East Asian Financial Architecture for Stable Economic Development*

By

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1. Ever since the early part of the economic crisis in East Asia, numerous discussions have taken place within the region exploring the need for more monetary cooperation within the region, including the possibility of a new financial architecture for East Asia, such as the setting up of an Asian Monetary Fund, more stable relationships among currencies within the region, management of short-term capital flows, and the need to develop an effective long-term capital market for the region. These discussions reflect a feeling among diverse parties within the region that East Asia needs to develop new approaches and mechanisms to better protect itself from risks and volatility that have led to the current crisis in order to ensure a more stable economic development for the region in the future. They are also partly a reaction to the feeling that most of the key measures that countries under the IMF program have had to follow to deal with the crisis were designed by individuals and institutions from outside the region, and may not fully reflect the best interest of the affected countries. Examples of unilateral measures adopted by some countries, such as the imposition of control on capital outflow in Malaysia, or direct intervention by the government in the stock market in Hong Kong, also indicate that alternative approaches to dealing with market risks, volatility and speculation may have their place in times of crisis in addition to the standard IMF approach. In this paper, I present some personal views on these issues drawing mainly from the Thai experience with which I am most familiar, and suggest some possible directions for fruitful future regional monetary cooperation.

2. First, I think that it is important to clearly separate two types of discussions. One concerns the measures that are necessary to prevent or minimize the risk of such an economic crisis from happening again. This will involve looking at the fundamental cause of the crisis and examining the policies at the national, regional as well as global level that can serve to protect countries from getting into the same kind of crisis. The other concerns measures and institutions that can help countries deal with a crisis once it occurs. The various suggestions on regional monetary cooperation and financial architecture cover both of these issues. Personally, I believe that the first set of issues, how to prevent or minimize the risk of a crisis, is more important, although the second set of issues concerning what to do once a crisis develops cannot be ignored, as there is no absolute guarantee that a crisis will not happen again, even if the risks are minimized. I shall therefore focus my main discussion on the first set of issues.

3. A common feature of the countries that have had to ask the IMF for assistance is that they all became basically insolvent in term of not having enough foreign currencies to meet their obligations. In the case of Thailand, the central bank used up almost all of the

country's foreign reserves to fight against currency speculators in the first half of 1997, so that by the time the Baht was floated on July 2, 1997, while gross official reserves were about US$ 32.4 billion, free official reserves were down to only about US$ 3 billion (see Table 1).[1] At that time, the central bank had made forward commitments to sell US$ to defend the currency to the amount of US$ 29.5 billion. Taking into account the country's outstanding short-term foreign debt of US$ 43.0 billion and the current account deficit, which was running at about US$ 1 billion per month at that time, it is clear that the country was basically insolvent in terms of not having enough foreign currencies available to meet its foreign currency obligations. South Korea and Indonesia also ran into a similar insolvency problem. For example, South Korea had US$ 21.5 billion in official foreign reserves at the end of 1997, while short-term foreign debt (excluding that of oversea branches of domestic corporation) was about US$ 70.9 billion.[2] In fact, the three countries that had to ask the IMF for assistance were countries with the highest exposure to short-term foreign debt compared to foreign reserves (Table 2). In the case of Malaysia, the short-term foreign debt exposure was much less, yet the fact that Malaysia had to resort to the control on capital outflow suggested that Malaysia foresaw a liquidity problem in terms of foreign currency if the capital outflow measure was not implemented.

4. From my perspective, the rapid increase in short-term external debt arising from the financial and capital market liberalization together with the fact that the central bank did not take sufficient account of the risks arising from these short-term debt in the exchange rate and foreign reserves management policies were the main cause of the currency crisis. If the central bank had realized the importance of keeping enough foreign reserves to back up these short-term debt, whose flow could easily reverse, then it would surely not throw away most of the foreign reserves in the defense of the currency. The forward commitments to sell US$ to defend the Baht depleted the foreign reserves, so that the country ended up not having enough foreign currencies to meet its obligations which implied that the value of the currency had to depreciated substantially simply on demand and supply considerations.

5. It is now widely understood that with financial and capital market liberalization, a country cannot maintain a fixed exchange rate policy (whether to a single currency or to a basket of currencies) and also pursue an independent monetary policy. In the case of Thailand, financial and capital market liberalization accelerated since the early part of the 1990s. At the same time, a fixed exchange rate policy was maintained (to a basket of currencies) and the central bank also responded to overheating of the economy by trying to maintain high domestic interest rates. This simply led to a rapid increase in foreign borrowing, mostly short-term debt, as borrowers could profitably arbitrage on the interest rate differentials. Capital inflow was actually greater than the current account deficit for every year between 1990 and 1996, leading to a rapid increase in foreign reserves, from US$ 14.3 billion at the end of 1990 to US$ 38.7 billion at the end of 1996. Before the crisis, most people were still talking about the adequacy of the level of foreign reserves in terms of how many months of imports they covered. Viewed in this way, Thailand had a more than adequate level of foreign reserves, amounting to about 5.5 months of imports at the end of 1996. Thus, even though Thailand's current account deficit was around 8-9% of GDP in 1995 and 1996, looking at the adequacy of foreign reserves in this traditional way may have suggested that the exchange rate fundamental was still reasonably sound. Of course, as is now clear, this way of looking at the adequacy of foreign reserves is severely

flawed. It may have been a relevant measure in a world where capital flows were minimal and most currency transactions arose from some underlying current account transactions. However, in the current situation where capital account transactions far outweigh the current account transactions, exchange rate and foreign reserves policies need to take explicit account of the capital account transactions and the country's debt profile. The country's foreign exchange obligations arise from both the current account transactions and capital account transactions. Short-term debt are short-term by nature, and one cannot expect the debt to be continually rolled over. If the debt need to be repaid, then a sufficient amount of foreign currencies need to be available to repay the debt. Even if the borrowers have sufficient domestic currency resources to repay the debt, if the country does not have enough foreign currencies available, then the debt cannot be repaid.

6. By focussing on the short-term debt and the mismanagement of the exchange rate and foreign reserves policies, I do not imply that other factors that have been raised through various analyses and debates as contributing to the crisis are not important.

- Some have argued that the fixing of the currency mainly to the US$ led to a weakening in the competitive advantage of many East Asian economies when the US$ strengthened against the Yen starting around the middle of 1995. By maintaining the exchange rate, the competitiveness of the Thai economy declined, as witnessed by the negative export growth experienced in 1996. The devaluation by China of the Renminbi in 1994 presumably also contributed. So did the fact that all the East Asian economies were all pursuing vigorous policies of export-led growth, competing intensely with each other for a limited world market. This led to excess production capacities developing in many industries, and rapid changes in comparative advantages in labor intensive and assembly type industries to countries at lower levels of economic development, where wages and other production costs are lower.

- Some have pointed to weak financial systems in East Asia, where vast amounts of imprudent lending to non-viable projects took place. Business practices lacking in good corporate governance have also been highlighted, the so-called crony-capitalism. These certainly contributed to the crisis. In Thailand, lending to certain sectors, especially real estate and some heavy industries were excessive, and some banks lent most of its money to projects owned or managed by friends or relatives. However, it should also be pointed out that the foreign financial institutions that lent to banks and companies in East Asia, institutions that presumably have better prudential standards and codes of good corporate governance, also lent huge amount of money to non-viable projects, and also too easily trusted the borrowers who have had longer term relationships with them on the feasibility of various projects. Basically, there was "irrational exuberance" on the growth potential of East Asia, whether by the governments, the people, the domestic business and financial sectors, the foreign lenders, including international organizations who pointed to the growth miracle of East Asia, and cited the East Asian model as an example for the rest of the developing world to follow. Of course, some doubted the economic miracle, such as Krugman who suggested that most of the East Asian growth were due to perspiration rather than inspiration, and therefore may not by so sustainable.[3] But even Krugman did not expect that this feature of East Asian growth would lead to anything like the kind of crisis that occurred.[4]

7. While both of the above factors were important, I believe that if appropriate policies were pursued on exchange rate and foreign reserves, taking fully into account the foreign currency obligations of the country, the economic problems arising from these factors would have been much less severe than what actually happened. As the crisis was developing in Thailand, a number of analyses were carried out based on the real effective exchange rate to find out what would be an appropriate exchange rate for current account transactions. These pointed to an exchange rate of around 30-31 Baht per US$ compared to the level of about 26 Baht per US$ before the crisis, or a depreciation of about 15-17%. In actual fact, given the fiasco of the Baht defense and the outstanding foreign currency obligations from the vast amount of outstanding short-term foreign debt, the Baht weakened to around 55 Baht per US$ within six months after the Baht float in spite of the liquidity support from the IMF package, and only started to strengthen a few months after the foreign currency inflow from the current account surplus started to counterbalance the capital outflow. The large depreciation also led to widespread insolvency of the financial and business sector. In mid-1997, the private sector had about US$ 79.2 billion in foreign debt. As a result of the weakening of the Baht, by January 1998 their debt in Baht terms had increased by about 2.3 trillion Baht or about 49% of GDP. In such a situation, there is little chance for those businesses with large amounts of foreign debts to remain solvent. Even before the currency crisis, a financial crisis was already building up due to excessive lending to non-viable projects. With the currency crisis, the financial crisis could not be contained and became systemic. Domestic non-performing loans increased rapidly and still remain at around 38% of total loans as of the end of January 2000. Financial sector restructuring and debt restructuring are still major problems, and will likely require another 2-3 years to be fully resolved.

8. The economies of the crisis affected countries of East Asia are now showing clear signs of recovery in terms of achieving solvency with regards to foreign reserves, and showing satisfactory growths in production and GDP. In Thailand, the ratio of free official reserves to short-term foreign debt was 0.044 at the end of the third quarter of 1997, a clear sign of insolvency. The ratio was 1.25 at the end of 1999. The main contributing factor, of course, has been the surplus in the current account which started since the fourth quarter of 1997. The foreign reserves situation is now considered strong enough, so that Thailand will no longer make any further drawings from the IMF package. Real GDP growth has been positive since the first quarter of 1999, growing by 0.9% in the first quarter, 3.3% in the second quarter and 7.7% in the third quarter (Table 3). This a complete turnaround from the 10.4% negative growth in 1998. Capacity utilization has increased significantly in many sectors and the growth in the US$ value of export in 1999 surpassed the original target, achieving a growth rate of 7.4% compared to the target of about 4.0% set earlier in the year. In fact, export growth for January 2000 jumped to 33.2% compared to the same month in 1999, reiterating the up-trend in economic activity. Of course, many problems still remain, such as the NPL problem already mentioned, as well as threats to recovery from the rapid increases in world oil prices. However, the current situation is certainly much healthier than one year ago. Similar signs of recovery in real GDP growth can be seen for the other countries in the region as well (Table 3).

9. Given the recovery trend, one should ask whether the countries of East Asia are now more resilient to the kinds of risks and volatility that have led to the crisis in the first place. This is important as one should not simply be content with the various crisis

management measures that have lifted the economies from the recession, but should be wary of a similar crisis happening again in the future. On the whole, I believe that the various countries are now in a better position to avoid a similar kind of crisis from happening. However, a lot more can be done, both at the national, regional and global level to ensure a more stable growth environment for the future.

10. At the country level, the various reform measures that the crisis affected countries have had to carry out as a result of the crisis should put them in a better position to manage the risks and volatility arising from the financial and capital markets compared to the situation before the crisis.

- First, as a result of the crisis, there is now a much better understanding of the systemic risks that too much exposure to short-term foreign debt can create. Some economists, such as Professor Stiglitz, suggest that short-term foreign borrowing has negative externalities on the economic system given imperfect information and incomplete markets.[5] An example would be short-term foreign borrowing to finance a project with high import content and with little foreign currency earning. As a result of the project, the country's short-term foreign debt would increase by much more than the increase in foreign reserves remaining in the country. With imperfect information on the state of foreign debt, and with thin markets for hedging for the future debt repayment, a lot of such projects could be initiated, causing the ratio of short-term foreign debt to the country's reserves to increase to a dangerously high level. Once the true situation became know, this could lead to a rapid recall of debt. Holders of domestic financial assets could also get in on the band wagon, and increase the demand for foreign currencies expecting to make a windfall on the expected depreciation of the currency. Eventually, the exchange rate cannot be maintained, and with a large enough ratio of short-term foreign debt to foreign reserves, panic could set in leading to huge depreciation of the domestic currency. Elements of this scenario are similar to what actually happened. One year before the crisis, the information available to the Thai authority about the extent and maturity structure of private sector foreign debt was very imperfect. That available to the business sector and the public was even less. Now, given that everyone realizes the importance of foreign debt, the information about foreign debt is fairly complete and publicly available, and the authorities are paying much closer attention to foreign debt and the foreign currencies available to the country. Attention has also been given to the need for a broad surveillance of potential problems and early warning systems. The key is the availability of appropriate information and the transparency and accessibility of information. In Thailand, the economic information system is now much better than prior to the crisis. Before the crisis, there was no quarterly GDP series, and the lag in annual GDP data can sometimes be almost two years. This is certainly not conducive to rational decision making in a highly volatile world. Currently, quarterly GDP is available with a one quarter lag. Many economic and financial data series are available online. This should help in creating checks and balances in policy formulation by allowing more rational policy discussions by non-government and private institutions as well as the general public.

- The countries that became insolvent and came under the IMF programs all adopted a managed float exchange rate system out of necessity. There was no choice, as the countries did not have enough foreign reserves to manage a fixed exchange rate regime. At the same time, the previous fixed exchange rate regime (to a basket of currency) did not go well with financial sector liberalization, one of the key policy stance in the IMF program. The current managed float regime gives more flexibility for macroeconomic management in the current world where currency trading and capital movements can be very volatile. Instead of being committed to buy and sell foreign currencies at specified prices, the central bank can choose when to buy or sell foreign currencies. A policy to stabilize the currency can be pursued, but need not be. If currency trading becomes very volatile, the currency can be left to fluctuate, rather than have the foreign reserves accommodate to the volatility. If large capital inflows occurs, the domestic currency would tend to appreciate. On the one hand, this may encourage further capital inflow to take advantage of, or speculate on, further appreciation of the currency. On the other hand, the stronger domestic currency implies the need for a greater foreign inflow to finance the same amount of domestic currency usage, and also greater risk that the currency will eventually depreciate from current account fundamentals. Generally, one would expect the flexible exchange rate regime to provide some built in stabilizer to capital flows. However, the exchange rate swings could be very large before the stabilizer factor becomes effective, as witnessed by large swings between major currencies such as the US$ and Yen, in spite of interventions by the authorities. Nevertheless, allowing the currency to float gives an additional degree of flexibility in dealing with financial and capital market volatility. The value of the currency can be allowed to change in line with market forces or stabilized as appropriate. Of course, the floating of the currency cannot shield the economic system totally from external volatility. The exchange rate can still swing wildly creating problems for the business and financial sectors, especially where markets to hedge against volatility are thin, as they are for most developing countries. This is why regional and global measures are also needed.

- Apart from adopting a managed float system, the central banks of the countries under the IMF program are being reformed in similar fashions, to create greater transparency in their monetary operations. In Thailand, a situation where the central bank could throw away most of the foreign reserves to defend the currency while ignoring all the foreign currency obligations of the country obviously indicated grave flaws in the system. Simply changing to a managed float system is not sufficient. Attention needs to be paid to increasing the transparency of central bank operations, so that a more balanced view can be reflected in policy making. Checks and balances are needed, both within the policy making process itself, and in enhancing public scrutiny of policy. Also, given the floating exchange rate regime, an independent domestic monetary policy becomes feasible and important.[6] Each of the countries under the IMF program has or is moving to institutionalize an "inflation targeting" monetary policy framework. This is expected to significantly increase the transparency of monetary policy and also give more importance to price stability to counterbalance possibilities of excessive growth that might recur after the recovery. The extent to which a managed float exchange rate system together with an inflation targeting monetary policy framework can be effective in providing an adequate protection against risks from external volatility and in preventing the kind of economic bubble that occurred before the crisis will need to be constantly monitored and analyzed.

- Financial sector reform measures, which have been at the centerpiece of the IMF reform package, can also be seen as strengthening the financial sector against a reoccurrence of the vast amount of imprudent lending such as occurred before the crisis.

This is, however, more controversial. The push for rapid financial sector reform at a time of currency and financial crises, particularly the increase in prudential standards for financial institutions and the opening up of the sector to greater foreign control, has been criticize as being "fire-sale measures" for the benefit for foreign investors. Some critics have argued that the IMF does not have enough expertise in this area, and should focus mainly on the currency crisis.[7] Further, as already pointed out, imprudent lending (including so-called crony capitalism) was not only a feature of financial institutions in the crisis affected countries before the crisis, it was also true for foreign financial institutions that lent vast amount of foreign loans to the region before the crisis. However, while these financial sector reform measures, including changes in the financial legal framework, and measures to improve corporate governance, may not be able to prevent a future bubble if the conditions conducive to "irrational exuberance" return, they should prevent some of the extreme forms of anti-market behaviors that contribute to severe economic inefficiencies, such as banks that lent most of its loans to friends and relatives, borrowers that become strategic non-performing loans hoping to take advantage of the arduous legal process for foreclosure and bankruptcy, and clear cases of fraud and money siphoning that are currently under the legal process.

11. Malaysia and Hong Kong took unusual unilateral measures to deal with instability arising from speculative activities in the financial markets. Rather than follow the standard IMF approach, Malaysia adopted a fixed exchange policy and imposed a control on capital outflow to help with possible liquidity problems on foreign exchange. Hong Kong, which operates a currency board system, fought against speculators, who took advantage of the link between the currency board system and the stock market to make profits through short-selling on the stock market, by direct intervention of the government in the stock market. These measures taken by Malaysia and Hong Kong should be viewed as crisis management measures, rather than a policy stance that will be regularly utilized. They appeared to have been grudgingly accepted by the markets, given the extensive nature of the economic crisis that was occurring the region. Currently, both Malaysia and Hong Kong are showing clear signs of economic recovery along with the other countries that came under the IMF program (Table 3), so that it is difficult to credit the recovery to any particular crisis management approach, whether the more market based approach in the IMF program, or the interventionist approaches of Malaysia or Hong Kong.

12. There appears to be a greater consensus now on the need for countries to have instruments to manage capital flows, especially short-term capital flows. Many people have stressed the necessity for this as part of the normal rules of the game,[8] and some have even suggested the need for capital control as an instrument of adjustment during a currency crisis.[9] Over the first part of the crisis, the IMF was still very intent on the desirability of fully liberalized capital flow. However, later on, even the IMF appears to have accepted that capital flows management measures may be necessary under certain circumstances, and this issue is also included as part of the current discussions on the reform of the international financial architecture.[10] Theoretically, with imperfect information and incomplete markets, there seems to be clear negative externalities associated with short-term capital flow through the systemic risks and volatility that it can generate, so governments should be justified in having instruments at their disposal to manage the pace and structure of capital flow and hence the external debt profile of the country. The public sector does have elaborate rules, regulations and instruments to

manage its own debt structure, both domestic and foreign. It has relative few measures for effective management of the debt profile of the private sector. Clearly, too much management could be counter productive, as one wants the economy to remain predominantly *laissez faire*. On the other hand, not managing the private sector debt structure sufficiently led to the vast increase in short-term foreign debt before the crisis, and was one important element that eventually led to the crisis. A balance needs to be found that will minimize the risks, while at the same time still enabling potential benefits from access to the international capital market. Some international or regional consensus should be reached on the best practices for management of short-term capital flows, so that risks can be minimized while benefits from access to the short-term capital market can still be achieved. Some clear guidelines could be drawn up, so that each country will not have to come up with its own scheme, which could lead to much confusion and inconsistencies.

13. Reforms are also needed at the global and regional levels to bring about a more stable growth environment. Discussions on the reform of the international financial architecture at the global level have focussed on issues such as better and more transparent economic information, the development of codes of good practice in various areas, financial sector strengthening, "bailing in" the private sector to help deal with a crisis, and the development of the IMF's Contingent Credit Line (CCL) as a precautionary line of defense that countries with sound policies can draw upon to prevent impacts from international financial contagion (including discussions on capital flows as earlier mentioned).[11] Suggestions for the regulation and greater transparency of highly leveraged institutions have also been discussed, especially after the near collapse of the Long-Term Capital Management (LTCM). Another area for global reform, which I think is very important, has to do with the Basle Capital Accord and its risk weights to be applied to bank assets. In the current situation, loans to non-OECD banks or loans guaranteed by non-OECD banks with a maturity of less than one year have a 20% risk weighting. However, a similar loan but with a maturity of more than one year has a 100% risk weighting (Table 4). Clearly, this will encourage short-term lending to developing countries. From a partial point of view, a short-term loan will expose the lender to less risk, as uncertainties that can develop until the maturity date of the loan is less than for a long-term loan. However, from a systemic view point, vast increases in short-term loans to developing countries create risks to the macro-economy, especially since the ability of the authorities to appropriately manage the exchange rate and foreign reserves policy has proven to be woefully inadequate. And when a currency crisis occurs, as it has for many countries in recent years, the risks to the lenders from the crisis become all too clear. Thus, while the current risk weights appear sensible at the partial level, they create much greater risks to the system as a whole. A change in the risk weights that does not discriminate against long-term lending should help to increase the share of longer term loans, which is what developing countries really need.

14. One way to deal with the problem of short-term debt is obviously to rely less on them. This is easy to say, but in the past most countries in East Asia have been financing their investment-saving gap through short-term foreign borrowing. However, this need not be so. If one looks at the East Asian region as a whole, one finds that the region is a capital surplus region (Figure 1). In the years before the crisis, the aggregate current account surplus of the East Asian region was running at between US$ 150-180 billion per year.[12] Clearly, if the surplus saving within the region could be tapped for long-term

investment financing, the need for deficit countries in the region to rely on short-term capital flows would be greatly reduced. In the past, this did not occur as the surplus was mostly invested outside the region, particularly in US$ denominated assets, which, in turn, return to finance the deficit countries in the region in the form of short-term loans. It is in the interest of the countries in East Asia to change this scenario. This will require an effective mechanism for long-term recycling of funds from the surplus countries in the region to the deficit countries. Recycling at the government to government level is not much of a problem, and the Miyazawa initiative to make funds available to crisis affected countries or to help guarantee public bonds of some countries is an example of what could be done. However, what is much more needed, especially as the recovery gets under way, is for a mechanism to recycle long-term funds to the private sector in the region.

15. A lot of work need to be done to promote the long-term recycling of funds to the private sector. This will require a substantial deepening of the regional corporate bond market, as well as greater internationalization of regional currencies.

- National bond markets need to be developed. Before the crisis, the bond market in most of the East Asian countries was very thin or almost non-existent. Governments in most countries were running budget surpluses for many years before the crisis, so the supply of government bond was minimal. There was no clear benchmarks for private sector bonds, and bond trading in general was very limited. Currently, the government in most of the crisis affected countries had to incur large budget deficits to get the country out of the recession and deal with the financial crisis. This has led to the emergence of a much deeper market for government bonds in these countries. Together with low deposit rates arising from an excess liquidity in the financial system, government bonds have become very popular. The number of interested buyers of recent issues of Thai government bonds have far surpassed expectation, and rationing had to be imposed. The corporate sector has also taken advantage of the situation, by issuing long-term debt instruments to the general public, using the rates on government bonds as benchmarks. Bond trading is now much more active than before.

- For the regional bond market to develop, the currency denomination of the regional bonds become important. Obviously, a Japanese institutional investor would like to invest in Yen denominated instruments, as there would be no exchange rate risks. However, for an issuer in a country whose currency may be linked to the US$ or be floating, a debt instrument in the local currency would be more desirable. In the current situation, where each country in the region is pursuing very different exchange rate policies (from Yen based for Japan, to managed float in Thailand, Singapore, South Korea and Indonesia, to US$ based in China, Hong Kong and Malaysia) exchange rate risks become an important factor. Market forces may lead to the development of bonds indexed on various combinations of a basket of the regional currencies as instruments to share the risks between the borrower and the lender. Obviously, if currencies in the region become more closely linked to each other, then the exchange rate risks would be reduced, but this is unlikely to be possible in the short to medium term, given the diversity of exchange rate and policy regimes in the region, not to mention the diversity in the economic development levels and fiscal and monetary situations.[13] Also, even for major currencies of the advanced countries, such as the US$, Yen and Euro, interventions by the authorities cannot forestall highly volatile movements between these currencies, so for the less developed countries of East Asia the task of trying to stabilize their currencies with respect to each other would be daunting under current market environment. For the development of these indexed bonds, initiatives of the governments may be necessary. Indexed bonds many need to be introduced for government to government borrowing within the region, in order to establish some benchmarks for the market. For example, instead of just giving Yen loans to various countries, the Japanese government may cooperate with various countries to buy some government indexed bonds (say between the Yen and the local currency).

- The development of the regional bond market will imply the need for more internationalization of the regional currencies. Japan has been actively working on greater internationalization of the Yen.[14] This is necessary to lessen the dependence on the US$ as the dominant denomination for trade and investment, and will facilitate the recycling of surplus Japanese saving to the region. Also, if the market for regional indexed bonds develops, then obviously there will have to be deep regional markets for the currencies on which the bonds are indexed. This may be a problem in the short-term, as the crisis has shown how off-shore markets for a domestic currency can be used by speculators to attack the currency. Singapore has always had controls to limit the size of the off-shore Singapore dollar market. Thailand now has similar controls, and, of course, the off-shore market for the Malaysian Ringitt has been closed down. As regional economies become stronger, and the post-crisis macroeconomic and exchange rate management regimes in the various countries prove to be robust, then the internationalization of some of the stronger regional currencies can increase. In the short-term, the development of the regional bond market may have to rely on bonds indexed on the major currencies, such as Yen, US$ and Euro. Even this more limited development may be able to serve the needs for fund recycling fairly well, since the exchange rate policies of the countries in the region cover the broad spectrum from Yen to US$ and in between.

16. Finally, I would like to touch upon the Asian Monetary Fund or AMF. This seems to be an on-again, off-again and on-again suggestion. When it was first suggested at the very early stage of the crisis, it was quickly shot down both from outside the region and from some countries within the region. I believe that the initial impression of the AMF was that it was very much a reaction to the harsh nature and seemingly pro-Western stance of the IMF program, particularly on financial sector restructuring, and the inability of Japan to have much say in the design of the IMF program, even though Japan played a major role in organizing assistance to the affected countries. Therefore, the immediate focus on the AMF was that it would strongly overlap with the IMF, have much more lenient conditionality, and create moral hazard in dealing with crises. Indeed, if the AMF was simply to act very much like an East Asian IMF, except with East Asian money and management, then the case for the AMF would not be very strong. Clearly, Japan would dominate the AMF in the same way that the US dominates the IMF. Inevitably, if the AMF played a similar role to the IMF in a crisis situation in the region, many countries may be as suspicious of Japan in designing the conditionality as they were suspicious of the US in the case of the IMF. I believe that there is a role for a new regional monetary cooperation agency in the region. However, the function of the agency should be defined mainly in relation to the promotion of monetary cooperation and regional financial and capital market developments, rather than mainly on currency crisis management along the line of the IMF. Of course, regional monetary cooperation and financial and capital market developments are not completely unassociated with crisis prevention and

management issues. However, one can easily relate a focus on cooperative and development issues to long-term goals for greater financial and economic integration in the region, goals that would not be too difficult to reach a regional consensus on.

17. In fact, a regional monetary organization is nothing new. It may surprise many people that an AMF already exists, in the form of the Arab Monetary Fund. This was set up by the Economic Council of the League of Arab States in 1976, with the aim of assisting member countries in eliminating payments and trade restrictions, in achieving exchange rate stability, in developing capital markets, and in correcting payments imbalances through the extension of short- and medium-term loans; the coordination of monetary policies of member countries; and the liberalization and promotion of trade and payments, as well as the encouragement of capital flows among member countries.[15] Another regional monetary organization is the Latin American Reserve Fund (LARF). The LARF was established in 1991 as the successor to the Andean Reserve Fund (ARF). The aims are to assist in correcting payments imbalances through loans with terms of up to four years and guarantees extended to members, to coordinate their monetary, exchange, and financial policies and to promote the liberalization of trade and payments in the Andean sub-region.[16]

18. An East Asian institution to promote regional monetary cooperation and financial and capital market developments would be very desirable. As discussed earlier, the region can do much to protect its economies from the risks and volatility arising from financial and capital markets. This can be achieved through monetary coordination, the development of long-term regional capital markets, developing a framework for management of short-term capital flows, and the development toward greater economic and monetary integration of the region in the long-term. The institution could play important technical and coordinating roles on these issues. Some role in crisis prevention and management could naturally emerge from the agenda concerning cooperation and development, but should not be made a prime role of the institution right from the beginning. If greater cooperation can be achieved by countries in the region to minimize the risks of future crises, then the need for a crisis management role would also be minimized. Finally, a new name for such an organization may be necessary to clearly connote its role. The Asian Monetary Fund sounds too much like the International Monetary Fund, and after all, an AMF already exists.

Table 1
Foreign Reserves, Short-term External Debt and Current Account
(Billion US$)

		Gross Official Reserves	Free Official Reserves	Short-term External Debt	Current Account
1997	Q1	38.1	24.1	45.1	-2.1
	Q2	32.4	2.9	43.0	-3.1
	Q3*	29.6	1.7	38.8	-0.7
	Q4	27.0	1.8	34.3	2.9
1998	Q1	27.7	2.9	31.4	4.2
	Q2	26.6	5.1	28.4	2.8
	Q3	27.3	7.3	26.2	3.4
	Q4	29.5	11.7	23.5	3.9
1999	Q1	29.9	14.1	20.5	3.4
	Q2	31.4	16.2	17.6	2.6
	Q3	32.4	16.7	15.7	2.8
	Q4	34.8	17.2	13.7	2.5

Source: Bank of Thailand
Note: Free Official Reserves are Gross Official Reserves net of outstanding forward commitments and borrowing from the IMF package (including drawings from the IMF package contributed from other sources).
* Drawing from the IMF package started in September 1997

Table 2

Ratio of Short-term Foreign Debt to Official Reserves

Unit: Percent of reserves

	1990	1991	1992	1993	1994	1995	1996
Thailand	58	68	69	89	96	111	97
Indonesia	128	141	157	144	146	174	166
Malaysia	18	18	20	25	35	29	40
Philippines	221	112	99	85	81	68	68
Singapore	2	1	1	1	0	0	0
South Korea	154	183	147	137	156	180	164
India	164	104	73	27	18	23	28

Source: Asian Development Bank, Key Indicators 1998.

Table 3

Real GDP Growth

	Hong Kong	Indonesia	South Korea	Malaysia	Thailand
1998	-5.1	-13.2	-5.8	-7.5	-10.4
1999 Q1	-3.0	-7.9	4.5	-1.3	0.9
1999 Q2	-1.1	3.3	9.9	4.1	3.3
1999 Q3	4.5	0.7	12.3	8.2	7.7
1999 Q4	5.0	5.8	13.6	10.6	

Source: Data from Official Country Sources

Table 4

Basle Capital Accord: Risk weights by Category of On-balance-sheet Asset

Weights	Category
0%	(a) Cash[1] (b) Claims on central governments and central banks denominated in national currency and funded in that currency (c) Other claims on OECD[2] central governments[3] and central banks (d) Claims collateralised by cash of OECD central-government securities[3] or guaranteed by OECD central governments[4]
0, 10, 20 or 50% (at national discretion)	(a) Claims on domestic public-sector entities, excluding central government, and loans guaranteed[4] by such entities
20%	(a) Claims on multilateral development banks (IBRD, IADB, AsDB, AfDB, EIB, EBRD)[5] and claims guaranteed by, or collateralised by securities issued by such banks[6] (b) Claims on banks incorporated in the OECD and claims guaranteed[6] by OECD incorporated banks (c) Claims on securities firms incorporated in the OECD subject to comparable supervisory and regulatory arrangements, including in particular risk-based capital requirements,[7] and claims guaranteed by these securities firms (d) Claims on banks incorporated in countries outside the OECD with a residual maturity of up to one year and claims with a residual maturity of up to one year guaranteed by banks incorporated in countries outside the OECD (e) Claims on non-domestic OECD public-sector entities, excluding central government, and claims guaranteed by or collateralised by securities issued by such entities[6] (f) Cash items in process of collection
50%	(a) Loans fully secured by mortgage on residential property that is or will be occupied by the borrower or that is rented
100%	(a) Claims on the private sector (b) Claims on banks incorporated outside the OECD with a residual maturity of over one year (c) Claims on central governments outside the OECD (unless denominated in national currency - and funded in that currency -see above) (d) Claims on commercial companies owned by the public sector (e) Premises, plant and equipment and other fixed assets (f) Real estate and other investments (including non-consolidated investment participations in other companies) (g) Capital instruments issued by other banks (unless deducted from capital) (h) all other assets

Source: Basle Committee on Banking Supervision (1988). "International Convergence of Capital

Measurement and Capital Standards," Annex 2, Bank for International Settlements, Basle, July 1988, and Basle Committee on Banking Supervision (1998). "Amendment to the Basle Capital Accord of July 1988," Bank for International Settlements, Basle, April 1998.

Notes:

1 Includes (at national discretion) gold bullion held in own vaults or on an allocated basis to the extent backed by bullion liabilities.

2 For the purpose of this exercise, the OECD group comprises countries which are full members of the OECD or which have concluded special lending arrangements with the IMF associated with the Fund's General Arrangements to Borrow.

3 Some member countries intend to apply weights to securities issued by OECD central governments to take account of investment risk. These weights would, for example, be 10% for all securities or 10% for those maturing in up to one year and 20% for those maturing in over one year.

4 Commercial loans partially guaranteed by these bodies will attract equivalent low weights on that part of the loan which is fully covered. Similarly, loans partially collateralised by cash or securities issued by OECD central governments and multilateral development banks will attract low weights on that part of the loan which is fully covered.

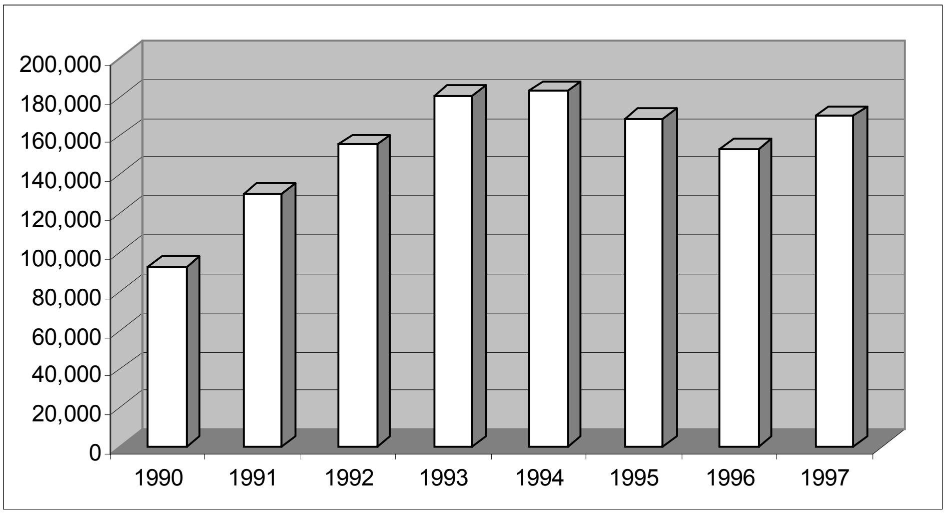
5 Claims on other multilateral development banks in which G-10 countries are shareholding members may, at national discretion, also attract a 20% weight.

6 Commercial claims partially guaranteed by these bodies will attract equivalent low weights on the part of the claim which is fully covered. Similarly, claims partially collateralised by cash, or by securities issued by OECD central governments, OECD non-central government public-sector entities, or multilateral development banks will attract low weights on that part of the claim which is fully covered.

7 I.e., capital requirements that are comparable to those applied to banks in this Accord and its Amendment to incorporate market risks. Implicit in the meaning of the word " comparable" is that the securities firm (but not necessarily its parent) is subject to consolidated regulation and supervision with respect to any downstream affiliates.

Figure 1
Aggregate Current Account of East Asian Countries

Unit: Millions of U.S dollars



Source: IMF, International Financial Statistics, 1998.

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[1] Free official reserves in Table 1 are gross official reserves minus forward commitments to sell US$ minus borrowings from the IMF package (which did not start until September 1997).

[2] Data from the Bank of Korea.

[3] Paul Krugman (1994). "The Myth of Asia's Miracle," *Foreign Affairs*, November/December, pp. 62-78.

[4] Paul Krugman (1997). "The Rules of the Game," Interview in Newsweek. *Newsweek*, September 29, 1997.

[5] Joseph Stiglitz (1998). "Must Financial Crises Be This Frequent and This Painful? " McKay Lecture, Pittsburgh, Pennsylvania, September 23, 1998

[6] See Robert A. Mundell (1963). "Capital Mobility and Stabilization under Fixed and Flexible Exchange Rates," Canadian Journal of Economics and Political Science, XXIX(4), November, pp. 475-485. Reprinted in American Economic Association, *Readings in International Economics*, London, George Allen and Unwin, 1968.

[7] For example, Martin Feldstein (1998). "Refocusing the IMF." *Foreign Affairs*, March/April.

[8] Joseph Stiglitz (1998) Op. Cit., and UNCTAD (1998). *Trade and Development Report, 1998*. (Chapter 4) New York and Geneva: United Nations publication.

[9] Paul Krugman (1998) "Saving Asia: It's Time to Get Radical," *Fortune*, September.

[10] IMF (1999). "A Guide to Progress in Strengthening the Architecture of the International Financial System," December 22, 1999.

[11] See IMF (1999), Op. Cit.

[12] It is now even higher, as many of the countries previously with current account deficit are now in surplus as a result of the crisis.

[13] For discussion of many issues and ideas related to monetary cooperation in the region, see Institute for International Monetary Affairs: "Stabilization of Currencies and Financial Systems in

East Asia and International Financial Cooperation." Tokyo, March 1999. Also Thailand Development Research Institute (TDRI): "Foreign Capital and Exchange Rate Policy." Report presented at the TDRI 1998 Year-end Conference on From Crisis to Sustainable Development, December 1998 (in Thai).

[14] See Council on Foreign Exchange and Other Transactions (1999). "Internationalization of the Yen for the 21st Century," Ministry of Finance, Japan, April 20.

[15] There are 22 members of the AMF; Algeria, Bahrain, Comoros, Djibouti, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, Palestine, Qatar, Saudi Arabia, Somalia, Sudan, Syrian Arab Republic, Tunisia, United Arab Emirates, and the Republic of Yemen.

[16] There are 5 members of the LARF: Bolivia, Colombia, Ecuador, Peru, Venezuela. Details of the AMF and LARF can be found on the IMF web site.