market economies will be in a hurry to participate in any existing RFAs or to take initiatives for creating new ones among themselves.

There has also been a proliferation of bilateral FTAs in recent years in East Asia. While negotiating FTA, among themselves or with partners from different regions, the members of ASEAN+3 have at the same time mounted collective efforts at creating large unified regional financial markets. Although the ASEAN+3 states have made firm commitment to financial cooperation and integration, it is rather uncertain whether they will be able to sustain the integration movement through the promotion of the CMI and ABMI. This uncertainty arises from the difficulty they find in deregulating capital account transactions to facilitate cross-border trading and issuance of stocks and bonds and other financial investments. Even if they do manage, a priori, it is not clear whether the deregulation will steer East Asian economies to forging closer financial linkages with one another or with global financial markets. This is because financial market opening unleashes divergent forces of adjustment that could lead to either regional or global integration.

As Eichengreen and Park (2004) show, East Asian economies share in common similar structural characteristics, pursue a similar development strategy and display synchronized business cycles. To the extent that they are subject to symmetric shocks, then the risk diversification for consumption smoothing may induce them to integrate with those non-regional economies with different structural characteristics and cyclical patterns rather than regional ones, because credit and market risks of

non-regional financial assets are likely to be less correlated with those of domestic assets. If indeed different regions are subject to idiosyncratic shocks to regional outputs, then a substantial portion of the risks related to stabilizing consumption can be shared through portfolio diversification across different regions. There is another advantage of global integration. Through integration into the international financial system, countries may find it easier to stabilize their consumption spending by lending to and borrowing from international financial markets with large pools of various financial instruments.

Using the consumption-smoothing model developed by Asdrubali (1996), Jeon, Oh, and Yang (2005) estimate the degree of global consumption risk sharing in East Asia. According to their results, the East Asian countries included in the study are moving to global rather than region financial integration. Against the risk diversification, however, there may be regional bias in portfolio investment. As McCauley et al. (2002) show, Asian investors prefer holding Asian bonds and stocks to those issued by non-Asian entities largely because they have more and better information about the risk-return profiles of regional assets than about non-regional ones. There are few empirical studies that shed light on the relative significance of the risk diversification and regional bias. At present, the available pieces of evidence are not reliable enough to judge the direction of integration that will follow region-wide financial liberalization and market opening.

The well-known home bias in asset holdings suggests that the benefit of the risk diversification would not be as large as the theory would predict. Despite the ongoing financial liberalization for more than two decades, the increase in international diversification in assets, in particular bonds, across countries have been relatively small. McKinnon (2002) points to the principal-agent problem as the main cause of limited global portfolio diversification.

### **3. Financial Integration and Monetary Unification**

Integration of financial markets has a number of important implications for the criteria for a common currency area (CCA). As shown by the European experience with monetary integration, once capital account controls are removed it is almost impossible to maintain a collective exchange rate system for a group of economies

such as the ERM that is designed to stabilize the bilateral exchange rates of the economies in the group. This is because free capital mobility and a fixed or an intermediate exchange rate system is inconsistent with divergent monetary policies of the countries participating in the collective exchange rate regime. For an alternative regime for the group of economies with a deregulated capital account would be either free floating or monetary unification.

Under free floating, the presence of currency risk increases the cost of international portfolio diversification in terms of foreign securities and hence reduces the scope of the international sharing of the risk. Free floating then bottles up the cost of the shock more in the country it is originated, thereby offsetting some of the gains of financial integration. Therefore, one implication of financial integration is that countries of which financial markets are closely linked with one another will have incentives for forming a monetary union.

The second implication follows from the first in that financial liberalization and integration call in question some of the tradition criteria for an optimum currency area that include the relative share of intra-regional trade, the nature of shocks, flexibility of factor markets, and economic size of participating countries. Once financial market integration is taken into consideration, it can be shown that a group of countries with asymmetric shocks and dissimilar structural characteristics may, other things being equal, find it as easier to establish a CCA as a group of homogeneous countries does. This is because heterogeneous countries in a CCA could minimize their losses arising from adverse supply shocks by drawing down on its claims on or borrowing from other countries through reserve pooling and international portfolio diversification (Mundell 1973)<sup>4</sup> A large scope of international portfolio diversification would therefore make the traditional criteria for forming a CCA less important than they are claimed to be.

The traditional argument on the CCA is that countries with synchronized business cycles may readily yield their monetary independence to a supra national authority, because they are likely to pursue a similar monetary policy. The heterogeneous countries could also agree to a

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4) In presenting this possibility, Mundell considers only an asset portfolio consisting two different currencies. A recent analysis on risk sharing through international portfolio diversification, see Mckinnon (2001).

common monetary policy if they were financially integrated. To these economies synchronization of business cycles may not be as critical an obstacle to forming a CCA as it may appear. Indeed, when financially integrated dissimilar countries may have as many incentives to form a CCA as do similar but financially disconnected economies.

To elaborate on this, consider an adjustment process within the group of countries with symmetric shocks that is hit by an adverse supply shock such as an oil price increase. Given the similarity of their economic structure, all of the countries in the group will suffer from the shock, causing a group-wide slowdown. This group-wide slump then will cut back intra-group trade.<sup>5)</sup> The slump in one country then amplifies output contraction in other countries through the trade channel. Since all countries in the group suffer from the same shock, they cannot supplement their output and income losses by liquidating their claims on the outputs of other countries.

Most countries in the group may also experience deterioration in their current accounts, making it difficult to finance by borrowing from other countries in the group. For the group as a whole, the deficit financing to be secured from outside of the group would be larger than otherwise and hence, other things being equal, the cost of financing higher than when the group consists of countries with asymmetric shocks. The advantage of a CCA consisting of countries having dissimilar structural characteristics and exposed to asymmetric external shocks is that, although they may not be able to pursue common monetary policy, they are subject to a smaller burden of adjustment to external shocks. In such a CCA, the members have more opportunities to obtain financing of current account deficits from other countries unaffected by the shocks and also assume a smaller cost of adjustment as the asymmetric shocks facilitate in the long-run the movement of factors of production from the countries affected to those that are not by the shocks. When these adjustments are operative the impact of the shock would be less severe and hence more manageable, if the members of the CCA have different structural characteristics.

A third implication of financial integration is that from the point of view of portfolio diversification in a liberalized and open financial

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5) It is shown that an adverse supply shock in one country could be much more contagious to other countries when they are more homogeneous (Park and Song 2001).

## 18 Prospects for Regional Financial and Monetary Integration in East Asia

environment, larger currency unions with more heterogeneous countries are likely to be more successful than smaller ones with homogeneous members: as far as financial integration is concerned, countries with asynchronous macroeconomic shocks would make better candidates for a CCA. The risk sharing through international portfolio diversification implies that investors in a given region may not stock up their portfolios with regional financial instruments but diversify them to include those assets of countries from different regions. Focusing on finance alone, therefore, globalization may be a better strategy than regionalization including forming a CCA for a large number of small countries: dollarization, or Eurorization, may make more sense to many emerging market economies than forming a currency union among themselves.

The preceding argument is in part supported by a recent study by Heathcote and Perri (2002). They show that the decline in the correlations of output, investment, employment, and consumption between the United States and the rest of the world comprising Europe, Japan, and Canada between the two post Bretton Wood periods -1972-86 and 1986-2000 - could in part be explained by a decrease in the correlation of exogenous shocks, but also by financial globalization. Emergence of global financial markets expands the scope of international portfolio diversification and hence increases opportunities for intertemporal specialization in production that in turn contributes to lowering the correlation of factor supplies.

The analysis of Heathcote and Perri (2002) supports the arguments presented in the section: capital account liberalization could reduce the business cycle correlation of output investment, and employment in East Asia. Another implication is that increasing similarity of business cycles among the East Asian countries through trade expansion may encourage global diversification of portfolios to include assets issued by corporations and financial institutions of advanced countries and hence integration of East Asian financial markets into global financial markets.

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### III. Capital Flows in Asia

Cross-border capital flows in general have grown rapidly since the 1980s, because institutional investors began to show a high tendency to structure diversified portfolio to lower risks in their international portfolio. In addition, the development of information and communication technology enabled global investment and broadened opportunities for investors to manage risks through investment in diversified financial assets across various countries. In line with this, the changes in the form of capital flows in emerging market economies have been induced to both push effect and pull effect. That is to say, with lower returns on domestic capitals due to sluggish economic growth in advanced economies, investors' demand for investment in emerging market portfolio began to soar. At the same time, major emerging market economies relaxed their regulatory measures on cross-border capital flows.

The cross-border capital flows in APEC economies have dramatically increased for the last three decades. The size of capital flows in APEC countries has increased almost 12 times from 119 billion in 1981 to 1.494 trillion in 2003. The capital flows in APEC region account for 20% of world capital flows in 1980, but the share of capital flows in APEC to global capital flows has increased 24% in 2000 and 31% in 2003. However, the patterns of capital flows in APEC countries have changed during the period. In early 1980s, bank loans were dominant capital flows, but the importance of bank loans have significantly reduced, from 61 billion in 1980 to -81 billion in 2003. During 1990s, foreign direct investment was a dominant form of capital inflows, but portfolio investment became equally important since late 1990s with the wave of merges and acquisitions (M&A). In a rather different form, workers remittances are also getting a lot of attention from developing as well as international institutions in that it has potential developmental impacts to the recipient economy.

The question that might rise by looking at the current capital flows in APEC is whether the current capital flows are stable or desirable for each member country. For a capital export country, the concern lies on

whether they pursue efficient investment decision regarding profit maximization and risk minimization. On the other hand, the stability of current capital flows is a major concern for a capital import country. As far as capital movements, there has been long history of fears for sudden capital reversals among developing economies. It is necessary to first investigate the trends and patterns of regional capital flows, and its determinants. More importantly, rules and regulations for capital flows are quite heterogeneous among economies, and the knowledge of them might enable us to identify and remove obstacles to free movement of capital. Thus, careful examination of the characteristics of capital flows might give us insights about keeping free and stable movements of capital.

This paper tries to assess the current status of capital movements among the APEC economies, and shed light on the judgment for the stability and desirability of cross-border capital flows in the APEC region. To this aim, the rest of the paper is organized as follows. Section 2 examines the trends and characteristics of capital flows in the APEC region, focusing on foreign direct investment (FDI), portfolio investment, and workers remittance flows. Section 3 finds the stylized facts on cross-border capital flows in APEC countries. Section 4 concludes and derives policy implications to promote stable cross-border capital flows and greater economic integration among the member economies.

### **1. Trends and Characteristics of Capital Flows in Asia**

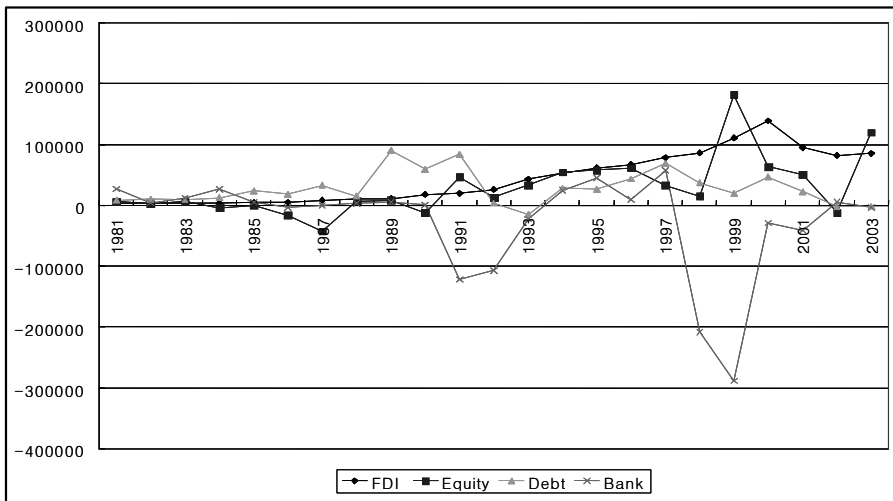
This section examines the current status of capital movements among the Asian economies by finding the regional characteristics of capital inflows and outflows since 1980's.

In terms of capital inflows, FDI, compared to other investment flows, is known to be a stable source of capital. It has been important in Asia since early 1990s. Although equity investment caught up with FDI investment in 2003, it is expected that FDI will continue to remain an important source of capital flows in the region. Equity has been regarded as a candidate to solve the financial crisis, and Asian economies removed barriers to investment on equity markets in general. As a result, equity financing has rapidly increased in 1999, but its momentum has been reversed in 2000 due to global burst of IT bubble. Unlike equity, debt financing is not an important component of capital inflows in the region.

In particular, rudimentary development of the bond market has been pointed out as one of main reasons of the Asian crisis. Ideas to promote regional bond markets have been proposed and they are under close examinations.

Bank financing has shown most volatile flows in Asia. It has plummeted twice, in early 1990s and after 1997 Asian crisis. Since then, bank lending accounts for only negligible amount of capital flows in Asia.

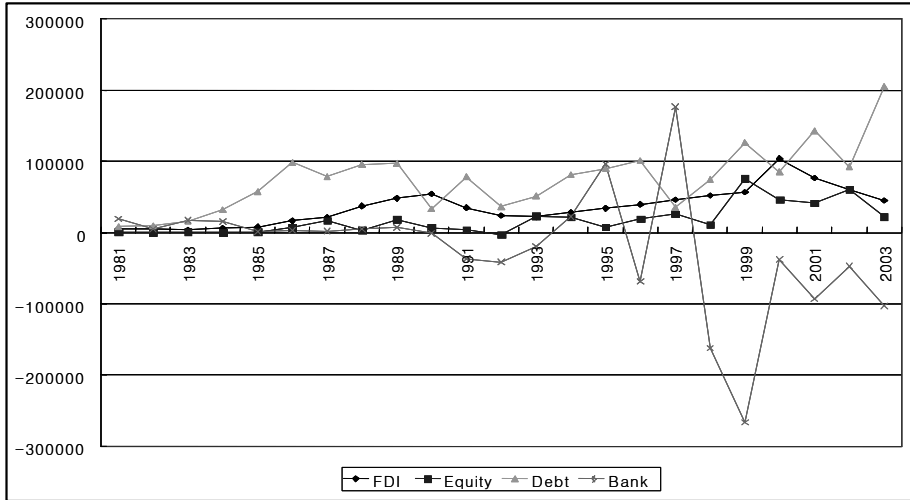
<Figure III-1> Patterns of Capital Inflows in Asian Economies



Source: IMF, *Balance of Payments Statistics*.

In terms of capital outflow, abrupt decline of bank loans after the financial crisis is a conspicuous feature in the patterns of capital outflows in Asian economies. An important fact is that since the Asian crisis, Asian economies began to have current account surplus, particularly against the United States. (Figure III-2)

<Figure III-2> Patterns of Capital Outflows in Asian Economies

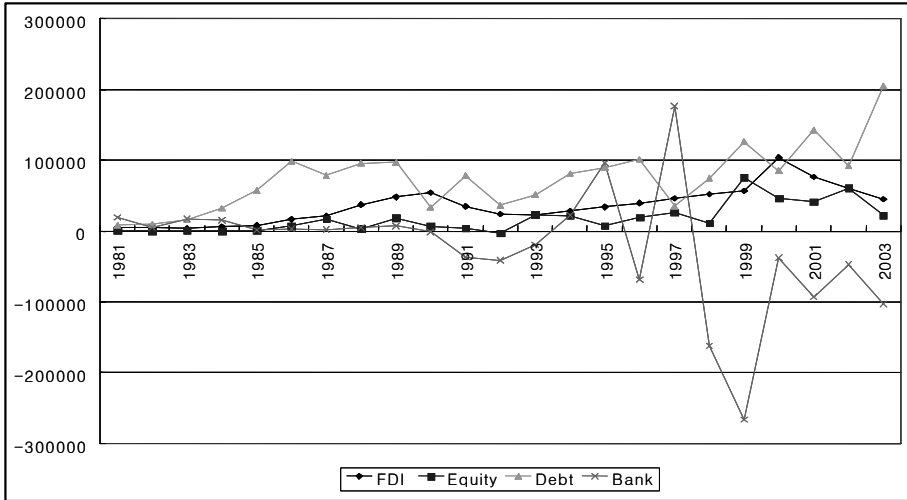


Source: IMF, *Balance of Payments Statistics*.

The Asian crisis has brought significant changes to the form of capital flows in Asia. The current surplus of Asian economies led them to switch from being capital importers to capital exporters. Further, the current account surplus was translated into a rapid increase in foreign exchange reserves. (Table III-1) In turn, expanded foreign exchange reserves prompted Asian economies to import safe assets and export risky assets.<sup>6)</sup> Asian economies invested with expanded foreign reserves into safe assets such as US Treasury bonds, and this led to large inflow of debt financing for the North American and Oceanian economies as shown below.

6) Oh, *et al.* (2003), p. 25.

<Figure III-3> Trends of Current Account in Asia



Source: IMF, *Balance of Payments Statistic*.

<Table III-1> Foreign Reserves in East Asian Economies

	1995	1996	1997	1998	1999	2000	2001	2002	2003
China	75.4	107.0	142.8	149.2	157.7	168.3	215.6	291.1	408.2
Hong Kong	55.4	63.8	92.8	89.7	96.2	107.5	111.2	111.9	118.4
Indonesia	13.7	18.3	16.6	22.7	26.4	28.5	27.2	31.0	35.0
Japan	183.3	216.6	219.6	215.5	286.9	354.9	395.2	461.2	663.3
Korea	32.7	34.0	20.4	52.0	74.0	96.1	102.8	121.3	155.3
Malaysia	23.8	27.0	20.8	25.6	30.6	29.5	30.5	34.2	44.5
Philippines	6.4	10.0	7.3	9.2	13.2	13.0	13.4	13.1	13.5
Singapore	68.7	76.8	71.3	74.9	76.8	80.1	75.4	82.0	95.7
Thailand	36.0	37.7	26.2	28.8	34.1	32.0	32.4	38.0	41.1
Vietnam	1.3	1.7	2.0	2.0	3.3	3.4	3.7	4.1	6.2

Notes: 1) Foreign reserves are defined as total reserve minus gold.

2) Unit: US Billion dollars.

Source: IMF, *International Financial Statistics*.

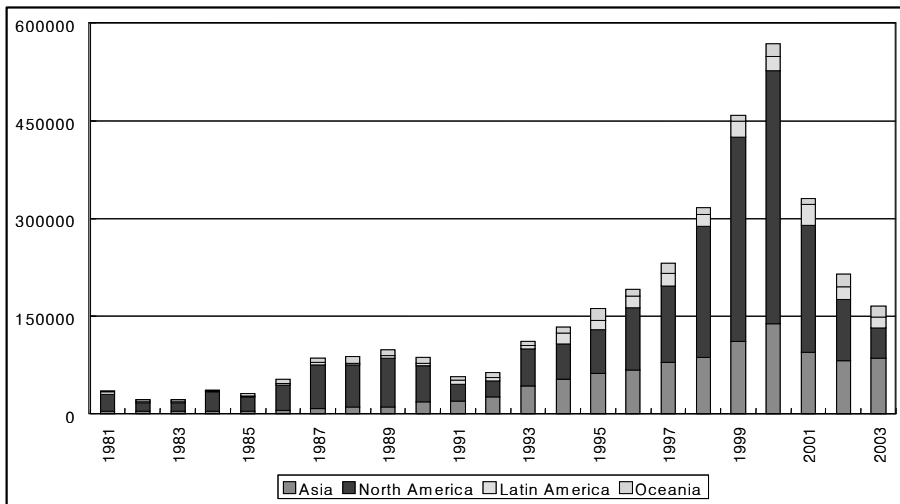
## 2. Stylized Facts on Capital Flows in the APEC region

In the following, we will describe major stylized facts on capital flows among APEC economies.

### 1) FDI as a stable and primary source of capital

FDI inflows in the APEC region grew by an average of 23 percent a year during 1990-97. These inflows increased by an average of nearly 40 percent a year during 1998-2000 reaching a record \$570 billion in 2000, and they were mainly driven by large cross-border mergers and acquisitions (M&A). Cross-border M&A were an important contributor of these inflows, reflecting the privatization of state-owned assets, especially in Latin America, and the purchase of distressed banking and corporate assets in several Asian economies in the wake of the 1997 financial crisis.

<Figure III-4> FDI Inflows by Region



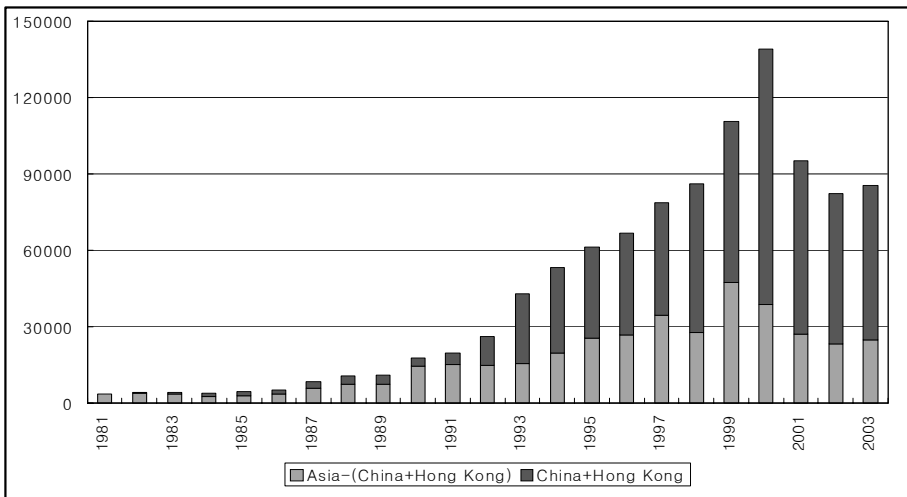
Source: IMF, *Balance of Payments Statistics*.

Figure III-4 shows the distribution of FDI inflows within APEC regions. Most direct investment flowed into North America until recently, but the overall size of FDI has decreased from \$570 billion in 2000 down to \$165 billion in 2003, mostly as a result of the sharp drop

in cross-border M&A among the industrial economies. (Patterson, 2004). Direct investment into Asian economies has fallen rather less significantly, however, and began to take up the largest portion in international FDI flows in 2003.

In terms of FDI and portfolio investment, capital flows are concentrated in only a few economies. Within Asia, the two largest recipients of FDI inflows for the last two decades were China and Hong Kong. As mentioned above, Asian economies are becoming more important in FDI liability, and China absorbed about 55% of FDI inflows into the region in 2003. If we include Hong Kong, it becomes more than 70% of total FDI inflows. This investment capital is one of the main sources of economic growth for China.

<Figure III-5> FDI Inflows into Asia

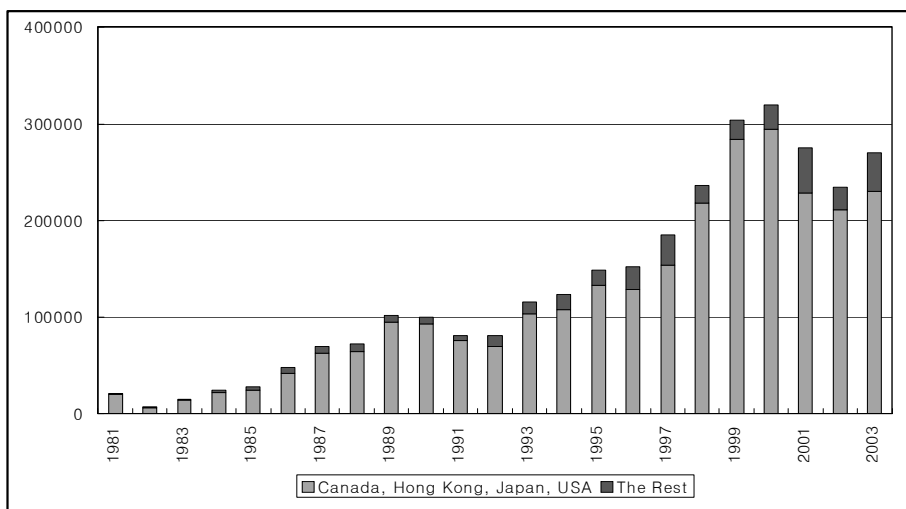


Source: IMF, *BBalance of Payments Statistics*.

In terms of FDI inflows, Asian economies are gaining more importance in the market and becoming the largest recipient of direct investment. In terms of FDI suppliers, however, Canada, Hong Kong, Japan, and the United States are the main supplier of FDI into the APEC region. Among them, in particular, the United States provided about 65% of FDI outflows in 2003. This shows that supplier and demander of

capital are limited to a few economies rather than diversified across member economies. It is also notable that in FDI flows, the proportions of FDI flows to and from Latin American and Oceanian economies are insignificant.

<Figure III-6> FDI Outflow



Source: IMF, *Balance of Payments Statistics*.

FDI began to take the dominant role in total capital flows from the middle of 1990's. In late 1990's, FDI accounted for more than half of all private capital flows to APEC economies, and more governments are providing special incentives to foreign firms to set up companies in their economies. This trend may be because 1) they give positive externalities to the recipient country, such as transfer of technology and management skills, 2) it is costly for FDI to reverse direction, thus having less volatility; FDI relies on long-term profits of investor companies, having less sensitivity to international interest rates.

The coefficient of variation of FDI flows in the APEC region is lower than that of other capital flows. The coefficient of variation of FDI is 0.81, but that of other capital flows is 1.13 for equity, 1.19 for bank loan and 0.90 for debt. This confirms the view that FDI flows are considered cold money which is generated by long term considerations of the

foreign investors. In contrast, portfolio investments are deemed as unstable hot money, which is triggered by short-term consideration of the foreign investors.

<Table III-2> Coefficients of Volatility of Capital Flows in APEC

	FDI	Equity	Debt	Bank Loans
Coefficient of Variation	0.814	1.133	0.903	1.194

Note: The sample period of estimation is from 1980 to 1993.

However, the argument for the irreversibility of FDI is worthy of examining more carefully. Albuquerque (2002) suggests that withdrawals of FDI do not necessarily have to include liquidation of physical capital and in fact foreign investors of FDI have many ways to withdraw funds that were invested as direct investment such as selling shares. Related to this issue, the liquidity condition of capital market is crucial to determine the lower volatility of FDI flows in a country. Lipsey (1999) shows that the volatility of net FDI flows is smaller in developing countries than in developed countries, and the differences in volatilities between net FDI flows and other types of net inflows are smaller in developed economies.

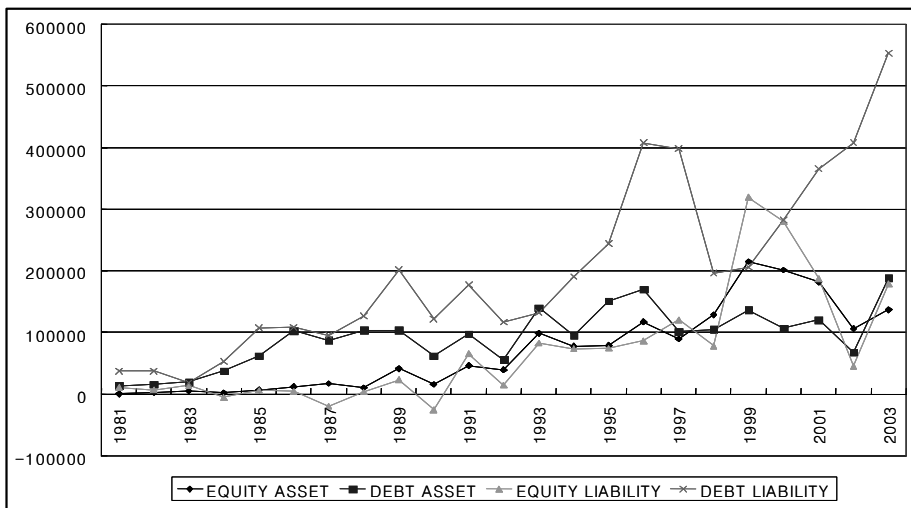
### 2) *Portfolio investment is gaining more weights*

Portfolio investment including bonds and stocks is increasing in most emerging economies since the 1990s. Portfolio transaction was almost negligible in most emerging market economies in the 1980s, but in the following decade, portfolio investment inflow such as bonds (especially for Latin American economies) and stocks (especially for Asian economies) began to expand its proportion in the total capital inflow to emerging market economies. Particularly, gradual liberalization of foreign investment in emerging economies' capital markets began around the same time, enhancing the availability and reliability of financial information of domestic companies.

Cross-border capital flows in developed economies grew rapidly since 1980s, since institutional investors began to show a high tendency to structure diversified portfolios to lower risks in their international portfolio.<sup>7)</sup> In addition, the development of information and communications

technology enabled global investment and broadened opportunities for investors to manage risks through investment in diversified financial assets across various economies. As shown earlier in Figure III-7, the assets and liabilities of portfolio investment increased significantly in late 1990s compared with FDI. Moreover, the relative importance of components of portfolio investments has also changed notably.

<Figure III-7> Portfolio Investment of APEC Economies



Source: IMF, *Balance of Payments Statistics*.

Normally it is difficult to expect active cross-border portfolio investment in a country without well-developed macroeconomic policy instruments, or with a weak financial system. Nevertheless, the fundamental reason for the extensive spread of portfolio investment across regions is the international diversification of assets by advanced economies. Cross-border portfolio investment in emerging market economies is on the rise, as the demand for bonds and stocks of emerging markets by institutional investors of the United States, Japan, and Europe is increasing. Bottom-low interest rates and slowdown of economic growth of major advanced economies are other significant reasons. At the same

7) Oh, et al. (2003), p. 17.

time, emerging market economies loosened regulatory measures on domestic portfolio investment through capital liberalization, leading to the expansion of international portfolio investment.

### 3) *Financial globalization and real regionalization*

As capital flows in APEC increase, there is considerable cross-country heterogeneity in the level of cross-holdings of foreign assets. Following is the table for the distribution of international portfolio investment in the APEC region. IMF conducts the Coordinated Portfolio Investment Survey (CPIS) on an annual basis in response to global asymmetries in reported balance of payments data, especially those in portfolio investment flows. The results of this survey provide a relatively high-quality stock measure of the bilateral equity holdings among economies at the end of the year. The table indicates the destination economies of portfolio investment by each economy, and shows the capital flows across the APEC economies. Note that economies in the columns are investing in the economies in the rows.

Quick glance at the table reveals, however, that portfolio investment flows are also concentrated to a few economies. Hong Kong, Japan, and Singapore are main capital exporters in Asia, but the link between Asia and Latin America is severed. These three Asian economies are also investing in North American and Oceania economies. Oceanian economies are well connected with Asian and North American economies, but they are not much involved with Latin American economies. On the other hand, North American economies have active relationships with other regions as well as with Latin American economies. In particular, the United States plays a dominant role as the main importer and exporter of portfolio investment. <Table III-3> shows regional distribution of portfolio investment in more details. As noted above, North American economies are dominant investment importers. However, Asian economies take second largest portion of portfolio investment, in particular, in terms of equity and long-term debt.

&lt;Table III-3&gt; Regional Distribution of Portfolio Investment

Total Portfolio	Asia	Latin America	North America	Oceania
Asia	12.4	1.6	45.3	14.5
Latin America	0.0	0.0	1.2	0.0
North America	79.6	97.2	44.4	80.5
Oceania	8.0	1.3	9.1	5.0
Equity	Asia	Latin America	North America	Oceania
Asia	24.5	0.7	54.8	15.5
Latin America	0.0	0.0	0.4	0.1
North America	72.0	99.3	37.2	79.9
Oceania	3.5	0.0	7.6	4.5
Long term Debt	Asia	Latin America	North America	Oceania
Asia	7.0	3.5	21.6	3.4
Latin America	0.0	0.0	3.6	0.0
North America	85.2	92.4	62.9	94.1
Oceania	7.8	4.1	11.8	2.5
Short-term debt	Asia	Latin America	North America	Oceania
Asia	27.0	0.0	4.6	0.0
Latin America	0.0	0.0	0.0	0.0
North America	42.9	100.0	68.9	87.8
Oceania	30.1	0.0	26.5	12.2

Note: Economies in the columns are investing in the economies in the rows.

Source: IMF, *Coordinated Portfolio Investment Survey (CPIS)*.

However, the trade flows show completely different picture in the APEC region. Asia and North America region's total trade volume are concentrated in their own region. Latin America trades mostly with North America, and Oceania mostly with Asia. In Faruquee, et al. (2004), international portfolio holdings are determined by market size, transaction

costs (such as per-minute international phone costs) and information costs (such as physical distance between the capital cities of two economies). That is to say, financial market size and distance variables are powerful explanatory variables, and economies with larger domestic market size tend to hold greater quantity of foreign assets. Lane suggests that, in a cross-section of economies, gross international investment positions are positively associated with trade openness and a large domestic financial market. A possible explanation for this is that those factors that stimulate trade in goods also stimulate trade in assets and, moreover, trades in goods and assets are complementary activities. Comparing capital flows and trade flows in the APEC region, it is fair to say that the region is financially globalized, but regionalized in term of real sector. It is not necessary for the direction of capital flows to be identical to that of trade flows. If capital flows pursue the liquid and efficient global market, trade can go in the other direction. However, in case of emerging market economies, the asset and liability dollarization due to the financial globalization might cause serious problems. In addition, criticisms have been raised at this particular pattern of capital flows in APEC countries<sup>8</sup>). First, capital flows from developing countries to the developed countries are not sustainable. It means that capital is flowing from economies that are catching up in productivity to mature economies that are assumed to have less productivity. There are concerns

<Table III-4> Trade Volumes among APEC Regions

(Unit: %)

	Asia	Latin America	North America	Oceania
Asia	70.0	40.1	33.3	63.4
Latin America	0.5	7.3	0.7	0.3
North America	25.8	51.3	64.6	21.8
Oceania	3.6	1.3	1.4	14.6

Note: Economies in columns are reporting economies and those in rows are partner economies.

Source: IMF, *Direction of Trade Statistics*.

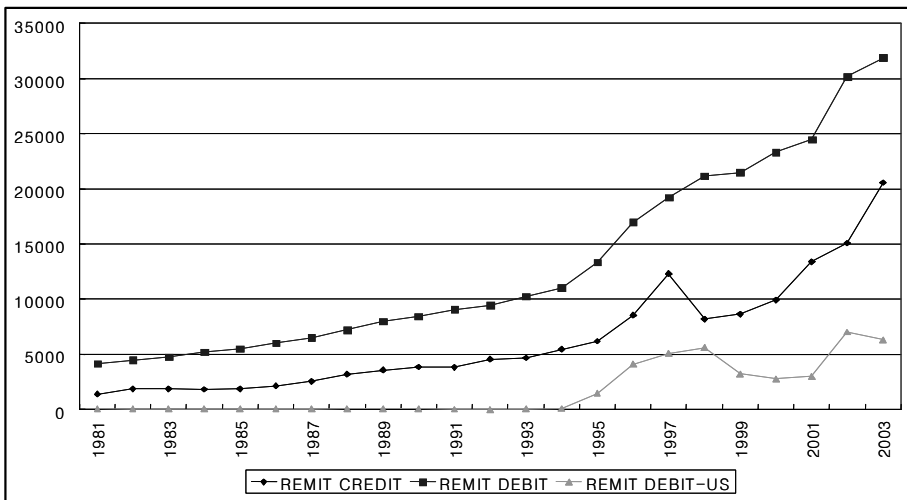
8) Crockett (2002) provides the following arguments in East Asia, but same arguments can be raised in APEC.

that the longer this pattern lasts, the greater the adjustment will have to be, which would prove to be devastating to emerging market economies. Second, there are concerns that the gross flows from emerging market economies to developed countries and back to emerging market economies signify missed opportunities for capital market development in emerging market economies.

4) *Workers remittance getting more attention as alternative source of income*

Workers remittances are getting attention as alternative source of capital flows because they have become a key source of global finance and provide one of the greatest potential benefits for economies of origin of temporary workers. Migrant remittances represent the most direct, immediate and far reaching benefit to migrants and their countries of origin. They are a more constant source of income to developing economies. They have increased steadily from 1980's and took momentum from 1995. Thus, the total size of remittance credit in APEC regions increased 230% from \$6.2 billion in 1995 to \$20.6 billion in 2003. (Figure III-8)

<Figure III-8> Workers Remittances of APEC Economies



Source: IMF, *Balance of Payments Statistics*.

Workers remittances are generally less volatile than other financial flows (OECD 2004). Moreover, workers remittances have beneficial effects on the economies of origin such as enlarging the available funds that can be invested in the recipient economy. During 2002, there were \$32 billion in remittances sent to the economies of Latin America and the Caribbean, an increase of 17.6% over the previous year. The United States accounted for 78% of the total. In 2002, the amount far exceeded the Official Development Assistance (ODA) received by the region and was only slightly less than foreign direct investment. (Ellerman 2003)

Table III-5 shows the change of workers' remittance flows of selected economies between 1995 and 2003. China, Indonesia, and Mexico are main recipient economies while Japan, Malaysia, Russia, and United States are sending economies. Korea ceased to be a recipient economy and began to be a sending economy in 2003. The United States is remitting more than 25 billion dollars in 2003 and a large proportion of this amount goes to Mexico.

<Table III-5> Flows of Workers Remittances

(Unit: US millions dollars)

	Credit		Debit	
	1995	2003	1995	2003
China	350	3342.7	-	476.8
Indonesia	651	1488.7	-	-
Japan	-	660	-	1230
Korea	291.4	42.9	-	371.3
Malaysia	-	-	1197.9	2642.7
Mexico	3672.7	13396.2	-	-
New Zealand	206.4	233.7	156.8	291.5
Peru	599	860	-	-
Philippines	432	236	136	18
Russia	-	300.2	-	1306.5
United States	-	-	11850	25540

Note: '-' implies Not Available.

Currently, barriers to official transfers of funds are the greatest obstacles faced in maximizing the benefits of remittances. Transfers via official bank channels are often complicated and lengthy, and often remain inaccessible for migrants who are unable to open bank accounts in their economies of residence due to their temporary status. (OECD 2004) Informal fund transfer (IFT) systems could fill the critical gap.

However, they are susceptible to use by criminals for money laundering, terrorist finance, smuggling, extortion and evasive activities. Thus, it is important to increase remittance volumes, facilitating the shift from informal to formal channels, and leveraging the use of remittances for sustainable poverty reduction. To do it, the identification of the constraints in the policy, regulatory, and institutional framework that influence or impact on these flows would be critical.

### 3. Freer and More Stable Capital Movements

This section tries to identify factors that contribute to free and stable cross border capital flows in the region. The literature on the causes and determinants of capital flows is expanding as the portion of capital flows in an economy's size becomes large. We will consider a few selected factors among ones that are discussed in the literature.

#### *1) Capital Controls and Regulations*

The government's capital control and regulation creates a distortion in international capital flows. Generally the government's capital control can never fully restrain the entire cross-border capital flows, but it can raise the cost of capital flows to suppress certain types of capital flows.

Capital control and regulation are often pronounced as the restriction on foreign financial institutions to enter the domestic financial market. They can also appear in the form of a cap on foreign equity ownership in domestic financial institutions, which can reduce competition in the domestic financial market and ensure steady profits for domestic financial institutions. Such restrictions have disappeared in advanced economies, but still a good number of Asian economies are limiting foreign financial institutions' access.

We consider the restrictions on the purchase of domestic financial products by nonresidents and overseas financial products by domestic residents. China, Indonesia, Malaysia, the Philippines, Russia, Thailand,

Vietnam, and Mexico control capital flows in many ways, especially in short-term capital outflows, whereas the other economies almost removed restrictions on capital flows.

There are some notable features of capital flow control of APEC economies. First, there are more restrictions on capital outflows than on capital inflows. This is a reflection of the concerns on the part of some economies for capital flight after having experienced the Asian currency crisis. Second, in some economies, control on capital inflows related to bonds is stronger than on capital inflows related to stocks. In China, foreign investment in Chinese stocks is allowed but limited only to qualified foreign institutional investors (QFIIs). But foreign investment in Chinese bonds is prohibited. Korea restricted foreign investment in the bond market more than in the stock market before the currency crisis.

Second, unlike Asian economies, the extent of openness of other economies' capital market is rather high, and few restrictions apply to the purchase of financial products by foreign and domestic investors. The capital markets of Latin American economies are also less regulated compared with those of Asian economies. However, it is notable that the capital flows of Latin American economies are concentrated to North American economies, and the cross-relations with other regions are considerably limited. This raises questions why such phenomenon happens.

### *2) Increase in risky asset trading by emerging market economies*

From the late 1990s, capital market liberalization in Asia was rigorously executed and capital flows in the region took various forms. Yet capital movement within the Asian region has not increased significantly. This is because both public and private investors from Japan, China, Korea, Hong Kong, and Singapore, who are able to invest abroad, have been reluctant to take risks. Asia tends to export risky assets and import safe assets. This tendency comes from the fact that foreign asset accumulation has led to the increase of foreign exchange reserves that are public funds. This is creating a situation that structurally forces Asian economies to manage their assets safely. While investors from advanced economies including the United States are purchasing risky assets of Asia, Asian investors buy safe assets more, for they have relatively weaker capability to evaluate and manage risks.

&lt;Table III-6&gt; Restrictions on Capital Flows in APEC

	Capital Control	Restrictions on purchase locally by nonresidents				Restrictions on purchase abroad by residents			
		Stock	Bond	Money instrument	Collective investment securities	Stock	Bond	Money instrument	Collective investment securities
China	Yes	Yes	Not permitted	Not permitted	Yes	Approval	Authorized banks only	Yes	Yes
Hong Kong	No	No	No	No	No	No	No	No	No
Indonesia	Yes	Yes	No	Yes	Less than 1%	No	Yes	Yes	No
Japan	Yes	No	No	No	No	No	No	No	No
Korea	Yes	No	No	No	No	No	No	Approval	No
Malaysia	Yes	No	Yes	No	No	Approval	Yes	Yes	Yes
Philippines	Yes	Registration	Registration	Yes	No	Approval	Approval	Yes	Yes
Russia	Yes	Yes	Yes	Yes	Yes	Authorization	Yes	Yes	Yes
Singapore	Yes	No	No	No	No	No	No	No	No
Thailand	Yes	Yes	No	No	No	Approval	Approval	Approval	Approval
Vietnam	Yes	Hold up to 30%	No	Yes	Yes	Not allowed	Not allowed	Yes	Yes
Canada	Yes	No	No	No	No	No	No	No	No
Mexico	Yes	Yes	No	No	limited	Authorization	No	No	No
United States	Yes	Yes	No	No	No	No	No	No	No
Chile	Yes	No	No	No	Minimum holding period of 5 years	No	No	No	No
Peru	No	No	No	No	No	No	No	No	No
Australia	Yes	Yes	No	No	No	No	No	No	No
New Zealand	Yes	No	No	No	No	No	No	No	No

Source: IMF (2004), *Annual Report on Exchange Arrangements and Exchange Restrictions*.

The crisis reinforced the risk-averse behavior of Asian private investors, discouraging active capital movement within the Asian region. If we compare the way Korean and Japanese institutional investors manage their assets with the way advanced institutional investors manage theirs, we can witness different patterns in the risk taking behaviors of the two groups. As shown in earlier figures, in Japan, investment by domestic institutional investors in stocks with relatively high risks was 32% of the total investment in 1990. However, when the bubble economy burst, investment in stocks decreased sharply, maintaining a 19% level in the late 1990s.

The dependency on bonds and bank loans, however, rose from 60% in the early 1990s to 70% throughout the 1990s, demonstrating a turn to safe asset management. What is interesting in Korea's case is that investment in bonds grew rapidly after the foreign currency crisis. Bond investment took up 37% of the total assets managed in 1997, but it rose to 54% in 1998. Equity investment faced a serious contraction since the foreign currency crisis, such that only 4% of the total assets managed by institutional investors went to stocks in 1998.

In sum, combining the higher concentration on surplus capital of foreign reserves and the risk-averse behavior of domestic investors resulted in lesser capital flows within Asia, and this in turn impedes the capital market development in emerging market economies.

### *3) Developing institutional investors base in emerging market economies*

Two developments in the financial structure of capital-exporting countries in particular have increased the responsiveness of private capital to cross-border investment opportunities. First, falling communication costs, competition, and increased costs in domestic markets have led firms in industrial countries to look for higher efficiency and profits by producing abroad. Second, institutional investors are more willing and able to invest abroad because of higher expected interest rates of return in developing economies and to wider opportunities of risk diversification. (Lopez)

As we can see from advanced economies in the 1980s, super-sized institutional investors cut down financial transaction costs and promoted international diversification of portfolio. Unlike individual investors, institutional investors pool their capital for concentrated investment, reducing unit transaction cost and allowing diversified international

financial asset transactions. Institutional investors in emerging market economies are for the most part small-sized and underdeveloped. Pension, mutual funds, and insurance companies' assets constitute a small portion of the overall financial market size in Asian countries. Although the number of institutional investors in emerging economies, such as Korea and Thailand, is increasing, most Asian countries, particularly China, are still far from financial institutionalization.

In sum, Asia's underdeveloped institutional investor base, unlike the institutional investor base of advanced economies, is not capable of expanding cross-border portfolio transactions. Most institutional investors in Asia are concentrating on domestic financial assets. Poor capital flows in the region are partially due to the underdevelopment of domestic bond markets in Asian countries.

### 4. Policy Implications

It is now well known that economic theory suggests that unfettered international capital flows can foster a more efficient allocation of resources, provide opportunities for risk diversification, and help promote financial development. (Edison) In recognition of these potential benefits, governments of industrial countries have undertaken widespread capital account liberalization over the past quarter century.

However, it is important to distinguish between the concepts of liberalization and integration. For example, a country might pass a law that seemingly removes all barriers to foreign participation in local capital markets. This is liberalization, but it might not be an effective liberalization that results in market integration. For de facto integration into the international capital markets, something more is needed.

As Bekaert (1995) suggests, there may be three categories of barriers to emerging market investment: (a) legal barriers; (b) indirect barriers that arise because of information asymmetry, accounting standards, and investor protection; and (c) risks that are especially important in emerging markets such as liquidity, political, economic policy, and currency risk. Thus, to enjoy the full potential of capital market liberalization, there are a few things that need to be established during the process of liberalization.

First, we still cannot overemphasize that economies may become more vulnerable to financial disruptions not of their own making when

their governments relinquish controls over the inflow and outflow of capital. However, it is not financial liberalization that is at the root of the problem but rather the inadequacy of prudential supervision and regulation. (Eichengreen and Mussa, 1999) There is thus an important role for policies that encourage adherence to world-class standards for accounting, auditing, and information disclosure; that facilitate enforcement of sound rules of corporate governance; and that protect investors and lenders from fraud and unfair practices.

Second, it is important to note what determines the cross-border capital flows. Empirical studies suggest that gross international investment positions are positively associated with trade openness and a large domestic financial market. Thus, an economy with large trade volumes also incurs large capital flows. This explanation is also supported by the argument that international portfolio holdings are determined by market size, transaction costs and information costs. This implies that signing free trade agreement (FTA), bilaterally or multilaterally, have a significant effect not only to trade volumes but also to international asset positions.

Third, the previous argument also asserts that domestic market size is also a critical element for inducing foreign capital inflows. The market size is usually measured by market capitalization or, simply, gross domestic product. Thus, to increase market size, it is crucial to achieve financial market development. Note that Asian economies have relatively developed financial markets, thus advanced economies were attracted to invest mainly in equity market in emerging Asian economies. The bond markets in Asian economies are not fully developed, however, and this might be due to limited liquidity in the bond markets, and explain large investment abroad for safe assets by Asian investors. On the other hand, Latin American economies have under-developed financial markets, and primary source of capital flows to Latin American economies became FDI.

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## IV. Financial Globalization and Real (Trade) Regionalization

As capital flows in Asia increase, there is considerable cross-country heterogeneity in the level of cross-holdings of foreign assets. Following is the table for the distribution of international portfolio investment in Asia, Latin America, North America, and Europe. This section examines the current status of capital movements by finding the regional characteristics of capital outflows. We divide 32 economies by region as follows.

**<Table IV-1> Geographic Division**

Regions	Economies
Asia	Hong Kong Indonesia, Japan, Korea, Malaysia, Philippines, Singapore, Thailand
North America	Canada, Mexico, United States
Latin America	Argentina, Brazil, Chile, Colombia, Uruguay, Venezuela
Europe	Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, UK, Netherlands, Portugal, Spain, Sweden, Luxembourg

The Table IV-2 indicates the destination economies of portfolio investment by each economy, and shows the capital flows across the specified region. Note that economies in the rows are investing in the economies in the column. The data for portfolio flows comes from Coordinated Portfolio Investment Survey (CPIS). IMF conducts the Coordinated Portfolio Investment Survey (CPIS) on an annual basis in response to global asymmetries in reported balance of payments data, especially those in portfolio investment flows. The results of this survey

provide a relatively high-quality stock measure of the bilateral equity holdings among economies at the end of the year.

Quick glance at the table reveals, however, that portfolio investment flows are concentrated to a few economies. Hong Kong, Japan, and Singapore are main capital exporters in Asia. These three Asian economies are also investing in North America and Europe. As a result, Asia has mostly invested in North America and Europe, which consists 94.5% of total overseas portfolio investment. Latin America also shows heavy concentration on their overseas portfolio investment into North America (60.7%) and Europe (33.1%). On the other hand, North American economies have active relationships with other regions as well as with Latin American economies, even though 59.8% of total portfolio investment goes to Europe. In particular, the United States plays a dominant role as the main importer and exporter of portfolio investment. In addition, North American economies are dominant investment importers. In case of Europe, they are well invested within the European capital market. The 73% of total overseas investment goes to other countries in Europe.

**<Table IV-2> Regional Distribution of Portfolio Investment**

(Unit: %)

Total Portfolio	Asia	Latin America	North America	Europe
Asia	4.6	0.3	47.5	47.0
Latin America	0.2	6.0	60.7	33.1
North America	17.1	2.9	20.2	59.8
Europe	4.8	0.7	21.5	73.0

Equity	Asia	Latin America	North America	Europe
Asia	8.0	0.1	53.0	39.0
Latin America	0.1	1.1	49.1	49.7
North America	22.4	2.0	18.2	57.5
Europe	10.0	0.5	27.0	62.4

## 42 Prospects for Regional Financial and Monetary Integration in East Asia

<Table IV-2> Continued

Long term Debt	Asia	Latin America	North America	Europe
Asia	3.4	0.4	45.3	50.8
Latin America	0.3	13.9	76.7	9.1
North America	7.7	5.6	27.8	58.9
Europe	2.2	0.8	17.6	79.4

Short-term debt	Asia	Latin America	North America	Europe
Asia	9.3	0.1	50.4	40.2
Latin America	0.3	0.1	87.2	12.5
North America	0.5	0.7	10.5	88.3
Europe	0.8	0.7	27.0	71.5

Note: Economies in the rows are investing in the economies in the column.

Source: IMF, *Coordinated Portfolio Investment Survey (CPIS)*.

However, the trade flows show completely different picture in general. Asia, Europe and North America region's total trade volume are concentrated in their own region. Latin America trades mostly with North America. In Faruqee, et al (2004), international portfolio holdings are determined by market size, transaction costs (such as per-minute international phone costs) and information costs (such as physical distance between the capital cities of two economies). That is to say, financial market size and distance variables are powerful explanatory variables, and economies with larger domestic market size tend to hold greater quantity of foreign assets. Lane suggests that, in a cross-section of economies, gross international investment positions are positively associated with trade openness and a large domestic financial market. A possible explanation for this is that those factors that stimulate trade in goods also stimulate trade in assets and, moreover, trades in goods and assets are complementary activities

&lt;Table IV-3&gt; Export Flows among Regional Specification

(Unit: %)

	Asia	Latin America	North America	Europe
Asia	44.56	33.16	0.98	21.29
Latin America	9.86	45.02	18.77	26.17
North America	14.58	65.62	2.72	17.08
Europe	5.55	13.02	1.10	80.33

Note: Economies in columns are reporting economies and those in rows are partner economies, which is final destination for export.

Source: IMF, *Direction of Trade Statistics*.

Comparing capital flows and trade flows in the regions, it is fair to say that the region is financially globalized, but regionalized in term of real sector. It is not necessary for the direction of capital flows to be identical to that of trade flows. If capital flows pursue the liquid and efficient global market, trade can go in the other direction. However, in case of emerging market economies, the asset and liability dollarization due to the financial globalization might cause serious problems. In addition, as Crockett (2002) points out, criticisms have been raised at this particular pattern of capital flows in Asia. First, capital flows from developing countries to the developed countries are not sustainable. It means that capital is flowing from economies that are catching up in productivity to mature economies that are assumed to have less productivity. There are concerns that the longer this pattern lasts, the greater the adjustment will have to be, which would prove to be devastating to emerging market economies. Second, there are concerns that the gross flows from emerging market economies to developed countries and back to emerging market economies signify missed opportunities for capital market development in emerging market economies.

More to analyze the discrepancy between asset trade and good trade, we develop the following index as follows

#### 44 Prospects for Regional Financial and Monetary Integration in East Asia

$$CT_i = \sum_{j=1}^n \frac{C_{ij}}{T_{ij} + C_{ij}}$$

where  $CT$  is capital-trade discrepancy index,  $C_{ij}$  stands for capital export from  $i$  country to  $j$  country, and  $T$  is export flows from  $i$  country to  $j$  country. If a country exports no good but asset,  $CT$  will be 1, on the other hand, if a country exports no asset but good, then  $CT$  index will go to 0.

**<Table IV-4> CT Index for Asia**

	1997	2001	2002	2003
Korea	0.0420	0.0225	0.0204	0.0271
Japan	0.1745	0.1797	0.1754	0.1684
Malaysia	0.0155	0.0315	0.0327	0.0177
Singapore	0.0329	0.0947	0.0993	0.1100
Indonesia	0.0060	0.0092	0.0081	0.0137
Thailand	0.0113	0.0089	0.0135	0.0141
Philippines	-	0.0169	0.0359	0.0507
Hong Kong	-	0.0457	0.1141	0.1229
Average	0.0470	0.0511	0.0624	0.0656

**<Table IV-5> CT Index for Europe**

	1997	2001	2002	2003
Belgium	0.1376	0.1310	0.1410	0.1359
Denmark	0.0976	0.1431	0.1690	0.2153
Germany	-	0.1308	0.1364	0.1483
Greece	-	0.0712	0.0979	0.1096
Spain	0.0530	0.0819	0.1149	0.1245
France	0.1338	0.1411	0.1513	0.1744

<Table IV-5> Continued

Ireland	0.1835	0.1812	0.2027	0.2271
Italy	0.1023	0.1546	0.1538	0.1581
Luxembourg	-	0.5967	0.5670	0.5946
Netherlands	0.1322	0.1742	0.1704	0.2101
Austria	0.1536	0.2078	0.2116	0.2277
Portugal	0.1510	0.1110	0.1033	0.1119
Finland	0.0391	0.0642	0.0714	0.1062
Sweden	0.0856	0.0904	0.1042	0.0980
United Kingdom	0.5510	0.2633	0.1120	0.2635
Average	0.1517	0.1695	0.1671	0.1937

<Table IV-6> CT Index for Latin America

	1997	2001	2002	2003
Argentina	0.0315	0.0193	0.0211	0.0230
Brazil	0.0000	0.0399	0.0424	0.0416
Chile	0.0211	0.0530	0.0773	0.0692
Colombia	-	0.0301	0.0622	0.0220
Uruguay	-	0.0578	0.0495	0.0591
Venezuela	0.0173	0.0050	0.0039	0.0145
Average	0.0175	0.0342	0.0427	0.0382

<Table IV-7> CT Index for North America

	1997	2001	2002	2003
Canada	0.1999	0.1888	0.1842	0.1953
Mexico	-	-	-	0.0167
United States	0.3307	0.2631	0.2670	0.2819
Average	0.2653	0.2260	0.2256	0.1646

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## **V. Economic Rationale for a Regional Financial Arrangement in East Asia**

The 1997-98 Asian Financial crises has been by far the most significant development that has underscored the need to create a regional mechanism of defense against future crises in East Asia. However, there have been other developments that have propelled the regional integration movement. This section discusses some of these developments for an examination of whether they can maintain the momentum for enhanced regional cooperation and lead to financial market integration and monetary unification in the long run.

### **1. Regional Financial Arrangements: Stumbling Blocks?**

Any argument supporting regional trade and financial arrangements must address the fundamental question of whether they, whatever forms they may take, are conducive to an orderly global integration of trade and financial markets. Despite many misgivings about the role of regional economic arrangements, the experiences of the past decade - in particular, those of the EU and NAFTA - suggest that they have not interfered multilateral trade and financial liberalization. On balance, they have been building blocks rather than stumbling blocks for a more integrated world economy. Institutionalization of the CMI over the past five years has in fact shown little indication that an East Asian financial arrangement will be oriented toward a withdrawal from the global economy and, hence, erect barriers to global financial integration.

Lawrence (1996) pointed out that the forces that were driving the wave of regionalism in the early 1990s differ fundamentally from those driving earlier moves toward regionalization in this century and that the regional initiatives represented efforts to facilitate their members' participation in the world economy rather than their withdrawal from it. Trade and financial developments since then have not refuted with this observation. Many developing countries are motivated to join regional groupings as their participation could facilitate liberalization and opening

of their economies.

Since most of the East Asian EMEs are pursuing export cum foreign investment-led policies, they will gain very little by forming a regional arrangement that is designed to thwart their economic globalization. As will be argued in section V, the ABMI will develop market forces as well as peer pressure for financial market deregulation and opening throughout East Asia. As a regional liquidity assistance system, the CMI will facilitate the bond market development, as it will contribute to reducing the likelihood of the recurrence of financial crises. It will be also be shown that regional bond markets in East Asia cannot discriminate against non-regional investors and issuers of financial instruments and hence will over time be integrated into the global financial system. For these reasons, the CMI and ABMI are expected to serve as building blocks for financial globalization.

## **2. Trade Integration and Stability of Bilateral Exchange Rates**

Since the early 1990s, many of the East Asian countries have made sustained efforts to deregulate and open domestic markets including financial markets to foreign competition. As a result of market orientation and trade liberalization, East Asia has seen a large increase in intra-regional trade and investment. In terms of imports, intra-regional trade in East Asia (ASEAN+3 and Taiwan province of China) accounted for 46 percent of the region's total trade (see Table 1A and Table 1B) in 2001 when the entire region was still recovering from the crisis. There is every indication that this trend will continue.

Financial liberalization and market opening has also contributed to both regional and global integration of financial markets of East Asian countries. And there is growing awareness that further integration of intra-regional trade in goods, services and financial assets would call for stabilization of the bilateral exchange rates of East Asian currencies. With deepening in regional trade integration, East Asia is bound to lose disproportionately more from trade disruptions caused by currency crises than other regions. Stability of the bilateral exchange rates would also facilitate and as noted in the preceding section, increase the benefits of capital mobility in the region.

## 48 Prospects for Regional Financial and Monetary Integration in East Asia

<Table V-1A> Trade Share in East Asian Countries (export)

(Unit: percentage)

Export form To	East Asia									China			Japan			Korea			Other NIEs			ASEAN 4		
	'80	'90	'01	'80	'90	'01	'80	'90	'01	'80	'90	'01	'80	'90	'01	'80	'90	'01	'80	'90	'01			
East Asia	32.0	36.2	42.2	52.9	66.9	44.9	21.8	24.2	32.6	28.5	33.0	38.9	31.3	39.9	49.5	54.2	50.6	47.4						
China	2.8	4.6	9.8	0.0	0.0	0.0	3.9	2.1	7.7	0.0	0.0	12.1	4.0	15.7	24.2	0.8	2.1	4.4						
Japan	10.2	8.2	8.9	22.3	14.8	16.9	0.0	0.0	0.0	17.4	19.4	11.0	6.3	6.9	6.6	34.6	24.4	16.1						
Korea	2.7	3.8	4.0	0.0	0.7	4.7	4.1	6.1	6.3	0.0	0.0	0.01	1.3	2.3	2.6	1.7	3.9	3.7						
Other NIEs	9.3	12.3	11.5	26.4	47.0	19.6	6.7	8.3	9.4	6.2	8.6	9.0	6.0	4.5	4.7	13.8	16.0	15.9						
ASEAN 4	7.0	7.1	8.1	4.3	2.9	3.8	7.0	7.7	9.3	5.0	5.0	6.8	13.7	10.6	11.5	3.2	4.2	7.2						
South Asia	1.7	1.4	1.5	1.1	1.5	1.5	1.6	1.2	0.8	2.0	1.7	1.8	2.8	1.9	2.1	1.1	1.3	1.8						
Central Asia	0.0	0.0	0.1	0.0	0.0	0.4	0.0	0.0	0.0	0.0	0.0	0.3	0.0	0.0	0.0	0.0	0.0	0.0						
CER	2.8	2.2	2.0	1.4	0.8	1.5	3.1	2.8	2.2	1.5	1.7	1.6	4.3	2.2	2.0	1.8	1.8	2.5						
USA	21.4	25.7	21.0	5.4	8.6	20.4	24.5	31.7	30.4	26.4	29.9	20.8	19.4	23.0	10.3	18.8	19.4	20.0						
EU	14.6	17.7	14.9	13.1	10.1	15.4	14.0	20.4	16.0	15.5	15.4	13.1	17.9	17.2	14.0	13.6	16.7	15.0						
Other	27.5	16.8	18.2	26.1	13.6	15.9	35.1	19.6	18.0	26.0	18.3	23.4	24.3	15.9	22.1	10.4	10.2	13.2						
World	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100						

<Table V-1B> Trade Share in East Asian Countries (import)

(Unit: percentage)

Export from To	East Asia									China			Japan			Korea			Other NIEs			ASEAN 4		
	'80	'90	'01	'80	'90	'01	'80	'90	'01	'80	'90	'01	'80	'90	'01	'80	'90	'01	'80	'90	'01			
East Asia	30.4	38.7	45.8	33.3	49.0	32.3	20.7	23.4	36.2	33.4	34.4	39.9	47.9	57.1	62.8	41.1	46.2	50.8						
China	3.9	7.8	15.0	0.0	0.0	0.0	3.1	5.1	16.6	0.1	0.0	9.4	10.8	22.6	29.9	2.8	2.6	5.6						
Japan	11.2	12.8	9.0	27.0	14.7	0.3	0.0	0.0	0.0	26.3	26.6	18.9	20.4	17.8	12.2	24.3	25.6	19.8						
Korea	1.8	3.4	5.4	0.0	0.5	13.7	2.2	5.0	4.9	0.0	0.0	0.0	2.3	3.8	4.1	2.0	3.4	5.1						
Other NIEs	3.1	6.4	5.1	4.0	29.6	8.5	1.5	2.4	2.0	1.2	2.2	3.0	4.3	3.6	3.8	8.3	10.6	10.9						
ASEAN 4	10.4	8.2	11.2	2.4	4.2	9.8	14.0	10.9	12.7	5.9	5.6	8.6	10.2	9.2	12.8	3.8	4.1	9.4						
South Asia	0.9	1.1	1.4	1.0	1.7	2.4	0.9	1.0	0.8	0.3	0.7	1.1	1.2	1.0	1.5	0.7	1.5	1.6						
Central Asia	0.0	0.0	0.1	0.0	0.0	0.6	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0						
CER	4.7	4.1	3.4	6.4	2.9	3.6	5.6	6.0	4.7	3.4	4.4	4.4	2.3	1.6	1.4	4.3	3.8	3.1						
USA	17.0	17.8	14.5	20.0	12.7	15.4	17.4	22.5	18.3	21.9	24.3	15.9	13.0	11.5	10.3	16.1	13.9	12.9						
EU	8.8	14.9	12.9	14.7	17.6	20.9	5.9	16.1	12.8	7.2	13.0	10.6	11.7	11.8	10.5	13.5	16.4	11.7						
Others	38.3	23.4	22.0	24.6	16.2	24.8	49.5	31.0	27.3	33.6	23.4	28.0	23.9	17.1	13.5	24.2	18.3	19.9						
World	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100						

Note: Other NIEs (Singapore, Hong Kong), ASEAN+4 (Indonesia, Malaysia, Philippines, Thailand), South Asia (India, Sri Lanka, Bangladesh, Pakistan), Central Asia (Kazakhstan, Uzbekistan), CER (Australia, New Zealand)

Source: International Monetary Fund, *Direction of Trade Statistics Yearbook*, Various Years.

In the aftermath of the East Asian crisis, the flexible exchange system became the accepted norm in the new international financial architecture. The new consensus, however, did not last very long. Williamson (2000) and Frankel (1999) argue that intermediate regimes such as the basket, band, and crawl (BBC) system are more likely to be appropriate than the two corner solutions for many emerging market economies (EMEs). Fischer (2001) suggests that developing countries which are not exposed to capital flows could choose from a wide variety of intermediate regimes and that flexible exchange rate systems suitable for EMEs could include crawling bands with wide ranges.

If indeed East Asian countries find it desirable to follow some type of intermediate regime, then one can make a case for creating regional financial cooperative arrangements that could help stabilize the bilateral exchange rates in the region. As will be argued in section (VI), all of East Asia's EMEs including China manage a variety of the Basket, Band, and Crawl (BBC) system. Now that China has shifted to a managed float against a basket of currencies, the similarity of the exchange rate regime in the region will entail closer coordination of exchange rate policies among East Asia's EMEs. Although the authorities of the ASEAN+3 have no plan of transforming the CMI into a monetary union, East Asian countries could use the CMI as a framework as a mechanism of the coordination of exchange rate policies in the region.

### 3. IMF and Capital Account Crisis Management

A recent IMF report (2003) makes it clear that East Asia suffered a capital account crisis in 1997 and 1998, which required a management and resolution strategy different from the traditional IMF recipe for crises originating from current account deficits.<sup>9)</sup> A large increase in capital inflows into some of the East Asian countries set off an asset market boom and a precipitous increase in the current account deficit, making these countries vulnerable to speculative attacks. The perception of vulnerability of these countries triggered a sharp and large capital outflow, which was further aggravated by the panic and herding of foreign investors. Once the dollar peg became indefensible, the value of the currencies plummeted. Many banks and corporations with balance

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9) See IMF (2003).

sheet mismatches could not service their foreign currency denominated debts and eventually became insolvent. A sharp contraction in the level of output then followed.

The crisis resolution strategy of the IMF was twofold. First, it imposed tight monetary and fiscal policy with the aim of stabilizing the exchange rate and generating current account surpluses by contracting domestic demand. These policies together with weak currencies were expected to contribute to luring back foreign investors. Second, the IMF required these crisis countries to undertake a wide range of reform covering the corporate, financial, and public sectors to strengthen the structural foundation of the economy. The reform was to help these countries return to the pre-crisis path of robust growth; it was also viewed critical to restoring the confidence of international lenders to these economies.

Once the crisis broke out, output contraction and the turbulence of the foreign exchange and other financial markets in one country were rapidly transmitted to other economies in the region through trade and financial market linkages. The pronouncements by international financial institutions including the IMF and policymakers of the G-7 countries that the crisis countries had serious structural problems in their financial, corporate, and public sectors did not help inspire confidence in these economies (Furman and Stiglitz 1998). In some sense, the IMF crisis management program was fueling contagion of the crisis.

Seven years after the crisis, the assessment of the structural reforms remains mixed. A recent World Bank report (2002) still argues that “progress on structural and institutional reforms remain key to retaining confidence and resilience to shocks” in East Asia. One of the lessons of the Asian crisis is that when a crisis in a country originates in the capital account, policy coordination or at least policy dialogues and reviews among neighboring countries is essential in preventing contagion of the crisis.

Another lesson is that an appropriate response to a capital account crisis is to serve notice to international financial markets that the crisis country is prepared to supply whatever amount of liquidity it takes to thwart an impending speculative attack by itself or in cooperation with regional or global financial institutions including the IMF.

These lessons clearly suggest that regional financial cooperative arrangements such as the CMI could complement the role of the IMF in

managing a capital account crisis. In the absence of policy dialogues and exchanges of information among the neighbors, individual countries may not be able to find the causes of large changes in capital flows and exchange rates and more importantly respond to the contagion of the crisis. An efficient regional mechanism of policy coordination will help monitor and make policy adjustments to changes in market expectations. Even smoothing-out of high frequency movements of the nominal exchange rate in individual countries may have to be coordinated at a regional level in order not to send wrong signals to foreign exchange markets. Unless the countries in the region maintain close working relationships in coordinating policies and exchanging information they will not be able to make a prompt assessment of the nature of and response to the crisis.

The IMF could monitor capital flows within and between regions and also the behavior of market participants. But given its narrow mandate and its small staff, the IMF may not have the institutional as well as professional capacity to keep track of developments in financial markets of all of its member countries. Since the Fund obtains most of its macroeconomic and market information from the authorities of its member countries, it may be limited in its ability to assess market developments in each country and in the region as a whole and hence to prescribe preventive measures to the member countries vulnerable to the crisis. At best it can serve as a lender and manager of a crisis when it occurs. Even in this case, the Asian experience demonstrates that IMF was severely constrained in managing the crisis.

At the time of the crisis, the CMI countries as a whole held about US\$700 billion in foreign reserves. The total amount of financing required restoring financial stability in Indonesia, Korea, and Thailand by the IMF, other international financial institutions, and a number of donor countries amounted to US\$111.7 billion. If the IMF had been ready to supply a large amount of liquidity to the crisis countries or the thirteen countries of ASEAN+3 had established a cooperative mechanism in which they could pool their reserves to assist other countries in need of short-term liquidity, they could have nipped the Thai crisis in the bud and minimized its contagion by supplying a small fraction of their total reserves. In view of the large loss of output and fall in employment in the region, such a cooperative response was indeed desirable.

Insofar as East Asia suffered a liquidity crisis compounded by the

panic and the herding behavior of foreign investors, a more effective IMF crisis management strategy would have been supplying a large amount of short-term financing to replenish foreign exchange reserves at the first sign of a speculative attack, instead of tightening monetary and fiscal policy. Such a strategy could have stopped the spread of the crisis and slump throughout the region.<sup>10)</sup> At the time of the crisis, there were neither regional nor global lenders of last resort to deal with bank run problems East Asian countries were facing. With limited financial resource, the IMF could not manage the East Asian crisis by itself; it had to enlist the financial support of the G-7 and other countries. The G-7 support is then a testimony that as a global institution, the IMF would be more effective in resolving crises if it establishes cooperative relations with its regional counterparts and hence encourage development of regional financial mechanisms.

Once established, an East Asian monetary fund could provide additional resources to the IMF while joining forces to work on matters related to the prevention and management of financial crises. At the same time, it could also support the work of the IMF by monitoring economic developments in the region and taking part in the IMF's global surveillance activities. As Henning (2002) noted, the validity of the additionality is difficult to assess *ex ante*. The problem arises in principle whenever there are multiple sources of finance and conditionality, yet it appears to have been managed successfully in numerous historical cases. Potential conflicts can be avoided through coordination and consultation, which may be provided in part by the United States and East Asian governments.

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10) Contagion is geographically concentrated, so that a regional grouping for support is logical. In addition to providing financial assistance in tandem with international support, a regional financial cooperation mechanism may conduct policy reviews and initiate a dialogue process. Policy dialogue, including monitoring and surveillance, is the bedrock on which coherent policy formation under the regional financial arrangements rests. A monitoring and surveillance process would provide prompt and relevant information for assessing the situation of countries in trouble and the potential contagious effects of a crisis to neighboring countries. Furthermore, a joint exercise based on a region-wide early warning system would facilitate closer examination of financial vulnerabilities in the region. In addition, the regional policy dialogue process would contribute to ensuring effective implementation of high-quality banking and financial standards, and promoting financial market development in East Asia.

#### 4. Limited and Slow Progress in International Financial Reform

One of the recent developments that have reinforced regionalism in East Asia has been the slow progress in the reform of the international financial system. The urgency of reform is no longer visible in the G-7 countries despite the collapse of Argentina and growing trade imbalance between the US and East Asia. In fact, there has been no serious discussion of the reform of the international financial system since 2001. The slow progress has been further compounded by the perception that none of the many proposals for a new architecture may be effective in sustaining global financial stability. In particular, as long as the structural problems on the supply side of international capital markets are not addressed, East Asian countries fear that they will remain as vulnerable to future crises as they are now (Park and Wang 2002).

Griffith Jones and Ocampo (2002) show that there has been no international reform agenda accepted by both developing and developed countries. The recent Monterrey consensus has produced a new international agenda, but it is not altogether clear whether the new agenda will be put into action. Some of the progress that has been made is asymmetrical in the sense that the reform has focused on strengthening financial and corporate sectors of emerging market and developing economies while ignoring imperfections of international capital markets. Some of the advances in the new architecture have also met the risk of reversal such as the growing opposition of developing countries to support large IMF financing. This opposition has also reflected the reality in which EMEs including those from East Asia has been largely excluded in the key institutions and fora involved in international financial reform.

Faced with the uneven and slow process of the reform, it is natural that many emerging market economies would consider developing their own mechanisms of defence against future financial crises. One such defensive measure is the CMI in East Asia. Instead of waiting until the G-7 creates a new architecture, whose effectiveness is at best questionable, East Asian countries have taken the initiative of working together to create their own system of defence. To fortify their defensive mechanism, they have also been arming themselves with large amounts of reserves to deal with sudden and unexpected capital outflows as we discuss in the next sub-section.

## 5. Accumulating Reserves: a War Chest or Insurance?

Many emerging market and developing economies, in particular those countries that fell victim to financial crises, have taken recourse to amassing their foreign reserves as a means of defending against future crises. Before the onset of capital account liberalization in the early 1990s foreign currency reserves were held mainly for transactions purposes and as far as the adequacy of reserves was concerned, the rule of thumb was holding an amount of reserves equivalent to imports of three to four months. This implicit rule appears to be no longer acceptable. There has been a large increase in the demand for reserves arising from a growing volume of capital account transactions. But many East Asian emerging market economies have gone on to accumulate large amounts of reserves to secure self-insurance or to build a war chest for staving off future speculative attacks.

For example, at the end of 2003, the volume of reserves as a share of GDP in Korea was 25.7 percent, which was more than four times the level of 1996. Similar developments have taken place in other crisis-hit countries in East Asia (see Table 2A and Table 2B). In Indonesia, the ratio of reserves to GDP almost doubled between 1996 and 2003. The ratio climbed to 43.2 percent at the end of 2003 from about 20 percent in 1997 in Malaysia. Although reserve accumulation has been relatively modest in both Thailand and the Philippines, these countries have added almost 10 percentage points to the ratios at the end of 1997. The group of the ten East Asian countries held more than \$2.4 trillion in foreign exchange at the end of May 2005. By any measure, this level is excessive, costly, and represents a clear case of misallocation of resources.<sup>11)</sup> Depending on how these reserves are pooled together and managed, a mere ten percent of the total amount will be sufficient to provide a formidable line of defence against any future crises.

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11) In a recent speech at a Tokyo conference, Stiglitz (2002) argued that the existing dollar based reserve system benefits the U.S. whereas developing countries bear a disproportionate burden of holding large amounts of reserves to counter volatility in the currency market. He went on to say that an Asian Monetary Fund, which would have given a quicker remedy to the Asian financial crisis, could be an alternative model, providing a good basis for a new global regime.

&lt;Table V-2A&gt; International Reserve of East Asia, 1999-2005

(Unit: US dollar, Billions)

	1999	2000	2001	2002	2003	2004	2005*
Japan	287.0	354.9	395.2	461.3	663.3	833.9	829.9
	(31.8)**	(34.9)	(35.1)	(34.3)	(37.2)	(36.4)	(35.2)
Hong Kong	96.3	107.5	111.2	111.9	118.4	123.5	122.4
	(10.7)	(10.6)	(9.9)	(8.3)	(6.6)	(5.4)	(5.2)
Korea, South	74.0	96.1	102.8	121.4	155.3	199.0	206.0
	(8.2)	(9.5)	(9.1)	(9.0)	(8.7)	(8.7)	(8.7)
Singapore	76.9	80.1	75.4	82.1	95.7	112.2	116.0
	(8.5)	(7.9)	(6.7)	(6.1)	(5.4)	(4.9)	(4.9)
Taiwan	106.2	106.7	122.2	161.7	206.6	242.0	253.2
	(11.8)	(10.5)	(10.9)	(12.0)	(11.6)	(10.6)	(10.7)
Subtotal	353.4	390.6	411.6	477.1	576.0	676.7	697.6
Indonesia	26.5	28.5	27.3	31.0	35.0	35.0	33.3
	(2.9)	(2.8)	(2.4)	(2.3)	(2.0)	(1.5)	(1.4)
Malaysia	30.6	29.5	30.5	34.2	44.5	66.4	74.1
	(3.4)	(2.9)	(2.7)	(2.5)	(2.5)	(2.9)	(3.1)
Philippines	13.2	13.1	13.4	13.1	13.5	12.9	14.8
	(1.5)	(1.3)	(1.2)	(1.0)	(0.8)	(0.6)	(0.6)
Thailand	34.1	32.0	32.4	38.1	41.1	48.7	47.1
	(3.8)	(3.1)	(2.9)	(2.8)	(2.3)	(2.1)	(2.0)
China	157.8	168.3	215.7	291.2	408.2	614.5	659.1
	(17.5)	(16.6)	(19.2)	(21.6)	(22.9)	(26.9)	(28.0)
Subtotal	262.2	271.4	319.3	407.7	542.2	777.5	828.4
Total	902.6	1,016.9	1,126.1	1,346.1	1,781.5	2,288.1	2355.9

&lt;Table V-2B&gt; Current Account Surpluses

(Unit: US dollar, Billions)

	2000	2001	2002	2003	2004	Total	Share
Japan	119.7	87.8	112.4	136.2	172.1	628.2	48.8
Hong Kong	7.1	9.9	12.6	16.7	16.0	62.4	4.85
Korea, South	12.3	8.0	5.4	12.3	27.6	65.7	5.1
Singapore	13.2	16.1	18.9	28.2	26.1	102.5	7.96
Taiwan	8.9	18.2	25.6	29.3	18.7	100.6	7.81
Indonesia	8.0	6.9	8.12	7.5	3.1	33.7	2.62
Malaysia	8.5	7.3	7.2	13.4	14.9	51.3	3.99
Philippines	6.3	1.3	4.4	3.3	2.0	17.3	1.34
Thailand	9.3	6.2	7.0	8.0	7.3	37.8	2.94
China	20.5	17.4	35.4	45.9	68.7	187.9	14.6
Total	213.7	179.2	237.1	300.8	356.5	1,287.3	100

Source: IMF, *International Financial Statistics and CEIC Data Company Ltd.* (www.ceic.com)

In theory, floating rates and capital account liberalization are supposed to reduce the amounts of reserves to be held for the prevention of crises. Except for China, Hong Kong, and Malaysia, all other crisis countries have been on a flexible exchange rate system and deregulated their capital account transactions to a considerable degree since the 1997 crisis. However, the shift to floating rates and participation in international financial markets for the past seven years have not reduced their reserve holdings relative to their output, largely because capital flows have been unstable and there is uncertainty as to whether they would have access to international capital markets for short-term liquidity in case they suffer from a current or capital account deficit.

In emerging economies with a relatively open capital account, the adequacy of reserve holdings often gauged by the amount of short-term foreign borrowings; a good benchmark is that the ratio of reserves to short-term foreign debts should be equal to or higher than one.<sup>12)</sup> In

both Korea and Thailand, the ratios have been higher than 2, and even in Indonesia, it has fluctuated between 1.3 and 1.45 (see Table 3). If emerging market economies in East Asia and elsewhere have to hold such a large amount of reserves relative to their short-term foreign indebtedness, then questions arise as to whether they should borrow at all from the short end of international capital markets and whether they should open their financial markets in the first place.

Commercial banks hold a small fraction of their deposit liabilities that are mostly short-term, and they could do so because, among other things, they have access to the domestic lender of last resort. In the absence of a global and regional lender of last resort, financial institutions in EMEs cannot engage in term transformation involving foreign currency loans. Could the EMEs then make arrangements with international financial institutions to establish private contingent lines of credits they could draw from in case they come under a speculative attack? The Mexican experience is instructive in this regard: the availability of contingent credit lines does not increase the availability of liquidity once a financial crisis breaks out, because the foreign financial institutions which provide contingent credit lines to the central bank withdraw other credits extended to financial institutions and other firms to reduce their overall country exposure (Carstens, 2001).

Given the limited availability of private contingent lines of credit, together with the absence of a global or regional lender of last resort, EMEs may therefore have to hold a larger amount of reserve than otherwise, and to do so they may have to run a sizeable amount of surplus on the current account as the East Asian crisis countries have done since the crisis in 1997. The reserve accumulation in EMEs has in part been responsible for the growing trade imbalance between East Asia and the US.

As an increasing number of EMEs continue to increase their holdings of reserves by running current account surpluses trade relations between developing and developed countries are likely to suffer from tension and unnecessary conflicts. The large accumulation of reserves in EMEs could also slow global growth as it reduces global aggregate

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12) The short-term foreign debt benchmark therefore suggests that reserve holdings for other uses must be secured by long-term foreign borrowing or accumulating current account surpluses.

&lt;Table V-3&gt; Ratios of Foreign Exchange Reserves to Short-term External Debt and GDP

	As percent of short-term foreign debt										As percent of GDP									
	1997	1998	1999	2000	2001	2002	2003	2004	1997	1998	1999	2000	2001	2002	2003	2004				
China	769	833	1,000	1,250	435	556	526	588	15.89	15.77	15.91	15.57	18.34	22.99	28.95					
Hong Kong	51	71	110	153	183	226	-	-	54.27	55.14	59.91	65.04	68.26	69.27	74.63					
Indonesia	50	90	126	146	166	240	-	-	7.69	23.80	18.89	18.98	19.29	17.90	16.78					
Japan	-	-	41	43	39	33	-	-	5.09	5.47	6.42	7.45	9.46	11.55	15.33					
Korea	32	132	172	192	244	244	286	333	4.27	16.39	16.62	18.78	21.32	22.20	25.65					
Malaysia	167	270	526	625	476	400	500	588	20.75	35.41	38.65	32.74	34.64	36.06	43.15					
Philippines	115	159	270	238	222	238	222	263	8.86	14.17	17.39	17.19	18.64	16.85	16.70					
Singapore	278	156	125	69	67	69	79	67	75.46	91.12	94.42	87.60	88.81	92.92	104.82					
Taiwan	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-					
Thailand	68	101	175	217	244	294	370	435	851.65	642.86	543.06	509.71	476.46	551.43	627.60					

Sources: IMF, *International Financial Statistics*, World Bank and [www.cbc.gov](http://www.cbc.gov).

demand. A regional financial cooperative arrangement such as the CMI could contribute to lowering the level of the reserves held by the member economies as it provides new credit facilities.

## **6. Regional Financial Arrangements: Prone to Moral Hazard?**

Ever since the proposal for creating an Asian Monetary Fund was made, the opponents of a regional financial arrangement in East Asia have raised two issues. First, they argue that the ASEAN+3 countries have yet to develop economic, social, and political preconditions that could support a regional financial arrangement. In the absence of these conditions, a regional arrangement for financial cooperation such as the CMI has the danger of undermining the role of the IMF and other global financial institutions. Specifically regional financial arrangements could aggravate moral hazard problems associated with excessive borrowing and undisciplined macroeconomic policies of the members of the arrangements, because they are likely to be subject to loose policy conditionality when they borrow from the arrangement. The opponents also contend that there is no need for regional financial arrangements as the new information and communication technology together with capital account liberalization is driving financial globalization at an unprecedented speed.

Many of the countries participating in the CMI have been embroiled in numerous territorial, political, and economic disputes with one another. Eichengreen (1999), Eichengreen and Bayoumi (1999), and Bayoumi, Eichengreen and Mauro (2000) argue that East Asia lacks the tradition of integrationist thinking and the web of interlocking diplomatic agreements that could encourage monetary and financial cooperation unlike in Europe. Therefore, according to the authors, "any monetary arrangement that seeks to stabilize exchange rates in the absence of the necessary political preconditions will be fragile and crisis prone". They are also concerned that regional mechanisms for financial cooperation would not be instilled with the kind of lending discipline and proper surveillance of the sovereign states participating in the arrangements.

Against these opposing views, one could point out that the ASEAN+3 member economies have participated in various regional groupings and in the process have accumulated a great deal of

experience in managing cooperative arrangements with other countries. The ASEAN states have more than thirty years' of experience with regional cooperation. Since its inception in 1967, ASEAN has contributed to consolidating unity, promoting free trade, and providing mutual financial assistance among the member states. The ASEAN+3 also have been active members of the APEC. Some of these countries also participate in the Manila framework; and there are other regional cooperative arrangements such as EMEAP, SEACEN, and SEANZA that have served as informal fora for policy dialogues.

Economic integration in Europe has in no small measure owed its success to political cohesiveness and integration of Europe. Such a favourable political environment does not exist in East Asia. However, political integration may not be as critical as it was in Europe largely because many of the East Asia's central banks now enjoy greater independence than before and, more importantly, democratic principles are taking root in the governance of these countries. East Asia is changing and may be on the brink of an historical evolution, as Europe was half a century ago (Bergsten, 2000). Despite the many political and economic issues that have fractured the unity of the ASEAN+3, the thirteen countries were able to agree to the creation of the CMI. In that respect, the launching of the CMI has been a milestone in financial cooperation in East Asia. Having suffered such a painful and costly financial crisis, the East Asian countries appear to have enough incentives to set aside their differences to develop a region-wide mechanism of defence against future crises.

Nevertheless, it may be true that the East Asian countries may not be prepared to negotiate an international treaty that includes provisions for sanctions and fines for countries that do not adjust their domestic policies accordingly. This unwillingness would make it difficult for the regional fund to impose politically unpopular policies on the member countries and, hence, may pose a serious problem concerning policy discipline.<sup>13)</sup> However, moral hazard is not a problem that will beset

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13) Eichengreen (2000) finds it useful to distinguish between technical assistance and financial assistance. True enough, there is no reason to discourage competition in the market for technical assistance. Governments should be free to choose the source of technical assistance with the best track record. However, his concern is that if multiple monetary funds were available, East Asian governments

only regional arrangements. The IMF is not immune to this problem. The moral hazard concern is so serious that some people even question whether the IMF should continue to play the role of a quasi lender of last resort, and to them creation of regional monetary funds must be an anathema. (The Meltzer Commission, 2000)<sup>14)</sup>

The ongoing revolution in information and communication technology will no doubt accelerate financial globalisation. However, it should be noted that an orderly globalization requires global governance; at present, the world economy has no system of global governance, which may include a global central bank and global regulatory authorities, and the prospects for developing one are rather remote. Global governance, though reasonable on paper, in reality is politically unacceptable and must be dismissed as quixotic (Eichengreen, 1999). As a second best alternative to the global governance system, global standards and codes of conduct on banking, corporate governance, management of monetary and fiscal policies, and many others have been proposed. However, doubts have been raised as to whether one-size-fit-all codes and standards should be imposed on emerging and developing economies alike, and if they should, whether they could be enforced. If regional differences matter in devising standards and codes and harmonizing institutions, one could argue that some of the public goods for finance such as the CMI could be more efficiently produced at the regional level.

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would have an incentive to shop around for the most generous assistance and the least onerous terms. He seems to believe that AMF conditionality would be much softer than IMF conditionality. At the end of the day, his concern should be well taken when Asians consider further development beyond the CMI that assumes IMF conditionality as a given.

- 14) The task force report of the Council on Foreign Relations (1999) advises the Fund to adhere consistently to normal lending limits to redress the moral hazard problem. The reasons why East Asian financial arrangements would suffer more from the moral hazard problem than the IMF or any other regional institution have not been made clear.

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## VI. Recent Developments in the Chiang Mai Initiative (CMI)

### 1. The Background of the Chiang Mai Initiative

When the financial crisis that broke out in Thailand became contagious, spreading to other East Asian countries in the second half of 1997, Japan proposed to create an Asian monetary fund (AMF) as a framework for financial cooperation and policy coordination in the region, in particular for creating lending facilities, in addition to those of the IMF, against future financial crises in East Asia. Although the proposal was well received throughout the region, the idea was shelved at the objection of the U.S, EU, and IMF.

The AMF idea was revived again when the finance ministers of ASEAN, China, Japan, and South Korea (ASEAN+3) agreed on May 6 2000 in Chiang Mai, Thailand to establish a system of bilateral currency swap arrangements among the ASEAN+3 countries in what is known as the Chiang Mai Initiative (CMI). The eight countries participating in the CMI have also institutionalized regular meetings of finance ministers (AFMM+3) and deputy ministers (AFDM+3) for policy dialogue and coordination as well as the annual summit for ASEAN+3.<sup>15)</sup> As a sequel to the CMI for regional financial integration, ASEAN+3 has also launched the Asian bond market development initiative (ABMI) - an initiative for the development of regional bond markets in Asia. Six working groups have been established to construct regional financial infrastructure and to develop plans for coordination of market practices and policies of individual Asian countries.

A regional financial arrangement (RFM) for economic cooperation

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15) Financial market participants have ignored the CMI as a defense mechanism against future crises because the amount of liquidity any member can draw from the system is small and worse yet it is uncertain whether it can activate the swap borrowing. Despite these criticisms and the market's disregard, ASEAN+3 has managed to close ranks to expand the scope of policy dialogue and to move to the second stage of integration

and policy coordination in general comprises: (i) a mechanism of short-term liquidity support for the members experiencing balance of payments deficits such as the CMI; (ii) a mechanism of surveillance for monitoring economic and policy developments in the member countries and for imposing policy conditionality on those countries receiving financial support; and (iii) a regional collective exchange rate system designed to stabilize the bilateral exchange rates of the member countries. The ASEAN+3 states are working on a plan to establish a surveillance system for the CMI network. There has been so far no serious discussion on developing a collective exchange rate system for the region as a whole. The ABMI will be complementary to the CMI as it attempts to create large regional bond markets by integrating domestic bond markets of individual countries in East Asia.

The structure of financial cooperation conceived by the architects of the CMI covers only the basic principles and operational procedures for the bilateral swap transactions. To serve as a full-fledged regional financial mechanism comparable to the European Monetary System, for example, further organizational and operational details on surveillance and exchange rate policy coordination will have to be worked out.

The large currency crises of the last decade have been regional in nature (Glick and Rose 1999). Clearly, neighboring countries have a strong incentive to engage in mutual surveillance and to extend one another financial assistance in the face of potentially contagious threats to stability. Regardless of whether the sudden shifts in market expectations and confidence were the primary source of the Asian financial crisis, foreign lenders were so alarmed by the Thai crisis that they abruptly pulled their investments out of the other countries in the region, making the crisis contagious. The geographical proximity and economic similarities (or similar structural problems) of these Asian countries prompted the withdrawal of foreign lending and portfolio investment, whereas differences in economic fundamentals were often overlooked.

If the channels of contagion cannot be blocked off through multilateral cooperation at the early stage of a crisis, countries without their own deep pockets of foreign reserves could not survive independently. Hence, neighbors have an interest in helping put out a fire (a financial crisis) before it spreads to them (Ito, Ogawa and Sasaki 1999). As long as a crisis remains country-specific or regional, there is no urgent political need for unaffected countries to pay the significant costs associated with

playing the role of a fire fighter.

The formation of a regional financial arrangement in East Asia also reflects frustration with the slow reform of the international financial system (Park and Wang 2002). The urgency of architectural reform in the G7 countries has come to a complete halt, although there is a widespread consensus that the current international architecture is defective. The lack of global governance, including a global lender of last resort and international financial regulation is not likely to be remedied anytime soon. As long as the structural problems on the supply side of international capital markets such as volatile capital movements and gyrations of the exchange rates of the dollar, the Euro, and the Yen persist, the East Asian countries will remain as vulnerable to future crises as they were before. It would be in the interest of East Asians to work together to create their own self-help arrangements.

The Chiang Mai Initiative (CMI) of ASEAN+3 is one such option. However, the availability of regional liquidity support will be hardly enough to prevent future crisis. Without sound financial institutions and adequate regulatory regimes, Asian financial markets and institutions will remain vulnerable to external shocks. It is therefore equally important that East Asian countries continue to undertake financial sector restructuring and development. Regional policy dialogue should also contribute to strengthening the efforts to restructure and advance the financial markets in East Asia. The CMI is more than a system of regional liquidity assistance; it has been a milestone in regional policy cooperation as it has been developed into a regional forum for policy dialogue and also for concerted regional efforts at financial reform in the region.

The three pillars of liquidity assistance, monitoring and surveillance, and exchange rate coordination are essential elements for regional financial and monetary cooperation of regional financial arrangements that are founded on the three pillars will evolve over time as shown in the case of European monetary integration. A shallow form of financial cooperation may comprise no more than a common foreign reserve pooling or mutual credit arrangement such as bilateral swaps, which does not require any commitment to exchange rate policy coordination under which exchange rates of the participating countries are pegged to each other as in the ERM or agree to the adoption of a common currency. East Asian countries presently appear to pursue a shallow form

of financial cooperation (Henning 2002). Although a full-fledged form of monetary integration is not viable at this stage, East Asia has begun to examine the feasibility and desirability of cooperation and coordination in exchange rate policies.

Questions have also been raised as to viability of regional financial integration in a world economy that has seen a fast pace of financial globalization. In order to integrate financial markets into a single unified regional market, individual countries will have to open their financial markets. But then they will be integrating their markets into global financial markets at the same time unless they discriminate against non-regional market participants. The architects of the CMI have primarily been interested in creating a regional liquidity support system as a defensive measure against future of financial crises. However, there is no evidence that regional financial arrangement, whichever forms they may take are effective in warding off financial crises. There is also the lingering doubt whether given its small size, the CMI arrangement could be taken seriously by market participants and whether it would even be activated. Although these arguments raise legitimate questions, they do not mean that the creation of a regional financial arrangement in East Asia is not justified. Depending on how it is structured and managed, it could facilitate multilateral trade and financial liberalization, thereby contributing to global financial stability.

This section analyzes recent developments in and prospects for regional cooperation for financial integration in East Asia through the consolidation of the CMI.

## **2. Structure and Status of the CMI**

The CMI consists of two regional financial arrangements. One is the expanded ASEAN swap system and the other is the network of bilateral swaps and repurchase agreements among the eight members of ASEAN+3. In 1977, the original five ASEAN countries agreed to establish an ASEAN swap arrangement (ASA). In May 2000, the ASA was expanded to include the other five new members, and the total amount of the facility was raised to US\$ 1 billion from the initial amount of US\$ 200 million.

The CMI network of bilateral swap arrangements (BSA) among the eight members of ASEAN+3 provides for liquidity assistance in the form

of swaps of U.S. dollars for the domestic currencies of the participating countries. The maximum amount that can be drawn under each of the BSAs is to be determined by the contracting parties. The bilateral swap agreement allows an automatic disbursement up to 10 percent of the maximum amount of drawing. A member drawing more than the 10 percent from the facility is placed under an IMF program for macroeconomic and structural adjustments. In this sense, the network of BSAs is complementary to the IMF lending facilities.

The participating countries are able to draw from their respective BSAs for a period of 90 days. The first drawing may be renewed seven times. The interest rate applicable to the drawing is the LIBOR plus a premium of 150 basis points for the first drawing and the first renewal. Thereafter, the premium rises by an additional 50 basis points for every two renewals, but it is not to exceed 300 basis points.

The BSAs include one-way and two-way swaps (see Table 4). Since China and Japan are not expected to request for liquidity assistance to the ASEAN members, their contracts with the five Southeast countries are one-way BSAs from which only the ASEAN five can draw. As of May 2004, the first round of CMI implementation was completed, concluding the sixteen BSAs that amount to US\$36.5 billion in total. Japan concluded seven agreements, and both China and Korea five respectively (See Table 4).

South Korea, which is the largest beneficiary of the CMI can draw for a maximum \$12 billion from the system including the Miyazawa initiative. In the eyes of global financial market participants, however, the availability of liquidity to Korea and other members may not be large enough to be of any significance for preventing future crises. But it should be noted that what is more important than the availability of liquidity is the commitment of the members for mutual financial support for the prevention financial crises. If any member suffers from a short-term balance of payment problem, other members would come to assistance through many official and private channels of support. The CMI will be one of these channels. In this sense, the CMI represents a broad framework of liquidity support in East Asia.

The CMI is comparable to the liquidity support arrangements that had supported the European Monetary system before the creation of a monetary union in 1999. In comparison with Europe, however, the CMI had a different motivation from the beginning. The European facilities

&lt;Table VI-1&gt; Progress on the Chiang Mai Initiative

(As of May 30, 2004)

BSA <sup>1)</sup>	Currencies	Conclusion Dates	Size
Japan-Korea	\$/Won (one way)	4 July 2001	\$7 billion <sup>2)</sup>
Japan-Thailand <sup>3)</sup>	\$/Baht (one way)	30 July 2001	\$3 billion
Japan-Philippines	\$/Peso (one way)	27 August 2001	\$3 billion
Japan-Malaysia	\$/Ringgit (one way)	5 October 2001	\$3.5 billion
Japan-PRC	Yen/Renmimbi (two way)	28 March 2002	\$3 billion
Japan-Indonesia	\$/Rupiah (one way)	17 February 2003	\$3 billion
Korea-PRC	Won/Renminbi (two way)	24 June 2002	\$2 billion
Korea-Thailand	\$/local (two way)	25 June 2002	\$1 billion
Korea-Malaysia	\$/local (two way)	26 July 2002	\$1 billion
Korea-Philippines	\$/local (two way)	9 August 2002	\$1 billion
PRC-Thailand	\$/Baht (one way)	6 December 2001	\$2 billion
PRC-Malaysia	\$/Ringgit (one way)	9 October 2002	\$2 billion
PRC-Philippine	\$/Peso (one way)	29 August 2003	\$1 billion
Japan-Singapore	\$/Sing \$ (one way)	10 November 2003	\$1 billion
PRC-Indonesia	Rupiah/Renminbi (one way)	30 December 2003	\$1 billion
Korea-Indonesia	\$/local (two way)	3 December 2003	\$1 billion

Notes: 1) BSA: Bilateral Swap Arrangement

2) The U.S. dollar amounts include the amounts committed under the new Miyazawa Initiative: \$5 billion for Korea and \$2.5 billion for Malaysia.

3) The first contract has expired. The two countries are now negotiating a two-way BSA

were created with the purpose of limiting bilateral exchange rate fluctuations among regional currencies. The CMI started with high capital mobility and flexible exchange rates, although some members of ASEAN+3 have maintained a relatively fixed exchange rate regime. So far, the ASEAN+3 countries have not presumed any manifest exchange rate coordination. In the absence of exchange rate coordination, incentives for mutual surveillance will be limited because a member country facing a speculative currency attack may be free to float its exchange rate vis-à-vis those of other neighboring countries (Wang and Woo 2004).

### 3. Strengthening the CMI

As long as the CMI is simply a source of financial resources supplementary to the IMF, the size of the swap borrowing does not have to be large enough to meet the potential liquidity need. Although the CMI can be managed without its own conditionality at this point, it does need to establish its own surveillance mechanism to avoid breach of the swap contract. Because up to 10 percent of each BSA swap can be disbursed only with the consent of swap-providing countries, the swap-providing countries need to formulate their own assessments of the capacity as well as credibility of the swap-requesting countries to honor their contracts. The current practices under the ASEAN+3 processes cannot effectively resolve the problems of default on repayment.

A number of the participating countries proposed to sever the BSA from its linkage with the IMF conditionality and also a gradual increase of the automatic 10 percent drawing. Most participating countries agree in principle that the CMI network needs to be supported by an independent monitoring and surveillance system, that monitors economic developments in the region, serves as an institutional framework for policy dialogue and coordination among the members, and that imposes structural and policy reform on the countries drawing from the BSAs. However, the ASEAN+3 members at the current stage do not seem well prepared for establishing a policy coordination mechanism in the surveillance process although collective efforts are being made in this regard.<sup>16)</sup>

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16) For instance, the ASEAN surveillance process is built on the basis of consensus and informality in keeping with the tradition of non-interference (Manzano

As the annual meeting of the ADB in April 2004 finance ministers of ASEAN+3, agreed to undertake a further review of the CMI to explore ways in which the scope of the CMI operations can be further enhanced and consolidated. A working group was created to conduct the review. The group presented a report on some of the major issues related to the enlargement and consolidation of the CMI to the AFMM+3 meeting at the annual ADB May 2005 in Istanbul (ASEAN+3A 2005). In order to develop the CMI into a more credible and effective liquidity support system, the ASEAN+3 finance ministers approved the proposal that will double the size of the existing individual bilateral swaps with the provision that the actual increase would be decided by bilateral negotiations among the members.

At this stage of development, there is no guarantee that the BSAs will be activated as some of the swap providing countries may exercise their opting-out right. Under the current arrangement of the CMI, any country wishing to obtain short-term liquidity must negotiate the activation with all swap-providing countries individually. If a large number of the members refuse to provide swaps and different swap providers demand different terms and conditions, then the CMI may cease to be an efficient liquidity support system. The discussion of the swap activation with a multiple of contractual parties may take time and hence may deprive the swap requesting country of the ability to mount an effective and prompt defense against a speculative attack. In order to avoid this bias inherent in the system, it has been proposed to create a secretariat or committee, which will determine joint activation of all swap contracts of the swap requesting countries, so that swap disbursements can be made in a concerted and timely manner. At the Istanbul ADB meeting, the financial ministers of ASEAN+3 agreed to adopt in principle a collective decision making mechanism of the network of BSAs to ensure the timely availability of liquidity from the

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2001). East Asia in contrast to Europe lacks the tradition of integrationist thinking and the web of interlocking agreements that encourage monetary and financial cooperation (Eichengreen and Bayoumi 1999). Eichengreen and Bayoumi (1999) stress that East Asia does not meet the necessary intellectual preconditions for regional integration. For this reason, they conclude that it is unrealistic to speak of pooling national sovereignties. While there is no doubt considerable work to be done in promoting policy coordination in the region, it is wrong to say that it cannot be done in East Asia.

system through the joint activation of the swaps. Details of the collective decision making mechanism are to be worked out by AFDM+3. (See appendix for alternative proposals for the decision making process presented to AFMM+3 in Istanbul)

As noted earlier, the swap requesting country can draw up to ten percent of the contract amount without subjecting itself to the IMF conditionality on policy adjustments. Some members of the CMI argue that the limit should be raised to 20 or 30 percent. At the 2005 AFMM+3 meeting the limit was raised to 20 percent. However, the CMI members realize that multilateralization together with the increase in the drawing limit more than 20 percent of the CMI would not be possible unless a more effective surveillance system is established. Creating a surveillance mechanism for the CMI has been a controversial issue, and the working group has not been able to produce a surveillance system acceptable to all of the members. The ASEAN+3 finance ministers reaffirmed the need to enhance the ASEAN+3 economic surveillance and integrate it into the CMI, but were not able to make any decision as to the structure, role and the location of a surveillance unit.

If the CMI members were to agree on the multilateralization and creation of a regional surveillance unit, then their agreement would amount to establishing an institution similar to a regional monetary fund. The ASEAN+3 members may find it premature to set up such an institution, but they do need an institution that can manage and set terms and conditions of bilateral swap transactions and perform secretariat functions for policy dialogues and coordination among the members. There have been several proposals for organizing an ASEAN+3 secretariat, but none has been seriously considered because the member countries have been divided on the structure and location of the secretariat.

There are two other remaining issues concerning the enhancement of the CMI as a regional financial institution. One involves the enlargement of the CMI membership. Several non-member Asian countries including India have expressed their interest in joining the CMI. At present, the consensus view is that until some of the operational issues of the CMI are settled the enlargement should be held over for the time being. Only the inclusion of some of the less developed ASEAN members in the CMI is likely to be raised at the future meetings of the ASEAN+3.

Another issue is coordination of exchange rate policy among the

members of ASEAN+3. With the growing need to stabilize bilateral exchange rates among the ASEAN+3 states, proposals have been made to strengthen the CMI network so that it could serve as an institutional base for monetary integration in East Asia in the future. Although a formal discussion of monetary integration has been put on hold, China's shift to an intermediate regime from the dollar pegging is likely to renew the debate on the need as well as modality of coordination of exchange rate policy in the region.

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# VII. The Asian Bond Market Initiative (ABMI)

## 1. Objectives and Structure

Since the 1997-98 East Asian crises, many countries in the region have given priority of domestic financial reform to developing domestic capital markets in order to compliment the bank-based financial systems in the region. Underdevelopment of domestic bond markets and the absence of efficient regional bond markets are often argued to have exacerbated capital outflows in East Asia during the crisis, thereby multiplying the loss of output and employment. Since the crisis it has been pointed out that the absence of regional bond markets has in part been responsible for the massive increase in the region's overseas portfolio investment. (See Table VII-1)

While there is a clear need to develop domestic bond markets in many East Asian countries, smaller economies may not be able to support efficient domestic capital markets that are broad and deep in terms of the variety of financial instruments, issuers and investors. Even to larger economies, the costs of constructing market-supporting infrastructure could be so high that they may stay with the banking system rather than developing bond and stock markets. To overcome these efficiency and cost problems of domestic capital markets, repeated calls have been made for East Asian countries to join forces to develop larger and more efficient regional capital markets.

At the informal AFDM+3 meeting in Tokyo in November 2002, Korea proposed a study on the feasibility of creating new and improving existing Asian bond markets under the ASEAN+3 framework. This proposal received broad support among the thirteen members, and a month later, Japan introduced a plan for the development of regional bond markets in Asia, and the Asian Bond Market Initiative (ABMI) was born. The member countries agreed at the AFDM+3 meeting to organize six working groups on a voluntary basis to conduct detailed studies on the construction of market infrastructure and creating new debt

instruments including bonds denominated in local currencies.

<Table VII-1> Net Overseas Portfolio Investments of Asian Economies<sup>1)</sup>

	Net Portfolio Investments of Private Sector (A)			Net Portfolio Investments of Public Sector* (B)			Total (A+B)		
	1998	2002	2003	1998	2002	2003	1998	2002	2003
USD billions									
China	3.7	10.3	-11.4	6.2	75.2	117.0	9.9	85.5	105.6
Hong Kong	-22.1	38.8	30.5	-6.8	-2.4	1.0	-28.9	36.4	31.5
Indonesia	1.9	-1.2	-2.3	2.1	4.0	3.7	4.0	2.8	1.4
Korea	1.2	0.1	-10.7	31.0	11.8	25.8	32.2	11.9	15.1
Malaysia	n.a.	1.4	-1.1	10.0	3.7	10.3	10.0	5.1	9.2
Philippines	0.9	-1.9	0.7	1.9	-0.4	0.1	2.8	-2.3	0.8
Singapore	9.4	12.6	10.9	3.0	1.3	6.8	12.4	13.9	17.7
Thailand	-0.4	1.6	0.6	1.4	4.2	0.1	1.0	5.8	0.7
TOTAL	-5.4	61.7	17.2	48.8	97.4	164.8	43.4	159.1	182
Japan	39.2	106.0	98.7	-6.2	46.1	189.4	33.0	152.1	288.1
Taiwan	2.4	9.1	5.9	4.8	33.7	37.1	7.2	42.8	43.0

Note: 1) This Table was prepared by Julia Leung. See Park, Park, *et al.* (2004).

\* Reflected by increase in reserves

Source: IFS

A progress report of the six ABMI working groups was presented to the Istanbul meeting of the AFMM+3 in May 2005. (ASEAN+3, 2005) The report shows that the working groups have not made any substantial progress in advancing the ABMI. The best the ASEAN+3 finance ministers could do was to introduce a roadmap that will guide gathering and sharing information on bond market developments among the

member economies. They also managed to launch new studies on Asian Bond Standard, which will identify necessary market infrastructure and introduce market procedures comparable to those of global bond markets, and the possible issuance of Asian currency basket bonds. Few of substantial issues such as the deregulation of cross border transactions in financial instruments in the region were on the agenda of the 2005 AFMM+3 meeting.

While the ASEAN+3 has been primarily engaged in constructing regional infrastructure for Asian bond markets and harmonizing various financial standards, regulatory systems, and tax treatments throughout the region, another regional institution has taken initiative in establishing Asian bond funds that will invest in bonds issued by Asian governments and corporations. The eleven central banks of East Asia and Pacific belonging to EMEAP (Executive Meetings of East Asia and Pacific Central Banks) have launched Asian Bond Fund (ABF) I and II.<sup>17</sup> ABF I invest only in dollar denominated Asian sovereign bonds whereas ABF II is structured to invest in local currency denominated Asian bonds.

The establishment of ABF I was announced in June 2003. All eleven EMEAP central banks invested in ABF I at its launch, which had a capitalization of about USD 1 billion. The initial subscription has been fully invested in US dollar-denominated bonds issued by sovereign and quasi-sovereign issuers in eight EMEAP economies (China, Hong Kong, Indonesia, Korea, the Philippines, Malaysia, Singapore and Thailand).

Building on the momentum of developing ABF I, EMEAP has also launched ABF II. ABF II consists of two components: a Pan-Asian Bond Index Fund (PAIF) and a Fund of Bond Funds (FoBF)<sup>18</sup>. The PAIF is a single bond index fund invested in local currency denominated bonds in EMEAP economies. The FoBF is a parent fund investing in a number of

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17) They are Korea, China, Japan, Hong Kong, Singapore, Thailand, Malaysia, the Philippines, Indonesia, Australia, and New Zealand.

18) The PAIF is a single bond index fund investing in local-currency denominated bonds in EMEAP economies. It will act as an investment fund and new asset class for regional and international investors who wish to have a well-diversified exposure to bond markets in Asia.

The FoBF is a two-tier structure with a parent fund investing in a number of country sub-funds comprising local currency denominated bonds issued in the respective EMEAP economies. While the parent fund is confined to EMEAP investment, the country sub-funds are intend

country sub-funds, which in turn investing in local currency bonds issued in EMEAP economies, ABF II was launched on December 16 2004 and will invest in sovereign and quasi sovereign bonds denominated in local currencies. The total amount of EMEAP investment is expected to be around \$2 billion, 50 percent of which will be allocated to the PAIF and the FoBF each. The ABF II funds are intended to passively manage against a set of transparent and pre-determined benchmark indices, covering local-currency bonds issued by sovereign and quasi-sovereign issuers in EMEAP economies.

In view of its small size, market participants believe that ABF I may have had little effect on the market for East Asian sovereign dollar bonds. If anything, the Fund's investment may have crowded out private investors. Creation of Asian Bond Fund II has been more controversial as there is no shortage of the demand for high quality Asian bonds denominated in Asian currencies. Managers of the FoBF will certainly not touch Asian local currency bonds that private and institutional investors would not invest in. ABF II may then end up competing for a limited supply of high quality Asian bonds; in particular when the spreads on them are as tight as they have been.

There are also two other concerns on the viability of ABF II. One is that since ABF II is likely to invest in East Asian sovereign bonds denominated in local currencies, it may serve as a mutual scheme of financing fiscal deficits among the countries belonging to EMEAP. In such a case, the investment policy of ABF II cannot solely be dictated by profit motives alone, even though a private institution manages the Fund. The second concern is the possible signaling problem. If ABF II is of considerable size, then it is also possible to imagine that its investment operations could affect the foreign exchange and interest rate policies of the EMEAP member countries whose bonds are purchased or sold by the Fund. Even if the amount of a sale or purchase is relatively small, the Fund's operations may send the wrong signals to the financial markets against the wishes of the EMEAP central banks. This signaling problem is likely to remain even if a private institution manages the Fund insofar as EMEAP central banks have a controlling stake in it. Despite these concerns, the EMEAP member central banks could contribute to the development of Asian bond markets, if they were to use the ABF II leverage to strengthen the regional financial infrastructure and to remove institutional constraints on the supply of high-grade

Asian corporate and sovereign bonds.

## 2. Rationale and Need

While many proposals have been made for the development of Asian bond markets, the advocates of the ABMI have failed to answer several fundamental questions on the need and rationale for the creation of Asian bond markets. One such question is why the existing regional capital markets have not been able to serve as alternative sources of financing to local or global bond markets in East Asia. In particular, Tokyo was, and perhaps still is, a logical place to host a regional center for bond listing and trading, but it has yet to develop a regional bond market that can compete against the Euro or Yankee bond market.

Another question is the structure of the proposed Asian bond markets; that is, whether they are going to be distinct from the domestic bond markets, on the one hand, and global bond markets, on the other. If financial globalization proceeds as fast as it has in the past, domestic as well as regional markets will eventually have to be integrated into the global bond markets. This being the case, East Asian economies may be better off by integrating their domestic bond markets with the global markets rather than investing in the creation of regional bond markets. To many smaller East Asian countries, it is true that global integration may be neither practical nor feasible. But then there is no assurance that these countries will find it easier to integrate with the proposed regional bond markets, which may or may not be building blocks for a truly integrated global financial system.

A third question is related to the prospects of financial reform in East Asia. There is general consensus that the developing deep and liquid regional bond markets should begin with removing the bewildering array of controls of domestic capital markets and of cross border investment. The ABMI proponents have not been able to articulate whether and how the ABMI would contribute to speeding up financial reform in many East Asian countries where there has been backsliding of the reform.

These questions show that the objectives of the initiative have not been clarified in drawing up the structure and characteristics of the proposed Asian bond markets. One of the most often heard objectives is that robust Asian bond markets will keep, at least in part, Asian savings

in Asia, instead of sending them to other countries, in particular the United States, to finance their current account deficits. Another one is that deep and liquid Asian bond markets will help East Asian economies defend themselves more effectively against future crises as they will be able to raise more funds in their own currencies in the regional bond markets, thereby avoiding the currency mismatch problem. A third is that the ABMI will exert peer pressure on and at the same time generate incentives to Asian countries to continue with their financial reform so that they can take advantage of regional bond markets from which they can secure long-term financing in local currency and where they can place their investments.

Of these objectives, the second one appears to be the least important. Because there is no theory or evidence that suggests that competitive regional bond markets can reduce susceptibility to financial crises. As for the first objective it is difficult to argue that holding most of official reserves in East Asia in terms of short-term securities of the developed economies is both a consequence and, to a lesser degree, a cause of the underdevelopment of the Asian bond markets. It is incorrect to argue that East Asian economies as a whole invest less than they save because of the absence or the inefficiency of existing regional or domestic bond markets. Before the 1997 crisis, when they had smaller and less liquid regional bond markets, East Asian economies invested much more than they have since the crisis. If East Asian countries unloaded a substantial portion of their holdings of US dollar reserves to finance domestic investment, such an operation would strengthen the values of East Asian currencies vis-à-vis the U.S. dollar. When the effects of the currency appreciation are taken into account, it is not clear whether the purchase of Asian bonds instead of US Treasury securities will lead to more investment in East Asia than before.

In view of the preceding analysis, it would be reasonable to argue that the most important objective of the ABMI is to build regional bond markets that are complementary to global bond markets for more efficient allocation of resources in and diversification of bank-based financial systems of the region. And the most realistic road map for the development of Asian bond markets is to begin with deregulating and opening the domestic financial systems so that more investment grade local currency bonds can be issued, domestic investors are allowed to invest in foreign bonds, and foreign borrowers to issue bonds

denominated in different currencies in East Asia's domestic bond markets. This market liberalization and opening would facilitate cross-border investment in bonds in Asia, which would in turn naturally form integrated Asian bond markets. In this evolutionary process, those countries with well-developed financial infrastructure and few financial restrictions will then emerge as regional trading centers of Asian bonds.

Market liberalization and opening will not, however, be sufficient to expand cross-border investment unless a regional financial infrastructure that includes a regional system of clearing and settlement, regional credit guarantee institutions, hedging facilities, and regional credit rating agencies is also constructed. In addition to the infrastructure construction, East Asian countries should also be able to join forces to harmonize their legal and regulatory systems, domestic clearing and settlement systems, market practices, and withholding taxes on bond coupon payments. However, the prospects for close cooperation among ASEAN+3 members are not promising at this stage. Many of the smaller member countries have been indifferent to the promotion of the ABMI; to these countries, the benefits from efficient regional bond markets are rather abstract. And it is not clear which country or a group of countries has the moral authority, influence, and money to lead the region-wide financial reform and the construction of the regional financial infrastructure in East Asia.

In developing strategies for the regional capital markets, East Asian countries could take either a market-led or government-led approach. A government-led approach requires active participation on the part of East Asian governments not only in building the market supporting infrastructure, but also in offering a wide range of capital market instruments tailored to preferences of a wide range of investors through, for example, schemes of guaranteeing the principle and interest payments on private bonds, securitizing bank loans, and credit enhancement.

The market-led or evolutionary approach relies more on competition among the countries attempting to transform their domestic capital markets into regional ones. In view of the lack of leadership, a high cost of constructing the financial infrastructure and differences in interest among ASEAN+3 members, the market-oriented approach may be a preferable strategy. It is preferable because the thirteen countries may find it difficult to reconcile different interests of different members of ASEAN+3 in developing Asian regional bond markets. Even if they can

reach agreement, the chosen strategy may not see daylight as long as some of the ASEAN+3 states are locked in competition to develop their domestic capital markets into regional financial centers. This inter-country rivalry is one reason -perhaps the most important one- why a market-oriented approach would be more realistic than the government-led one. If the market-oriented strategy were pursued, the most efficient domestic capital markets in East Asia would emerge as dominant regional capital markets. In this approach, the primary responsibility of the East Asian governments is to develop financial, legal, and regulatory infrastructures at the regional level to ensure the efficiency and stability of the regional capital markets.

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## VIII. Exchange Rate Policy Coordination for Monetary Unification

Assuming that East Asian countries are committed to creating a currency union as a long-run objective, they will have to lay out a plan for building requisite institutions, developing procedures for policy coordination and surveillance, and management of liquidity support over periods of time divided into several stages before actually adopting a common currency. The plan will also include the choice of a common currency and a collective exchange rate regime during the transition period that could facilitate monetary integration in the region. For a common currency, they have two alternative choices: they could use one of the currencies of large countries such as the dollar, euro, and yen; instead create their own currency as the EU.

As the European experience suggests, monetary integration is essentially a political process. Whatever the economic merits of using another currency as region's monetary anchor, few countries, in particular Japan and China, will be able to accept the US dollar as their currency. If joining the dollar bloc or for that matter any other currency bloc, is not a realistic option, then East Asia may emulate the European experience of creating a regional common currency. During the preparation period for introducing a common currency, likely to stretch over many years, East Asian planners may begin implementation of their plan by searching for a region-wide collective exchange rate system that could facilitate and speed up monetary integration in the region.

Given the wide divergence of political interests among China, Japan, South Korea, and ASEAN, any unforeseen developments such as territorial and trade disputes could easily derail the integration movement in East Asia. Differences in the stages of development and the degree of trade and financial market liberalization, not to mention the diversity of exchange rate regimes in the region, suggest that it would be almost unthinkable at this stage that ASEAN+3 would be able to negotiate a collective exchange rate regime acceptable to all members.

Monetary integration in East Asia is expected to be an evolutionary

process, beginning with a system of policy dialogues and review, while maintaining a variety of exchange rate systems in the region and then gradually moving into deeper stages of integration. Overtime, the non-binding policy reviews and dialogues could develop trust and help establish working relationships for policy coordination and financial support among CMI members, eventually creating a political and economic environment conducive to introducing a collective exchange rate system. After five years of discussion and negotiation on financial cooperation, CMI members may believe that the time has come for them begin their search for a common exchange rate system for the region, as a transitional system before making the ultimate leap to a common currency.

As far as collective exchange rate systems are concerned, there appear to be three alternative mechanisms East Asia could consider for adoption. East Asian countries could replicate the European experience by introducing an East Asian version of the EMS that includes Japan as a member. Another alternative is pegging to a variety of baskets of currencies. If neither alternative is practical, then they may choose to move to free floating, although this option appears to be highly unlikely.

### **1. East Asian Monetary System (EAMS)**

An East Asian exchange rate mechanism (ERM) may appeal to many policymakers in the region simply because they could be guided by the evolution and management of the EMS in taking the steps to replicate the ERM in East Asia. The ERM in Europe was a transitional arrangement that eventually led to the advent of the euro.

However, few people would be prepared to recommend institutionalization of a similar system for East Asia at this stage of the region's economic integration. Although many of the East Asian countries intervene in their foreign exchange markets, they are at least officially classified as floaters. Moving from quasi floating (or managed floating) to a system in which bilateral exchange rates among member countries are tightly fixed as in the ERM is not a system that many East Asian countries can manage easily or prepared to accept. In order to support the East Asia Monetary system, countries in the region need to agree on a new monetary unit similar to the ECU whose value will be tied to a basket of specified amounts of East Asian currencies. They will

also have to establish a multilateral grid of the ERM and an East Asian version of the European Monetary Cooperation Fund. There is also the problem of including the yen in the system. Because of the super economy status of Japan, the yen is likely to emerge as the dominant currency in the EAMS as the German mark did in the EMS. The dominant status of Japan may mean the creation of a de facto to yen bloc in East Asia, as other East Asian countries, would have to fix their currencies to the yen.

The EMS was sustainable in part because it was embedded with unlimited financial support along with capital controls in the weak currency countries (Wyplosz 2002). In contrast, the limited amount of financing available through the CMI-Bilateral Swap Arrangements (BSA) is so small that it can hardly send a clear message to the market that any speculative attempt at any one currency from the others in the region is going to fail because there is no collective commitment to provide unlimited support in fending off the speculation monetary unification is essentially a political process, and there is no leadership needed to persuade East Asian economies to give up a pact on their policy autonomy.

## 2. Pegging to Currency Baskets

If an East Asian version of the ERM is not a practical solution to East Asia's exchange rate policy coordination, then would be pegging to currency baskets be a credible as well as realistic alternative?

There are three versions of basket pegging that may serve as an exchange rate regime appropriate to a group of East Asian countries. One version, which is classified as a *soft basket* pegging is a collective system in which East Asian countries agree to a managed float tied to currency baskets consisting of the US dollar, euro, yen, and other currencies and loosely stabilize their exchange rates vis-à-vis such baskets, that is, stabilizing their nominal effective exchange rates. The currencies included and their relative weights in these baskets would vary from country to country. Now that both China and Malaysia have shifted to a basket peg, soft pegging is currently the prevailing exchange rate regime in East Asia.

The second version is the common basket pegging, advocated by Williamson (2005). In this version, the basket of the dollar, euro and yen

is chosen as a common peg with almost equal weight. In this scheme, the participating countries essentially use the basket of the three currencies as a common unit of account in their conduct of exchange rate policy. Williamson argues that the nine East Asian countries he examines have reached the stage where they could benefit from the adoption of a common basket peg, because they are close competitors in world markets and their geographic distribution of trade is similar.

The third version - a regional basket pegging - is one in which each of the East Asian countries pegs to a basket that includes other East Asian currencies with their weights based on intra-regional trade relations. As will be discussed below, the regional basket pegging may require the creation of a regional unit of account such as the Asian Currency Unit (ACU) similar to the ECU.

Targeting the nominal effective exchange rate (NEER) in either the soft or common regional basket pegging, means adopting the exchange rate as a nominal anchor. Hernandez and Montiel (2001) argue that some of the East Asian crisis countries may have legitimate reasons for choosing the NEER as the appropriate variable. One reason for this is related to the declining role of the US dollar in East Asia and its instability vis-à-vis other major currencies. Another is the desire to prevent exchange rate overvaluation or undervaluation that could result from tight pegging to the US dollar.

### **3. The Asian Currency Unit (ACU): What is it and what will it do?**

A number of Japanese economists, among them Mori, Kinukawa, Nukaya and Hashimoto (2002), and Ogawa(2006) have recently proposed a plan for the creation of an East Asian unit of account, known as the Asian Currency Unit (ACU). Although the ADB has been the most vocal advocate of the ACU, it has yet to define the structure or clarify the role of the ACU in monetary cooperation and integration in East Asia. If it is to be an Asian version of the European Currency Unit (ECU), the ACU would be a numeraire, defined as a basket of East Asian currencies that will presumably be weighted by their relative importance in the region in terms of GDP, trade volume, population, and the degree of capital account liberalization of participating countries. It could be used as an accounting unit of an East Asian collective exchange rate system as the ECU was for the Exchange Rate Mechanism (ERM). If some, not

necessarily all East Asian countries wish to create a parallel currency as suggested by Eichengreen (2005), then its value could be defined by the ACU. In due course, it is expected that the structural features and objectives of creating a regional unit of account will be clarified, but its creation will be a different matter.

If the ACU is promoted as part of a regional arrangement for macroeconomic policy cooperation, its creation would symbolically reaffirm East Asia's continuing interest in pursuing monetary and exchange rate policy cooperation and monetary integration in the long-run. It would be an important initiative even though the ACU itself would not serve as a mechanism for stabilizing the bilateral exchange rates of East Asian currencies. However, a successful launch of the ACU must be preceded by both an understanding and agreement among prospective participants on the nature and modality of the proposed policy cooperation. Otherwise, the ACU will serve no particular purpose other than reminding East Asian countries of the need to sustain the region's efforts at promoting economic integration.

### *1) How to calculate the ACU or AMU*

Ogawa(2006) proposes the creation of an Asian Monetary Unit (AMU) and AMU Deviation Indicators for East Asian currencies. He claims that they will help coordinate the exchange rate policies of East Asian countries and ultimately enhance the monetary authorities' surveillance capabilities. The AMU is defined as the weighted average of ASEAN10+3 currencies using the same method of calculating the European Currency Unit (ECU). The AMU Deviation Indicators for each East Asian currency measure the degree of deviation from the Benchmark Rate for each of the East Asian currencies in terms of the AMU.

The weight of each currency in the AMU basket is calculated according to the country's shares of the thirteen countries' total GDP measured at Purchasing Power Parity (PPP) and total trade volume (the sum of exports and imports). In order to reflect the most recent trade relationships and economic trends, Ogawa uses the average for the most recent three years for which data is available is used.

The value of the AMU is quoted in terms of a weighted average of the US dollar and the euro as both the United States and the EU are important trading partners for East Asia. The weighted average of the US dollar and the euro is based on the volume of trade of ASEAN10+3

with the United States and the euro area. The weights on the US dollar and the euro are set at 65% and 35%, respectively. The benchmark period of AMU Deviation Indicators is the period when the total trade balance of member countries excluding Japan, the total trade balance of member countries including Japan, and the total trade balance of member countries with the rest of the world are relatively close to zero.

$$\begin{aligned}
 \text{US\$ / euro / AMU} = & 0.0069 \text{US\$ / euro / BNS} + 7.4235 \text{US\$ / euro / CBR} + 2.7711 \text{US\$ / euro / CNY} \\
 & + 452.7871 \text{US\$ / euro / IDR} + 30.5681 \text{US\$ / euro / JPY} + 113.1459 \text{US\$ / euro / KRW} \\
 & + 5.9500 \text{US\$ / euro / LOK} + 0.1953 \text{US\$ / euro / MLR} + 0.0239 \text{US\$ / euro / MYK} \\
 & + 1.3347 \text{US\$ / euro / PLP} + 0.1075 \text{US\$ / euro / SPS} + 2.0630 \text{US\$ / euro / TLB} \\
 & + 243.0432 \text{US\$ / euro / VTD}
 \end{aligned}$$

### *2) Advantages of the ACU: Are They Real?*

In a recent speech, Kuroda (2006) articulates some of the advantages of creating the ACU. One advantage is that the unit would first support and facilitate regional monetary and exchange rate policy coordination, and subsequently assist in achieving regional trade and investment integration and financial stability in East Asia. In Kuroda's view, the shift of both China and Malaysia to an intermediate exchange rate regime last July in which their currencies were linked to a basket of currencies of their major trading partners is a tentative step in this direction. Such a step, he claims, can be reinforced by taking bolder coordinated steps to increase the flexibility of East Asian currencies vis-à-vis the US dollar and to sustain stability of intra-regional exchange rates.

Another advantage is that the ACU can assist Asian monetary authorities in formulating their exchange rate policies by serving as an indicator monitoring both the collective movement of Asian currencies against the US dollar and the euro, and the individual movements of each Asian currency against the accounting unit. A third advantage is that the ACU will help develop a regional market for bonds denominated in the ACU. This note will show that these advantages are either overstated or misrepresented.

### 3) *The ECU and EMS*

Before examining these alleged advantages, it would be instructive to learn more about the evolution of the ECU, an artificial currency basket created on March 13, 1979 by EC members to be used as the internal accounting unit of the European Monetary System. The ECU was no more than a symbolic creation as it was explicitly designed not to be a currency: central banks did not carry out transactions in ECUs (Baldwin and Wyplosz 2004). Private markets adopted the ECU and began issuing debt instruments using this unit, but Dammers and McCauley (2006) show that these instruments owed their limited success in the 1980s and 1990s to restrictions on the internationalization of the Deutsche Mark and speculative investments.

The table below shows the composition of the initial ECU basket:

**<Table VIII-1> Amounts and Weightings of ECU Currencies**

	13 Mar 1979	17 Sep 1984	21 Sep 1989	13 Mar 1979	17 Sep 1984	21 Sep 1989
Belgian Franc	3.80	3.85	3.301	9.64	8.57	8.183
German Mark	0.828	0.719	0.6242	32.98	32.08	31.915
Danish Krone	0.217	0.219	0.1976	3.06	2.69	2.653
Spanish Peseta			6.885			4.138
French Franc	1.15	1.31	1.332	19.83	19.06	20.306
British Pound	0.0885	0.0878	0.08784	13.34	14.98	12.452
Greek Drachma		1.15	1.44		1.31	0.437
Irish Punt	0.00759	0.00871	0.008552	1.15	1.20	1.086
Italian Lira	109	140	151.8	9.49	9.98	7.840
Dutch Guilder	0.286	0.256	0.2198	10.51	10.13	9.87
Portuguese Escudo			1.393			0.695

Note: The ECU basket values for Belgium and Luxembourg are combined and shown only as Belgium until 1989 because the two countries were in a currency union. Weights are evaluated at central parities on March 13, 1979 and September 17, 1984.

Although the composition values of the participating currencies were fixed, the weights were adjusted every five years. In order to calculate ACU exchange rates against external currencies, each of the amounts of the national currencies in the baskets are divided by their exchange rates vis-à-vis an external target currency such as the US dollar. These numbers are then added to obtain the US dollar exchange rate of the ECU.

The EMS was a system of fixed but adjustable exchange rates that defined bands in which the bilateral exchange rates of the member countries could fluctuate. A set of adjustable bilateral *central parities* and a range of permissible fluctuations defined the fluctuation bands. This set of parities was called a *parity grid* which tabulated all pair wise central parities and their associated fluctuation margins which were set by the *upper intervention point* and *lower intervention point*. In general, the bands were 2.25% on each side of the central parity, with a wider margin for the Italian Lira. Following the currency crisis of August 1993, the bands were widened to 15% on each side, but in practice the fluctuations were kept within a narrow band. When a bilateral market exchange rate reached either of these intervention points, the associated central banks were obliged to intervene to keep it within its margin through open market operations by purchasing the weakening currency or selling the appreciating currency.

As seen from the management of the EMS, the ECU played no particular role in stabilizing the bilateral exchange rates of the ECU constituent currencies, although it was one of four elements of the EMS in addition to the grid, mutual support, and a commitment to joint decision of realignments (Baldwin and Wyplosz 2004 chapter 12). Initially, the ECU was expected to impose a symmetric burden on both weak and strong currencies to intervene. In reality, market interventions were made by the weak currencies well before the limits of the system were reached so that the burden was largely asymmetrical. The ECU was a political gesture towards monetary union. The unit of account was symbolic, just as the SDR is a symbol for a future world currency or a tribute to Keynes' failed Bancor proposal. This is why all European governments made sure that it would not be a currency: they were not prepared to make the move to monetary integration when it was created in 1979.

When monetary union was eventually decided, France proposed the currency be named Ecu, the name of an ancient French coin. Germany,

which had always written E.C.U., vetoed this proposal. In the end, a compromise proposal by the Dutch to name the new currency "Euro" was accepted. The only real lasting effect of the ECU is that when the euro became the European Monetary Union's new unit of account, its conversion rate was €1 = ECU 1, an obscure stipulation of the Maastricht Treaty\* (the author owes this point to Charles Wyplosz).

#### 4) *The ACU: For Whom?*

As a regional development bank, the ADB may have an interest in supporting trade integration, closer policy cooperation, and financial stability in East Asia. It certainly has the right to recommend that East Asian countries develop a regional accounting unit such as the ACU to enhance and expand the role of existing regional cooperative arrangements such as the Chiang Mai Initiative (CMI). However, it does not have the mandate to create one on its own initiative independently of economies whose currencies will be included in the ACU. At this stage of the debate, very little is known about the Asian currencies to be included in the ACU, although the members of ASEAN+3 constitute a realistic group of candidates.

Selecting a set of criteria to determine the weightings would prove difficult given the necessity for political decisions to be made among sovereign nations. Aside from such economic and political issues, the ADB is overlooking the fact that the ACU has to be part of a collective regional exchange rate mechanism designed to stabilize bilateral exchange rates of the participating currencies, as the ECU was for Europe. Given that there is no emerging consensus on the regional exchange rate mechanism, one must question the rationale of the ACU. It is not altogether clear whether ASEAN+3 are interested in forming a regional arrangement for intra-group exchange rate stability. Even if they are, technical details such as the currency weightings must be determined through negotiations among the participating countries and not by outside institutions.

#### 5) *Can the ACU Assist in formulating Monetary and Exchange Rate Policy?*

Kuroda points out that the regime shift in both China and Malaysia to a basket pegging heralds a tentative step to further monetary and exchange rate policy coordination in East Asia and that the creation of

the ACU would broaden the scope of and strengthen this cooperative process. As will be shown below, however, this is not necessarily the case. The significance of China's move to an intermediate regime is that it has underscored the need for the coordination of exchange rate policy as most ASEAN+3 emerging economies have adopted basket pegging and as a result, have revived East Asia's interest in strengthening cooperative efforts for financial and monetary cooperation and in furthering monetary integration in the long run.

As Kawai (2002) notes, South Korea and Thailand have shifted to a de facto currency basket arrangement similar to Singapore's managed floating since the 1997-98 crisis. Malaysia has also adopted a basket arrangement. The behavior of both the nominal and real effective exchange rates of Indonesia and the Philippines indicate that their currencies are linked to a basket of major currencies. Excluding the yen, which will remain an independently floating major currency, this means that practically all seven emerging economies in East Asia - the original ASEAN 5, China, and South Korea - now have a similar exchange rate policy goal of stabilizing either a nominal or real effective exchange rate.

Policy authorities in the seven emerging East Asian economies are expected to adjust their dollar exchange rates with changes in the bilateral exchange rates of currencies in their baskets including the dollar, euro, and yen, to keep their nominal or real effective exchange rates stable. Consequently, they will be closely monitoring changes in the dollar exchange rates of other members to make sure there is no erosion in their export competitiveness. Growing trade with China, before its regime shift, had increased the share of the renminbi in their baskets to such an extent that changes in the dollar-euro or dollar-yen exchange rates did not leave much room for adjusting their dollar exchange rates in line with their policy objectives. If China were to adjust its dollar exchange rate in the event of changes in the dollar-euro or dollar-yen exchange rates, a depreciation of the dollar against the yen or euro would not necessarily increase the competitiveness of Chinese exports as in the past. At this stage, however, it remains unclear whether Chinese authorities are considering stabilizing either a nominal or real effective exchange rate.

Among seven of the thirteen members of ASEAN+3, if any economy moves to weaken its currency vis-à-vis the dollar, such an intervention will set off a competitive devaluation in the region. These countries have

a common interest in creating a collective exchange rate regime to prevent such competitive skirmishes. With a new regime in place, and its growing economic influence, China will be placed in a position to initiate the discussion on the coordination of exchange rate policies among the seven countries. There are two possible frameworks the seven countries could consider for a collective exchange regime that would stabilize their bilateral exchange rates: an Asian version of the Exchange Rate Mechanism (ERM) and pegging to a common basket of external currencies.

According to Williamson (2005), the seven emerging economies will benefit more from adopting a common basket of external currencies including the dollar, the euro and the yen rather than the different baskets to which their currencies are linked. Common basket pegging would reduce the room for competitive devaluation for export promotion while simultaneously adjusting their dollar exchange rates among participating countries and improve the chance for cooperation on monetary integration in the long run. It is unlikely that the seven countries could agree on either arrangement in the near future. Even if an agreement is achieved, the unit of account in an Asian ERM will not include the yen because Japan will not be an ERM member. For the common basket pegging, the seven economies would not need an accounting unit.

Could these seven economies benefit from participating in an ACU that includes the Japanese yen in formulating their monetary and exchange rate policy as Kuroda argues? Financial markets would calculate the ACU exchange rates of the seven economies if they were included in the unit. Financial news services would post these rates along with other bilateral exchange rates. Policy authorities in these countries would also know the exchange rates of the ACU against the US dollar and euro. Under these circumstances, suppose a member country's currency depreciates against the ACU. What action would policymakers in this country take? To the extent that this economy links its currency to a basket of currencies of its major trading partners, it is likely to ignore the depreciation unless it brings about a similar depreciation of its nominal effective exchange rate, all the more so when there is no commitment of mutual liquidity support among ACU countries. If this country decides to intervene to prevent a further depreciation of its currency, it will have to decide on the intervention point.

As far as financial market participants are concerned, they will not

know whether the country in question suffers for a serious balance of payments problem or will intervene or not by simply observing changes in its ACU exchange rate. Depending on how the market perceives of these changes, the depreciation could provide an opportunity for currency traders to speculate on the country's currency. Given this danger, this country will be better off by not joining the ACU arrangement unless they are assured of liquidity support from the central banks of other ACU member countries

It is also true that traders in this country are likely to be left without a mechanism ascertaining the local currency value of trade contracts that mature in the future. In case the ACU is taken seriously, this country would need to create its own forward market. It may be costly if this country is a small economy (Williamson 2005).

Suppose this country intervenes to arrest a further depreciation of its ACU exchange rate. It will have to choose an intervention currency. If the Japanese yen is a constituent currency, it is most likely to be the intervention currency in view of Japan's importance in the region. This country will then have to hold a large amount of yen in its foreign exchange reserve in addition to US dollars, which may not be consistent with its reserve management objective.

Kuroda also suggests that the ACU would make it easier to engineer changes in East Asia's exchange rates across the board vis-à-vis the US dollar. Again, this contention is based on the assumption that Japan will be a member of the ACU and that ACU economies will have agreed on establishing a regional collective exchange rate arrangement. Even if an agreement is reached, it is unclear whether the ACU members will be capable of bringing about a uniform change in the exchange rates of the ACU economies against the US dollar and euro unless they are jointly floating against the external currencies, while the bilateral exchange rates of participating countries are fixed.

For the time being the seven emerging economies of East Asia will not deviate from their basket arrangements. It should be noted that creating the ACU and using currency baskets that include both external and internal currencies to peg the exchange rates of the region's currencies are two independent decisions, and the latter could be taken without the former and vice versa (Williamson 2005). The ACU may not contribute either to macroeconomic policy cooperation or monetary integration, but it can be a symbolic move on the part of ASEAN+3.

Would this not be in the interest of ASEAN+3? Not necessarily.

*6) The Japan Factor in Regional Monetary Cooperation and Integration in East Asia*

Japan has not indicated its official position on the creation of the ACU, although the idea came from Japan and the ADB, where it is the largest shareholder. In the event Japan participates in the ACU, as is likely, there is a high probability that the yen will dominate the ACU however the composition values and weightings of the constituent currencies are determined. Yet, Japan will not, and perhaps cannot, participate in any regional currency adjustment, at least for now simply because it will find it difficult to forgo its free-floating regime. According to Williamson (2005), Japan may not be prepared to “face the opprobrium that would result from breaking ranks” with its peers in the G7 by abandoning free-floating. If Japan cannot eschew free floating, it will not join any collective exchange rate arrangement among the seven countries and the yen will remain an independently floating external currency.

Indeed, if the yen were to be a constituent currency, there is no reason why the US dollar and euro should not be included in the ACU. The pitfalls of including the yen in the ACU while Japan does not participate in any regional arrangement for macroeconomic policy cooperation are easy to see. Unless upper and lower limits on the weights are imposed, the yen will become the dominant currency in the ACU with a possible weighting of larger than 50 percent depending on the weight indicators chosen. The imposition of the ceiling may be politically expedient, but may not make the ACU a reliable indicator worth monitoring because it does not reflect the reality.

If the yen were to keep its dominant position, a great deal of variations of the ACU with regard to the external currencies would result from changes in the yen-US dollar or the yen-euro exchange rates assuming other members follow the policies of stabilizing either a nominal or real effective exchange rate. Similarly, most changes in the exchange rates of the members other than Japan vis-à-vis the ACU will originate in their bilateral exchange rates vis-à-vis the yen. These members might question why a free floating currency like the yen, which will increase the variability of the ACU against the external currencies as well as that of their ACU exchange rates while remaining

outside of any regional collective exchange rate regime, should be included in the cooperative arrangement for exchange rate stability among themselves either in or out of the ACU. Japan will not make commitment to any East Asian exchange rate arrangement but make sure that if one occurs they will be included. Is this the motive behind Japan's interest in the ACU? Should Japan not declare its intention of first joining in a regional exchange rate arrangement before campaigning for the creation of the ACU?

### *7) ACU Bond Market*

Could the creation of the ACU generate incentives to issue Asian multi-currency bonds and facilitate a deepening of capital markets in East Asia? In a recent paper, Dammers and McCauley (2006) show that there are certain advantages of issuing basket bonds such as bonds denominated in the ACU. These multi-currency bonds allow the diversification of the constituent currencies, promising to be less volatile investments. They facilitate arbitrage of government regulations. For example, bonds denominated in the ECU owed much of their success in the 1980s and 1990s to the restriction on the use of the Deutsche Mark to denominate bonds to non-residents. The multi-currency bonds could also serve as a means for investors to speculate on currency stability to achieve excess returns over any single currency yields.

Against these advantages, there are several disadvantages related to the complexity and illiquidity of multi-currency bonds. Park and Park (2005) argue that the diversification benefits of multi-currency bonds are overstated. If the menu of Asian bonds differentiated in terms of the currency denomination and maturity expands, private as well as institutional investors will be able to diversify the currency risk by holding a portfolio of bonds denominated in many currencies. The EMEAP member central banks launched the Asian Bond Fund II, which is specialized in investing in local Asian currency bonds. Private bond funds similar to ABF II may also begin trading.

There is a strong demand for investment grade Asian bonds denominated either in US dollars or the local currency. Advocates of the multi-currency bonds should also take note that (i) an official basket solely defined for the purpose of issuing basket bonds may not induce widespread private use and that (ii) international institutions that sell basket bonds incur a cost of having to offer a higher yield to cover the

multi-currency exposure to attract arbitrageurs rather than natural buyers which may offset any policy benefits of basket issuance (Dammers and McCauley 2006, p. 90).

#### **4. China's New Exchange Rate Regime and Growing Need for Exchange Rate Policy Coordination**

China has revalued its currency- Renminbi-by 2 percent against the US dollar on July 21<sup>st</sup> in an effort to diffuse growing external pressure, including the threat of protectionism, for reducing its burgeoning current account surplus with the US and other countries that argue that the undervaluation is the source of competitiveness for Chinese exports. More importantly, it has decided to move to a managed float against a basket of major currencies and adjust the renminbi with changes in the bilateral exchange rates of currencies in the basket. Little is known, however, as to the currencies included in the basket or the size of the band within which the currency is allowed to change.

It remains to be seen whether Chinese authorities will manage the new exchange regime in a way that will strengthen the renminbi relative to other major currencies so as to restrain further increases in the current and capital account surpluses. Although the external pressure for additional revaluation has not subsided, it appears highly unlikely that China will accept the demand of 20 to 30 percent revaluation relative to the dollar the US administration and a number of American economists including Bergsten and Roubini. China's revaluation and regime change will not have any discernible effect on its growing trade surplus, nor will they discourage speculative capital inflows. Although China is likely to increase its holdings of other major currencies, such a shift, unless large, will not weaken the US dollar or raise US interest rate.

What is significant about China's move to an intermediate regime is that it will broaden the scope and underscore the need of coordination of exchange rate policy among some of the members of ASEAN+3 and revive East Asia's interest in strengthening the CMI for financial and monetary cooperation in the region.

As Kawai (2002) notes, South Korea and Thailand have shifted to a de facto currency basket arrangement similar to Singapore's managed floating since the crisis. Malaysia has also adopted a basket arrangement.

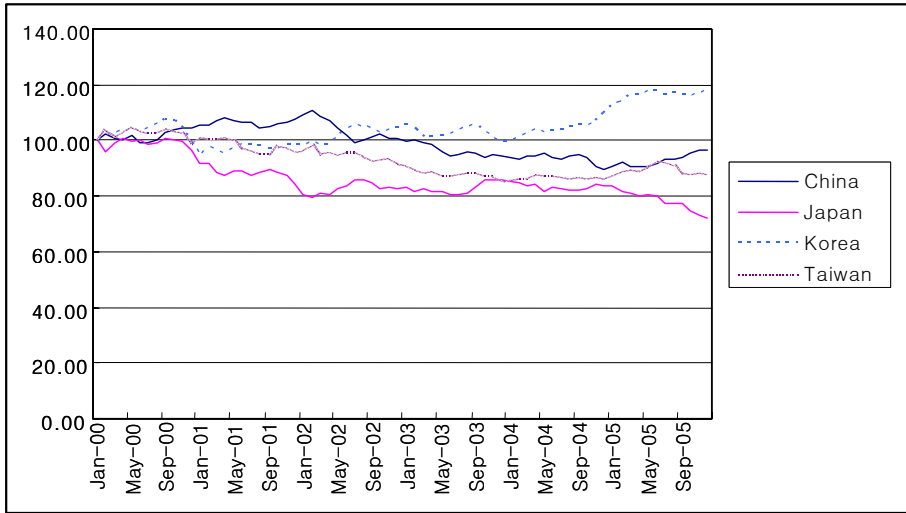
The behaviors of both nominal and real effective exchange rates of Indonesia and the Philippines (Figure VIII-1A and VIII-1B) also indicate that the currencies of the two economies are also linked to a basket of major currencies. Excluding the yen, which will remain an independently floating major currency; as noted earlier this means that practically all emerging economies in East Asia now have a similar exchange rate policy framework.

Since the policy authorities of these economies will be adjusting their dollar exchange rates with changes in the bilateral exchange rates of currencies in their baskets including the dollar, euro, and yen to keep their nominal or real effective exchange rates stable, the original ASEAN 5, China, and Korea will keep a close watch over changes in the dollar exchange rates of other members to make sure that their export competitiveness does not slip. Before the regime shift, growing trade with China had increased the share of the renminbi in their baskets so much that changes in the dollar-euro or dollar-yen exchange rates did not leave much room for adjusting their dollar exchange rates in line with their policy of stabilizing nominal or real effective exchange rates. Now that China is expected to adjust its dollar exchange rate whenever there are changes in the dollar-euro or dollar-yen exchange rates, depreciation of the dollar against the yen or the euro will not necessarily increase the competitiveness of Chinese exports as it did before.

Among the seven members of ASEAN+3 and Taiwan, if any economy moves to weaken its currency vis-à-vis the dollar, such an intervention will set off competitive devaluation in the region. To prevent such competitive skirmishes would be in the interest of the region. With a new regime in place, and its growing economic influence, China will be placed in a position to initiate the discussion of coordination of exchange rate policy.

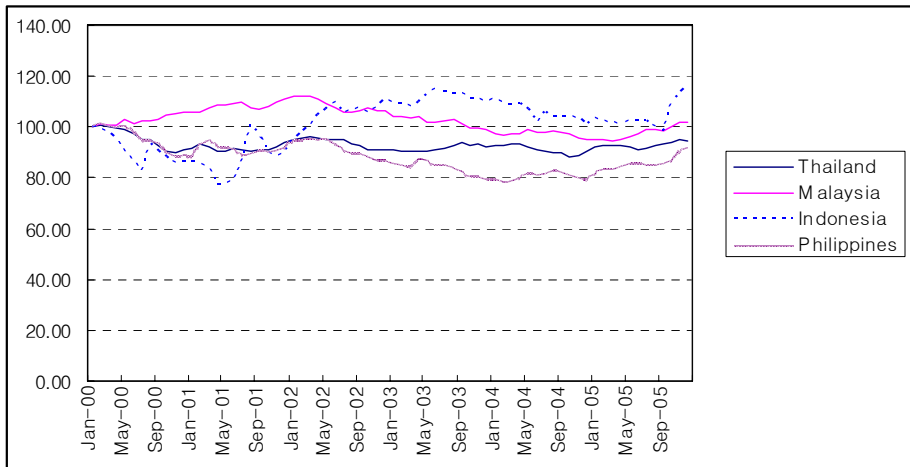
According to Williamson (2005), the seven countries will benefit more from adopting a common basket of external currencies including the dollar, the euro and the yen rather than the different baskets to which their exchange rates are linked. The common basket pegging reduces the room for competitive devaluation for export promotion among participating countries. And the common basket will certainly improve chances of obtaining cooperation for monetary integration in the long run. A third advantage is that the seven countries may find it easier to adjust their dollar exchange rates simultaneously.

**<Figure VIII-1A> Real Effective Exchange Rate**  
(January 2000=100)



Source: Bank for International Settlement

**<Figure VIII-1B> Real Effective Exchange Rate (ASEAN 4)**  
(January 2000=100)



Source: Bank for International Settlement

Another choice of the basket arrangement for the seven economies would be the adoption of a common basket of regional currencies, following in the footsteps of European monetary integration. Instead of creating a basket of outside currencies, each of the seven East Asian countries could agree to peg to different baskets of regional currencies based on its trade patterns.

In recent years a number of Japanese economists have proposed to create an East Asian version of the ECU, which is known as the Asian currency Unit (ACU). The ACU is a numeraire, which will be defined as a basket of East Asian currencies that will be weighted by their relative importance in the region. Given its large economic size, the Japanese yen will be a dominant currency in the basket. Some authors propose issuance of ACU denominated Asian bonds, but the objectives of creating a regional unit of account have not been made clear and there has been no serious discussion on whether the ACU will pave the way for or speed up monetary integration.

The ECU was a political gesture towards monetary union. The unit of account was symbolic, just as the SDR is a symbol for a future world currency or a tribute to Keynes' failed Bancor proposal. This is why all European governments made sure that it would play no role at all: they were not prepared to make the move. When the monetary union was decided, the French wanted the name to be Ecu, an old French currency. But the Germans vetoed it (they always had written E.C.U.). The only real lasting effect of the ECU is that when the euro became the new unit of account of the Commission, it had to be  $\text{€ } 1 = \text{ECU } \text{€}$ , an obscure stipulation of the Maastricht Treaty (the author owes this point to Charles Wyplosz).

Going one step further, East Asian countries could create the ACU as a parallel Asian currency, constructed as a weighted average of the currencies of the participating East Asian countries and allow it to circulate along with the existing national currencies. Few of the ASEAN+3 members including China will be prepared to take such a major step toward creating the ACU plus the regional basket pegging at this stage, because without Japan's participation the renminbi will occupy a dominant share in the ACU and all of the regional currency baskets adopted by the seven countries (see the trade weights in Table 6). From the point of view of other members, the ACU arrangement would be similar to pegging to the renminbi.

The yen could be included in the ACU and regional baskets in which case the ACU will be dominated by the yen, although Japan will not participate in any regional currency adjustment, at least for now. If Japan does not join any regional exchange rate arrangement, the ACU that includes the Yen will serve no other purpose than a wider use of the Yen as the transactions currency in East Asia. Japan will no make commitment to any East Asia's exchange rate arrangement but make sure that if one occurs they will be included. Is this the motive behind Japans' promotion of the ACU?

<Table VIII-2> Trade Weights of East Asian Economies\*

(Unit: Percentage)

China	2000	2001	2002	2003	2004
US	15.6	15.8	16.3	14.9	15.6
Japan	17.2	17.2	15.4	15.7	14.0
Korea	7.1	7.0	6.0	7.4	7.5
EU	14.3	15.0	15.1	14.7	15.3
ASEAN	12.8	12.8	11.4	14.3	13.7
Japan	2000	2001	2002	2003	2004
US	25.2	24.8	23.7	20.7	18.8
China	10.0	11.8	13.5	15.5	16.5
Korea	6.0	5.7	5.9	6.2	6.5
EU	14.6	14.5	13.9	14.2	14.4
ASEAN	14.9	14.4	14.2	14.0	13.8
Korea	2000	2001	2002	2003	2004
US	20.2	18.5	16.7	16.0	15.3
Japan	15.7	14.8	13.7	14.4	14.5
China	9.4	10.8	11.9	15.3	17.8
EU	11.8	11.9	12.2	11.9	12.2
ASEAN	11.5	11.1	10.2	10.4	10.0

VIII. Exchange Rate Policy Coordination for Monetary Unification 99

<Table VIII-2> Continued

Indonesia	2000	2001	2002	2003	2004
US	12.4	12.6	10.9	10.8	10.2
Japan	20.7	20.3	19.5	19.1	18.7
Korea	6.7	6.9	6.2	6.3	5.7
China	5.0	4.6	5.8	7.2	7.4
EU	13.4	13.5	12.8	12.3	12.2
ASEAN**	18.2	17.2	18.1	19.7	20.7
Malaysia	2000	2001	2002	2003	2004
US	18.8	18.4	18.2	17.8	16.9
Japan	16.7	16.1	13.8	13.6	12.8
Korea	3.8	3.7	4.0	4.0	4.2
China	3.5	4.7	6.2	7.5	8.1
EU	12.4	13.3	11.8	12.0	12.4
ASEAN**	25.4	24.0	23.1	24.6	24.7
Philippin	2000	2001	2002	2003	2004
US	24.5	23.6	20.3	19.9	16.0
Japan	16.7	17.9	18.1	18.2	17.8
Korea	5.4	4.8	5.7	5.0	4.7
China	2.0	2.7	3.6	5.3	9.4
EU	13.7	14.2	12.1	12.1	12.1
ASEAN**	15.6	15.5	15.7	17.6	18.2
Singapore	2000	2001	2002	2003	2004
US	16.2	15.9	14.3	14.2	12.9
Japan	12.3	10.7	9.3	9.2	9.0
Korea	3.6	3.6	3.6	4.0	4.2
China	4.6	5.3	6.0	7.8	9.2
EU	12.3	12.6	12.7	13.0	14.0
ASEAN**	26.1	26.0	24.7	24.7	23.7

&lt;Table VIII-2&gt; Continued

Thailand	2000	2001	2002	2003	2004
US	16.8	16.1	13.7	13.4	11.8
Japan	19.5	18.8	18.1	19.0	18.7
Korea	2.6	2.6	2.7	2.9	2.8
China	4.7	5.2	5.8	7.5	7.9
EU	13.1	14.2	13.0	12.4	12.3
ASEAN**	18.1	17.8	16.9	18.7	19.2

Notes: \* The volume of trade(exports + imports) with i th country as a percentage of total trade

\*\* Excluding the member under examination

Source: IMF, Direction of Trade Statistics (DOTS).

The common basket would therefore be more realistic option, but even this arrangement will have to clear many hurdles before any serious discussion can begin. All seven economies will manage their dollar exchange rates vis-à-vis the baskets of their choice for the foreseeable future. The region wide soft pegging may require closer policy dialogue to preventing competitive devaluation and resolving the imbalance problem. For first time since the inception of the CMI the seven ASEAN+3 members will be prevailed on coordinating their exchange rate policies. The CMI will then serve as a forum for the coordination, and how successful it is in this regard will determine the future of the CMI.

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# IX. Barriers to Financial Cooperation and Integration

## 1. Institutional Constraints

East Asian policymakers who conceived the idea of the CMI would easily concede that the BSA system as it is currently structured has a long way to go before it can be accepted as an effective mechanism of defense against financial crises. Although almost five years have passed since the system was established in May 2000, the leaders of the CMI group have yet to produce an operational structure for BSAs, in particular a monitoring and surveillance mechanism. And it is highly unlikely that they will do so anytime soon as they are subject to a number of institutional and political constraints on further expansion of the CMI.

The most serious constraint has been that the thirteen countries have failed to articulate the ultimate objectives of the CMI arrangement. The participating countries themselves are still unclear about whether the CMI is going to be fostered as a regional liquidity support program or as a building block for a full-fledged regional monetary system in East Asia. As noted in section IV, bilateral swap arrangements are activated collectively and supported by a surveillance system, and then they constitute a de facto regional monetary fund. The CMI could then be used as the base on which an elaborate system of financial cooperation and policy coordination is built by following in the footsteps of the European monetary integration.<sup>19)</sup> At this stage of development, many

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19) From the theoretical point of the neo-functionalists, initial steps toward integration trigger self-sustaining economic and political dynamics leading to further cooperation. Economic interactions create spillovers or externalities that need to be coordinated by governments involved. Such economic policy coordination at the regional level can be seen as an inevitable response to the increased economic interactions within the region. Once integration process starts, spillovers deepens and widens integration by working through interest group pressures, public opinion, elite socialization or other domestic actors and process (George 1985).

countries in East Asia are not prepared to accept the idea of or may feel uneasy about restructuring the CMI into a forerunner of the AMF.

A second institutional constraint is related to the need to coordinate the activities of the CMI with other regional arrangements such as the Manila framework supported by the U.S, Australia, and New Zealand. Most of the CMI countries also participate in the Manila framework and APEC. At some point in the future, the leaders of the ASEAN+3 countries may have to decide on the mode of cooperation and division of labor in promoting regional growth and stability between these institutions and the CMI. Many of the ASEAN+3 states have been engaged in policy reviews and dialogues through the various APEC meetings and the Manila framework. Unless the CMI is developed into a credible financing mechanism by increasing swap amounts, it will take on a role similar to other regional economic forums. The coherence of the group will then be weakened, as questions are raised as to whether the thirteen countries constitute an appropriate grouping for a regional financing arrangement in East Asia.

A third constraining factor is that as the fear of another round of financial crisis has receded with the recovery that has been faster than predicted on the basis of previous episodes of crises. With this false perception, the ASEAN+3 countries have become less interested in enlarging and institutionalizing the CMI operations. Instead, their focus has recently shifted to creating free trade areas in East Asia (See Table IX-1).<sup>20)</sup> The ASEAN free trade area (AFTA) now includes the whole of Southeast Asia. AFTA continues to expand. On November 29, 2004, China and the ASEAN countries agreed to form a free trade area by 2010, allowing for some preferential treatments for less developed ASEAN countries. Japan has concluded a free trade agreement with Singapore and started negotiations on a similar agreement with Korea, ASEAN, and several states of the ASEAN on the individual basis.

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20) Historically, there has been much less movement towards trade regionalism in East Asia than in Europe. East Asian countries are reliant on the US and European Union (EU) markets, so there has been less incentive for them to expand trade integration within the region. The first major attempt was made only in 1992, when six ASEAN countries agreed to launch a scheme for ASEAN free trade.

&lt;Table IX-1&gt; Free Trade Agreements in East Asia

	Year	Participants and Status
FTA in Force		
ASEAN Free Trade Area (AFTA)	1992	10 ASEAN members
Australia-New Zealand Closer Economic Relations Trade Agreement (CER)	1983	Australia, New Zealand
Singapore-New Zealand FTA	2001	Effective in January
Japan-Singapore Economic Partnership Agreement (JSEPA)	2002	Effective in November
Singapore-EFTA (European Free Trade Association) FTA	2002	Signed in June and effective in January 2003
Korea-Chile FTA	2003	Signed in February
Agreements Being Negotiated, Studies, or Considered		
East Asia Free Trade Area (EAFTA)	2000	
China-Japan-Korea FTA	2000	
ASEAN-China Free Trade Area (ACFTA)	2001	
Japan-ASEAN Closer Economic Partnership	2002	
ASEAN-India Regional Trade and Investment Agreement	2002	
Taiwan-Panama	2002	
Bilateral FTA Under Consideration		
ASEAN-US		
China		Hong Kong SAR, Australia, New Zealand
Japan		Malaysia, Mexico, Philippines, Korea, Thailand
Korea		Japan, Mexico, Thailand, ASEAN
Singapore		Australia, Canada, Mexico, United States, New Zealand, Bahrain, Egypt, India, Sri Lanka, Panama
Thailand		Australia, India, Japan

Source: Park, Urata, and Cheong 2005 and various other sources.

The free trade movement is undoubtedly a desirable development, and the CMI could facilitate further liberalization of trade by stabilizing bilateral exchange rates of regional currencies and minimizing the disruptive effects of financial market turbulence. This advantage suggests that the ASEAN+3 countries may have an incentive to broaden the scope of the CMI in parallel with negotiations on establishing free trade areas in the region. In reality, however, it appears that free trade discussions have rather distracted many East Asian countries from their CMI negotiations.

A region-wide East Asian FTA covering ASEAN+3 countries is slow to materialize because China and Japan are seeking bilateral trade agreements rather than multilateral ones. In particular, the current pattern of regional trade agreements in East Asia is bewildering (Scollay and Gilbert 2001). It essentially consists of a web of bilateral arrangements, many of which are still on the drawing board. There has apparently been no formal attempt to build a regional multilateral agreement like the Common Market agreement. Bilateral agreement is unlikely to foster a collective framework (Wyplosz 2004). Furthermore, in seeking FTA partners, ASEAN itself, its individual members, China, Japan, and South Korea have all reached out to the economies outside of the region, including an economy as far away as Chile. Financial cooperation has a clear regional dimension whereas the FTA movement does not in East Asia. Furthermore, there is little, if any, policy coordination between the ministries responsible for financial cooperation and FTAs in most of the East Asian economies. It remains to be seen, but this dichotomy could weaken the interest of the ASEAN+3 members to strengthen and augment the CMI. A similar divergence exists between the CMI and ANBI. As far as the CMI is concerned, the membership is important and clearly defined, but not in the case of the AMBI, which has to be multilateral in creating regional bond markets.

A fourth constraint is that financial deregulation and market opening has drawn East Asia away from regional financial integration. Over the past decade, a number of East Asian countries have liberalized their financial markets to foreign capital by reducing restrictions on inward and outward capital flows. Financial liberalization throughout East Asia has brought many countries to establish closer linkages with international financial centers (Lee et al. 2004). In East Asia, there is no sign of the development of an integrated regional financial market. This

less progress in regional financial integration is not surprising. Eichengreen and Park (2003) explain the various factors by comparing the two regions - Europe and East Asia.

According to their analysis, Europe has gone further than East Asia in the integration of product and factor markets. While the EU has a true single market in goods and services, progress towards the creation of an Asian free trade area remains incomplete. While Europe has removed essentially all barriers to the free movement of capital and most barriers to the movement of labor, in East Asia limits on factor mobility remain pervasive. In Europe, regionalism is motivated in no little part by a desire for political integration that has no counterpart in East Asia. While Europe has built institutions of transnational governance (e.g., the European Commission, the European Parliament, the European Court of Justice, and now the European Central Bank), East Asian integration is "weakly institutionalized." That is, it is predicated not on transnational institutions but on intergovernmental agreements that defer to the sovereignty of the participating states. Nor is integration in East Asia driven by an alliance of key nations like France and Germany or by a single hegemonic power (the role played by the United States in the Western Hemisphere); it is a more multi-polar process.

Evidently, East Asia is less financially integrated than Europe. Financial claims are all denominated in the U.S. dollar and the bulk of foreign lending and borrowing are intermediated through international financial markets in New York and London. As far as finance is concerned, therefore, regional financial arrangements themselves cannot effectively address the inherent structural balance sheet problem most East Asian emerging and developing countries are currently facing. The absence of regional financial integration is closely linked to the absence of regional lender of last resort. In Europe, West Germany provided unlimited supply of short-term liquidity under the European Monetary System (EMS) when weak currency countries were under severe pressure of currency devaluation. In East Asia, Japan appears to play a limited role as a regional lender of last resort.

## 2. Leadership Issue

Finally, there is the leadership problem that defies an easy solution. If the thirteen countries have a more ambitious goal of developing a

collective exchange rate mechanism similar to the ERM in Europe with the long-term objective of adopting a common currency, they will have to increase the number and amounts of the BSAs. As the European experience shows, such an extension requires leadership that can foster coherence among the thirteen countries by mediating between the divergent interests of the members.

China and Japan are expected to provide leadership in forging regional consensus for expanding and consolidating the BSAs as a regional institution, but they have not been able to agree on a number of operational issues including the surveillance mechanism. Except for Japan, no other potential swap lenders including China are prepared to increase the amounts of their bilateral swaps with other contracting parties. Japan could increase its swap amounts with the ASEAN states and Korea (under the presumption that China will not borrow from Japan) to make the CMI a more credible financing scheme. However, unless Japanese authorities receive some sort of assurance that their short-term lending will be repaid, they are not likely to lead an expansion and institutionalization of the CMI. As a minimum condition for expansion of the CMI, Japan would demand the creation of an effective surveillance mechanism for the region in which it can exercise influence commensurate with its financial contribution. However, China may feel that it cannot play the second fiddle to Japan in any regional organization in East Asia. This concern appears to be the most serious roadblock to further development of the CMI.

China and Japan have different interests and hence different strategies for economic integration in East Asia. As far as China is concerned, economic integration with the ASEAN 10 members, South Asian and central Asian countries may be more important both economically and geo-politically than financial cooperation or free trade with either Japan or South Korea. While China is a super military power in the world, it is still a developing economy with a huge gap to narrow in terms of technological and industrial sophistication vis-à-vis Japan. Although China has been growing rapidly, it has a long way to go before catching up with Japan. These differences in the economic and military status of the two countries suggest that, even if they manage to reconcile their troubled memories of the past, China and Japan may find it difficult to work together as equal partners for regional integration in East Asia.

Despite slow progress in reconciliation between China and Japan, China seems to emerge as an active player in both the international and regional arena. Since the mid-1990s, China has expanded the number and depth of its bilateral relationships, joined various trade and security accords, deepened its participation in key multilateral organizations, and helped address global security issues. The pinnacle of this process was the Treaty of Good-Neighborliness and Friendly Cooperation that China signed with Russia in 2001 (Medeiros and Fravel 2003).

China borders Russia and many of the South Asian and Central Asian countries in addition to several ASEAN members. Therefore, it is natural for China to seek expansion and deepening of its trade and financial relations with those neighboring countries. In fact, for this reason, China has been courting ASEAN for a free trade agreement and joined in November 2001 the Bangkok agreement on a free trade area that includes Korea and the South Asian countries (Bangladeshi, India, Laos and Sri Lanka). In Central Asia, China has also taken a leading role in establishing the region's first multilateral group, the Shanghai Cooperation Organization. The organization, originally founded to settle long-standing territorial disputes and to demilitarize borders, now stresses counter-terrorism cooperation and regional trade among Russia, Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan and China.<sup>21)</sup>

In contrast, Japan has not been able to articulate its strategic interests in East Asia. While Japan has been at the forefront in supporting greater economic cooperation among the East Asian countries, its perspective on the geographical contiguity of East Asia has not been altogether clear. Japan has failed to map out a clear vision and as a result, its strategy has been focused on curbing the influence of China in the region. A classic example is the ASEAN+6 summit meeting; Japan has been promoting integration among the "ASEAN+6", known as the members of the East Asian Economic Summit instead of ASEAN+3.

The East Asia Summit is intended to become an annual event, held

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21) In June 2001, the presidents of six countries signed the Declaration of the Shanghai Cooperation Organization (SCO). The SCO aims at strengthening mutual trust and friendly relations among member states, encouraging their further effective cooperation in politics, economy, science and technology, culture, education, energy, transportation, environmental protection and other fields, jointly ensuring regional peace, security and stability, and creating a new international political and economic order.

simultaneously with leadership meetings of the Association of South-East Asian Nations (ASEAN) and ASEAN+3, which also includes China, Japan and South Korea.

The summit consists of the ASEAN+3 countries and three countries from outside the region: India, Australia and New Zealand. However, there was little agreement about what this new group should be. China, currently the most active player in the East Asian region, had wanted something more strictly east Asian. Japan wanted the inclusion of countries that could weaken China's influence. Japan won, so China is quietly ignoring the new forum, and concentrating its diplomatic energies on the more exclusive ASEAN+3 instead.<sup>22)</sup>

Chinese leaders now regard ASEAN+3, instead of the East Asia summit group, as the region's most important multilateral forum. China's focus is moving towards establishing its own free-trade area with ASEAN. It is worth nothing, though that China's efforts have run into major obstacles; Free trade negotiations within the ASEAN are behind schedule, and a plan to sign a deal with South Korea at the summit failed over rice.

Aside from the question of which countries should be included in the summit, the mandate of the group is rather unclear. Some speak of building a giant free-trade area spanning most of Asia and Oceania. But, as the *Economist* ("Dead on Arrival", Dec 14<sup>th</sup> 2005) points out, "achieving consensus among such vastly different economies, cultures and political systems would be more arduous than anything encountered in regional community building elsewhere". Also, the fact that China and Japan have utterly different motives for taking part in the summit makes it unlikely that such a grand vision will be realized any time soon.

Inevitably, the summit's final declaration lacked content. The declaration was worded to deliberately avoid anything specific; there was no mention of establishing an East Asia community, or working towards a free-trade area. The geographic boundary of the group was not pinned down either. Russia wants to take part in the next summit while the US is so sure whether the summit is worth its attention. In assessment, Japan succeeded in interfering with China's grand vision for ASEAN+6 but is not presenting any alternative.

There is also the suspicion that Japan is not interested in free trade

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22) "Dead on Arrival", the *Economist*, Dec 14th 2005.

and financial arrangements per se in East Asia for purely economic reasons. Instead, Japan is engaged in the discussion of those regional arrangements with other East Asian countries to maintain its leadership role as the region's largest economy by checking and balancing China's expansion. Many analysts believe that Japan's active involvement in regional economic integration is therefore motivated by its desire to maintain its traditional pole position.<sup>23)</sup> On top of this suspicion, Japan is perceived to be a country insensitive to and unwilling to resolve wartime legacies and disputes on historical and territorial claims. Japan has also been gripped with a decade long recession and unable to restructure its economy.<sup>24)</sup> These developments combined with its lack of a strategy for East Asian development seem to undermine Japan's ability to pull East Asian countries together for regional cooperation and integration.

What are then the likely courses of development of the regional financial architecture in East Asia? How would regional financial integration proceed in East Asia? One possible scenario is that China and Japan will come to realize that despite the differences in their strategies, they hold the key to developing a common political will in East Asia. Sakakibara (2003) argues that the role of China and Japan in East Asia's integration process is synonymous with that of France and Germany in Europe's integration process. Similarly, the Kobe Research Project report submitted to the fourth gathering of the finance ministers of the Asia-Europe Meeting (ASEM Finance Ministers' Meeting) held in Copenhagen in July 2002 states that "It is essential for the Japan-China cooperation, as a core in East Asia, to lead the process of economic and financial integration, as the France-German alliance played a central role in the integration and cooperation process in Europe."<sup>25)</sup>

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23) See David Wall, "Koizumi Trade Pitch Nests," the Japan Times, April 21, 2002.

24) Uncertain economic prospects may make Japan unlikely to be the driver in the region's integration movement as it was in the past. China is emerging both as a strong competitor and as a promising market.

25) France and Germany also had a wartime legacy. Although de Gaulle's nationalism was generally popular within the country, he also appreciated that membership of the common market would benefit France economically. However, de Gaulle remained implacably opposed to any increase in the powers of the European Commission, or to any other increase in supranationalism. He showed just how opposed in 1965, when he precipitated the most dramatic

This realization could soften their positions to compromise on an institutional setting and augmentation of the existing financial architecture of East Asia. For instance, China may accept Japan's demand for de facto control over monitoring and surveillance in return for Japan's pledge for a substantial increase in financial assistance in the form of one-way swaps and ODA to ASEAN members. China could agree to this scheme, if it is confident about concluding a free trade agreement with the ASEAN members in the near future. China's free trade pact with ASEAN could weaken Japan's influence on ASEAN affairs even if Japan is a major provider of financial resources to the region. In this process, Korea and ASEAN would serve as a mediator in the cultivation of a common political will between China and Japan.<sup>26)</sup>

Another scenario focuses on the possibility of China assuming a more aggressive leadership role in regional integration. In view of the uncertain prospects of the Japanese economy, China could emerge as the region's engine of growth over the longer term if it sustains its growth. Given the envisaged leadership role, China may choose to negotiate both the expansions of the BSAs and a free trade pact with ASEAN. In this case, the original CMI would become "ASEAN+1" in the sense that Japan could play the second fiddle. Realizing that financial integration is an integral part of a successful free trade area, China may indeed seriously consider this option. However, without Japan, ASEAN+1 will not be a viable arrangement for a regional financing scheme simply

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crisis in the history of the European Community (George, 1985). It was German Chancellor Helmut Schmidt and French President Giscard d'Estaing that accelerated stalled integration process at the end of the 1970s. The joint initiative of Chancellor Helmut Kohl and President Francois Mitterand resulted in a great leap towards EMU in the beginning of the 1990s. The Franco-German alliance formed the core for the integration process in Europe, as it was the political will of these two countries that motivated further integration.

- 26) Murase (2004) emphasizes the role of Korea by saying that "as East Asian monetary and financial cooperation move ahead, Korea can be expected to fulfill a similar role to that played by the Benelux countries in Europe. In the regional monetary system formation process, therefore, it could play a constructive role as a medium-sized industrialized economy supplementing Sino-Japanese leadership while representing the interests of smaller countries in the region. When it comes to setting up regional institutions sometime in the future, Korea could well rank alongside the key members of ASEAN as a possible location for the secretariat and other organizations."

because China is hardly in a position to commit itself to financing the balance of payments deficits of all ASEAN member states. It is also questionable whether ASEAN will join any regional financial arrangement in which China is the dominant member.

A third scenario is the enlargement of the CMI to include Australia and New Zealand and possibly India from South Asia. This is the route favored by Japan in the sense that Japan would find it easier to deal with China when there are more countries supporting its strategy. However, many members of ASEAN+3 believe that at this stage forming a critical mass of the CMI should precede any enlargement discussion because they have not considered qualifications of new members. The ASEAN+3 members at present also do not see the need of policy dialogue and coordination with non-member Asian economies. Since the enlargement is not likely to increase substantially the availability of short-term financing, most members of ASEAN+3 would not take the third scenario seriously.

Perhaps the most realistic scenario is that the countries participating in the CMI will muddle through, continuously discussing modalities of policy dialogue, the types of the surveillance system the CMI needs, and also augmentation of swap amounts, in the process, they will make a slow but sustained progress overtime as manifested by their decision to expand the availability of credit at and multilateralize the CMI in May 2005.

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## X. Concluding Remarks

The adoption and implementation of the CMI and ABMI could be counted as a major step toward strengthening the financial cooperation and development among the thirteen East Asian countries belonging to ASEAN+3. However, the ASEAN+3 economies will face much tougher challenges and tasks in exploring developments beyond the CMI. East Asian countries need to clarify to what their motivations are to the international community, how they will develop an action plan, and how they believe it fits in with the existing global financial system (Park and Wang 2000). This articulation is needed more than ever because the ASEAN+3 members will enter a period of intense discussion of policy coordination and the CMI will be subject to a test of whether it can serve as an institution for that purpose as a result of China's shift to an intermediate exchange rate regime.

Regionalism in East Asia is taking two forms: free trade arrangements (FTAs) and financial cooperative arrangements. Although it is too early to judge, the two processes may or may not reinforce each other. This uncertainty arises because the CMI is defined in terms of the participating members, whereas both the ABMI and FTAs are not subject to any membership or geographic restrictions, and because implementation of these regional initiatives are under the jurisdiction of different parts of the government in East Asian countries. It is also true that not much is known about the causal relations between trade and financial integration.

The euro area pursued trade integration first, but from a theoretical point of view there is no clear reason for trade-first integration. In Europe, trade integration slowed down whenever there were concerns about exchange rate stability among the member countries. This experience suggests that some form of monetary integration could facilitate trade integration (Shin and Wang 2004).

The increase in trade following from an FTA is likely to occur mostly within similar industries. The trade expansion will in turn weaken asymmetric shocks across the member countries and hence decrease the costs of maintaining a monetary union. Financial integration can also accelerate monetary integration even among heterogeneous countries,

which might not be accomplished otherwise. In view of this interdependency, it would not be unreasonable to argue that financial integration and cooperation can proceed with the FTA movement simultaneously.

Few East Asian policymakers would be naive enough to believe that they will be able to work out an agreement on creating an East Asian monetary fund or a common currency area in the near future. At best monetary unification is a long-term objective, and the ASEAN+3 have just taken the first step toward regional integration in financial markets. The first step may comprise a number of policy initiatives to be pursued by the members of ASEAN+3. The credit facility provided by the CMI symbolizes the determination of East Asian economies to return to the pre-crisis path of rapid growth with stability by coordinating their macroeconomic policies and pooling their resources. Now that most East Asia's EMEs have accumulated large amounts of reserves as self-insurance, the importance of the CMI as a provider of new credit facility has declined. The CMI would therefore serve better East Asia's needs, if it is restructured to focus more on policy dialogue and coordination.

In promoting the ABMI, the priority of cooperation among the ASEAN+3 members would be to resuscitate the financial reform enacted by most East Asian economies after the 1997-98 financial crises. Deregulation and opening of the domestic capital market with the construction of the requisite market supporting infrastructure will overtime create domestic demand for foreign financial instruments and encourage domestic borrowers to seek the capital markets of other countries for financing. These developments- particularly deregulation of cross border trading and investment in financial instruments denominated in different currencies- which will establish the foundation of efficient regional capital markets, should precede the creation of regional capital markets.

East Asia enjoys the latecomer's advantage in promoting financial and monetary integration as it can learn from the European experience. But the success of its integration efforts will in no small measure depend on the support of the US and EU. In the end, the western countries will have to decide whether the regional financial arrangements in East Asia will contribute to global stability and welfare. And the European experience suggests that they are likely to do so. It would therefore be

in the US and European interest to support the expansion and consolidation of the CMI insofar as financial deepening and integration in East Asia supports an orderly globalization of the world economy.

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# Appendix 1.

## The Joint Ministerial Statement of the 8th 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 Asian 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>27)</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.<sup>28)</sup> We also endorsed three research areas for 2005-06 that will

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<sup>27)</sup> <http://asianbondson>

To be disseminated through the websites of the ASEAN Secretariat, the ADB, and member countries where available.[line.adb.org](http://line.adb.org)

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

15. 2006.

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28) To be disseminated through the websites of the ASEAN Secretariat, the ADB, and member countries where available.

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## Appendix 2.

### Joint Message The 5th Trilateral (China, Japan and the Republic of Korea) Finance Ministers' Meeting

1. We, the Finance Ministers of China, Japan and the Republic of Korea, held our 5<sup>th</sup> meeting in Istanbul, Turkey, 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 solidifying the cooperation among the three countries as the following:

2-1. We noted that the prospects of three countries' economic growth for 2005 are positive although the continuous high oil price may pose a major risk to the regional economy. Therefore, we welcome the efforts to increase medium-term energy supply and efficiency including the encouragement of dialogues between oil producing and oil consuming countries.

2-2. We agreed that the financial cooperation within the ASEAN+3 is going toward a favorable direction. We agreed especially to seek to enhance the effectiveness of the Chiang Mai Initiative (CMI) and to promote its multilateralization as an advanced regional cooperative system. We also reaffirmed our strong commitment to promote other regional cooperation projects, such as the Asian Bond Markets Initiative (ABMI), ASEAN+3 Research Group, and so on.

2-3. Furthermore, considering the growing economic importance of the three countries, we recognized the need to strengthen our roles in achieving global as well as regional sustainable growth and financial market stability. Acknowledging the importance of addressing the issue of under-representation of the ASEAN+3 countries in the IFIs, we agreed to exert concerted efforts so as to improve our representation in the IFIs, including through redistribution of quotas at the IMF, to properly reflect

respective countries' economic importance.

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.

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## Appendix 3.

### Report of the Review of the Chiang Mai Initiative - Ways of Enhancing Its Effectiveness<sup>29)</sup> -

[ASEAN+3 Finance Ministers Meeting, 4 May 2005, Istanbul, Turkey]

#### Glossaries of Abbreviations and Terms

ABMI	Asian Bond Markets Initiative
ADB	Asian Development Bank
AFDM+3	ASEAN+3 Finance and Central Bank Deputies Meeting
AFMM+3	ASEAN+3 Finance Ministers Meeting
ASA	ASEAN Swap Arrangement
ASEAN	Association of South East Asian Nations
BSA	Bilateral Swap Arrangement(s)
C/C	Coordinating Country(ies)
CCL	Contingent Credit Lines
C/M	Coordination Meeting
CMI	Chiang Mai Initiative
Deputies	Deputies of the ASEAN+3 Finance Ministers and Central Bank Governors
ERPD	ASEAN+3 Economic Review and Policy Dialogue
GAB	General Arrangements to Borrow
GE	Group of Experts
IFI	International Financial Institutions
IMF	International Monetary Fund
JMS	Joint Ministerial Statement
Lao PDR	Lao People's Democratic Republic
Ministers	ASEAN+3 Finance Ministers
NAB	New Arrangements to Borrow

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29) This report contains the confidential information that could mislead the market. Therefore, according to the agreement among the ASEAN+3 member countries, this report shall be treated as "strictly confidential" even after the AFMM+3 in May 2005.

SCFM	Short-term Capital Flow Monitoring
SPC	Swap Providing Country(ies)
SRC	Swap Requesting Country(ies)
TOR	Terms of References
WG	Working Group on the CMI Review

## Executive Summary

### *Background*

*i.* Tasked by the ASEAN+3 Finance Ministers (Ministers) in May 2004, the Deputies of the ASEAN+3 Finance Ministers and Central Bank Governors (Deputies), based on the report by their Working Group on the CMI Review (WG), undertook the comprehensive review of the BSA network to explore ways of enhancing its effectiveness. The Deputies recognized that, to prepare against future uncertainties, it is important to make the CMI more effective and disciplined, and the Deputies reaffirmed that it would maintain the two core objectives of the CMI as basic principles in the review, namely: (a) to address short-term liquidity difficulties in the region; and (b) to complement existing international financial arrangements.

*ii.* The Deputies reviewed the various functions of the current BSA network to enhance its effectiveness, which are: (1) modality/structure, (2) size, (3) swap activation mechanism, (4) terms and conditions of the swap facility, (5) linkage with the IMF, and (6) peacetime surveillance. In so doing, the Deputies particularly took into account of the following three aspects: (i) to maintain the CMI's two core objectives as above, (ii) to send a strong signal to the market to obtain stronger market confidence, and (iii) to incorporate elements that would lead to future evolution and foster our regional co-operation.

### *Proposed measures for the Ministers' consideration*

*iii.* The Deputies, therefore, would like to propose the following measures to enhance the CMI's effectiveness for the Ministers' consideration:

<i>Issues</i>	<i>Proposed measures for the Ministers' consideration</i>
Modality/ Structure	<ul style="list-style-type: none"> <li>- To take a step-by-step approach toward multilateralization</li> <li>- To adopt a collective decision making mechanism within the existing structure of the network of BSA as a first step toward multilateralization</li> <li>- To explore various ideas and concepts of multilateralization after May 2005</li> </ul>

## 124 Prospects for Regional Financial and Monetary Integration in East Asia

<i>Issues</i>	<i>Proposed measures for the Ministers' consideration</i>
Size	<ul style="list-style-type: none"> <li>- To significantly increase the size of the BSA network by (i) raising the amount of existing bilateral commitment, (ii) reaching new BSAs, and (iii) transforming one-way BSAs into two-way BSAs, and embark on bilateral negotiations, if possible. Member countries favored an enhancement of up to 100% increase of the existing individual BSAs, while noting that the size could be flexibly decided by bilateral negotiations when exploring new BSAs or reviewing existing BSAs.</li> </ul>
Linkage with the IMF	<ul style="list-style-type: none"> <li>- To maintain the linkage with the IMF until there were credible regional alternatives</li> <li>- To significantly enlarge the size of swaps that could be withdrawn without the IMF-supported program (i.e., IMF non-linked portion) from the current 10 percent to 20 percent so as to better cope with sudden market irregularities</li> <li>- To affirm that (a) the IMF non-linked portion is aimed to cope with market irregularities of a relatively small magnitude when an IMF-supported program is not necessary, and (b) the current conditions would be maintained.</li> </ul>
Swap Activation Mechanism	<ul style="list-style-type: none"> <li>- To clarify the swap activation process and to formulate Terms of References (TOR) (Att. 6)</li> <li>- To pre-appoint the Coordinating Countries (C/C) for each SRC from the list of actual SPCs for each SRC on a rotation basis</li> <li>- The C/C will host the Coordination Meeting (C/M), implement surveillance and monitoring, and undertake a coordination and administrative role</li> <li>- The procedure and the agenda of C/M</li> <li>- To set a time framework for each step of the swap activation process as a guiding principle (2 business days for meeting/ teleconference, 2 weeks for consensus building, and 4 weeks for decision making from the date an inquiry letter reaches C/C), which would be kept confidential. Notwithstanding this timeframe, in cases where the IMF-supported program is not necessary, the C/C would make every effort to conclude the swap activation process as quickly as possible</li> <li>- To adopt a collective decision making mechanism when consensus building is difficult and to explore the feasibility of having a binding decision-making mechanism, possibly in the form of an umbrella scheme.</li> </ul>

<i>Issues</i>	<i>Proposed measures for the Ministers' consideration</i>
<p>Swap Activation Mechanism</p>	<ul style="list-style-type: none"> <li>- Voting weights for collective decisions would, in principle, reflect the commitment of each SPC. Nevertheless, in such exceptional cases where one SPC holds the majority voting weight or veto, this issue was left for further consideration.</li> <li>- To maintain the "opt-out" clause but to restrict its exercise more rigidly to the following conditions:               <ul style="list-style-type: none"> <li>(a) Before the voting process begins, SPCs can exercise their right to "opt-out" only under specific conditions such as (i) the SPC's BOP difficulties, (ii) the SPC's tight reserve position, or (iii) the SRC's insufficient safeguard measures (e.g., absence of an economic program in the SRC that could satisfy the needs of the SPC's accountability to its taxpayers).</li> <li>(b) After the voting process begins, "opting out" will be available only when the SPC's own reserves fall below three months of average imports (i.e., three times of average monthly imports of the SRC for the latest six-month period provided in the latest available edition of International Financial Statistics (IFS)).</li> </ul> </li> <li>- To maintain most of the current conditions as flexible as they are to preserve flexibility in swap activation while noting that the collective decision making mechanisms would not be materialized unless, at least, certain conditions and covenants are harmonized such as:               <ul style="list-style-type: none"> <li>(i) setting the minimum requirement of necessary economic and financial information as a guiding principle</li> <li>(ii) fixing the minimum threshold level of usable foreign reserves at three months of imports; and</li> <li>(iii) full compliance with Article 15 (cross default) of the Main Principles</li> </ul> </li> <li>- To revise the articles of the current Main Principles in regard to the governing laws to enable the member countries to choose a third country's law</li> </ul>
<p>Terms and Conditions</p>	<ul style="list-style-type: none"> <li>- To maintain the current basic framework to use US dollars as a base currency but to seek further use of East Asian local currencies as a long-term agenda after May 2005</li> <li>- To maintain the current interest rate level and structure</li> <li>- To consider a certain framework so that comparability is secured in case substantial deviations occur between the interest rates of the CMI and the IMF after May 2005</li> <li>- To maintain the current maturity period</li> <li>- To contemplate an exceptional extension rule for cases where small market irregularities develop into large ones requiring an IMF-supported program towards the end of the extended drawing period (i.e., 90 days * 2)</li> </ul>

<i>Issues</i>	<i>Proposed measures for the Ministers' consideration</i>
Peacetime Surveillan	<ul style="list-style-type: none"> <li>- To integrate and enhance the existing surveillance mechanism (e.g., Informal AFDM+3) into the CMI framework with a view to developing effective regional surveillance capabilities that complement the current undertaking by the International Financial Institutions (IFIs).</li> <li>- To implement various concrete measures such as (a) reporting of Informal AFDM+3 to AFMM+3, (b) enhancement of data exchange using IMF SDDS data where available, and (c) utilization of external resources for surveillance</li> <li>- To work further on the recommendation to develop regional surveillance capabilities and expertise, including in the form of Group of Experts, especially by clarifying the source of financing and clearly defining the area of responsibilities in order to avoid overlap and duplication with the surveillance work done by IFIs, while taking note of the necessary timeframe to launch the process</li> </ul>

**i. The Deputies would also like to propose to the Ministers that the WG continue its work after the AFMM+3 in May 2005 (entitled "Second Phase") to conduct the following tasks:**

- (a) Deliberation of the legal and technical aspects of the measures above, such as on the collective decision-making mechanism, and on the issue whether the agreed time framework still holds given the increased efficiency derived from the multilateralized decision making mechanism; and
- (b) Discussion of medium- to long-term measures for further enhancement of the CMI and monetary and financial stability in East Asia in such areas as:
  - (i) More evolved form of multilateralization - for a simpler arrangement and more efficient resource utilization with an increasing number of swap providers;
  - (ii) Further utilization of East Asian local currencies; and
  - (iii) Exploration of ways to attain further intra-regional exchange rate stability.

## **I. Introduction - History of the Chiang Mai Initiative (CMI)**

**1. The ASEAN+3 Finance Ministers agreed on the Chiang Mai Initiative (CMI) on May 6, 2000 in Chiang Mai, Thailand as a regional**

financing arrangement to supplement the existing international facilities to address short-term balance of payments difficulties (Attachment 1). The CMI comprises (a) a network of bilateral swap and repurchase arrangements among ASEAN countries, China, Japan, and Korea, and (b) the expanded ASEAN Swap Arrangement (ASA). The Basic Framework of the CMI, the Main Principles of the Bilateral Swap Arrangements (BSA) under the CMI, and the Main Principles of the repurchase arrangements under the CMI were subsequently agreed in December 2002 (see Attachments 2, 3, and 4).

**2. The network of BSAs has grown to 16 BSAs among eight countries** (China, Indonesia, Japan, Korea, Malaysia, the Philippines, Singapore, and Thailand) **and the total size of the BSA network now reaches US\$39.5 billion.**<sup>30</sup> A BSA was concluded in March 2005 between Japan and Thailand, a two-way BSA between US dollars and either Thai baht or Japanese yen amounting to US\$3 billion for each. Meanwhile, the ASA was also expanded on November 17, 2000 from ASEAN 5 to all ten countries and from US\$200 million to US\$1 billion, and was agreed to be further expanded to US\$2 billion in April 2005. The overview of the CMI is described in Attachment 5.

**3. In parallel with the development of the CMI, various efforts in regional financial cooperation have been made among the ASEAN+3 countries.** One notable attempt was the launch and development of the regional economic surveillance process entitled “ASEAN+3 Economic Review and Policy Dialogue (ERPD)” that started in April 2002. The ERPD has been conducted half-yearly among the Deputies of the ASEAN+3 Finance Ministers and Central Bank Governors and strengthened step by step incorporating various measures including the recommendations by the “ASEAN+3 Study Group to examine ways of enhancing the effectiveness of economic reviews and policy dialogue.” Also, steady progress has been made in the areas of (a) Short-term Capital Flow Monitoring (i.e., voluntary bilateral data exchange), (b) Asian Bond Markets Initiative (ABMI), which aims to alleviate the root cause of the 1997-98 Asian financial crisis, i.e., currency and maturity mismatch, (c) Capacity Building in Macroeconomic Statistics, and (d)

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30) The BSA between China and Thailand, which expired in December 2004, will be renewed shortly. The total amount of US\$39.5 billion includes the BSA between China and Thailand.

ASEAN+3 Research Group.

4. **Since the launch of the CMI in May 2000, neither a BSA nor the expanded ASA has been activated to date.** This could be interpreted to mean that the CMI has played a certain role in preventing currency and financial crises in the region, which has been also supported by the authorities' economic management and overall market sentiment in the region.

## II. Objectives of the CMI and Recent Related Developments

5. **At the last AFMM+3 on May 15, 2004 in Jeju, Korea, the ASEAN+3 Finance Ministers agreed to undertake further review of the CMI to explore ways of enhancing its effectiveness** (Attachment 1). For that purpose, a working group (WG) was tasked to conduct the review and report the outcome, through the Deputies, to the ASEAN+3 Finance Ministers at the AFMM+3 to be held in 2005 in Istanbul, Turkey.

6. **A WG composed of ASEAN+3 officials was set up and had intensive discussions over the course of five meetings** on August 4, 2004 (Shanghai), October 15-16, 2004 (Singapore), November 9-10, 2004 (Tokyo), February 2, 2005 (Kuala Lumpur), and March 11, 2005 (Manila). The WG also obtained guidance from the Deputies at the AFDM+3 on November 27, 2004 in Sanya, China. The WG was attended by representatives of all ASEAN+3 countries and was co-chaired by (a) Singapore (Monetary Authority of Singapore) and China (People's Bank of China) in 2004, and (b) Lao PDR (Bank of Lao PDR) and Japan (Ministry of Finance) in 2005.

7. **The Deputies had two occasions to give instructions to the WG and deliberate the proposed measures by the WG** on November 27, 2004 in Sanya, China and on April 5, 2005 in Vientiane, Lao PDR.

### *1) Core Objectives of the CMI*

8. **The Deputies, at the outset, decided to focus on the review of the network of BSAs vis-à-vis ASA**, given its predominant size within the CMI and the membership that covers both ASEAN and Plus Three (i.e., China, Japan, and Korea).

9. **The Deputies was convinced that the implementation of good policies is the best prescription to prevent recurrence of the 1997-98 Asian currency and financial crisis.** Nevertheless, the Deputies

recognized that, to prepare against future uncertainties, it is important to make the CMI more effective and disciplined, and reaffirmed to maintain the following two core objectives of the CMI, as basic principles to explore ways to enhance the effectiveness of the BSA network:

(a) The CMI aims to address short-term liquidity difficulties in the region; and

(b) The CMI aims to supplement existing international financial arrangements.

## 2) Economic and Financial Developments in the Region since 2000

10. The Deputies confirmed the economic and financial developments since 2000 in the region. East Asia has not only recovered from the 1997-98 Asian currency and financial crisis, but also has demonstrated economic growth and financial stability in recent years, which can be verified by a wide variety of macroeconomic statistics and external vulnerability indicators. With the substantial increase in foreign reserves (now the region's foreign reserves exceed US\$2.0 trillion<sup>31)</sup> and the

	Growth		Inflation		Current account (-:deficit)	
	1998	2003	1998	2003	1997	2002
Brunei						
Cambodia	3.7	na	14.8	1.2	-210	-64
China	7.8	na	-8.0	1.2	36,963	35,422
Indonesia	-13.1	4.5	57.7	5.1	-4,889	7,823
Japan	-1.2	2.5	0.6	-0.3	96,810	112,450
Korea	9.5	3.1	7.5	3.6	-8,287	5,394
Lao PDR	4.0	5.8	91.3	15.4	-306	na
Malaysia	-7.4	10.4	5.3	1.0	-5,935	7,190
Myanmar	5.8	na	51.6	36.6	-416	na
Philippines	-0.6	4.9	9.8	2.9	-4,351	4,383
Singapore	-0.9	1.1	-0.3	0.5	14,908	18,704
Thailand	-10.5	7.2	8.1	1.8	-3,021	7,014
Vietnam	5.8	7.2	7.2	3.1	-1,528	-604

Source: IMF/IFS

31) This figure includes Hong Kong SAR's foreign reserves.

## 130 Prospects for Regional Financial and Monetary Integration in East Asia

(Billion of US dollars)

	External debt				Total International Reserve		Imports (CIF)
	Total external debt		o/w short-term debt		Reserve		(3 months)
	(WB, GDF 2004 <sup>1/</sup> ) 1997	2002	(WB, GDF 2004 <sup>1/</sup> ) 1997	2002	(IMF, IFS) 1997 Jun	2005 Jan <sup>2/</sup>	(IMF, IFS) 2003
Brunei							
Cambodia	2.4	2.9	0.1	0.2	0.3	0.9	0.4
China	146.7	168.3	31.5	47.9	141.9	609.9	103.3
Indonesia	136.2	132.2	32.9	23.3	18.2	34.5	8.2
Japan	n.a.	n.a.	n.a.	n.a.	228.4	841.0	95.7
Korea	159.2	117.7	53.8	35.1	24.4	199.7	44.7
Lao PDR	2.3	2.7	0.0	0.0	0.1	0.2	0.1
Malaysia	47.2	48.6	14.9	8.4	21.9	62.7	20.5
Myanmar	5.5	6.6	0.4	1.2	0.2	0.6	0.5
Philippines	50.7	59.3	11.8	5.6	8.7	12.7	9.9
Singapore	n.a.	n.a.	n.a.	n.a.	74.4	105.6	29.3
Thailand	109.7	59.2	37.8	11.9	25.4	47.1	19.0
Vietnam	21.8	13.3	2.3	0.8	1.9	6.6	6.2
Hong Kong SAR	n.a.	n.a.	n.a.	n.a.	63.4	119.5	58.0
Total (excl. Japan)	681.7	610.7	185.6	134.3	380.7	1,200.0	300.0
Total	681.7	610.7	185.6	134.3	609.1	2,041.0	395.7

1/ The figures of Korea are of 2001.

2/ IFS (Jan 2005 edition). The figures are mostly as of end-November 2004 (excluding gold).

The figures of China, Japan and Korea are those of respective authorities including gold.

decline in external indebtedness, the external vulnerabilities in many member countries have receded considerably.

**11. Economic interdependence within the ASEAN+3 has accelerated** as evidenced in the increase in intra-regional trade and investment. According to research conducted by the ASEAN+3 Research Group, the share of intra-regional exports in ASEAN+3 countries increased from 31.8% in 1980 to 37.5% in 2003 while that of imports expanded from 33.6% in 1980 to 49.7% in 2003.

**12. Meanwhile, the Deputies noted the growing financial uncertainties surrounding the region, under which the importance of gaining market confidence was keenly recognized.** As an open economy, East Asia is even more exposed to the risks of global adjustment and economic volatility. Also, global capital movements have been rapidly expanding. Under such circumstances, the Deputies recognized the importance of further enhancing the crisis-prevention effect of the CMI and, thereby consolidating market confidence.

### *3) Regional Financial Cooperation since 2000*

**13. The Economic Review and Policy Dialogue (ERPD), an ASEAN+3 initiative to conduct regular economic surveillance at the Deputies level, began in April 2002,** nearly two years after the CMI agreement. At the second Informal AFDM+3 in November 2002 in Tokyo, the ASEAN+3 Deputies agreed to conduct the ERPD twice a year, and thus far have held seven meetings leading up to the Informal AFDM+3 in April 2005 in Vientiane, Lao PDR. After its launch, the ERPD has been strengthened step by step, incorporating various measures including the recommendations by the ASEAN+3 Study Group. The enhancement of economic surveillance was also intensively discussed by the ASEAN+3 Research Group in 2004-05.

**14. Short-term Capital Flow Monitoring (SCFM) among ASEAN+3 also started and expanded in 2002.** Based on the agreement reached at the AFMM+3 in May 2001 in Honolulu, U.S., voluntary bilateral data exchange on short-term capital flows started in 2002 and expanded to Brunei, Indonesia, Japan, Korea, the Philippines, Thailand, and Vietnam that same year. With the completion of ASEAN+3 Technical Assistance under JAFTA in 2004, more countries are ready to participate in the data exchange.

**15. Technical Assistance (TA) on Capacity Building in Macroeconomic Statistics is now underway.** The TA has been provided by JAFTA to Brunei, Cambodia, Indonesia, Lao PDR, the Philippines, Thailand, and Vietnam since 2003, and is contributing to more-accurate data compilation for enhanced policy dialogue.

### *4) International Financial Architecture*

**16. The volume of possible assistance from the IMF to BSA participating countries has remained relatively small.** The under-representation of East Asian countries in the IMF, which has kept East Asia's voting power below the economic realities, has not been alleviated. This under-representation also means that the access limit for East Asian countries to the IMF resources, which is, in principle, three times their quota, has been insufficient for possible future needs, or smaller in comparison with the amount of assistance rendered during the 1997-98 Asian currency and financial crisis. The IMF's available resources for new financial commitments in the coming year (i.e., defined as "one-year forward commitment capacity") as of the end of February 2005 stood at

US\$117 billion (excluding available resources of US\$52 billion under its borrowing arrangements, namely GAB and NAB).

(US\$ billion)						
	BSA		ASA		IMF *	
	Commitment	Receipt	Commitment	Receipt	Quota	Calculated quota**
<b>Plus Three</b>	<b>32.5</b>	<b>19.0</b>	-	-	<b>32.0</b>	<b>45.5</b>
China	10.5	5.0	-	-	9.6	15.0
Japan	16.0	6.0	-	-	20.0	23.6
Korea	6.0	8.0	-	-	2.4	6.9
<b>ASEAN</b>	<b>7.0</b>	<b>20.5</b>	<b>1.000</b>	<b>2.000</b>	<b>11.0</b>	<b>21.6</b>
Brunei	-	-	0.150	0.300	0.3	0.2
Cambodia	-	-	0.015	0.030	0.1	0.1
Indonesia	1.0	5.0	0.150	0.300	3.1	2.4
Lao PDR	-	-	0.005	0.010	0.1	0.0
Malaysia	1.0	3.5	0.150	0.300	2.2	4.2
Myanmar	-	-	0.020	0.040	0.4	0.1
Philippines	1.0	5.0	0.150	0.300	1.3	1.7
Singapore	-	1.0	0.150	0.300	1.3	9.5
Thailand	4.0	6.0	0.150	0.300	1.6	2.8
Vietnam	-	-	0.060	0.120	0.5	0.6
<b>ASEAN+3</b>	<b>39.5</b>	<b>39.5</b>	<b>1.000</b>	<b>2.000</b>	<b>43.0</b>	<b>67.1</b>

\* The IMF's available resources for new financial commitments in the coming year (i.e., defined as "one-year forward commitment capacity") as of the end of February 2005 stood at SDR 77 billion (US\$117 billion) (excluding available resources of SDR 34 billion (US\$52 billion) under its borrowing arrangements, namely GAB and NAB). (Source: IMF "IMF's Financial Resources and Liquidity Position - February 2005")

\*\* Sources: IMF IFS (February 2005), IMF Staff Paper (Quotas-Updated Calculations (August 30, 2004))

17. The IMF introduced the facility of Contingency Credit Lines (CCL) in 1999 as part of its efforts to strengthen member countries' defenses against future financial crises. For various reasons, it was never used and expired in November 2003.

### III. Review of the Functions of the BSA Network

18. The Deputies undertook the comprehensive review of the BSA network taking into account the issues described above. In so doing, the Deputies particularly considered the following three aspects: (a) to maintain the CMI's two core objectives, (b) to send a strong signal to the market to obtain stronger market confidence, and (c) to incorporate elements that would lead to future evolution and foster our regional co-operation. Based on the above aspects, the Deputies reviewed various

functions of the current BSA network to enhance its effectiveness. The functions are (1) modality/structure, (2) size, (3) swap activation mechanism, (4) terms and conditions of the swap facility, (5) linkage with the IMF, and (6) peacetime surveillance.

### *1) Modality /Structure*

**19. The Deputies examined the pros and cons of both the network of bilateral swap arrangements and a multilateral arrangement.** The BSA network offers an advantage in terms of “flexibility” (e.g., free choice of partners, tailor-made agreement according to each country’s requirements, full discretion in decision making and quick disbursement) while the possible multilateral arrangement may be superior in terms of (a) full utilization of resources, (b) avoidance of free riding, and (c) standardization of the entire procedure.

**20. The Deputies agreed to take a step-by-step approach toward multilateralization and to adopt a collective decision making mechanism within the existing structure of the BSA network** as a first step toward enhanced multilateralization in the future that possibly would feature an earmarking of foreign reserves, etc.

**21. The Deputies agreed to explore various ideas/concepts of multilateralization, including the multilateralization of resources, after the AFMM+3 in May 2005 as a long-term agenda.**

### *2) Size*

**22. The Deputies discussed the importance of increasing both the total size of the BSA network and the size of each BSA** from the perspectives of (a) better preparation against future uncertainties amid evolving globalization and increasing cross-border financial activities and potential monetary outflows in the region and (b) better utilization of the region’s foreign reserves. As a reference, it was pointed out that the fluctuations in the capital account before and after the 1997-98 Asian currency and financial crisis reached US\$87.9 billion for the three most crisis-affected countries (i.e., Thailand, Korea, and Indonesia). It was also revealed that the assistance package during the said crisis amounted to US\$112.8 billion in total (including IMF, multilateral, and bilateral), of which US\$50.0 billion was provided as bilateral assistance.

**23. The Deputies agreed to significantly increase the size of the BSA network and to embark on bilateral negotiations, if possible.**

There are several ways to increase the size such as (i) raising the amount of the existing bilateral commitment, (ii) concluding new BSAs, for example, among ASEAN countries, and (iii) transforming one-way BSAs into two-way BSAs. Member countries favored an enhancement of up to 100% increase of the existing BSAs, while noting that the size could be flexibly decided by bilateral negotiations when exploring new BSAs or reviewing existing BSAs.

24. The Deputies also agreed to consider how to announce the size increase effectively so as to maximize its impact. An adequate size, coupled with firm disciplines envisioned in conditionalities and terms, is essential in gaining sufficient market confidence.

### 3) *Linkage with the IMF*

25. The Deputies reaffirmed that the rationale for the CMI's linkage with the IMF was still valid in light of certain roles it plays in the CMI. The Deputies also revisited the issue of how to enhance the CMI's flexibility without jeopardizing its credibility.

26. The Deputies agreed that, given the CMI's one core objective to provide short-term liquidity (and the importance of having a safeguard for SPCs to rely on the IMF's reform package when necessary), the CMI would maintain the linkage with the IMF until there were credible regional alternatives. Even if a credible regional alternative were in place, the IMF linkage would still play a catalytic role in crisis prevention and resolution in the region, especially in mobilizing financing from other official and private players in the forms of new lending and rescheduling of the existing debt.

27. As for the portion that could be disbursed without an IMF-supported program ("IMF non-linked portion"), the WG affirmed that (a) the IMF non-linked portion was aimed to cope with market irregularities of a relatively small magnitude when an IMF-supported program is not necessary, and (b) the current conditions would be maintained. Given the development of regional surveillance and growing cross-border capital movements, the Deputies agreed to significantly enlarge the IMF non-linked portion from 10 percent to 20 percent to better cope with sudden market irregularities.

### 4) *Swap Activation Mechanism*

28. The Deputies was convinced that establishing a prompt swap

activation mechanism was one of the most important elements to enhance the effectiveness of the CMI. The Deputies also explored measures to materialize a binding collective decision making mechanism as a first step toward multilateralization.

#### *Swap Activation Process*

29. The Deputies agreed to clarify the current swap activation process, to depict a flowchart of the swap activation process, and to formulate Terms of References (TOR), which should bring about greater certainty and efficiency in the swap activation process. The TOR consists of (1) SRC's inquiry letter (to a Coordinating Country), (2) Coordinating Countries (C/Cs), (3) Coordination Meeting (C/M) including its tentative agenda and participants, (4) Swap Renewals, and (5) Collective Decision Making and subsequent Individual BSA Activation. The same process for the initial swap activation is applied for subsequent swap renewals.

#### *Coordinating Countries (C/C)*

30. The Deputies agreed to pre-appoint the Coordinating Countries (C/Cs) for each SRC - one from ASEAN where possible and the other from Plus Three - from the list of actual SPCs for each SRC on a rotation basis. The appointment rule, which is described in the TOR, is as follows:

*“The C/Cs will be the two co-chairs of the Informal AFDM+3: one from the ASEAN and the other from the Plus Three, from the list of actual SPCs for each SRC. If a pre-appointed C/C becomes a SRC or has opted out, then the next actual SPC of the AFDM+3 chair rotation order will assume the role of a C/C. The rotation proceeds continuously in the following sequence: ‘this year (N)’, ‘next year (N+1)’, ‘previous year (N-1)’, ‘N+2’, ‘N-2’, ‘N+3’, ‘N-3’. In such cases where members fail to appoint two C/Cs according to the above sequence, it is permissible for there to be only one C/C.*

31. The Deputies agreed that the C/C would host the Coordination Meeting (C/M), implement surveillance and monitoring (even after swap activations), and undertake a coordination and administrative role.

*Coordination Meeting (C/M)*

32. The Deputies agreed upon the procedure and the agenda of the Coordination Meeting (C/M) as below, which would be organized by the C/C within two business days after an SRC's inquiry letter reached the C/C. Notwithstanding this, the agenda and the participants would be decided by the C/C for each C/M.

- (1) SRC's recent economic and financial statistics (Presenter: SRC)
- (2) SRC's analysis on the following issues (Presenter: SRC)
  - (a) Recent economic and financial situation
  - (b) Background and factors that caused the short-term liquidity difficulties
  - (c) SRC's policy responses
  - (d) Possibility of assistance from the IMF and other donors
  - (e) Short-term economic prospects
- (3) IFIs' assessment on the following issues (when invited) (Presenter: IFIs)
  - (a) Recent economic and financial situation
  - (b) Necessity and prospects for an IMF-supported program and other assistance
- (4) Opt-out - Consultation among SPCs
- (5) SPCs' discussion regarding the swap activation
  - (a) Consensus building
  - (b) Collective decision-making
  - (c) Disbursement timing and share

*Timeframe*

33. The Deputies noted the importance of ensuring "promptness" in the swap activation process and agreed that prompt conclusion was critical. For this purpose, the Deputies agreed to set a time framework for each step of the swap activation process as a guiding principle, according to which the C/C would organize a meeting (or teleconference) within two business days, consensus building would be sought within two weeks, and collective decision making would be made within four weeks from the date an inquiry letter reached the C/C, respectively. Notwithstanding this timeframe, the WG agreed that, in cases where the IMF-supported program is not necessary, the C/C would make every effort to conclude the swap activation process as quickly as possible.

34. The Deputies agreed that this time framework should be kept

among member countries in order to avoid giving unintentional messages to the market.

*Collective decision making and swap activation*

35. In order to ensure prompt swap activation, the Deputies agreed to adopt a collective decision making mechanism when consensus building is difficult at the C/M.

36. As for the voting rule, the Deputies agreed that voting weights for collective decisions would, in principle, reflect the commitment of each SPC. Nevertheless, in such exceptional cases where one SPC holds the majority voting weight or veto, this issue was left for further consideration.

37. It was confirmed that individual bilateral swap activation(s) would not be precluded when the result of SPCs' collective decision is no.

38. The Deputies agreed to explore the feasibility of having a binding decision-making mechanism, possibly in the form of an umbrella scheme, together with the remaining issues regarding the collective decision-making after AFMM+3 in May 2005. It was pointed out that a supplementary contractual arrangement (i.e., an umbrella scheme) was necessary for collective decisions to bind and force all BSAs, which would also protect the authorities from domestic accusations (especially when their voting was different from the collective decision) and would lay a basis for future multilateral arrangements.

*Opt-out*

39. In regard to the opt-out clause, the Deputies discussed ways to enhance the effectiveness from the following two perspectives - (i) to give SRCs more certainty on the availability of funds and (ii) to maintain flexibility for SPCs to cope with unforeseen events.

40. The Deputies agreed to maintain the "opt-out" clause but to restrict its exercise more rigidly to the following conditions:

- (a) Before the voting process begins, SPCs can exercise their right to "opt-out" only under specific conditions such as (i) the SPC's BOP difficulties, (ii) the SPC's tight reserve position, or (iii) the SRC's insufficient safeguard measures (e.g., absence of an economic program in the SRC that could satisfy the needs

of the SPC's accountability to its taxpayers).

- (b) After the voting process begins, "opting out" will be available only when the SPC's own reserves fall below three months of average imports (i.e., three times of average monthly imports of the SRC for the latest six-month period provided in the latest available edition of *International Financial Statistics (IFS)*).

41. **In this connection, the Deputies stressed that integrating the "ASEAN+3 surveillance" into the CMI framework was of significant importance** in that the enhancement of surveillance could increase the predictability of SPCs' exercise of the "opt-out" clause. The restrictive "opt-out" conditions, together with effective surveillance, could send positive signals to the market.

#### *Harmonization of conditions/covenants*

42. **The Deputies agreed to maintain most of the current conditions as flexible as they are to preserve flexibility in swap activations.** Nevertheless, the collective decision making mechanisms would not be materialized unless, at least, the following certain conditions and covenants are harmonized:

- (1) Setting the minimum requirement of necessary economic and financial information as a guiding principle such as:
  - (a) The IMF's Special Data Dissemination Standard (SDDS) data;
  - (b) Qualitative/analytical information (for activation and renewal)
    - Current economic situation and economic policies
    - Causes and background of the crisis
    - The SRC's economic and financing plan to cope with the situation (including the IMF-supported program and other multilateral / bilateral / private financing [new financing / debt rescheduling])
    - Short-term economic outlook
  - (c) Quantitative information that should be provided more frequently (weekly or daily)/latest
    - short-term capital flow
    - international reserves and foreign currency liquidity
    - short/long-term external debt
  - (d) Others - Real estate prices (at least for the past one year)
- (2) Fixing the minimum threshold level of usable foreign reserves at "three times of average monthly imports of the SRC for the latest

six-month period provided in the latest available edition of *International Financial Statistics (IFS)*," which would be specified in the Main Principles; and

- (3) Full compliance with Article 15 (cross default) of the Main Principles. Otherwise, a judgment of "default" by one SPC, which may not qualify as an "event of default" to other SPCs, would not trigger a default in the other BSA.

**43. The Deputies also agreed to revise the articles in the current Main Principles in regard to the governing laws so that the member countries could choose a third country's law for their BSA, if necessary.**

#### *5) Terms and Conditions of the Swap Facility*

**44. The Deputies reviewed the terms and conditions of the current swap facility articulated in the Main Principles to make it more disciplined and effective.**

#### *Currency*

**45. The Deputies basically agreed to maintain the current basic framework to use US dollars as a base currency while the use of other currencies would not be precluded when bilaterally agreed.** In this connection, the Deputies agreed to seek further use of the East Asian local currencies as a long-term agenda for regional financial cooperation after May 2005. In this connection, the WG noted that having local-currency BSAs solely for peacetime needs (supplementing the existing US\$ base BSAs for crisis prevention) would also enhance the CMI in a broader sense.

#### *Interest rates*

**46. The Deputies revisited the rationale for the current formula of the CMI interest rate, which was set to be comparable with the global facilities that the CMI complements, and reviewed the current interest rate level and structure based on the following three clear principles, namely, (a) comparability with global facilities, (b) simplicity and harmonization, and (c) rule-based adjustment.**

**47. The Deputies agreed to maintain the current interest rate level as the current CMI interest rate (US\$ 3 month LIBOR + 150bp, US dollar base) which has been broadly comparable with that of the IMF (IMF's adjusted rate of charge + 150bp, SDR base). The Deputies, given**

the different trajectory of US\$ and SDR interest rates, agreed to consider a certain framework so that comparability is secured in case substantial deviations occur between the interest rates of the CMI and the IMF.

48. **The Deputies also agreed to maintain the current escalating structure of surcharges** (i.e., premium over LIBOR would be increased from 150bp to 300bp per every 180-day period) to impose incentives to the SRCs for early repurchases in light of the CMI's characteristic as a short-term facility that complements the global facility.

#### *Maturity period*

49. **The Deputies reviewed the current maturity period of the CMI, which was 90 days but extendable up to 7 times when the SPCs concur.**

50 The Deputies agreed to maintain the possible maximum drawing period of 2 years, in light of the CMI's core objective to cope with short-term liquidity difficulties. The WG also agreed to keep the "90-day" maturity period, given the CMI's short-term characteristic, the importance of timely review under crisis/short-term liquidity difficulties for the sake of the SPCs' domestic accountability, and complementarity with the IMF (that conducts "program review" and purchase every quarter). Nevertheless, the Deputies agreed to contemplate an exceptional extension rule for cases where the small irregularities develop into large ones requiring IMF-supported program towards the end of the extended drawing period (i.e., 90 days \* 2).

#### *6) Peacetime Surveillance*

51. **On the topic of peacetime surveillance, the Deputies recognized that effective surveillance can play a critical role in (1) detecting irregularities and providing opportunities for the authorities to take remedial policy actions and thereby, prevent crises, (2) enabling the SPCs to make swift swap-activation decisions, and (3) avoiding moral hazards by SRCs.**

52. Reflecting the launch and development of the Informal AFDM+3 since 2002, the Deputies agreed to integrate and enhance the existing surveillance mechanism (e.g., Informal AFDM+3) into the CMI framework (i.e., Basic Framework and Main Principles) with a view to developing effective regional surveillance capabilities that complement the current undertaking by the International Financial Institutions

(IFIs), while noting the necessity of gradual improvements in light of practical constraints faced by members. In addition to the steady implementation and continuance of the ASEAN+3 Study Group recommendations, the Deputies agreed on various concrete measures including:

- (a) The content of the discussions at the Informal AFDM+3 would be reported to the AFMM+3;
- (b) The data exchange would be enhanced by using the IMF's Special Data Dissemination Standard (SDDS) data where available (N.B. Countries with experience in SDDS could provide TA to non-SDDS-subscribing countries);
- (c) External resources for surveillance (such as economic assessment by the IFIs) would be utilized until the region builds up a credible regional surveillance framework.

53. In addition, the Deputies noted that it would be useful to create an ASEAN+3 virtual secretariat to facilitate and strengthen the surveillance process. The Deputies also agreed to work further on the recommendation to develop effective regional surveillance capabilities and expertise, including in the form of Group of Experts, especially by clarifying the source of financing and clearly defining the area of responsibilities in order to avoid overlap and duplication with the surveillance work done by IFIs, while taking note of the necessary timeframe to launch the process.

#### IV. Conclusions and Recommendations

##### 1) *Outcome of the review 2004-05*

54. The Deputies would like to report the outcome of its review to date and seeks the Ministers' agreement on the proposed measures as described above.

##### 2) *Proposals for the Second Phase of the Review (after May 2005)*

55. The Deputies would like to propose to the Ministers that the WG continue its work after the AFMM+3 in May 2005 ("Second Phase") to conduct the following tasks:

- (a) Deliberation of the legal and technical aspects of the measures above, such as on the collective decision-making mechanism, and on the issue whether the agreed time framework still holds given

the increased efficiency derived from the multilateralized decision making mechanism; and

- (b) Discussion of medium- to long-term measures for further enhancements of the CMI and monetary and financial stability in East Asia, including such issues as:
  - (i) More evolved form of multilateralization - for a simpler arrangement and more efficient resource utilization with the increasing number of swap providers;
  - (ii) Further utilization of East Asian local currencies; and
  - (iii) Exploration of ways to attain further intra-regional exchange rate stability.

## **Joint Ministerial Statement of the AFMM+3**

### **AFMM+3 on May 6, 2000 (Chiang Mai, Thailand)**

6. In order to strengthen our self-help and support mechanisms in East Asia through the ASEAN + 3 framework, we recognized a need to establish a regional financing arrangement to supplement the existing international facilities. As a start, we agreed to strengthen the existing cooperative frameworks among our monetary authorities through the "Chiang Mai Initiative". The Initiative involves an expanded ASEAN Swap Arrangement that would include ASEAN countries, and a network of bilateral swap and repurchase agreement facilities among ASEAN countries, China, Japan and the Republic of Korea.

### **AFMM+3 on May 15, 2004 (Jeju, Korea)**

5. On the Chiang Mai Initiative (CMI), we are pleased to note the continued expansion of its network of bilateral swap arrangements. Since we last met in Makati City in the Philippines, in August 2003, four more Bilateral Swap Agreements (BSA) have been concluded. That brings the total number of (BSA) to sixteen, and the size of the network to USD 36.5 billion.

6. We agreed to undertake further review of the CMI to explore ways of enhancing its effectiveness. A working group will be tasked to conduct the review and report the outcome, by the end of 2004, to our Deputies who will report to us at the next AFMM+3.

## Basic Framework of the Chiang Mai Initiative

### 1. Components of the Initiative

#### *1) Expansion of the ASEAN Swap Arrangement*

The first component of the Initiative is to expand the present ASEAN Swap Arrangement to include all ASEAN countries. Brunei Darussalam has agreed to join the ASEAN Swap Arrangement. The details of the accession will be worked out subsequently. For Cambodia, Lao PDR, Myanmar and Vietnam, some flexibility will be given for their gradual accession into the ASEAN Swap Arrangement. Details on this phase-in mechanism shall be worked out later under the ASEAN countries' leadership. The amount available under the Arrangement was raised to USD 1 billion.

#### *2) Network of bilateral swap and repurchase agreements*

The second component of the initiative is to construct a network of bilateral currency swap and repurchase agreements among the ASEAN+3 countries. Each participating country will choose feasible arrangements among the following options and negotiate specific conditions of the arrangements bilaterally with other participating countries.

- a) Currency swap between U.S. dollar and local currency  
A country in need for foreign exchange liquidity purchases U.S. dollar from the counterparty country with a contract of future selling, in exchange for selling of its local currency with a contract of future repurchasing.
- b) Currency swap between local currencies  
A country in need for foreign exchange liquidity (country A) purchases a local currency of country B with a contract of future selling, in exchange for selling of the local currency of country A to country B with a contract of future repurchasing.

c) Repurchase agreement of U.S. Treasury securities  
A country in need for U.S. dollar cash sells U.S. Treasury securities to the counterparty country with a contract of future repurchasing.

d) Repurchase agreement of sovereign securities denominated in local currency  
Country in need for foreign exchange cash (country A) sells sovereign securities denominated in local currency of country B with a contract of future repurchasing.

Choice of option(s) should be left to each bilateral negotiation. In order to facilitate bilateral negotiation process, main principles of bilateral swap and repo arrangements under the initiative are to be agreed.

## **2. Economic policy dialogue among the ASEAN+3**

Economic policy dialogue process among the ASEAN+3 countries can be utilized for actual operation of this mechanism.

## **3. Relation with the multilateral cooperation framework**

### ***1) Swap arrangement***

The financial assistance under the bilateral swap arrangement will be disbursed when the IMF facilities are activated or will be activated in the very near future.

Notwithstanding the paragraph above, up to 10 percent of the maximum amount of drawing could be provided without linkage with the IMF facilities for a short-term period, in a case where the swap-providing countries judge that the swap-requesting country is facing a short-term liquidity problem.

### ***2) Repurchase agreements***

As is the case with the existing agreements among the Asian countries, repurchase agreement can be operated regardless of the existence of the financial support from the IMF.

#### 4. Others

Swap agreements to provide short-term liquidity for purposes such as stabilizing financial markets can be considered if and when both parties of a swap agreement agree. Specific conditions for such swap will be determined by the both parties.

**The existing bilateral swap or repurchase agreements between participating countries will operate separately from this mechanism. However, the participating countries can incorporate the existing swap or repurchase agreements into this mechanism, if and when they agree.**

## **Main Principles of Bilateral Swap Arrangements under the Chiang Mai Initiative <sup>32)</sup>**

### **I. Purpose of Arrangement**

1. Under the Chang Mai Initiative, a network of the bilateral swap arrangements (the "Swap Arrangement") would be established among participating countries<sup>33)</sup>. The activation of the Swap Arrangements would be on simultaneous basis in line with the provisions in the Swap Arrangements.

The purpose of the Swap Arrangement is to provide short-term financial assistance in the form of swaps to any country participating in Chiang Mai Initiative which is in a need of balance of payment support or short-term liquidity support (a "Swap-Requesting Country").

2. The Swap Arrangement shall supplement existing international financing facilities, including those provided by the International Monetary Fund (the "IMF") and the ASEAN Swap Arrangement dated August 5, 1997 as amended from time to time (the "ASEAN Swap Arrangement").

3. Each country participating in the Chiang Mai Initiative shall, at its discretion, enter into a bilateral agreement (each an "Agreement") with each other country participating in the Chiang Mai Initiative to provide for the terms and conditions of the swap transactions to take place under the Swap Arrangement.

### **II. Drawing and Maximum Amount of Drawing**

4. The maximum amount of the aggregate monetary obligation outstanding at any time under each Agreement (the "Maximum Amount of Drawing") shall be provided for in such Agreement. When the

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32) As long as bilateral swap arrangements between ASEAN countries are concerned, this document will not be used as compulsory one.

33) Brunei Darussalam, Cambodia, China, Indonesia, Japan, the Republic of Korea, Lao, PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam.

amount available to the Swap-Requesting Country is drawn by means of purchase and is repaid by means of repurchase, it may be redrawn.

### **III. Maturity**

5. Drawing may be renewed in whole or in part up to seven times on the terms and subject to the conditions to be provided for in the Agreement, provided, however, that each drawing or renewal of drawing by the Swap-Requesting Country under the Agreement shall mature ninety (90) days after the day when such drawing or renewal of drawing takes place (such day of drawing or renewal of drawing being the "Value Date").

### **IV. Drawing Period and Termination**

6. No drawing or renewal of drawing under the Agreement may be made with a Value Date that will occur after the expiration of a drawing period (the "Drawing Period") which commences on the effective date of the Agreement and ends three (3) years after such effective date. The Drawing Period may be extended by agreement between the parties to the Agreement.

7. The Agreement may be terminated upon one (1) month's prior notice by either party to the Agreement to the other of its intention to terminate the Agreement, provided, however, that if any obligation under the Agreement remains outstanding at the time of termination, all terms and conditions of the Agreement shall continue to apply to such obligation until it has been fulfilled.

### **V. Interest Rate**

8. When a repurchase in any swap transaction is to be made, the Swap-Requesting Country shall repay to the counter-party to the swap transaction under the Swap Arrangement (the "Swap-Providing Country") the original amount, together with an additional amount equivalent to interest on such amount calculated at an interest rate determined in accordance with the Agreement. Such interest rate shall be LIBOR plus

a premium of 150 basis points for the first drawing and the first renewal of drawing. Thereafter, the premium shall be increased by an additional 50 basis point for every two renewal of drawing; provided that such premium shall not be higher than 300 basis point.

## **VI. Relationship among Swap-Providing Countries**

9. Each drawing or renewal of drawing shall be made upon request from the Swap-Requesting Country to the Swap-Providing Countries in accordance with the terms and conditions of the Agreements and subject to the conditions set forth below in Section VII.

10. Prior to making any official request for a drawing under the Swap Arrangement, the country contemplating such request shall dispatch to each of the countries with which it is party to an Agreement a letter of inquiry as to willingness to accept such request when made. Such letters of inquiry shall set forth indicative amounts requested for drawing on a pro rata basis based on the Maximum Amount of Drawing under the Agreements (less the amount of any outstanding swaps thereunder).

Among the countries which received such letters of inquiry (the "inquiry recipients"), a coordinating country will be designated. The inquiry recipients have consultation among themselves as to whether they can accept the request when made. The coordinating country will coordinate this consultation process. If all inquiry recipients can accept the request when made, the coordinating country shall give notice to that effect to the inquiring country and inquiring country shall issue official requests for drawing to each inquiry recipient in accordance with the letter of inquiry. The disbursements will be made in accordance with the official requests simultaneously.

If any of the inquiry recipients determines that it will not be able to accept the request partially or entirely due to its balance of payment and reserve position, or in the light of the amount stated in such inquiry, etc., such inquiry recipient shall immediately give notice to that effect to the inquiring country and the other inquiry recipients. In this case, the inquiring country shall issue official requests for drawing to the recipients who will accept the requests. The disbursements will be made in accordance with the official requests simultaneously. After that, the inquiring country and the inquiry recipients shall have consultation

among themselves as to the method to settle the discrepancy between the amount to be requested by the inquiring country and the amount to be accepted by the inquiry recipients. The coordinating country will coordinate this consultation process. When the inquiry recipients and the inquiring country can reach an agreement as to such method, the inquiring country shall issue other official requests for drawing in accordance with such agreement. The disbursements will be made in accordance with the official requests simultaneously. The inquiry recipient shall take into consideration the circumstances of the inquiring country and the other inquiry recipients when it determines that it will not be able to accept the request partially or entirely.

11. In the event that the Swap-Providing Country judges that the Swap-Requesting Country is subject to extraordinary circumstances, notwithstanding the procedure specified in the immediately preceding paragraph, the Swap-Providing Country may initiate a bilateral consultation with the Swap-Requesting Country as to the amount and the timing of a drawing under the Swap Arrangement. In such case, an official request for drawing shall be made in accordance with the result of such bilateral consultation.

## VII. Conditions

12. Each Agreement will provide for certain conditions, which the Swap-Requesting Country must satisfy, as determined by the Swap-Providing Country in its judgement, as a condition to the drawing or renewal of drawing, including, but not limited to, the following:

- (1) Conditions precedent for perfecting the Agreement<sup>34</sup>:
  - a) Appropriate measures shall have been taken for the security of the interest of the Swap-Providing Country under the Agreement, which may consist of the provision of security interests in certain assets or the provision of a guarantee by the government of the Swap-Requesting Country;
  - b) The government of the Swap-Requesting Country shall have
    - (i) agreed that it shall comply with all of its covenants under the Agreement and
    - (ii) submitted to the Swap-Providing

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34) b) and c) are negotiable depending on domestic legal structure of both parties to the Agreement.

Country a certificate confirming such agreement; and

- c) The Swap-Requesting Country shall have provided to the Swap-Providing Country legal opinions with respect to the legality, validity, binding power and enforceability of the Agreement.
- (2) Conditions precedent for first drawing, any other drawing and any renewal of drawing under the Agreement:
- a) Appropriate steps shall have been taken by the Swap-Requesting Country to gain and maintain access to private market financing;
  - b) The Swap-Requesting Country shall have undertaken implementation of sound economic measures to counter unusual downward pressure on the foreign reserves;
  - c) One of the following conditions is fulfilled:
    - i) An economic program for financial assistance agreed between the IMF and the Swap-Requesting Country (the "IMF Program") is already in existence;
    - ii) the Swap-Providing Country judges that there is a reasonable level of assurance that an IMF Program for the Swap-Requesting Country will be established in the very near future, provided that the drawing shall be subject to the right of the Swap-Providing Country to require early repurchase in the event of the non-establishment of such IMF Program; or
    - iii) An arrangement for the Contingent Credit Line between the IMF and the Swap-Requesting Country is already in existence, and the Swap-Requesting Country has made a purchase thereunder or the Swap-Providing Country judges that there is a reasonable level of assurance that such a purchase will take place in the very near future.
  - d) The drawing is consistent with the IMF Program existing or to take place in the very near future;
  - e) Notwithstanding the condition c) and d) of this paragraph, the Swap-Providing Country may disburse up to 10 percent of the Maximum Amount of Drawing under the Agreement when the Swap-Providing Country judges that the Swap-Requesting Country does not need to rely on the IMF program. In this case, notwithstanding paragraph 5, renewal

- of drawing cannot be repeated.
- f) The IMF Program, if any, shall be proceeding in accordance with the plans therefor; and
  - g) The Swap-Requesting Country shall not have failed to comply with any of its covenants, warranties, obligations, agreements or undertakings under the Agreement and no event shall have occurred and be continuing which, had the drawing or renewal of drawing already been made, would result in failure to comply with any of its covenants, warranties, obligations, agreements or undertakings under the Agreement.

### VIII. Covenants<sup>35)</sup>

13. Each Agreement shall contain covenants of the Swap-Requesting Country, including, but not limited to, the following:

- a) Provision of reports on foreign exchange reserves (including information on increasing or decreasing categories) and other economic and financial information as may be requested by the Swap-Providing Country with appropriate frequency to be determined by mutual agreement between the parties to the Agreement ;
- b) Maintenance of Usable Foreign Reserves (as such term shall be defined in the Agreement) at a level as provided for in the Agreement;
- c) Negative pledge;
- d) Undertaking to ensure that the obligations of the Swap-Requesting Country under the Agreement shall rank *pari passu* in right of repayment with all other present and future direct, unsecured, and unsubordinated external debt obligations of the Swap-Requesting Country;
- e) **Compliance by the Swap-Requesting Country with the IMF Program, if any, agreed between the Swap-Requesting Country and the IMF; and**

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35) The contents of the covenants are negotiable depending on domestic legal structure of both parties to the Agreement.

- f) **Non-imposition of any control on capital outflows which could deter or prevent the performance by the Swap-Requesting Country of any monetary obligation under the Agreement.**

## **IX. Events of Default**

14. Each Agreement shall provide for certain events of default, upon the occurrence of which all outstanding monetary obligations thereunder of the Swap-Requesting Country shall become immediately due and repayable.

15. The events of default shall include the cross default clause so that any default in the performance of monetary obligations under the Agreements would constitute an event of default under the Agreement.

16. When any of the Swap-Providing Countries determines any of the events of default has occurred under the Agreement, the Swap-Providing Countries under the Agreements and the Swap-Requesting Country in default shall consult with each other as to the method to ensure that the Swap-Requesting Country in default can repay the amount of the outstanding swap under the Agreement.

## **X. Governing law and Jurisdiction<sup>36)</sup>**

17. The governing law of each Agreement shall be the law of the Swap-Providing Country. The Swap-Requesting Country must agree to the waiver of sovereign immunity to the extent possible under the law of the Swap-Requesting Country.

18. The Agreement shall provide for submission by the Swap-Requesting Country to the jurisdiction of the Swap-Providing Country.

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36) The contents of the second sentence of paragraph 17 and paragraph 18 are negotiable depending on domestic legal structure of both parties to the Agreement.

## *Main Principles of Repurchase Agreements* **under the Chiang Mai Initiative**

### **I. Purpose of Agreement**

1. The purpose of the repurchase agreement under the Chiang Mai Initiative ("Repo Agreement") is to provide short-term foreign exchange liquidity to any participating country in the Chiang Mai Initiative ("Participant"), which is in need of foreign exchange liquidity support, via the sale and buyback of appropriate Securities.

2. The Repo Agreements can be operated without any relation to support from International Financial Institutions.

3. Each Participant shall, at its discretion, enter into a bilateral Repo Agreement with each other Participant to provide for the terms and conditions of the repurchase transactions to take place under the Repo Agreement.

### **II. Securities for the Repo Agreements**

4. There are two types of Repo Agreements as stipulated below. In both cases, each transaction shall be effected to mutual agreement.

#### *1) US Treasury Notes or Bills with remaining life of not more than 5 years*

This type of Repo Agreement transaction shall be a sale and buyback of US Treasury Notes or Bills with remaining life of not more than 5 years. A Participant in a need for US dollar cash sells such securities to the counterparty Participant with a contract of future repurchasing.

#### *2) Government issued securities of the counterparty country of the Repo Agreement*

This type of Repo Agreement transaction shall be a sale and buyback of sovereign securities of the counterparty Participant of the Repo Agreement, which is denominated in local currency of the

counterparty Participant. A Participant in a need for the local currency cash of the counterparty Participant sells such securities to the counterparty Participant with a contract of future repurchasing.

### III. Period of Repo Agreement

5. A Repo Agreement shall be for a period of not more than one (1) week, which may be rolled over on the termination value date, subject to mutual agreement. The period of the Repo Agreement, however, may be extended by agreement between the parties of the Repo Agreement. The conditions and procedures on early repurchase shall be determined by the parties of the Repo Agreement.

### IV. Minimum Amount of Each Repo Transaction Request

6. Each request shall be for a minimum amount of 5% of the amount of the Repo Agreement unless otherwise agreed between the parties of the Repo Agreement.

### V. Repo Agreement Rate

7. **The Repo Agreement rate of the type II.a shall be the reverse repo rate for US Government Securities from an appropriate source, as quoted on the day the request is agreed upon. In this case, the Repo Agreement interest amount shall be derived according to the following formula:**

$$\text{Repo Interest} = (\text{Start Proceeds}) \times r\% \times t/360$$

whereby

$$\text{Start Proceeds} = [(\text{Nominal Amount} \times \text{Market Price}) + (\text{Accrued Interest})] / \text{buyer's margin}$$

t = actual number of days of the repo

r% = repurchase agreement rate as indicated above

8. **The appropriate rate of the Repo Agreement of the type II.b, however, shall be agreed by the parties of the Repo Agreement.**

## VI. Margin

9. The buyer's margin shall be 102% for the Repo Agreement of the type 2.a and 105% for the Repo Agreement of the type 2.b, unless otherwise agreed between the parties of the Repo Agreement.

## VII. Operational Procedure, Rollover, and Settlement

10. Operational Procedure, Rollover, and Settlement for the Repo Agreement shall be determined by the parties of the Repo Agreement.

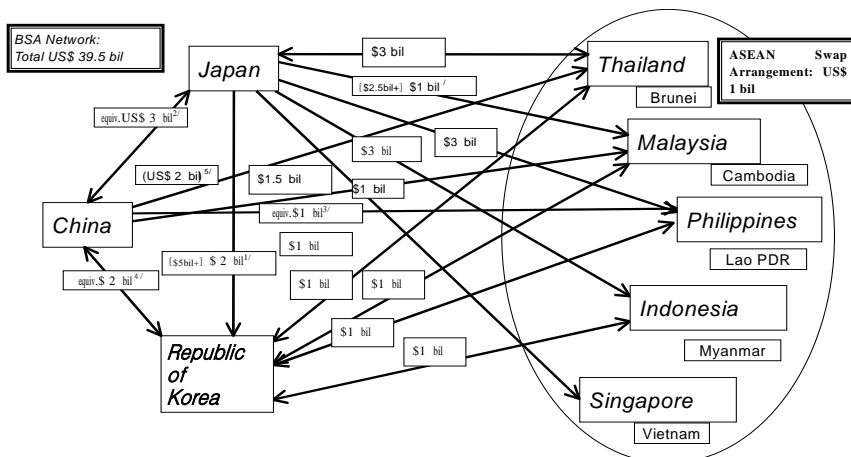
## VIII. Duration of the Repo Agreement

11. The Repo Agreement shall remain in force and effect until terminated by a party of the Repo Agreement upon thirty (30) days after written notification is issued to the other party of the Repo Agreement, unless otherwise agreed between the parties of the Repo Agreement.

## IX. Others

12. Outright purchase of appropriate Securities of 2.a or 2.b above shall be incorporated in the Repo Agreement, provided that both parties of the Repo Agreement agree.

### Overview of the CMI (as of end-April 2005)



No.	BSA		Currencies	Status	Size	Total Size
1	Japan-Korea	one-way	US\$/Won	Concluded / 4 July 2001	US\$2 billion	US\$2 billion
2	Japan-Thailand	one-way	US\$/Baht	Concluded / 30 July 2001 Expired / 29 July 2004	US\$3 billion	-
3	Japan-Philippines	one-way	US\$/Peso	Concluded / 27 August 2001	US\$3 billion	US\$3 billion
4	Japan-Malaysia	one-way	US\$/Ringgit	Concluded / 5 October 2001	US\$1 billion	US\$1 billion
5	China-Thailand	one-way	US\$/Baht	Concluded / 6 December 2001 Expired / 5 December 2004	US\$2 billion	-
6	Japan-China*	two-way	Yen/Renminbi, Renminbi/Yen	Concluded / 28 March 2002	US\$3 billion	US\$6 billion
7	China-Korea*	two-way	Renminbi/Won, Won/Renminbi	Concluded / 24 June 2002	US\$2 billion	US\$4 billion
8	Korea-Thailand*	two-way	US\$/Baht, US\$/Won	Concluded / 25 June 2002	US\$1 billion	US\$2 billion
9	Korea-Malaysia*	two-way	US\$/Ringgit, US\$/Won	Concluded / 26 July 2002	US\$1 billion	US\$2 billion
10	Korea-Philippines*	two-way	US\$/Peso, US\$/Won	Concluded / 9 August 2002	US\$1 billion	US\$2 billion
11	China-Malaysia	one-way	US\$/Ringgit	Concluded / 9 October 2002	US\$ 1.5 billion	US\$ 1.5 billion
12	Japan-Indonesia	one-way	US\$/Rupiah	Concluded / 17 February 2003	US\$3 billion	US\$3 billion
13	China-Philippines	one-way	Peso/Renminbi	Concluded / 29 August 2003	US\$1 billion	US\$1 billion
14	Japan-Singapore	one-way	US\$/SG\$	Concluded / 10 November 2003	US\$1 billion	US\$1 billion
15	Korea-Indonesia*	two-way	US\$/Rupiah, US\$/Won	Concluded / 24 December 2003	US\$1 billion	US\$2 billion
16	China-Indonesia	one-way	US\$/Rupiah	Concluded / 30 December 2003	US\$1 billion	US\$1 billion
17	Japan-Thailand*	two-way	US\$/Baht, US\$/Yen	Concluded / 7 March 2005	US\$3 billion	US\$6 billion

\*: This BSA is a two-way swap arrangement where each party can request the other party to enter into the swap transaction to provide liquidity support when necessary to overcome balance of payments difficulties in the specified currency up to the agree amount. The overall availability for the BSA is therefore counted doubled the face value of the BSA.

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## Appendix 4.

### Progress Report of the Asian Bond Markets Initiative (ABMI)

[ASEAN+3 Finance Ministers Meeting, 4 May 2005, Istanbul, Turkey]

#### I. Overview of ABMI and Asian Bond Markets

1. **More than two years have passed since the ASEAN+3 launched the Asian Bond Markets Initiative (ABMI) in December 2002.** Over that time, active efforts have been pursued by the ASEAN+3 officials under six working groups, where we have not only strived for creating an enabling environment for bond markets development in their own countries, but also have conducted regular dialogues and discussions among themselves as well as with academics and private-sector market participants through various meetings, seminars, forums, and symposiums.

2. **Initial intensive efforts are bearing fruits in 2004/05.** A number of meetings and seminars for each of the working groups, as well as two Focal Group meetings, have been held since the AFMM+3 in May 2004 in Jeju, Korea. During that period, concrete achievements have been realized under the ABMI such as:

- (a) Issuance of Ringgit-denominated bonds by the ADB and the IFC in Malaysia in November and December 2004,
- (b) Issuance of cross-country primary collateralized bond obligations (CBOs) (named "Pan- Asia Bond") by Korea and Japan in December 2004,
- (c) Provision of credit guarantees by JBIC for bond issued by an Asian multinational company in Thailand in June 2004, and
- (d) Launch of the Asian Bonds Online Website (ABW) in May 2004.

In addition, various studies, research projects, and capacity-building programs for the development and harmonization of bond markets in the region have been concurrently undertaken in each working group, some of which have even completed their initial goals. The details of

such progress are described in “II” below (see also Attachments (1) to (6)).

**3. Driven by ABMI and continued demand in the market, East Asian local currency bond markets have been growing rapidly, and some structural changes are occurring.** In 2004, according to the “*Asia Bond Monitor, April 2005*” published by the ADB, outstanding local currency government bonds grew by 32 percent for East Asia as a whole (excluding Japan) in US dollar terms, and the outstanding corporate bonds also grew by 10 percent on average in US dollar terms in the five countries where data are available (i.e., Indonesia, Korea, Malaysia, Singapore and Thailand). Also, the “*Asia Bond Monitor, April 2005*” pointed out the following important structural changes emerging in the East Asian local currency bond markets:

- (a) Issuance of longer maturity bonds extended government yield curves in Malaysia and Korea<sup>37</sup>;
- (b) Efforts continued to increase issue size of benchmark government bonds in Indonesia, Korea, Malaysia, the Philippines, and Singapore; and
- (c) The strong growth of asset-backed securities and Islamic bonds, and the issuance of bonds by multilateral development banks, indicated a wider issuer base supported by investor demand in the region.

## II. Progress of Each Working Group

### *Working Group 1 (Thailand)*

#### *Creating New Securitized Debt Instruments*

**4. WG1 has continued to take a three-pronged approach toward its goal of creating new securitized debt instruments and increasing the supply of local currency bonds, with additional emphasis on the withholding tax issue.**

The first element in this approach is to encourage member countries to issue more local currency bonds, to increase more supply as well as to broaden the issuer base and types of bonds. In Malaysia,

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37) In 2004, Malaysia issued a 15 year-bond and Korea began a policy of issuing longer-dated securities beyond 3-5 year maturities traditionally preferred by local investors.

concentration has been placed on issuing asset-backed securities denominated in Malaysian ringgit and withholding tax exemption has been granted for non-resident investors with effect from 11 September 2004. In Thailand, a plan to issue Thai-baht Asian bonds has materialized. Necessary amendments to the Royal Decree and Ministerial Regulations were made and non-resident investors of Thai-baht Asian bonds will receive tax-free income from bondholding. At this point, when non-resident investors purchase bonds issued by the government, non-listed state-owned enterprises and specialized financial institutions, incomes including interests, capital gains, and discount are exempt from withholding taxes. Since Thai-baht Asian bonds include both existing bonds and new bonds issued by such institutions, they account for large portion in the market. Thai-baht Asian bonds will be issued regularly and listed in the Bond Electronic Exchange to ensure transparency while promoting liquidity. Furthermore, through collaboration between Korea and Japan, the Pan-Asia Bond (CBOs: collateralized bond obligations) was successfully issued on December 13, 2004. It used SME bonds as underlying assets, amounting to 10 billion yen. Japan expressed, at the WG1 meeting in Manila in March 2005, its intention to work on further issuance of the same type of CBOs with other member countries.

The second element is treatment of withholding taxes on bond holding that could help promote liquidity and cross border activity of debt markets in the region. At the AFMM+3 in May 2004 in Jeju, Korea, the Ministers tasked Thailand to further explore a more systematic application of withholding taxes within the ASEAN+3 borders. Through the concept of attaining a level-playing field whereby non-resident investors are granted withholding tax exemption, the Ministry of Finance, Thailand submitted a proposal containing three "practical alternatives" to achieve this purpose. Nonetheless, the decision on whether and how to implement the withholding tax exemption should be left up to the discretion of each ASEAN+3 member country. The proposal with concurrence given by the AFDM+3 will be reported to the AFMM+3 in Istanbul, Turkey, in May 2005. The proposal appears as attachment 7.

The third element is Regional Multi-Currency Bonds (RMCB). The broad framework of the RMCB proposal was presented by the ADB consultants at the WG1 meeting in Manila, in March 2005. The RMCB project has a clear work plan where (1) preparatory analysis of needs,

ideal structure, and impediments will be done during March and April 2005; (2) detailed market sounding will be conducted during the period from May to July 2005; (3) draft will be finalized during the period from July to early August 2005. If any concrete proposals to issue RMCB between any member countries would emerge, preparation for such issuance could be commenced in parallel with the market sounding phase.

*Working Group 2 (Korea and China)*

*Credit Guarantees and Investment Mechanisms*

**5. WG2 has focused on studying a new guarantee and investment mechanism.** In November 2004, the working group discussed such topics as the status of the study, a new time table and the formation of a new team. To facilitate the study, additional international consultants were engaged as specialists in the area of banking and investment policy/administration, financial sector policy, and financial modeling. In March 2005, the ADB consultants explained the preliminary results of the study at that stage to the working group and various topics, such as the rationale of the new mechanism, possible organization choices, demand analysis, business philosophy, and investment guidelines were covered in their presentation.

Further demand analysis and research in other areas are expected to continue till June 2005. Consultation seminars are scheduled in the coming months in order to reflect the views of private-sector participants. After the report on the study is completed in June, it will be reported to the Finance Ministers.

*Working Group 3 (Malaysia)*

*Foreign Exchange Transactions and Settlement Issues*

**6. WG3 has intensively studied a possible regional clearing and settlement mechanism (i.e., Asia Link) and impediments to cross-border transactions.** The findings and recommendations of the study on the possibility of a linkage among the clearing and settlement systems of member countries, including such private sector as global custodians, in facilitating cross-border transactions were presented by the ADB consultants at the WG3 meeting in Manila, in March 2005. In the course of the study, market consultation meetings were held in Singapore, Hong Kong and Tokyo in January 2005. In the consultation, market participants

expressed various cautious views against the proposed regional linkage of the clearing and settlement system at this stage. The ADB report is expected to reflect the feedback from member countries and market participants.

In parallel with the ADB's study, a survey on impediments to cross-border investment and issuance has been carried out continuously by the Bank of Japan and Bank Negara Malaysia. The report on impediments will be updated in April 2005.

#### *Working Group 4 (China)*

##### *Issuance of Bonds Denominated in Local Currencies by MDBs, Foreign Government Agencies, and Multinational Corporations*

**7. WG4 has undertaken various surveys and seminars on the local currency bond issuances by MDBs, foreign government agencies, and multinational corporations.** Comprehensive surveys and seminars have revealed merits, key factors, regulations, and institutional requirements, which have paved the way for the successful issuance of local currency bonds by the ADB, World Bank, IFC, JBIC, and various multinational corporations in the region. WG4 has also commissioned a "Country Case Study on Local Currency Bond Issuance by Foreign Issuers."

**8. In this regard, much progress has been made so far.** Malaysia issued relevant regulations in August and October 2004. The first issuance by a foreign issuer was seen in November 2004 when the ADB issued bonds denominated in ringgit. Shortly after that, in December, another issuance of ringgit-denominated Islamic bonds by the International Finance Corporation was realized. The Philippines also issued tentative approvals for the ADB to issue bonds and a first issue by the ADB may be expected in the second quarter of 2005. Thailand has already provided the relevant approval to some MDBs and foreign government agencies and has issued the relevant regulations. First issuance by the ADB, JBIC, and IFC are expected in the near future. The PRC is also studying the possibility of allowing local issuance by foreign issuers and announced the relevant regulations in late February 2005 with first issuance expected in 2005. Also, the fact that many multinational corporations, including Japanese ones in the region, have started to issue local currency-denominated bonds in the region encourages our initiative.

**9. With the various efforts to resolve different issues of local**

**currency denominated bonds, significant progress has been made in achieving successful issuance by MDBs, foreign government agencies and multinational corporations.** At the WG4 meeting in Manila in March 2005, members expressed their satisfaction with the successful progress and thanked the chair for its leadership. **Therefore, it was recommended to the Focal Group that WG4 wrap up its proceedings since it has fulfilled its initial goal.**

*Working Group 5 (Singapore and Japan)*

*Rating Systems and Information Dissemination*

**10. WG5 continues to seek to enhance the visibility and credibility of local credit rating agencies (CRAs) to improve the rating systems in Asia.** As measures to raise the visibility of local CRAs, WG5 utilizes the Asian Bonds Online Website (ABW) and is organizing, with support from the ADB, seminars relating to the local CRAs on the sideline of the ADB's Annual Meeting. With a view to enhancing the credibility of local CRAs, WG5 continues its close collaboration with a caucus of local CRAs in the region (that conducts joint training workshops and best practice dialogues), and also is organizing forums and seminars, focusing on the most salient issues concerning local CRAs in Asia. For instance, WG5 held an ad-hoc forum to foster local CRAs' expertise in the credit rating of structured financial products in October 2004, and will organize another ad-hoc forum on the recent discussions on the CRAs at the BIS and IOSCO in June 2005, given the significant impact it could have on the activities of local CRAs in Asia. WG5 continues to seek new areas to contribute to Asian bond market growth, the latest being the exploration of ways to facilitate cross-border acceptance of Asian credit ratings. Singapore has agreed to draft a paper to initiate discussion.

**11. The Asian Bonds Online Website (ABW) was successfully launched in May 2004 and thereafter has been constantly updated and improved.** The ABW has attracted various viewers such as professional market practitioners, bond issuers, academic and research institution personnel, government and government agency officials. The number of daily visits to the ABW has increased steadily, peaking at 992 in early January 2005. The ABW thus far has been enhanced by (a) launching an on-line publication "*Asia Bond Monitor*" and (b) introducing the "*Asia Bond Indicators*" (including the list of leading underwriters and book-runners in local currency bond markets in Asia), and will be further

expanded by (c) establishing a section of “How to Buy a Bond,” which will provide a basic walk through the process of purchasing and holding government and corporate bonds in Asia and (d) introducing an “East Asian Bond Glossary” that will explain the terms and definitions specific to Asian bond markets.

*Working Group 6 (Indonesia, Malaysia and Philippines)*

*Technical Assistance Coordination*

**12. Technical Assistance (TA) on the regional bond markets development has been well coordinated under WG6.** “TA on the regional bond markets development” encompasses two phases: Phase I and Phase II. Phase I deals with (a) general issues and case studies of best practices in bond markets development and (b) a specific roadmap and work program for bond markets development. The “Phase I” has been delivered to Indonesia, Malaysia, the Philippines, Thailand, Vietnam and Cambodia and is to be provided to Lao PDR soon by Nomura Research Institute (NRI). Phase II started in December 2004, aiming to address the practical and operational needs of each country, based on a matrix formulated on each country’s needs. Five countries, namely, Cambodia, Indonesia, the Philippines, Thailand and Vietnam, have expressed their intention to participate in the Phase II, to which NRI and Daiwa Institute of Research (DIR) were appointed as consultants. To complement Phase II, Korea has also extended technical assistance to Thailand and Indonesia. In addition to Korea, Malaysia, and Thailand have also expressed their intention to provide TA.

**13. WG6 organized a Seminar on Bond Market Development for Cambodia, Lao PDR, Myanmar, and Vietnam (CLMV) in Bangkok on 17-18 March 2005.** The seminar provided a unique opportunity for CLMV countries to contemplate the further bond market development in CLMV countries, which was attended by in total 100 of the MOF and central bank officials and experts from other ASEAN+3 countries. The seminar offered a model for further collaboration among member countries on TAs under WG6.

### **III. Discussion at the Focal Group**

**14. The Focal Group fulfilled the role of monitoring the progress of six ABMI working groups and coordinate the future action plans.**

The 2<sup>nd</sup> and 3<sup>rd</sup> Focal Group meetings were convened on November 12, 2004, in Tokyo, Japan, and on March 20, 2005 in Vientiane, Lao PDR, respectively, with the attendance of representatives from all ASEAN+3 countries, the ASEAN Secretariat, and the Asian Development Bank. According to the agreed Terms of References, chairs of each Working Group reported their WG's progress made to date, future work, and issues for consideration at the Focal Group. The ADB also gave attendants a snapshot of bond markets in East Asia, based on the report in the *Asia Bond Monitor*. To further enhance the efficient and smooth coordination of ABMI, the ASEAN Secretariat launched the ABMI Internal Website in March 2005, with the aim of having the function of a virtual secretariat for e-mail communication and schedule coordination among the ABMI officials. The Focal Group made a deliberation on ways to redefine the future work of ABMI, as well as on the Report of the Withholding Tax Project.

#### **IV. Deliberation among the Deputies**

**15. Based on the intensive discussion, the chair of the Focal Group reported the overall progress of ABMI and a couple of proposals to the Deputies of the ASEAN+3 Finance Ministers and Central Bank Governors at the AFDM+3 on April 4, 2005 in Vientiane, Lao PDR.**

**16. The Deputies were pleased to observe the overall progress of the ABMI thus far and pointed out the benefit of reviewing the current framework of the ABMI at this juncture, possibly by reorganizing the existing working groups and incorporating new perspectives.** The Deputies witnessed (a) the achievement of the initial goal of WG4, (b) the launch of the Asian Bonds Online Website (ABW) by WG5, and (c) the completion of the survey on impediments to cross-border investment and issuance which will be updated periodically by WG3. The Deputies also felt the necessity to strengthen its functions of gathering, sharing and disseminating information on bond markets development in Asia, and enhancing its role of coordination among the working groups (e.g., more active use of local credit ratings in the initiative).

**17. In the AFDM+3 in April 2005, two new proposals were made by the Focal Group to redefine the future work of ABMI, namely, (i) the *ABMI Roadmap* and (ii) *Asian Bond Standards*.** The Roadmap aims at

creating a mechanism to gather and share information in an integrated manner on bond market development and our related efforts and to spread and coordinate the initiative under the strong leadership of the Focal Group, taking into account the three pre-requisites, namely, (a) efficiency, (b) continuity and consistency, and (c) flexibility. To this end, it was proposed that the functions of Focal Group as a navigator and an information center of ABMI would be strengthened by setting up an Ad-hoc Support Team for the Focal Group (ASTFG). The Roadmap also addresses the need to reorganize the current working groups by abolishing the current WG4 and renaming WG6 as TA Coordination Team for the Focal Group (TACT). (See Attachment (7) for details.)

Meanwhile, a usefulness to develop the international bond markets in Asia was suggested by Korea after its successful issuance of the pan-Asia Primary CBO that was denominated in yen and listed in the Singapore Stock Exchange. In the AFDM+3 in April 2005, it was proposed to start an in-depth study of the so called *Asian Bond Standards*, which would explore standards for international bonds using the infrastructure and the issuance procedures in Asia, possibly in the ASTFG (or a special task force under the Focal Group). (See Attachment (8) for details.)

**18. The Deputies received the Final Report of the Withholding Tax Project, which was tasked at the last AFMM+3 in May 2004 and has been deliberated by the WG1.** The report embraces the voluntary “practical alternatives” on the treatment of withholding taxes on bond holdings to achieve a level-playing field whereby withholding tax exemption are granted to non-resident investors.

## **V. Conclusion**

**19. The Deputies seek an endorsement and guidance by the Ministers on the activities of ABMI.**

## *ABMI WG Progress Report [April 2005]*

### **WG 1 [Creating New Securitized Debt Instruments]**

#### **I. Progress to date**

The Working Group on New Securitized Debt Instruments (WG1) chaired by the Ministry of Finance (MoF) of Thailand has an important mandate to help promote supply of local currency denominated Asian bonds. WG1 has convened working group meetings on a regular basis whereby WG1 meetings were attended by officials of relevant entities from public and private sectors of ASEAN+3 member countries. A summary of undergoing tasks can be summarized as follows:

#### *(a) Issuing more local-currency denominated Asian bonds*

To serve the purpose of helping to reduce the so called “double mismatches” of both duration and currency, it is logical to examine ways that could mitigate risks that may arise from both duration and foreign exchange sources. WG1 Chair has encouraged members to issue more local currency denominated bonds and has invited members to regularly provide updates during WG1 meetings. Recent updates are as follows:

**Republic of Korea:** Through cooperation with the Ministry of Finance of Japan, the Ministry of Finance and Economy (MoFE) issued collateralized bond obligations (CBOs) on December 13, 2004. It used SME bonds as underlying assets, amounting to 10 billion yen. The CBOs were offered to Asian investors.

**Malaysia:** Concentration has been placed on issuing asset backed securities denominated in Malaysian Ringgit. To promote liquidity of Ringgit denominated bonds, withholding tax exemption has been granted for non-resident investors.

**Thailand:** A plan to issue Thai-baht Asian bonds has materialized. At the initial stage, sovereign, non-listed quasi-sovereigns, as well as specialized financial institutions are classified as issuers who would be able to issue Thai-baht Asian bonds. To promote liquidity in the secondary market, non-resident bondholders of Thai-baht Asian bonds

will receive tax-free income from bondholding. In addition, Thai-baht Asian bonds will be electronically traded at the Bond Electronic Exchange (BEX).

*(b) Withholding tax treatment*

The ASEAN+3 Finance Ministers Meeting (AFMM+3) held in May 2004 in Jeju, Korea tasked Thailand, Chair of WG1 to further look into the withholding tax issue.

On 11 November 2004 in Tokyo, Japan, the Ministry of Finance of Thailand under the capacity of Chair of WG1 convened a WG1 meeting whereby the withholding tax proposal was one of the agenda items that had been discussed. As a result, members of WG1 requested the Ministry of Finance of Thailand to continue the study on this. Reflecting the request made by WG1 members, refinements have been made and presented at the WG1 meeting on 8 March 2004 in Manila, the Philippines.

The main objective of this project, emphasized during the WG1 meeting in Manila, is to recommend “practical alternatives” of withholding taxes on debt securities within the ASEAN+3 framework so as to effectively promote cross border bond trading as well as trading liquidity among ASEAN+3 member countries and provide sound environment to encourage more issuances of local currency denominated Asian bonds. It should be clearly noted that electing to implement any of the said alternatives depends upon judgment of each and individual ASEAN+3 member countries.

Through a “level playing field” concept whereby non-resident investors, investing in local currency denominated bonds of ASEAN+3 member countries, are not subject to withholding taxes, possible or practical approaches are:

- Alternative 1: Withholding tax exemption for non-resident investors using the types of bond issuers as an indicator for exemption.
- Alternative 2: Withholding tax exemption for non-resident investors using the types of bond investors as an indicator for exemption.
- Alternative 3: Withholding tax exemption or reduction for non-resident investors via Double Taxation Agreement.

The MoF, Thailand also informed the meeting that, Thailand has elected to adopt Alternative 1. The Royal Decree and Ministerial Regulations on granting withholding tax exemption for non-resident investors have been in effect on 25 January, 2005. At present, the exemption of withholding tax for non-resident investors covers 3 types of issuers which are (1) Government (2) Non-listed State Owned Enterprises and (3) Specialized Financial Institution. Moreover, the exemption includes not only the issuance of new bonds but also existing bonds traded in the market.

As a result, WG1 members provided support for the aforesaid revised proposal and the work plan proposed by the MoF, Thailand.

*(c) Regional Multi-Currency Bonds*

With technical assistance (TA) provided by the ADB, the regional multi-currency bond project (RMCB) has begun with a view to help promote cross border trading of local currency denominated bonds whereby attempts to yield deliverables will be explored. The broad framework of the RMCB proposal was presented at the WG1 meeting held in Manila, the Philippines on 8 March 2005 where the proposed stages of issuing multi-currency bonds are as follows:

- (1) Creation of reverse dual currency (RDC) bonds using Asian currencies
- (2) Creation of collateralized bond obligation (CBO) type Dual Currency Bonds
- (3) Creation of Synthetic Dual Currency (SDC) bonds using Asian currencies

The RMCB project has a clear work plan where 1) preparatory analysis on needs, ideal structure, and impediments will be done during March-April 2005; 2) Detailed market sounding will be conducted during May-July 2005; 3) final drafting will be finalized during July-early August 2005. In the case that issuing could be done, preparations would commence alongside the market sounding phase.

WG1 members had widely discussed on relevant matters of the issue and, in general, acknowledged the merits of exploring further on this. The WG1 chair also urged members to consider the proposed options that may be appropriate for ASEAN+3 member countries to issue their bonds in the future. The ADB and consultants will further discuss this issue with WG1 members.

## **II. Future Work**

To further develop the supply side of the ABMI, WG1 will carry on with the existing work with a view to emphasize on deliverables that could help reduce the supply constraints as much as possible. In this regard, the current tasks being undertaken include:

- (1) To encourage WG1 members to issue more local currency denominated bonds;
- (2) To complete the ASEAN+3 Withholding Tax Project through the AFMM+3 process;
- (3) To carry on with the undergoing work of the RMCB project.

## **III. Issues for consideration at the Focal Group**

WG1 kindly requests attention of the Focal Group to consider points noted in the Future Work section which are:

1. To encourage ASEAN+3 member countries to issue more local currency denominated Asian bonds whereby future plans of issuances of ASEAN+3 member countries, if available, should be shared among WG members;
2. To complete the assigned task by AFMM+3 on withholding tax issues by reporting to the AFDM+3 in April 2005 in Lao PDR and subsequently, to the AFMM+3 in May 2005 in Istanbul, Turkey.;
3. To undertake the RMCB project and encourage ASEAN+3 member countries to consider implementing the suggested proposal if applicable.

## ABMI WG Progress Report [April 2005]

### WG 2 [Credit Guarantee and Investment Mechanisms]

#### I. Progress to date

1. Since the two working groups on “creating new securitized debt instruments” and “credit guarantee mechanisms” were established at the informal meeting of ASEAN+3 Finance Ministers Deputies and Central Bank Deputies on February 28<sup>th</sup>, 2003 in Tokyo, all the delegates and experts of member countries have closely worked together.

2. They have strived to explore ways to promote the use of guarantee mechanisms in the region. Understanding that guarantee mechanisms are closely related to the issue of creating new securitized debt instruments, Korea and Thailand have jointly organized meetings and seminars to discuss related topics. Working group meetings were held four times in 2003, and two held in March and November 2004 to discuss the research to date of the Asian Development Bank (ADB) Technical Assistance (TA) for Regional Guarantee. Subsequently, the seventh meeting was held in Manila on March 8, 2005 to present and discuss further development of the study.

3. The first joint meeting was hosted by Korea in Seoul on April 4, 2003. The participants discussed new schemes for securitized debt instruments and credit guarantee mechanisms. They decided to invite market practitioners and experts to the second voluntary group meeting to seek their views on the proposed schemes.

4. The second meeting was held in Tokyo on June 16. Many renowned experts and practitioners from government, academia, and financial markets came and exchanged their views and ideas on the proposed schemes to create new securitized debt instruments and on the use of credit guarantee mechanisms, followed by the first seminar on credit guarantee mechanisms on June 17. Many experts from international financial organizations, investment banks, and credit guarantee corporations gave talks and engaged in deep discussions with delegates from member countries.

5. The third meeting was held in Hua Hin, Thailand on July 10, 2003. Korea and the ADB presented proposals to promote use of regional credit guarantee mechanisms.

6. The fourth meeting was held in Seoul, Korea on November 28, 2003. Japan explained recent developments in securitized and structured finance in Asia. Thailand presented a proposal on the next steps on the supply side of the ABMI. And the ADB explained its role in trade facilitation.

7. Throughout the four meetings and the seminar in 2003, many delegates and experts recognized the need to study this complex topic in more comprehensive and systemic way in order to produce more feasible proposals. To this end, the working group made a request to ADB to support its work by conducting a study on guarantee mechanisms in the region through TA.

8. The ADB project commenced in December 2003 and was conducted by two international consultants: Dr. Gyutaeg Oh (Bond Market) and Ms. Kerry Adby (Guarantee and Credit Rating). The first workshop was held on March 19, 2004 in Manila, Philippines to discuss the preliminary results of the international consultants.

**9. During the course of the workshop, the Working Group agreed to expand the scope of its study to cover both guarantee and investment to reflect China's proposal of establishing a regional investment mechanism. The Working Group concluded that China's proposed mechanism basically shared the same goal of bond market development in the region, which would benefit further regional economic development as the Working Group's proposed credit guarantee mechanism.**

**10. In this regard, the name of the Working Group was changed from the "Credit Guarantee Mechanism" to "Credit Guarantee and Investment Mechanism" with a view to clarifying its role and scope. Furthermore, Korea and China agreed to lead the Working Group as co-chairs. Korea informed all Working Group members of these new developments made in late April 2004.**

11. Thereafter, two rounds of the Informal Meeting between the Co-Chairs and ADB were held in Shanghai and Seoul respectively, to discuss future research plans, and funding issues. During that time, ADB, China, and Korea agreed to co-finance the additional budget for the expanded study in the ratio of 3:1:1 in order to mitigate ADB's

budgetary constraint.

12. In November 2004 at the Working Group Meeting in Tokyo, the ADB consultants presented key issues and work conducted to date, and the Working Group discussed topics including original and expanded scope of work, the status of the study, new timetable, and formation of a new team. In order to facilitate the expanded scope of work, additional international consultants were engaged as specialists in the areas including Dr. Kanbing Zheng (Banking and Investment Policy), Mr. Hugh Baylis (Banking and Investment Administration), Mr. Hajimu Yamashita (Financial Sector Policy), and Mr. Michael Brink (Financial Modeling) in January 2005.<sup>38)</sup> Furthermore, the demand survey has been distributed among Working Group member countries, and sought their assistance and cooperation in order to reflect the views of the members and enhance the analysis of the study.

13. In March 8, 2005, the Working Group Meeting was held in Manila, and the ADB consultants presented the preliminary report to the Working Group, and discussed issues topics covering drafts for rationale of the new mechanism, possible organizational choices, demand analysis, business philosophy and investment guideline at this stage of the study.

14. Important conclusions reached so far can be summarized as follows: development of local currency bond markets is fundamental to support long-term development across the region and to the retention of savings within the region. Utilization of guarantee as well as loan and equity investment mechanisms would be necessary to facilitate development of regional and local bond markets. Existing institutional arrangements would be insufficient to meet this need, although all the possible institutional options whether for existing or new entity are still up for further investigation at this stage. A highly rated regional credit guarantor is required to fill the gap. In addition, support of developing market infrastructure, nurturing bond issuers (i.e., pooling SME loans for later securitization) and ensuring private sector participation and development are required in many countries in advance of the development of effective local bond markets.

15. On the Focal Group meeting on March 20, 2005 in Vientiane, Lao, one discussant raised the issue that it was important to conduct

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38) Local consultants in PRC, Indonesia, Malaysia, Philippines, and Thailand have been selected to assist the international consultants with local issues..

further demand survey to establish the judgment on the future role of the new mechanism. Also, concern was raised about the timing of proposing a particular model for the mechanism. The co-chairs welcome the discussion and note that the current study is in its first stage and the proposed organizational options are up to further discussion among member countries. The detailed feasibility study of the preferred option will not be conducted before the Finance Ministers approve the final report that is to be completed in four months. The co-chairs also inform that market consultation seminars are scheduled in the coming months with the purpose to adequately reflect the views of the private practitioners. One member country also proposed to have all the ASEAN+3 countries covered in the operational scope of the mechanism. The co-chairs welcomed the proposal and look forward to more recommendations in this regard.

## **II. Future Work**

16. The future study will progress in the following stages.

The study is expected to take another four months to complete. At this stage, finalizing and refining demand estimates, financial models, and investment guideline is expected and also preliminary business plan and preferred organizational options will be presented in the final report. Market consultation seminars are scheduled in the coming months in order to reflect the views of private practitioners. The study is due for completion around June 2005.

17. When this study is completed, reported to the Finance Ministers and approved of its legitimacy, a second-stage study will be launched to look into the feasibility of the preferred option. The expected outcome of the study will be a full-blown business plan, recommendations, a detailed action plan, budget and project plan for implementation.

## **III. Issues for consideration at the Deputies Meeting**

18. Should countries of operation of the mechanism include all the ASEAN+3 countries or ASEAN countries + PRC?

19. What should be the venue for discussion by Working Group members after completion of the report?

20. What would be the areas that need special emphasis in the study?

## ABMI WG Progress Report [April 2005]

### WG 3 [Foreign Exchange Transactions and Settlement Issues]

#### I. Progress to-date

1. Working Group 3 had conducted a total of five working group meetings namely in June and October 2003, March and November 2004 and March 2005 to deliberate on issues related to foreign exchange transactions and settlement issues as well as to discuss on the findings of the study on regional settlement linkages.

2. In addition, as part of the efforts to enhance understanding and knowledge sharing among member countries for capacity building on this subject, a symposium on Foreign Exchange Transactions and Settlement Issues was organized in Kuala Lumpur on 20 October 2003. This was followed by working group discussions held on 21 and 22 October 2003.

3. During the above working group discussions and symposium, it was highlighted that impediments on cross-border transactions need to be studied and addressed in order to foster the development of regional bond markets as envisaged under the Asian Bond Markets Initiative (ABMI). The impediments include foreign exchange rules, tax issues, clearing and settlement, disclosure requirements, etc.

4. It was also recognized that some of these rules were put in place to serve certain purposes for macroeconomic management and stability reasons, and a phased or gradual approach should be taken in removing these impediments. In the payment and settlement area, it was viewed that a comprehensive study on the advantages and disadvantages on the existing settlement mechanisms and proposed settlement models be carried out.

5. Arising from the above discussion, the working group has embarked on two studies with the cooperation from:-

- (i) Asian Development Bank (ADB) on regional clearing and settlement mechanism (Asia Link); and
- (ii) Bank of Japan on the impediments on cross-border bond

investment and issuance.

*(i) Study on Asia Link by ADB*

■ The study is undertaken with a technical assistance provided by the ADB. The objective of the study is to examine the existing possibility of a linkage involving clearing and settlement systems of member countries in facilitating cross-border bond transactions. The scope of the study includes:

- o Updating the development of existing settlement systems in the region;
- o Evaluating the merits and demerits of linking the systems as well as the obstacles of settling via linked Central Securities Depositories (CSD);
- o Gathering market feedback on the existing settlement mechanisms; and
- o Making recommendations on cross border settlement options.

■ The study commenced on 19 December 2003 and the final draft on the interim report was distributed to member countries for comments on 26 October 2004. The first draft report was presented during the fourth working group meeting in Tokyo on 11 November 2004.

■ In addition, a market consultation on the draft was also held back-to-back with the working group meeting on 12 November 2004. Market participants provided views and feedback on the findings and recommendations. Further market consultations were conducted with financial institutions and regulatory authorities in Singapore, Hong Kong and Tokyo in January 2005.

■ The market feedback, comments and input were incorporated into the second report which was distributed to member countries in March 2005 and presented at the fifth working group meeting in Manila on 8 March 2005. The second report is currently being reviewed by member countries and is expected to be finalized by end-March 2005.

■ The study had highlighted the following views of the market participants:-

- o The private sector participants would not be interested in developing a regional facility solely for bonds since there was insufficient volume to make it financially viable and the timing was not right for the public sector to make a significant commitment for such a facility;

- o The market participants were not supportive of developing a secure network which could be used by the Central Securities Depositories to communicate with each other and for other purposes in the region; and
- o The current settlement arrangements were not a significant impediment to the development of a regional bond market, although there were areas that could still be improved.

*(ii) Study on Impediments on Cross-border Bond Investment and Issuance by Bank of Japan*

■ A survey to identify specific impediments on cross-border bond investment and issuance was conducted in the second half of 2004. The survey aims at assisting policy makers in drawing up strategies for further market developments. The survey is also expected to benefit the Asia Bond Fund II, which will invest in local currency denominated bonds.

■ The preliminary survey results were presented to working group members on 11 November 2004 by Mr Atsushi Takeuchi, Bank of Japan.

■ In addition, a market consultation on the draft was also held back-to-back with the working group meeting on 12 November 2004 in Tokyo. Market participants provided views and feedback on the findings and recommendations.

■ Some of the key findings of the survey were:-

- o Some markets imposed certain restrictions on purchase of local bonds by non-residents;
- o Withholding tax on interest income was charged in majority of countries;
- o Hedging of currency risk exposure may be limited or difficult in some countries;
- o Respondents were generally satisfied with the efficiency and reliability of local clearing and settlement systems.

■ The draft report is now being reviewed by member countries and will be updated in April 2005 to reflect current prevailing conditions and rules.

## II. Recent Key Developments

5. As part of Malaysia's initiative to further deepen the domestic bond market, Bank Negara Malaysia had, effective 1 April 2004, liberalized its foreign exchange administration rules to facilitate Multilateral Development Banks (MDBs), Multilateral Financial Institutions (MFIs) and foreign multinational corporations (MNCs) to raise ringgit-denominated bonds in the Malaysian capital market. Additionally, the issuers and the foreign investors subscribing to the ringgit-denominated bonds issued by the MDBs, MFIs and MNCs will be allowed to hedge their issuance and investments respectively.

6. Similarly, the Securities Commission had, on 28 July 2004 released Practice Note 2 setting out various relaxations with regard to the application of the Guidelines on the Offering of Private Debt Securities for the issuance of ringgit-denominated bonds by MDBs or MFIs.

7. In addition, Bank Negara Malaysia had released an information note on 7 October 2004 to serve as a guide on the issuance of ringgit-denominated bonds in Malaysia by MDBs or MFIs.

8. A separate information note on the issuance of ringgit-denominated bonds in Malaysia by MNCs was also released by Bank Negara Malaysia on 29 October 2004.

9. To further strengthen the above initiatives and to promote foreign participation in the domestic bond market, effective 11 September 2004, as announced in the Budget 2005 proposals, the Government of Malaysia had removed withholding tax on non-residents for investments in all ringgit-denominated bonds (excluding convertible loan stocks) approved by the Securities Commission as well as securities issued by the Government of Malaysia.

10. On 13 October 2004, Cagamas Berhad (the National Mortgage Corporation) issued its inaugural residential mortgage-backed securities (RMBS) backed by government staff housing loans. The RM1.555 billion fixed rate issue was done through a wholly-owned subsidiary, Cagamas MBS Berhad, and comprised 4 tranches, namely:

- (a) RM580 million for the 3-year tranche;
- (b) RM340 million for the 5-year tranche;
- (c) RM290 million for the 7-year tranche; and
- (d) RM345 million for the 10-year tranche.

11. The Ministry of Finance, Malaysia and Bank Negara Malaysia had approved the inaugural issuance of ringgit-denominated bonds for :-
- (a) the Asian Development Bank (ADB) on 3 November 2004. The ADB RM400 million 5-year issuance was concluded on 10 November 2004; and
  - (b) the International Finance Corporation (IFC) on 4 November 2004. The IFC RM500 million 3-year issuance was concluded in December 2004. This was IFC's first Islamic bond issuance in the world.

### III. Future Work

12. Based on the feedback received during the working group meeting on 11 November 2004, the meeting suggested that further work in the area of payment and settlement mechanism should seek ways to leverage on the relevant studies done or being done by other fora such as ASEAN and EMEAP. This would also include, among others, the area of harmonization of payment and settlement procedures for cross border bond transactions. This would alleviate any duplication of efforts currently being done by other working groups on the subject.

13. The ADB report on regional settlement linkage is expected to be finalized by end-March 2005. During the interim, further feedback is being sought from market participants and member countries. Thereafter, the permission of the countries will be sought for the ADB report to be updated on the Asianbondsonline web site.

14. The BOJ report on impediments on cross-border transactions will be updated in April 2005. As suggested by the roadmap, the updating of the study will be facilitated by BOJ and BNM by way of self-assessments and feedback on the findings in the report.

## **ABMI WG Progress Report [April 2005]**

### **WG 4 [The Issuance of Bonds Denominated in Local Currencies by MDBs, Foreign Government Agencies, and Multinational Corporations]**

#### **I. Objectives and Achievements of the Working Group**

Working Group 4 aims to help the ABMI Working Groups enhance their understanding on the current status and prospects of local currency bond issuance by foreign issuers in domestic bond markets as well as elucidate major issues and impediments to such bond issuance.

The Working Group is pleased to report that significant progress has been made since the inception of the Group. In particular, a number of member countries have actively studied the issue since the inception of the Working Group and some member countries have recently issued guidelines or are intending to do so shortly. Malaysia, for example, announced its intention to allow local issuance by foreign issuers in April 2004, issued the relevant regulations in August and October 2004 and saw its first local issuance by a foreign issuer on 10 November 2004 when ADB issued a RM400 million 5-year issue, followed shortly thereafter with another issue by International Finance Corporation. Similarly, Thailand has already provided relevant approvals to some MDBs and foreign government agencies, as well as issuing the relevant regulations. First issues by ADB, JBIC and IFC are expected in the near future. PRC is also studying the possibility of allowing local issuance and issued the relevant regulations in late February 2004 with first issues expected in 2005. Finally, the Philippines has also issued tentative approvals to ADB to issue bonds, and a first issue by ADB may be expected in the second quarter 2005.

On a chronological basis, the Working Group 4 has undertaken the following activities:

### *Working Group Activities in 2003*

In 2003, the Working Group conducted two key activities with a focus on the issue activity of supranational organizations:

■ **Survey of Supranational Issuance:** a survey was conducted on the experience and plans of ASEAN+3 members in local currency bond issuance by supranationals in their domestic capital markets. The results of the survey provided an overall picture of the current status of supranational bond issuance in the region.

■ **Seminar on Bond Issuance by Supranationals:** In November 2003, a seminar on *“Local Currency Bond Issuance by Supranationals and Foreign Governments”* was conducted in Beijing. The seminar generated strong interest from key participants and promoted an exchange of views among regulators, issuers, investors, and market intermediaries. The seminar also contributed to a better understanding of the merits and potential issues of supranational bond issuance in the region, and helped the ASEAN+3 members conceptualize next steps for further advancing such bond issues. After the seminar a number of member countries have undertaken a review of the regulatory framework of bond issuance by supranationals and foreign governments with a view to providing the enabling environment for furthering such bond issues.

### *Working Group Activities in 2004*

In 2004, the focus of the Working Group shifted towards multinational corporations. In August 2004, a seminar on *“Local Currency Bond Issuance by Foreign Multinational Corporations”* was organized in Shanghai. The main objective of this seminar was to facilitate a better understanding of enabling factors and existing impediments to regional bond issuance by foreign multinational corporations. The seminar also served as an opportunity for regulators of ASEAN+3 countries to share experiences and exchange ideas with potential issuers and investors from the private sector. In addition, it is expected that the seminar will help promote local currency bond issuance by foreign multinational corporations in the region and contribute to the development of the regional bond markets. The main conclusions of the seminar are summarized as follows:

■ **Since the Asian financial crisis, governments have moved proactively to develop local currency bond markets as deep and liquid bond markets would have mitigated currency and maturity mismatches**

that were sources of great pain for companies and financial institutions in the region. Against this background, Asia's (ex-Japan) local currency bond markets have doubled in size to USD1.6 trillion, or 5% of the world bond market. However, issuance by MNCs remains marginal as a percentage of total local currency issuance. It is important that regional countries continue to promote bond issuance by offshore entities considering benefits brought by offshore entities' participation in domestic markets such as diversification of investment alternatives, improving asset quality, and catalyzing the development of the domestic yield curve.

- Some key factors supporting regional governments in opening up domestic bond markets for foreign issuers include low domestic interest rates, current account surplus, and reduction of government bond issuance program. Normally, a step-by-step approach is taken to allow foreign issuers to enter into domestic bond markets. It normally starts with issuers with the best credit quality such as supranationals and foreign government agencies, and is followed by MNCs. In addition, to promote such bond issuance, governments normally introduce incentives to attract foreign issuers and investors such as relaxation of capital controls, preferential tax treatment, as well as simplified issuance process and disclosure requirements.

- MNCs' policies in local currency bond issuance are normally driven by their offshore operations. In this regard, the principal objective of such issuance is to match their funding with business level assets with respect to currency, duration, and interest rate. Common requirements of MNCs to tap a new market include (i) defined regulatory framework, (ii) clear disclosure requirements, (iii) established payment and clearing mechanism, (iv) sufficient participation of dealers to ensure secondary market liquidity, and (v) existence of derivatives market. In this regard, should a government plan to allow such bond issuance, it is important that these requirements be incorporated in the rules and regulations for the bonds.

Country Case Studies in Local Currency Bond Issuance by Foreign Issuers

In addition to organizing this successful seminar, the Working Group commissioned a study on "*Country Case Studies in Local Currency Bond Issuance by Foreign Issuers (LCBFI)*". The objective of the proposed

study was to help ABMI Working Groups deepen and enhance their understanding on the current stage and prospects of domestic bond market development, and major issues and impediments in furthering the market development. In addition, the studies included the experiences and strategies undertaken in selected regional and non-regional countries to allow local currency bond issuance by foreign issuers in domestic bond markets. Given the insights and analyses provided by the studies, the working group is expected to better understand the relevant issues in developing domestic bond markets, particularly in terms of promoting bond issuance by foreign issuers. The studies also facilitated the promulgation of concrete action plans by ASEAN+3 member countries for local currency bond issuance by foreign issuers in the region.

The paper reviews the experience of five East Asian economies that have permitted local currency bond issuance by foreign issuers. Japan first introduced "Samurai" bond issues in 1970 and since then the Samurai market has become an important part of the Japanese bond market with total outstanding bonds of Y7,000 billion (\$68 billion equivalent) in 2004. Hong Kong, China was the second market in East Asia to allow non-residents to issue local currency bonds in 1977. Since then LCBFI has grown substantially and in 2003 such issues account for 23 percent of all local bond issues in the territory. Australia was a relative latecomer to the LCBFI market, only permitting foreign issuers to enter the market in 1990. Since then, and especially over the last few years, LCBFI has taken off rapidly. Today, about 20 percent of all outstanding bonds in Australia are issued by non-residents. Korea liberalized entry by foreign issuers in 1995. However, after the issue of three supranationals between 1995 and 1997, issue activity has remained marginal, at least partly due to cumbersome regulatory requirements. In Singapore, entry was liberalized in 1998 and issue activity has picked up steadily with LCBFI accounting for between 10-20 percent of annual issuance volume over the last four years. The paper argued that LCBFI has a number of economic benefits. These include microeconomic benefits for local as well as foreign investors and issuers which result in a "win-win" situation for all parties involved. Macroeconomic benefits include the fact that by introducing LCBFI, countries are able to raise funds from international investors without associated currency risk.

From the analysis in the paper, a number of policy conclusions emerge for countries that are considering opening their markets to foreign issuers: first, it is clear that the introduction of foreign issuers occurred at a time when the local bond market was at a relatively early stage of development. Thus, there is no need to wait for the local market to reach an advanced stage of development before allowing foreign issuers to enter the market. Second, the development of the LCBFI market needs to be strategically driven by the government. Government policy and the chosen regulatory approach and incentives provided play a key role in developing the market. At the same time, government can retain effective control over the LCBFI market if considered necessary. Third, the potential issues that are sometimes associated with permitting foreign issuers into the local market, such as an adverse impact on the foreign exchange regime or possible "crowding out", did not play an important role in the countries that we studied. Given the relatively small size of the LCBFI market, the paper found that foreign and local issuers have a complementary rather than a competing role to play in developing the local currency bond market.

### III. Conclusion

Working Group 4 has made significant progress in considering the different issues involved in local issuance by MDBs, foreign governments, and multinational corporations. Working Group members are particularly pleased to observe that a number of member countries are actively reviewing the regulatory environment with respect to such issuance, or have already issued the enabling regulations to encourage local issuance by such institutions. At the Manila meeting Working Group representatives expressed their satisfaction with the significant progress that was made and thanked the Chair for its continued support of the Working Group which has had demonstrable impact in the member countries.

The Working Group believes that it has fulfilled its primary mandate and therefore recommends to the Focal Group to wrap up proceedings. This recommendation was adopted by the Focal Group on the meeting in Vientiane, Lao PDR on March 20, 2005.

## ABMI WG Progress Report [April 2005]

### WG 5 [Rating Systems and Information Dissemination]

#### I. Progress to date

1. WG5 continues to pursue its objectives of improving ratings systems in ASEAN+3 in partnership with a caucus of Asian credit rating agencies (CRAs) and the Asian Development Bank (ADB). Thus far, this has largely been in the form of forums and seminars, focusing on the most salient issues concerning Asian CRAs. For example, the WG decided to organize an ad-hoc seminar to update Asian CRAs on recent discussions at the Bank for International Settlements (BIS) and the International Organization of Securities Commissions (IOSCO).

2. On information dissemination, the Asian Bonds Online website, managed by the ADB in partnership with WG5, has grown noticeably. The number of daily visits to the website (<http://asianbondsonline.adb.org>) has increased steadily, peaking at 992 visits a day in early January 2005. More users are repeat visitors, with about 22,000 total repeat visitors in January 2005, compared to about 17,000 in October 2004. New sections on "How to buy a bond" and the "East Asian Bond Glossary" should also increase web traffic to the site. The ADB will soon publish the second issue of Asia Bond Monitor, which provides in-depth analysis of developments in East Asian local currency bond markets.

3. The WG continues to seek new areas to contribute to Asian bond market growth. A possible new area of interest is exploration on ways to facilitate cross-border acceptance of Asian credit ratings. Singapore agreed to draft a paper for members to use as a starting point for further discussion.

#### II. Future Work

4. Ad-hoc forum on recent discussions at BIS and IOSCO on CRAs on 3 June 2005 in Manila, Philippines. As the significance of credit rating agencies has phenomenally increased in the capital market recently,

financial authorities have embarked on exploring ways to adequately regulate CRAs, especially on their governing structure and their rating processes. At IOSCO, a “code of conduct” was published in December 2004, concerning analytical independence, managing conflicts of interests and confidentiality issues. In 2004, Basel II was agreed on, which introduced the use of international credit assessment by designated CRAs (DCAs) in calculating banks’ capital adequacy ratios (CAR). This stipulates the criteria for CRAs to be eligible for DCA, such as (a) objectivity, (b) independence, (c) international access/transparency, (d) disclosure, (e) resources and (f) credibility. This ad-hoc forum will be particularly relevant and useful as these developments will have significant impact on Asian CRAs.

5. Seminar on “The Role of Credit Rating Agencies in Asia’s Emerging Bond Markets” on 5 May in Istanbul, Turkey, on the fringes of the ADB Annual Meeting. The ADB will be organizing a seminar discussing how CRAs have played a vital role in facilitating bond market growth. The seminar promises to be a fruitful one as it will include keynote speeches by several prominent personalities in both the public and private sectors of finance and will include a panel of discussion.

6. Best Practices Dialogues. A caucus of Asian CRAs has organized two Best Practices Dialogues in June and November 2005. Topics proposed include Basel II, cross-sector consistency of ratings and convergence in basic rating methodologies, amongst others.

7. Ad-hoc seminar on “Establishing Expectations”. The WG is looking to organize a seminar in partnership with a caucus of Asian CRAs, focusing on developing a better understanding of what credit ratings users expect of Asian CRAs. The seminar will be in Q3 or Q4 at a location to be confirmed.

### **III. Issues for consideration at the Focal Group**

8. How do the FG members view the sharing of information on developments at international forums of regulatory and supervisory authorities with Asian CRAs?

9. How can we better coordinate with other ABMI WGs with a view to increasing the use of Asian credit ratings?

## ABMI WG Progress Report [April 2005]

### WG 6 [Technical Assistance Coordination]

#### I. Progress to date

1. Since the last meeting of the ABMI Focal Group in November 2004, Working Group 6 has made significant progress in facilitating technical coordination activities on regional bond market development under ASEAN+3.

2. **Phase I: Parts 1 and 2** of the Technical Assistance on Regional Bond Market Development (TA) under the Japan-ASEAN Financial Technical Assistance Fund (JAFTA) has been completed for five participating countries (Indonesia, Malaysia, Philippines, Thailand and Viet Nam), while **Part 3** (for Cambodia) is in entering its final stage of implementation. **Part 4** for Lao PDR is expected to begin soon. Phase I focuses on (a) general issues and case studies of best practices on various aspects of bond market development (government and corporate bond markets) and their application and (b) specific roadmap and work program for developing the corporate and government bond markets in each participating country that encompasses specific measures needed to develop a well-diversified and liquid market in each country. Phase I was undertaken by Nomura Research Institute.

3. To further assist countries in developing their bond markets, **Phase II** of the TA has been implemented since December 2004, focusing on practical aspects of bond markets through actual implementation of work programs and specific measures identified in Phase I. Recognizing the differences in the levels of bond market development among countries in the region, Phase II is envisaged to undertake country-specific capacity building programs with concrete outcomes based on each country's own needs and priorities.

4. Five countries, namely Cambodia, Indonesia, Philippines, Thailand, and Viet Nam, have signified their intention to participate under Phase II. The ASEAN Secretariat, in consultation with Japan MOF, has selected Nomura Research Institute (NRI) and Daiwa Institute of

Research (DIR) to implement the TA programs for this phase. The consultants have already visited the participating countries (except Cambodia) and discussed with relevant government agencies on the scope of the TA activities, based on needs identified by the countries themselves as well as assessment undertaken by the consultants. The following table shows the outcome of preliminary discussions with the concerned countries and the possible scope of the TA for Phase II:

**Participating Countries: Phase II Bond Market TA**

Country	Possible TA Scope	TA Provider
Indonesia	Design Primary Dealer or similar new system Design bond lending schemes Upgrade infrastructure for hedging and efficient market making	Nomura
Philippines	Structure bond lending framework Introduce bond index Promote new products (Bond ETF) Develop Credit Rating Industry	Daiwa
Thailand	Development of innovative government bonds Develop SROs to enforce rules Develop private Repo market Capacity building of PDMO and other relevant government offices including to developing futures market and to establish central clearing, settlement and depository	Nomura
Viet Nam	Draft regulations of Corporate Bonds Draft regulations of Municipal Bonds	Nomura

5. To complement Phase II of the TAs being undertaken by JAFTA, Korea, Malaysia and Thailand have also expressed their intention to offer technical assistance in various areas of bond market development. The form of assistance ranges from sharing of experiences, dispatching experts to recipient countries, conducting seminars as well as providing in-house training for officials in donor countries. In particular, since the

last WG, Korea provided two series of technical assistance. First, Korea Exchange dispatched experts to Thailand from December 14 to 17, 2004. Second, Korea Securities Depository provided an In-house Training Program for Indonesian securities-related organizations from November 29 to December 9, 2004. Further, the Ministry of Finance and Economy of Korea in collaboration with Bank of Korea and several other agencies (such as Korean Securities Depository, Korea Exchange, Korea Credit Guarantee Fund, Korea Asset Management Cooperation and Samsung Securities Co., Ltd.) has agreed to offer 2 (two) in-house invitation programs and 11 (eleven) expert dispatch programs scheduled to be carried out within 2005. Malaysia has offered to customize specialized training programs on bond markets through the Securities Industry Development Center (SIDC), the education and training arm of the Securities Commission. The SIDC also holds a series of bond market training programs throughout the year and Malaysia will forward the SIDC training calendar to the ASEAN Secretariat for circulation. Thailand has agreed to organize training programs as well as to dispatch experts (upon request) in the areas of bond issuance and establishment of benchmark yield curve. In addition to these TA programs under JAFTA and other potential TA providers (Korea, Malaysia and Thailand), Japan MOF will also consider implementing its bilateral technical assistance in Viet Nam and other countries to match their needs.

6. As part of capacity building support by WG6, a Seminar on Bond Market Development for Cambodia, Lao PDR, Myanmar and Viet Nam (CLMV) was held in Bangkok on 17-18 March 2005, under the joint sponsorship of the Ministries of Finance of Thailand and Japan and Stock Exchange of Thailand. Around 100 finance, central bank and capital market officials from CLMV, as well as experts from Japan, Korea, ADB and other ASEAN Member Countries, attended the Seminar. The seminar discussed general policy concepts for developing government bond markets, experiences in bond market development and roadmap design, current situation and challenges of bond market development in CLMV countries. The seminar was followed by a half-day study-tour to the Stock Exchange of Thailand, Bond Electronic Exchange and Thailand Securities Depository Co., Ltd.. The seminar offered a model for further collaboration among member countries on TAs under WG6.

## **II. Future Work**

7. Phase I for Lao PDR and Phase II of the Bond Market Development for the five participating countries are expected to be completed around July/August 2005. After which Japan MOF and the ASEAN Secretariat, in consultation with members of WG6, will assess the impact of the TA and identify additional needs to support further development of local bond markets in participating countries.

8. In addition to JAFTA TA activities, other ASEAN+3 Countries will organize seminars and workshops and dispatch their experts to share their experiences and expertise. These include the training and dispatch programs to be provided by Korea throughout the year and a Seminar on Securitization to be organized by the Securities Commission of Malaysia in Kuala Lumpur on 29-30 August 2005.

## **III. Issues for Consideration of the Focal Group**

9. Since the establishment of WG6 almost two years ago, efforts have been intensified to enhance capacity of countries in the region to develop their individual bond markets. To maximize their impacts, however, it is important that regional assistance to deepen national bond markets has to be equally supported by strong commitments and active implementation by relevant agencies concerned. It is therefore proposed that participating Member Countries report to WG6 regularly on their progress, including national efforts in implementing the regulations/guidelines and bond trading system or other market infrastructure as formulated and recommended by the JAFTA and other TAs.

10. To avoid duplication of efforts in provision of technical assistance, the ASEAN Secretariat has been requested to serve as a clearing house for the all the TA programs (regional and bilateral). To enable the ASEAN Secretariat to function effectively, Member Countries (both TA providers and recipients) are requested to promptly update the ASEAN Secretariat on any planned and new TAs. These information shall be summarized in a matrix and regularly reported to WG6.

## ASEAN+3 Withholding Tax Proposal [Thailand's Proposal]

### 1. Background

■ At the 7<sup>th</sup> ASEAN Finance Ministers Meeting (AFMM+3) held on 15 May 2004 in Jeju, Korea, the Ministry of Finance (MoF) of Thailand, Chair of the Working Group on Creating New Securitized Debt Instruments (WG1), informed the meeting her plan to issue the first series of “Thai-baht Asian Bonds” with appropriate withholding tax treatment given to non-resident investors. The MoF, Thailand also encouraged ASEAN+3 member countries to find appropriate solution to gradually remove withholding taxes on debt securities as well as to provide more supply of local currency denominated Asian bonds in regional markets.

■ The AFMM+3 agreed to further explore the withholding tax issue on the need for ASEAN+3 member countries to consider a common approach to facilitate a more systematic application of withholding taxes within the ASEAN+3 borders in order to expedite the development of regional bond markets. Subsequently, the AFMM+3 tasked Thailand, Chair of WG1 to further look into the issue.

■ The Ministry of Finance of Thailand under the capacity of Chair of the WG1 convened a WG1 meeting on 11 November 2004 in Tokyo, Japan whereby the withholding tax proposal was one of the agenda items that had been discussed. As a result, members of WG1 requested the Ministry of Finance of Thailand to continue the study on this.

■ Reflecting the request by members of WG1, in what follows, refinements to the previous version will be elaborated.

### 2. Objective

■ The main objective is to recommend “practical alternatives” of withholding taxes on debt securities within the ASEAN+3 framework so as to:

- effectively promote cross border bond trading as well as trading liquidity among ASEAN+3 member countries;
- provide sound environment to encourage more issuances of local currency denominated Asian bonds.
- It should be clearly noted that the practical alternatives recommended in this proposal are for illustrative purposes only. Electing to implement any of the said alternatives depend upon judgment of each and individual ASEAN+3 member countries.

### 3. The Status Quo of ASEAN+3 Withholding Tax Schemes

In table 1, a summary of the current schemes of withholding tax implementation is presented whereby the relatively more complete version is also attached as Annex 1. Information shown in Table 1 employs the following criteria:

- 1) Withholding tax exemption is considered in the case of non-resident investors being the bondholders only;
- 2) Types of income under consideration are interest income, capital gain, and discount.
- 3) Types of bond issuers are sovereigns and quasi-sovereigns.

**<Table 1> A Summary on Current Withholding Tax Schemes of ASEAN+3**

Existence of WHT	No. of Countries	Remarks
No	5	Laos, Malaysia, Singapore, Thailand, Vietnam
Combination	1	Japan (WHT on Quasi-sovereigns)
Yes	7	Brunei, Cambodia, China, Indonesia, Korea, Myanmar, Philippines,

*Sources: Official sources, Asian Bond Online Website, and Mohanty (2002)*

According to Table 1, it can be seen that the majority of ASEAN+3 member countries is of the two extremes—Yes (7 countries) meaning applying withholding taxes across the board while No (5 countries)

implying no existence of withholding taxes. Although the ratios between Yes (54%) and No (38.5%) appear not to be too far apart, it should be noted that only recently have Malaysia (September 2004) and Thailand (January 2005) joined the bandwagon in order to help promote Asian bond market development.

#### **4. Practical Alternatives on Withholding Tax Schemes**

■ In order to promote the supply side of Asian bonds through the operation of the ABMI WG1, there is an urgent need to seek appropriate ways and means to establish conducive environment that could lead to an increasing amount of local currency denominated bond issuances as well as a more efficient way to conduct cross border bond trading. To accomplish the aforesaid conditions, crucial measures that would help eliminate potential impediments should be carefully considered.

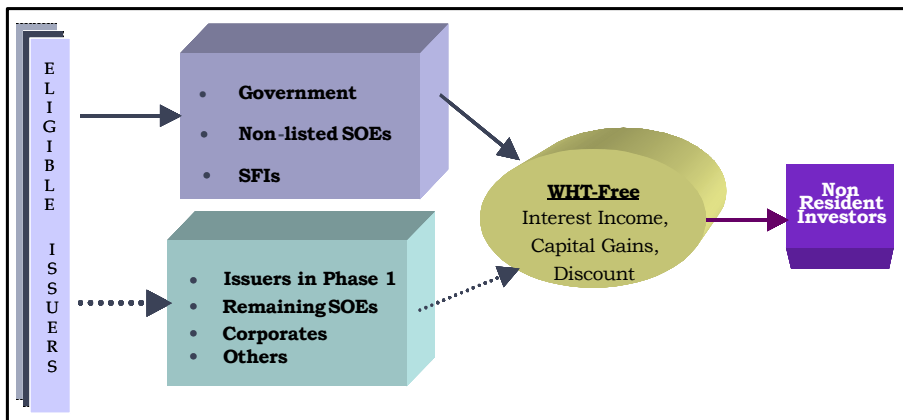
■ Among others, withholding taxes have been regarded as one of the potential hurdles that may limit foreign investors' interest in investing in Asian currency denominated bonds. Therefore, it is worthwhile to systematically investigate appropriate schemes that could help transform the existing withholding tax systems of ASEAN+3 member countries into a scheme whereby withholding taxes no longer appear to reduce the attractiveness of Asian currency denominated bonds in the eyes of foreign investors.

■ In doing so, a conceptual framework of attaining a "level playing field" is employed whereby non-resident investors, investing in local currency denominated bonds of ASEAN+3 member countries, are not subject to withholding taxes. This, in essence, means that taxable income that may arise from local currency denominated bondholding in ASEAN+3 jurisdictions will be taxed only at the residing country of investors.

■ There are a number of alternatives that could help achieve the stated level playing field concept on implementing withholding tax schemes. In this regard, three alternatives are illustrated as follows:

- 1) Alternative 1: Withholding tax exemption for non-resident investors using the types of bond issuers as an indicator for exemption.*

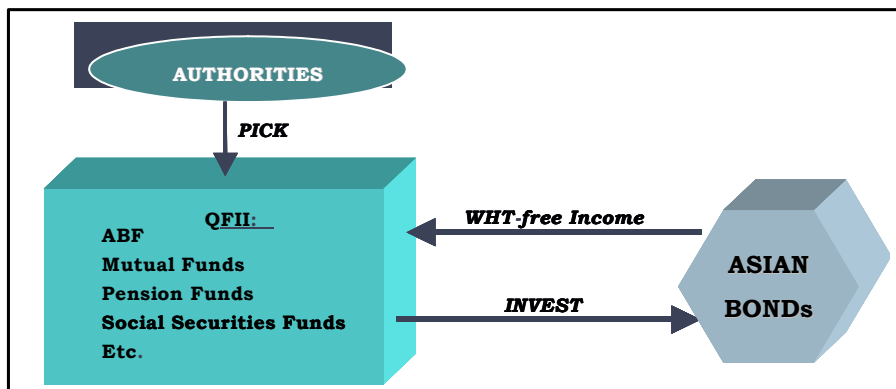
<Figure 1>



■ In practice, Alternative 1 uses *types of bond issuers* such as governments, quasi-government agencies, corporates, etc. as the main criteria to identify eligible debt securities that are deemed to achieve a withholding tax exemption status. Examples of ASEAN+3 member countries using this scheme are Malaysia and Thailand. An illustration is shown in figure 1.

2) *Alternative 2: Withholding tax exemption for non-resident investors using the types of bond investors as an indicator for exemption.*

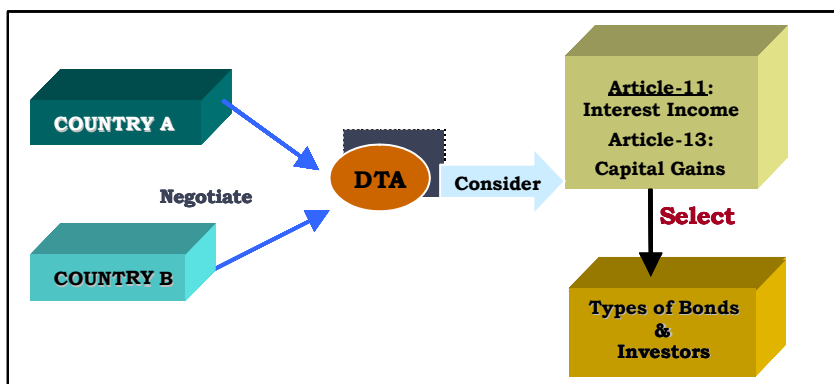
<Figure 2>



■ Similarly, relevant authorities of ASEAN+3 member countries can elect to employ *types of foreign investors* as the criteria signifying those who should receive withholding tax exemption. To provide non-resident investors with a withholding tax waiver, the types of bond investors scheme or Alternative 2 can be termed as a “Qualified Foreign Institutional Investor” scheme or QFII. By and large, instead of resorting to types of bond issuers of Alternative 1, Alternative 2 adopts the concept of identifying eligible institutional investors of foreign bodies such as mutual funds of both public and private sectors, pension funds, social security funds, and etc. whose withholding taxes will be waived. An illustration is shown in figure 2.

3) *Alternative 3: Withholding tax exemption for non-resident investors via Double Taxation Agreement.*

<Figure 3>



■ Notwithstanding Alternatives 1 & 2, implementation through the usage of “Double Taxation Agreement” or DTA is another means that can help remove withholding taxes. In practice, most ASEAN+3 member countries have engaged with one another on a bilateral basis through some forms of legal arrangement such as DTAs known as “Convention between Contracting States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income”. An illustration is shown in figure 3.

In practice, there might exist variations to the aforesaid three alternatives such as using duration of bonds as the threshold for withholding tax exemption. Nonetheless, all of these illustrated schemes lead to a shared target, that is, a level playing field that could lead to higher degrees of bond trading liquidity.

#### 4) *Conclusions*

To fulfill the task assigned by the AFMM+3 in May 2004, the Ministry of Finance of Thailand, Chair of WG1, has undertaken a study on practical alternatives of withholding tax schemes with an aim of promoting 1) liquidity; 2) cross border trading; and 3) more issuances of local currency denominated bonds among bond markets in the region. In this regard, the proposal serves as a succinct background paper for ASEAN+3 member countries, if interested, to pursue further acceptable schemes to each and individual country. In essence, withholding taxes may be visualized by non-resident investors as a potential impediment that may cause the attractiveness of investing in Asian bonds. Nonetheless, electing to remove or to retain withholding taxes depend upon judgment of each ASEAN+3 member country.

#### 5) *Expected Output (Work Program appears as Annex 2)*

- The pre-final proposal will be submitted for consideration at the AFDM+3 in Lao PDR in April 2005.
- The final proposal will be tabled for consideration at the AFMM+3 in Istanbul, Turkey in May 2005.

## Withholding Tax Status on Interest Income, Capital Gains, and Discount From Local Currency Denominated Securities held by Non-resident Investors

**Types of non-resident investors with withholding tax exemption:**

Type 1: Institution Investors only

Type 2: All non-resident investors (including both institutional and retail investors)

Securities (bills, bonds, debentures) Countries of Issuers	Government	State-owned enterprises/ financial institutions	Multilateral Development Banks	Foreign Governments and their agencies	Private Corporations	Remarks
Brunei <sup>1&amp;2</sup>	WHT*	WHT*	n/a	n/a	WHT*	* WHT on interest income; WHT-exempted on capital gains; no information on discount.
Cambodia <sup>1</sup>	WHT*	WHT*	n/a	n/a	WHT*	WHT on interest income; no information on capital gains & discount.
China <sup>1</sup>	n/a	n/a	n/a	n/a	n/a	
Indonesia	WHT	WHT	WHT	No WHT* (Type 2)	WHT	* except agencies fee is taxable (WHT)
Japan <sup>2</sup>	No WHT* (Type 2)	WHT	No WHT (Type 2)	WHT	WHT	* WHT-exempted on the redemption profit received on TBs & FBs held in transfer accounts with QFIs. Non-taxable on the interest received on coupon-bearing JGBs held in transfer accounts with QFIs.

n/a = no information available

## 198 Prospects for Regional Financial and Monetary Integration in East Asia

Securities (bills, bonds, debentures) Countries of Issuers	Government	State-owned enterprises/ financial institutions	Multilateral Development Banks	Foreign Governments and their agencies	Private Corporations	Remarks
Korea <sup>2</sup>	WHT	WHT	WHT	WHT	WHT	non-residents who receive interests and fees on foreign denominated bonds issued by the Korean government, local governments or domestic corporations are exempt from WHT. Capital gains from the aforementioned bonds and securities of domestic corporation denominated by foreign currency, issued and traded outside Korea, are excluded from taxation as well.
Laos <sup>1</sup>	NO WHT* (Type 2)	NO WHT* (Type 2)	n/a	n/a	NO WHT* (Type 2)	* WHT-exempted on interest income; no information on capital gains & discount.
Malaysia <sup>39)</sup>	No WHT (Type 2)	No WHT (Type 2)	No WHT (Type 2)	No WHT (Type 2)	No WHT* (Type 2)	* exempt for MNC
Myanmar <sup>1</sup>	WHT*	WHT*	n/a	n/a	WHT*	WHT on interest income; no information for capital gain & discount
Philippines <sup>1</sup>	WHT*	WHT*	n/a	n/a	WHT*	WHT on interest income & capital gains; no information for discount

n/a = no information available

1 Source: Asian bond online website

2 Source: Indonesia from Bank of Indonesia; Japan from Ministry of Finance; Korea from Ministry of Finance and Economy; Thailand from Ministry of Finance

39) Source: "Malaysia's Progress" material presented at ABMI Working Group Meeting on Foreign Exchange Transactions and Settlement Issues (WG3), 11 November 2004, Tokyo, Japan

**Appendix 4. Progress Report of the Asian Bond Markets Initiative (ABMI) 199**

Securities (bills, bonds, debentures)	Government	State-owned enterprises/ financial institutions	Multilateral Development Banks	Foreign Governments and their agencies	Private Corporations	Remarks
Singapore <sup>1</sup>	No WHT (Type 2)	No WHT (Type 2)	No WHT (Type 2)	No WHT (Type 2)	No WHT (Type 2)	
Thailand <sup>2</sup>	No WHT (Type 2)	No WHT* (Type 2)	No WHT (Type 2)	WHT	WHT	* exempt for non-listed SOEs only
Vietnam <sup>1</sup>	No WHT*	No WHT* (Type)	a	n/a	n/a	*exempt WHT on interest income and capital gains; no information for discount

n/a = no information available

1 Source: Asian bond online website

2 Source: Brunei from Brunei Yearbook “Key Information on Brunei 2004”; Indonesia from Bank of Indonesia; Japan from Ministry of Finance; Korea from Ministry of Finance and Economy; Thailand from Ministry of Finance

## ASEAN+3 Withholding Tax Project under the Asian Bond Markets Initiative Working Group on Creating New Securitized Debt Instruments

### Work Program

Events	Date
Circulate 1st draft proposal to ASEAN+3 member countries	Prior to ABMI WG 1 Meeting
Convene ABMI WG 1 Meeting to consider the Proposal to Seek a Common Approach on Withholding Taxes and other issues <u>Venue:</u> Tokyo, Japan	11 November 2004
Revise the proposal based on comments from the WG 1 Meeting	November-December 2004
Report the progress to the Informal AFDM+3 Meeting <u>Venue:</u> Sanya, China	27 November 2004
ABMI WG 1 Meeting <u>Venue:</u> Manila, the Philippines	8 March 2005
Submit the pre-final proposal to the AFDM+3 for review <u>Venue:</u> Lao PDR	April 2005
Submit the final proposal to the AFMM+3 for endorsement <u>Venue:</u> Istanbul, Turkey	May 2005

## ABMI Roadmap

### 1. Preface

The ASEAN+3 Finance Ministers' Meeting decided to establish six working groups (WGs) on the ABMI at its meeting on August 7, 2003. Since then, comprehensive efforts have been made to develop the region's bond markets, and concrete outcomes are being achieved, such as the issuance of local currency-denominated bonds by MDBs in the region.

Some working groups have completed their designated tasks while others are still working toward their targets.

Based on the above situation, *the concept of an ABMI Roadmap was proposed at the November Focal Group Meeting in Tokyo* and was endorsed by the November Deputies' meeting in Sanya last year.

*This paper is intended to revise the present WG framework and to provide an outline of a new framework to further promote and implement the ABMI.*

### 2. Principles in the Framework Revision

The following three prerequisites are presumed: First, the number of working groups should be kept to the minimum necessary so that the efficiency of the ABMI framework can be maintained. Second, continuity and consistency need to be maintained regarding future work that draws on past efforts. Third, flexibility is critical for a new framework to respond to the changing regional environment.

*Based upon these three prerequisites, a new mechanism is necessary to gather and share information in an integrated fashion about bond markets-development efforts and to spread the initiative across the region under the strong leadership of the Focal Group.*

### 3. Reorganization of the Working Groups

The present six working groups will be reorganized into the Ad-hoc Support Team for the Focal Group, the TA Coordination Team for the

Focal Group, and four Working Groups.

*1) Ad-hoc Support Team for the Focal Group*

The Ad-hoc Support Team for the Focal Group (ASTFG) will conduct the following three activities:

■ *To complement and fortify the functions of the Focal Group*

*The ASTFG will complement and fortify the functions of the Focal Group through providing data and information.*

In order to deal with emerging issues that cut across the mandates of the Working Groups, the ASTFG may also organize seminars on those issues.

Likewise, this team might be an appropriate place to support the Focal Group if the Focal Group is decided to conduct an in-depth study on the concept of “Asian Bond Standards” as proposed by Korea, which includes many important issues that may affect the future of entire initiative. (Establishing a special taskforce under the Focal Group is another alternative.)

■ *To gather, share, and disseminate information*

*The ASTFG will gather, share, and disseminate information on bond markets-developments in ASEAN+3 countries and the activities of other regional fora (i.e., EMEAP and APEC) in an integrated way.*

The use of the Asian Bonds Online Website (ABW), which is currently under the jurisdiction of the present WG5, is expected to be an effective tool for this purpose, especially for the prompt sharing of information gathered among the member countries. Since WG5 has successfully established the ABW, the function of “Information Dissemination” currently under the WG5 will be transferred to the ASTFG, which will update, utilize, and disseminate the data on the ABW thereafter. The WG5 and other WGs will continue to convey market voices to the ABW, if appropriate.

■ *To compile and update progress reports*

*The ASTFG will compile and update progress reports on member countries' bond market developments every six months.* The reports will basically be self-assessments by the member countries and also contribute to the coordination of technical assistance (TA) by the TA Coordination Team for the Focal Group (to be discussed later, present WG6).

In this context, the “Study of Impediments to Cross-Border Bond Investment and Issuance in Asian Countries” currently under the WG3

will be transferred to the ASTFG as well, since this study raised issues related to the mandates of all Working Groups and requires a response from each country. Therefore, each member will conduct a self-assessment including counterarguments to the findings of the study. The Bank of Japan and the Bank Negara Malaysia, which have been involved in this work in the present WG3, will continue to support members in this self-assessment after the transfer.

The additional workload or additional layer resulting from the establishment of the ASTFG will be nominal, since setting-up this team is equivalent to refining the existing behind-the-scenes work in each country to support the Focal Group and making its operations more timely and flexible. The ASTFG will consist of either the current Focal Group members or their junior staffs appointed by them.

### *2) TA Coordination Team for the Focal Group*

While the present WG6 (in charge of pooling technical assistance (TA) providers and recipients and matching them up) has advanced the regional capabilities so far, we acknowledge the importance of coordinating and providing TA in a more timely, more effective, and more visible manner in light of the rapid advancement of the regional bond markets. For these purposes, the coordination team will continue TA coordination and implementation drawing from its accumulated expertise as well as its full understanding of the concrete activities of each Working Group and the ASTFG.

Accordingly, *the WG6 will be transformed into the TA Coordination Team for the Focal Group (TACT), with the expectation of closer collaboration with the Focal Group as well as with the ASTFG.*

### *3) Working Groups*

#### *Principles*

It is logical to disband the Working Groups once they have completed their mission and to shift our priorities to newly emerging agenda, if any, because the Working Groups have been established to achieve specific goals. To this end, the activities of each Working Group need to be reviewed regularly.

### *Reorganization of the current Working Groups*

Based upon the above principles, we propose that the current Working Groups be reorganized as follows: (Please see the attached document for an easy-to-understand diagram of the changes.) If any new issues emerge in the future, we shall consider how to incorporate them into the framework.

■ *WG1 will adhere to its current mandates in helping to promote local currency denominated bonds.* The WG1 will complete the ASEAN+3 Withholding Tax Project by the upcoming AFMM+3 and will continue to undertake the Regional Multi-Currency Bond (RMCB) Project. An expansion of the RMCB Project may be explored to study on the future issuance of currency-basket bonds that use a currency-basket as common issuing denomination.

■ *WG2 and WG3 will continue to explore their current agendas because their missions are still being achieved.* It should be noted that the “Study on Impediments to Cross-Border Bond Investment and Issuance in Asian Countries” will be transferred from the present WG3 to the newly established ASTFG, which will compile the progress report on bond market developments in each country.

■ *WG4 will be abolished,* because the group has completed its mission and has brought fruitful outcomes.

■ *WG5 will focus more on rating system issues.* The goal of information dissemination has been achieved with the embarkment of the Asian Bonds Online Website (ABW) in May 2004. Management of the ABW will be transferred to the ASTFG.

■ *WG6 will be transformed into the TA Coordination Team for the Focal Group.*

## 4. Selection of Chair Countries

### *Ad-hoc Support Team for the Focal Group:*

The Chair Country of the Focal Group, which rotates regularly, will also be the Chair Country of the ASTFG. The ASTFG will create a “cyber secretariat” utilizing the ABMI internal website.

### *TA Coordination Team for the Focal Group and Working Groups:*

The present Chair and Vice Chairs of the WG6 will assume the same positions in the TACT, which will take over the tasks of the WG6.

The present Chairs of the Working Groups will stay in their current positions to ensure continuity in discussions, expertise, information, as well as cooperation and consultation with consultants. At the same time, flexibility should be maintained to allow any country interested in any WG to become a co-chair of the WG.

#### *Review of the Chairmanship*

The chairmanship of the TACT and the Working Groups will be reviewed at occasional intervals.

### **5. Frequency of Meetings**

*Focal Group:* The Focal Group will meet twice a year.

*Ad-hoc Support Team for the Focal Group:* The ASTFG will constantly share and communicate the information about the progress of the ABMI via E-mail network. The ASTFG makes preparations for the Focal Group and meets if necessary, normally at the same time with the FG.

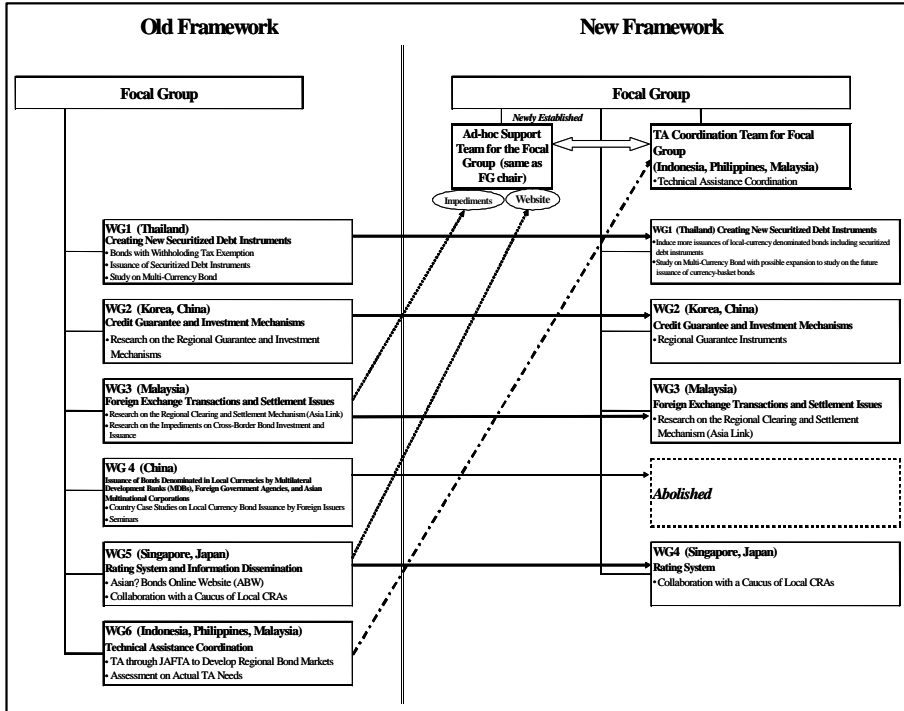
*TA Coordination Team for the Focal Group:* Meetings of the TA Coordination Team for the Focal Group will be held at the same time as those of the ASTFG. Ad hoc meetings can be held by the Chair at the request of a Group member.

*Working Groups:* The Working Group meetings will continue to be held twice or three times a year at least two weeks prior to the Focal Group meetings to allow enough time to prepare the WG progress reports.

### **6. The ADB's Contribution to ABMI**

The Focal Group and each Working Group have received support regarding various issues from the ADB since the launch of the ABMI.

After the reorganization of the Working Groups, we would expect the ADB will continue to contribute to the newly established Ad-hoc Support Team for the Focal Group and TA Coordination Team for the Focal Group as well as the Working Groups as ever by utilizing its expertise.



# **Terms of Reference of The Ad-hoc Support Team for the Focal Group and The TA Coordination Team for the Focal Group under The Asian Bond Markets Initiative**

## **1. Background**

After almost two year has passed since ASEAN+3 Ministers endorsed the Asian Bond Markets Initiative (ABMI), ASEAN+3 countries considered it necessary to revise the present WG framework under the ABMI to further promote and implement the initiative.

The concept of an ABMI Roadmap was proposed by Japan at the November Focal Group Meeting in Tokyo and was endorsed by the November Deputies' meeting in Sanya last year. After the discussions over the draft both at March Focal Group Meeting and April Deputies' Meeting in Vientiane this year, the Roadmap was revised and finalized.

Under the Roadmap, we will set up the Ad-hoc Support Team for the Focal Group (ASTFG), and transform current Working Group 6 into the TA Coordination Team for the Focal Group (TACT).

## **2. Purposes/Functions**

### ***1) Ad-hoc Support Team for the Focal Group***

The ASTFG will be established with the aim of gathering and sharing information in an integrated fashion about bond markets-development efforts, and spreading the initiative across the region under the strong leadership of the Focal Group (FG).

The FG had been set up to coordinate activities of the Working Groups in a systematic and harmonized manner, and its main function is to monitor the progress of the Working Groups and coordinate their future action plans. The ASTFG will support and fortify such function of the FG and making its operations more timely and flexible.

Respecting one of the principles of framework revision “the number of working groups should be kept minimum necessary”, the ASTFG will be set up by refining the existing behind-the-scenes work in each country to support the FG, and reinforcing the cyber network with the help of the ABMI internal website. In this respect, we note that the additional workload/layer resulting from the establishment of the ASTFG should be nominal, and any duplication/overlap of work should be strictly avoided.

With the consideration of the nature of the team, we will name the newly established body as an “Ad-hoc Support Team for the Focal Group (ASTFG)”.

The ASTFG will conduct the following three activities:

- To complement and fortify the functions of the Focal Group  
The ASTFG will complement and fortify the functions of the Focal Group through providing data and information.
- To gather, share, and disseminate information  
The ASTFG will gather, share, and disseminate information on bond markets-developments in ASEAN+3 countries and the activities of other regional fora (i.e., EMEAP and APEC) in an integrated way.
- To compile and update progress reports  
The ASTFG will compile and update progress reports on member countries’ bond market developments every six months.

## 2) *TA Coordination Team for the Focal Group*

In order to provide TA in a more timely, more effective, and more visible manner in light of the rapid advancement of the regional bond markets, the Working Group 6 will be transformed into the TA Coordination Team for the Focal Group (TACT), with the expectation of closer collaboration with the Focal Group as well as with the ASTFG.

The TACT will maintain the existing form of WG6 and continue TA coordination and implementation to all the Working Groups drawing from its accumulated expertise as well as its full understanding of the concrete activities of each Working Group and the ASTFG.

## 3. Membership

### 1) *Ad-hoc Support Team for the Focal Group*

The ASTFG will consist of either the current Focal Group members

or their staffs named by them.

*2) TA Coordination Team for the Focal Group*

The TACT will consist of the members of the current Working Group 6.

#### **4. Frequency and venue**

*1) Ad-hoc Support Team for the Focal Group*

The ASTFG will constantly share and communicate the information about the progress of the ABMI via E-mail network. The ASTFG makes preparations for the Focal Group and meets if necessary, normally at the same time with the FG.

*2) TA Coordination Team for the Focal Group*

The TACT Meetings will be held at the same time as those of the ASTFG. Ad hoc meetings can be held by the Chair at the request of a Group member.

#### **5. Chairmanship**

*1) Ad-hoc Support Team for the Focal Group*

The Chair Country of the Focal Group, which rotates regularly, will also be the Chair Country of the ASTFG. The ASTFG will create a “cyber secretariat” utilizing the ABMI internal website.

*2) TA Coordination Team for the Focal Group*

The present Chair (Indonesia) and Vice Chairs (Malaysia and Philippines) of the WG6 will assume the same positions in the TACT, which will take over the tasks of the WG6.

Flexibility should be maintained to allow any country interested in TACT to become a co-chair of the team. The chairmanship of the TACT will be reviewed at occasional intervals.

#### **6. Others**

The new framework introduced by the ABMI Roadmap and these terms of reference will be effective immediately after the endorsement by the ASEAN+3 Finance Ministers.

## Asian Bond Standards

### 1. Background

Two years have passed since the ASEAN+3 launched the Asian Bond Market Initiative (ABMI). During this time, six informal working groups have conducted discussions on various subjects regarding the ABMI, and made considerable progress. However, the discussion of these groups has been conducted with an implicit understanding of the concept of Asian bonds. Without establishing the clear concept and the standards of Asian bonds, discussions of each working group may lose consistency, which can even result in ABMI losing its identity.

Hence, it is necessary to adopt a future-oriented top-down approach on the ABMI by discussing the concept and the standards of Asian bonds. It may require a long period of time to conclude the discussion. But in the process, the activities of each working groups can be harmonized and properly coordinated. The approach will also be useful in identifying the beneficiaries of the regional agencies such as the credit guarantee and investment infrastructure and the regional securities depository which working group activities strive to establish under the ABMI.

### 2. Development of the Asian Bond Market

#### 1) *Asian Bonds for the ABMI*

*Asian issuers can issue bonds in three markets: local bond markets (domestic bonds), domestic bond markets of other Asian countries (foreign bonds), and eurobond markets (where eurobonds are issued without being registered in any country). All of these three markets are important in funneling savings into capital investment in the region; and in providing the long-term financing necessary for the economic development in the region. Therefore, the ABMI can promote all of these three markets in its efforts to develop regional bond markets.*

An ideal way to develop regional bond markets is to develop each

country's domestic bond market, open the market to foreign investors and issuers, and harmonize each country's bond market regulation. In reality, however, it will take a long time to develop and link local bond markets in Asia, let alone harmonize regulations because there exists a wide difference among East Asian countries in terms of market development, regulation, and infrastructure. The ABMI can contribute to the development of local bond markets by providing technical assistance to the governments who want to develop their nascent local bond markets. The ABMI has also contributed to the development of foreign bond markets through WG 4 activities.

While using the traditional bottom-up approach, the governments can also make joint efforts more actively in developing international bond markets in the region. This is a good subject for ASEAN+3 members to discuss together to meet ABMI's initial goal of mobilizing regional savings within East Asia. An international bond issued in the region is proposed to be named "Asian bond" (in a narrow sense). Asian bond markets will be similar to Eurobond markets in the beginning when Asian issuers issue bonds using most of the infrastructures and the issuing procedures of Eurobond. But the Asian bond market will have its own distinctive features in the future, as relevant infrastructures will be eventually established in Asia.

## *2) Opportunity to Develop the Asian Bond Market: Applying the EU Directive*

Two recent developments in the European Union (EU) - the launch of the Euro and introduction of the Prospectus Directive and the Transparency Directive-are providing opportunities to foster international bond markets in Asia.

The introduction of the Euro has created confusion about the meaning of the word "Eurobond." This is because, while the term was used to refer to international bonds in the past, now euro-denominated bonds sold in the eurozone are also termed Eurobonds. Such confusion has created a favorable atmosphere for the "Asian bond" to emerge as a terminology for international bonds issued in Asia.

The EU has introduced the Prospectus Directive and the Transparency Directive to harmonize the regulations on securities issuance and listing of EU member countries by requiring a minimum standard of Eurobond issuance and listing. The additional requirements

may not incur significant cost to European issuers because they make financial statements in accordance with International Accounting Standards (IAS).

The Directives, however, may adversely affect Asian issuers because, under the Directives, Asian issuers have to adjust their financial statements in accordance to IAS. This is why Asian Eurobond issuers are looking for Asian exchanges to list their Eurobonds.

### *3) Advent of Asian Bond Markets-*

Another insight can be gleaned by examining the supply of capital in Asia. After the financial crisis, Asian countries recorded current account surpluses, experienced a surge in exports and high personal savings, and accumulated substantial foreign exchange reserves. As a result, when Asian issuers with good credit quality issue international bonds, quite frequently most of the investors are located in Asia. These situations provide fertile ground for the development of Asian bond markets.

The issuance of the first pan-Asian Japanese yen-denominated Primary Collateralized Bond Obligations (P-CBO), which was concluded on December 13, 2004 based on the collaboration of the Korean and Japanese governments, illustrates that Asian bond markets have already evolved as international bond markets.

The P-CBO transaction involved a two-tier securitization process: one in Korea and the other in Singapore. In Korea, both senior and junior bonds were issued based on the underlying assets of a portfolio of yen-denominated corporate bonds of 46 Korean small and medium enterprises. Senior bonds were subscribed by the SPC incorporated in Singapore, which in turn, issued senior notes.

The senior notes have several features similar to those of traditional eurobonds. They are international bonds and the secondary market transactions are settled through Euroclear and Clearstream. They are governed by the English laws and are rated by international rating agencies.

But the senior notes differ from eurobonds in several aspects: They are issued in registered global form instead of bearer form; they are listed on the Singapore Stock Exchange; the senior notes are guaranteed by JBIC; the relationship between JBIC and senior noteholders is governed by the Japanese law; and all of the investors in the primary

markets are located in Asia.

The P-CBO transaction illustrates that Asian bond markets have already started to evolve with distinctive features from traditional eurobond markets. When the Asian bond markets develop further to the extent that they enable Asian issuers to raise money without depending too much on European or American investors, the goal of the ABMI to mobilize Asian savings within the region can be achieved. Hence, how to develop such international bond markets further in Asia can be an important discussion point in the ABMI.

### **3. How to Establish the Standards of the Asian Bond Format**

#### *1) Evolution of Eurobond Standards: a Benchmark*

The history of Eurobonds suggests the direction for the ABMI. Since inception, Eurobonds have evolved through three stages of development. Initially, Eurobond markets were naturally born out of necessity by the market participants without a particular effort to harmonize the standards. Subsequently, self-regulatory organizations such as International Primary Market Association (IPMA) and International Securities Market Association (ISMA) were created and began harmonizing the standards of Eurobonds. Now, as the European Commission tries to create integrated capital markets in the region, Eurobonds are expected to enter the process of regulation harmonization enforced by the directives of the EU.

Bond standards include items like issuing procedure, governing law, settlement, listing and disclosure, ISIN issuance, electronic disclosure, documentation, secondary transaction, syndicate rule, accounting standards, credit rating, etc. Each item of the Eurobond standards has gone through different developmental paths. (See Table 1.)

Take the issuing procedure as an example. During the initial stage, the issuing procedure of the Eurobonds was established on contract basis among the market participants. In the second stage, efforts were made by the IPMA to standardize the issuing documents. In the current third stage, which is undergoing implementation, the EU is endeavoring to harmonize the issuing procedure through the Prospectus Directive.

Take settlement process as another example. In the initial stage, Eurobonds were settled through physical delivery in the bearer form. Then, to reduce transaction costs, international central securities depositories (ICSDs) such as Euroclear and Clearstream were established

to serve as the depository and settlement agencies for Eurobonds. As a result, the laws of Belgium and Luxembourg where these international central securities depositories are located served as the governing laws for the settlement of Eurobond transactions.

## *2) Strategic Approach to Establish the Asian Bond Standards: 3-Stage Approach*

### **Stage 1: Institution Design & Specification of the Beneficiary Circle**

Based on the benchmark study of Eurobonds, one can tell that discussions on establishing the Asian bond standards cannot be concluded overnight. They require time, effort, and multi-stage approaches. Therefore, some issues which need prior discussions or which are relatively easy to tackle should be addressed first.

First, studies will be conducted on institutions that are needed in order to develop the Asian bond market. It is also necessary to identify the beneficiary circle of these institutions. The characteristics of Asian bonds can be distinctly visualized in this process.

In the stage of institution designing, the infrastructure whose establishment requires financial cooperation will be identified and its function will be defined. At the moment, there is a working group for the establishment of a credit guarantee and investment mechanism, a settlement institution, and credit rating agencies, respectively. However, more studies should be conducted to identify other institutions that can define the characteristics of Asian bonds.

In discussing the establishment of infrastructure institutions, it is necessary to define the beneficiary circle of each relevant agency. Each agency may specify the qualification for the beneficiary differently depending on the nature of the business. For example, the regional credit guarantee mechanism to be established under the ABMI may provide guarantee service to bonds as long as the obligor or the underlying asset's obligor is an Asian entity. That can include domestic bonds of each country. Although domestic credit guarantee agencies exist in Asian countries, generally, they do not provide guarantee services for project bonds or bonds issued through securitization. Therefore, the newly established regional guarantee agency can provide service for domestic bonds without worrying about competition with domestic agencies.

On the other hand, there are National Central Securities Depositories (NCSDs) in each Asian country in charge of providing depository and settlement service for domestic bonds. Thus, domestic bonds should be excluded from the beneficiary circle of the Regional Central Securities Depository (RCSD), which may be established under the ABMI. Otherwise, the RCSD would be competing with the NCSDs. The same logic applies to the regional credit rating agency.

Also, establishing the qualification for the beneficiary circle of each agency can be useful in implementing best practices as essential components of Asian bond standards or securing demand for the services of other regional infrastructure institutions that are to be established under the ABMI. For example, the regional guarantee mechanism may require adoption of the collective action clause for its guarantee service. In addition, the regional guarantee agency may require that, to receive the guarantee service, bonds must be rated by the regional credit rating agency, which may be established under the ABMI.

### **Stage 2 : Institution Building & Regulation by SROs**

In the second stage, important infrastructure institutions should be established according to priority and urgency set by the research done in the first stage.

Let us take settlement infrastructure as an example. Initially, Asian bonds will be deposited with and settled through Euroclear or Clearstream. However, because of the time zone difference between Asia and Europe where the ICSDs are located, the bonds and the settlement payments have to be deposited one day prior to the settlement date when Asian bonds transactions are settled through the ICSDs. Such a third time zone problem incurs unnecessary additional costs. Therefore, it is necessary that a regional depository and settlement system in East Asia be established at an earlier stage to foster the development of Asian bond markets. As the ICSDs such as Euroclear and Clearstream became one of Eurobond's defining characteristics, it is likely that the Asian regional depository system will become the defining characteristic of Asian bonds.

It is also possible to promote several relevant self-regulating organizations (SROs) if necessary. SROs may play an important role in standardizing issuing documents, setting up trading rules, establishing governing laws, etc.

### **Stage 3: Legally Binding Directive**

The third stage will come when Asian countries accumulate a long history of economic cooperation. When Asian countries endeavor to integrate Asian bond markets through legal enforcement supported by the participating Asian countries, regulation harmonization will be pursued by legally binding agreements like the directives of the EU.

## **4. Concluding Remarks**

In summary, Asian bonds are expected to evolve through three stages as shown indicatively in Table 2. Taking the issuing procedure as an example again, in the initial stage, Asian bonds will be issued following the current issuing procedure of Eurobonds determined by IPMA. In the second stage, an SRO may be formed to write rules that are more suitable for Asian bond markets. Ultimately, the issuing procedure of Asian bonds will be harmonized by legally binding regulations such as the EU's Prospectus Directive.

A point to be made clear is that the Initiative does not aim to create Asian bond markets exclusively for Asian investors and issuers separately from Eurobond markets. Nor does it aim to enforce certain standards without the consent of member countries. Establishing legally binding standards is a long term task that can be achieved only after a substantial progress in regional financial integration. In the mean time, regional financial cooperation will be pursued based on the principle of mutual recognition and with respect for the sovereign rules.

In this process, the identity of the Asian bonds can be established, the concept and standards of Asian bonds can be more clearly defined, and the spirit of ABMI will be strengthened. This would set the direction of the ABMI and foster the establishment of the relevant infrastructure agencies. Furthermore, joint efforts and cooperation of related countries will enhance the brand image of Asian bonds, which will increase investor's acceptance and thus promote the development of Asian bonds.

It is necessary to study these issues in-depth at an international level. Considering the urgency and importance of these issues to the development of the ABMI, it is also necessary for ASEAN+3 to form a group which addresses the Asian Bond Standards and relevant issues. Korea is willing to participate in this group actively if other member countries agree.

**<ABBREVIATIONS & DEFINED TERMS >**

ABMI	Asian Bond Market Initiative
EU	European Union
ICSD	International Central Securities Depository
IAS	International Accounting Standards
IPMA	International Primary Market Association
ISMA	International Securities Market Association
ISIN	International Securities Identification Numbers
JBIC	Japan Bank for International Cooperation
NCSD	National Central Securities Depository
RCSD	Regional Central Securities Depository
SPC	Special Purpose Company
SRO	Self Regulatory Organization

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## Appendix 5.

### Chairman's Statement of the First East Asia Summit Kuala Lumpur, 14 December 2005

1. The First East Asia Summit was held successfully on 14 December 2005 in Kuala Lumpur, Malaysia. The Meeting was chaired by The Honourable Dato' Seri Abdullah Ahmad Badawi, Prime Minister of Malaysia, and was attended by Heads of State/Government of ASEAN, Australia, the People's Republic of China, the Republic of India, Japan, the Republic of Korea and New Zealand. Russia was invited as Guest of the Government of Malaysia. Malaysia was privileged to host and chair this historic Summit.

2. We had a productive exchange of views on regional and international political and economic issues as well as on the challenges facing the region and the world.

3. Understanding that the de-nuclearisation of the Korean Peninsula in a peaceful and verifiable manner will greatly contribute to the peace, stability, and prosperity of the Asia Pacific region, we strongly endorsed the Joint Statement adopted at the Fourth Round of the Six-party Talks on September 19, 2005. We also shared the view that the Fifth Round of the Talks should be resumed as soon as possible, as agreed upon, to enable the Parties to the Talks to continue their discussion on ways to faithfully and expeditiously implement the commitments stated in the Joint Statement.

4. We exchanged views on the recent developments in the region, international terrorism, maritime security as well as the need to address the threat of infectious diseases. In this context we adopted the East Asia Summit Declaration on Avian Influenza Prevention, Control and Response. Leaders acknowledged the ongoing threat that terrorism poses to the region and stressed the continuing need for comprehensive efforts, including at national and regional levels, to combat it.

5. Recognizing the fact that our economies are dependent upon

stable fuel supplies and in the light of the uncertainty of global fuel prices, we supported cooperation in the energy field including development of fuel efficient technologies and alternative energy sources.

6. We recognized the increasing inter-linkages and growing inter-dependence among our countries and agreed to deepen integration and cooperation in order to promote the creation of a harmonious and prosperous community of nations.

7. We discussed development issues which include among others, issues such as sustainable development, technology transfer, trade and investment related issues, challenges to socio-economic development namely poverty, development gap, capacity building and issues related to good governance and promotion of human rights and democracy. We reiterated our commitment for concerted regional and global efforts to respond to these challenges.

8. We reaffirmed our abiding commitment to the objectives of the Doha Development Agenda of the World Trade Organization and the importance of the Hong Kong WTO Ministerial establishing a clear roadmap for completion of the Doha round in 2006. We reiterated our strong preference that all WTO members must achieve an ambitious and balanced outcome in the Doha Round that is development-orientated and delivers real gains for trade in agriculture, non-agricultural market access and services.

9. We also had an exchange of views on the effort at community building being undertaken in the East Asian region. In this regard we expressed our full support for ASEAN's efforts to realize the ASEAN Community. We also recognized that the East Asian community is a long term goal that would contribute to the maintenance of peace, security, prosperity and progress in the region and beyond.

10. We had extensive and in-depth discussions on the East Asia Summit and its role in the evolving regional architecture. We agreed that the East Asia Summit with ASEAN as the driving force is an integral part of the overall evolving regional architecture. We also agreed that the East Asian region had already advanced in its efforts to realise an East Asian community through the ASEAN+3 process. In this context we believed that the EAS together with the ASEAN+3 and the ASEAN+1 processes could play a significant role in community building in the region.

11. We reiterated our agreement that the East Asia Summit should

remain open and outward looking, with ASEAN as the driving force working in partnership with the other participants of the East Asia Summit. In this context, we welcomed the Russian Federation's expression of interest to participate in the East Asia Summit and agreed to consider its participation in future East Asia Summits based on the criteria established by ASEAN.

12. We agreed that the EAS would continue to be a leaders'-led Summit for strategic discussions on key issues affecting the region and the evolving regional architecture. We appreciated the informal, retreat style format of our first meeting which enabled us to discuss issues in a frank, spontaneous and free-flowing manner.

13. We also noted that some form of mechanism may be desirable to facilitate follow-up action of the EAS and to coordinate and implement the areas of cooperation we had identified. In this regard we agreed that the officials and the ASEAN Secretariat follow through with the decisions of the EAS.

14. We signed the Kuala Lumpur Declaration on the East Asia Summit outlining its principles and purposes, areas of cooperation and primary modalities.

15. We agreed that the East Asia Summit will be convened annually. In this context we agreed to convene the Second East Asia Summit in Cebu, Philippines on 13 December 2006.

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## Appendix 6.

### **Chairman's Statement of the Ninth ASEAN Plus Three Summit Kuala Lumpur, 12 December 2005**

1. The ASEAN Plus Three Summit was held successfully on 12 December 2005 in Kuala Lumpur, Malaysia. The Meeting was chaired by the Honourable Dato' Seri Abdullah Ahmad Badawi, Prime Minister of Malaysia, and was attended by Heads of State/Government of ASEAN Member Countries, the People's Republic of China, Japan and the Republic of Korea.

2. We signed the Kuala Lumpur Declaration on the ASEAN Plus Three Summit to reaffirm our commitment to ASEAN Plus Three cooperation, which has achieved substantial progress in the last eight years. We agreed to continue holding the ASEAN Plus Three Summit annually in conjunction with the ASEAN Summit to guide and provide political momentum to East Asian cooperation and community building efforts.

3. We agreed that the ASEAN Plus Three process will continue to be the main vehicle in achieving that goal, with ASEAN as the driving force, and with the active participation of the ASEAN Plus Three countries, in order to promote shared ownership. We reiterated our common resolve to realise an East Asian community as a long-term objective that would contribute to the maintenance of regional and global peace, security, progress and prosperity

4. We noted with satisfaction the steady progress achieved in the ASEAN Plus Three cooperation in the last eight years, which had brought about mutual benefits and closer linkages, thereby contributing to community building in East Asia. In this regard, we noted the progress made in the implementation of East Asia Study Group (EASG) short-term, and medium and long-term measures. We agreed to accelerate the implementation of all the short-term measures by 2007 as well as to expedite the carrying out of the medium and long-term

measures. We noted the ongoing feasibility study by the Expert Group on the East Asia Free Trade Area. We reaffirmed the need to strengthen the ASEAN Plus Three Unit at the ASEAN Secretariat to coordinate and implement cooperation. We welcomed concrete offers by the Plus Three Countries to promote substantive cooperation.

5. We noted the policy recommendations of the 3rd Meeting of Network of East Asia Think Tank (NEAT) in August 2005 entitled "Towards an East Asia Community" in August 2005 in Tokyo, and the outcomes of the 3rd East Asia Forum held in October 2005 in Beijing. We requested our Ministers and Senior Officials to study the recommendations and proposals of these meetings. We also noted the successful convening of the Joint Study Convention on East Asia Cooperation, which China convened on 30 October 2005.

6. We welcomed the developments in the Asian Bond Market Initiative (ABMI) and the Chiang Mai Initiative (CMI), which are making important contribution to the monetary and financial stability of our region. We also welcomed Thailand's proposal to host the First Asia Cooperation Dialogue (ACD) Finance Minister's Meeting in 2006 to promote ABMI in the ACD framework.

7. We welcomed the proposal to hold East Asia week annually to promote, among others, arts and culture, awareness about East Asia cooperation and foster people-to-people bonds.

8. The ASEAN Leaders expressed their appreciation to China, Japan, and the Republic of Korea for their assistance in narrowing the development gap in ASEAN and ASEAN integration through, among others, their support in implementing various projects under the Initiative for ASEAN Integration (IAI) Work Plan and sub-regional growth areas in ASEAN.

9. The Leaders of the Plus Three countries agreed to continue their support to ASEAN Community building efforts, including through the Vientiane Action Programme (VAP), which would at the same time contribute to the building of an East Asian community in the long-term.

10. We further agreed to take stock of ASEAN Plus Three cooperation since 1997 and issue a second Joint Statement on East Asia Cooperation and Work Plan at our Summit in 2007 to consolidate existing cooperation and set the future direction for the cooperation and East Asian community building on the occasion of the tenth anniversary of the ASEAN Plus Three cooperation in 2007.

11. We exchanged views on regional and international political and security, and economic issues of common interest and concern.

12. We shared our concerns on the challenges facing the region and the world as a whole, such as terrorism, maritime security and other transnational crime, the outbreak of avian influenza, and natural disasters. We reiterated our commitment to cooperate within the ASEAN Plus Three framework and participate actively in other regional and global efforts in addressing these challenges. In this regard, we welcomed Malaysia's proposal to establish a regional WHO collaborating centre for influenza and a Regional Avian Influenza Research and Reference Centre in Malaysia, as contribution towards global health security.

13. We reaffirmed the urgent need to address energy security issues. We noted that policy dialogue as well as search for alternative or renewable sources of energy such as hydro power, solar and bio-fuel from palm oil, sugar cane and even coconut could be cooperative initiatives we could look into. We noted that we could exchange best practices and technologies on energy efficiency and conservation. We tasked our Ministers and Senior Officials to study cooperation in this sector.

14. We recognised the need to address issues concerning the environment and sustainable development. We also acknowledged the importance to foster cooperation in the areas of transport and communication, including information communication technology in bridging the digital gap and promoting people-to-people linkages. We tasked our Ministers and Senior Officials to study possible areas for cooperation, including greater utilisation of IT in community building.

15. We reaffirmed our commitment to the peaceful and comprehensive solution to the nuclear issue of the Korean Peninsula. In this connection, we welcomed the Joint Statement of the Fourth Round of the Six-Party Talks adopted on 19 September 2005.

16. We welcomed the convening of the first East Asia Summit (EAS) on 14 December 2005 in Kuala Lumpur, Malaysia. We shared the views that the EAS should be convened annually and that the EAS will play a significant role in this region. The EAS will be consistent with and reinforce ASEAN's efforts in building the ASEAN Community. We recognised that the EAS will contribute to the evolving regional architecture. We look forward to a fruitful deliberation of the EAS.

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## Appendix 7.

### Kuala Lumpur Declaration on the ASEAN Plus Three Summit Kuala Lumpur, 12 December 2005

WE, the Heads of State/Government of the Member Countries of the Association of Southeast Asian Nations (ASEAN), and the People's Republic of China, Japan, and the Republic of Korea, on the occasion of the 9th ASEAN Plus Three Summit on 12 December 2005 in Kuala Lumpur, Malaysia;

**REAFFIRMING** the need for a peaceful, stable and prosperous East Asian regional environment through mutual solidarity and concerted efforts;

**FURTHER REAFFIRMING** our commitment to the purposes and principles of the Charter of the United Nations, the Treaty of Amity and Cooperation in Southeast Asia and other universally recognised principles of international law which will serve as the basis of norms governing state-to-state relations;

**RECALLING** the 1999 Joint Statement on East Asia Cooperation which sets out the principles and purposes of East Asia cooperation;

**REITERATING** our common resolve to realise an East Asian community as a long-term goal that would contribute to the maintenance of regional and global peace and security, prosperity and progress;

**CONVINCED** that the ASEAN Plus Three process will continue to be the main vehicle in achieving that goal, with ASEAN as the driving force and with the active participation of the ASEAN Plus Three countries in order to promote a sense of shared ownership;

**RECOGNISING** the importance of ASEAN integration and the ASEAN Community towards community building in the region and the continued support of the Plus Three countries for ASEAN's efforts;

**FURTHER RECOGNISING** the important role played by the ASEAN Plus One processes to the overall cooperation within the ASEAN Plus Three framework;

**CONFIDENT** that the growing interactions among the ASEAN Plus Three countries will help promote greater dialogue and collective efforts to both harness opportunities and meet the challenges posed by a fast-changing and globalising world;

**ACKNOWLEDGING** with satisfaction the steady progress achieved to date in the ASEAN Plus Three cooperation in all areas has brought about mutual benefits and closer linkages, thus contributing to the community building in East Asia;

**ENCOURAGED** by the progress in the implementation of the short-term, and medium and long-term measures proposed in the East Asia Study Group (EASG) Final Report, which we endorsed in November 2002 in Phnom Penh, Cambodia;

**WELCOMING** the convening of the First East Asia Summit in Kuala Lumpur on 14 December 2005;

**DO HEREBY DECLARE:**

1. We will continue to hold the ASEAN Plus Three Summit annually in conjunction with the ASEAN Summit to guide and provide political momentum to East Asian community building under the ASEAN Plus Three cooperation.

2. We will commence collaborative efforts to prepare a second Joint Statement on East Asia Cooperation on the tenth anniversary of the ASEAN Plus Three process in 2007 in order to consolidate existing cooperation and to set forth the future direction for the cooperation and East Asia community building, and task our Ministers to coordinate and undertake the necessary follow-up.

3. We will continue to encourage and support cooperation under the ASEAN Plus One processes to further contribute to the overall cooperation within the ASEAN Plus Three framework, which will form an integral part of the overall regional architecture in a complementary manner with other regional fora and processes.

4. We will speed up the implementation of the short-term, and medium and long-term measures of the EASG Final Report.

5. We will continue to support ASEAN integration, particularly in narrowing the development gap in order to realise the ASEAN Community and at the same time contributing to the building of an East Asian community as the long-term goal.

6. We will enhance people-to-people exchange aimed at developing

a “we” feeling.

7. We will encourage the sharing of ideas through greater interaction between students, academicians, researchers, artists, media, and youths among countries in East Asia.

8. We will conduct regular exchange of intellectuals, members of think tanks, religious personalities and scholars, which will benefit East Asia and the world through deeper knowledge and understanding so as to fight intolerance and improve understanding among cultures and civilisations.

9. We will enhance and strengthen the various mechanisms crucial for the development of ASEAN Plus Three cooperation, including the ASEAN Plus Three Unit in the ASEAN Secretariat.

**SIGNED** at Kuala Lumpur, Malaysia, on the Twelfth Day of December in the Year Two Thousand and Five.

For Brunei Darussalam:

**HAJI HASSANAL BOLKIAH** Sultan of Brunei Darussalam

For the Kingdom of Cambodia:

**SAMDECH HUN SEN** Prime Minister

For the Republic of Indonesia:

**DR. SUSILO BAMBANG YUDHOYONO** President

For the Lao People’s Democratic Republic:

**BOUNNHANG VORACHITH** Prime Minister

For Malaysia:

**DATO’ SERI ABDULLAH AHMAD BADAWI** Prime Minister

For the Union of Myanmar:

**GENERAL SOE WIN** Prime Minister

For the Republic of the Philippines:

**GLORIA MACAPAGAL-ARROYO** President

For the Republic of Singapore:

**LEE HSIEN LOONG** Prime Minister

For the Kingdom of Thailand:  
**DR. THAKSIN SHINAWATRA** Prime Minister

For the Socialist Republic of Viet Nam:  
**PHAN VAN KHAI** Prime Minister

For the People's Republic of China:  
**WEN JIABAO** Premier

For Japan:  
**JUNICHIRO KOIZUMI** Prime Minister

For the Republic of Korea:  
**ROH MOO-HYUN** President

&lt;Table 1&gt; Development of the Eurobond Format

Category	First Stage	Second Stage	Third Stage
Issuing Procedure	Natural formation	Harmonization by IPMA	Harmonization by EU
Governing Law	English law	English law	English law
Settlement	Natural formation	Euroclear, Clearstream and affiliated countries (Luxemburg, Belgium)	ICSD and affiliated nations
Listing and Disclosure	Securities exchange (LSE, Lux)	Securities exchange (LSE, Lux)	Also using securities exchanges outside the EU (Switzerland, Singapore)
ISIN	None	Securities exchanges, ICSD	Securities exchange, ICSD
Electronic Disclosure	None	Introduced by each country	Introduced by each country
Documentation	Use Yankee bond format	Develop IPMA format	Prospectus Directive IPMA form
Syndicate rule	Natural formation	Harmonization by IPMA	Harmonization by IPMA
Secondary transaction	Natural formation	Harmonization by ISMA	Harmonization by ISMA
Accounting Standard	Decided by either bond issuer's country or securities exchange	Decided by either bond issued country or securities exchange	IFRS
Credit Rating	Up to the underwriter/issuer (one or two)	Up to the underwriter/issuer (one or two)	Up to the underwriter/issuer (one or two)

**<Table 2> Road Map of the Asian Bond Format**

Category	Present	Medium-term	Long-term
Issuing Procedure	IPMA	Harmonization by an Asian self-regulatory organization	Harmonization by legal enforcement
Governing Law	English law	English law or Asian country law	Asian country law
Settlement	Euroclear, Clearstream	Regional Central Securities Depository (RCSD)	RCSD
Listing and Disclosure	Securities exchange (Mostly LSE, Lux)	Asian securities exchanges	Asian securities exchanges
ISIN	Securities exchange, ICSD	Securities exchange, RCSD	Securities exchange, RCSD
Electronic Disclosure	Introduced by each country	Harmonization of regulations	Harmonization of regulations
Documentation	Use Eurobond (IPMA) form	Develop Asian bond form	Use Asian bond form
Syndicate rule	Eurobond syndicate (IPMA)	Asian IPMA rule	Asian IPMA rule
Secondary transaction	ISMA	Asian ISMA rule	Asian ISMA rule
Accounting Standard	Decided by bond issued country	Harmonization of some accounting standards	Harmonization of accounting standards
Credit Rating	Up to the underwriter/issuer (one or two)	Up to the underwriter/issuer (Including regional credit rating mechanism)	Up to the underwriter/issuer (Including regional credit rating mechanism)

\*: table only for illustrative and indicative purposes

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Yung Chul Park and Doo Yong Yang

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