EXPLORING WAYS TO ENHANCE THE FUNCTIONS

OF

THE CHIANG MAI INITIATIVE IN THE MEDIUM TERM

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Section 1

Introduction

Structural Commonalities Among Asian Economies

Economies in the Asian region, particularly in East Asia, took on similar patterns of development in the past. Economic policies tended to emphasize growth with reliance mostly on external factors and the drawing of capital from abroad. Apart from leading to the same patterns of economic growth, the policy similarities also brought to bear for the East Asian countries the same set of problems. The high rates of expansion in exports and investment, for instance, implied fast growing imports of capital goods and raw materials. Consequently, current account deficits became a major problem for East Asian countries, such as, Thailand, Malaysia, and South Korea.

Economic Vulnerability Caused by Bilateralism and Inter-regionalism

Meanwhile, the dependency of Asian countries on the advanced industrialized economies of Europe and America was essentially bilateral in nature. In fact, the maintenance of such bilateral relationships was perceived by Asian countries as a key strategy to enhance a country's economic potential. The importance thus placed on the building up of relationships with economic superpowers was at the expense of neglecting each other's neighboring countries. In other words, interregional relationship took preference over intraregional relationships. This unbalanced policy approach, together with the fact that neither were the levels of economic development of the Asian countries very far apart, nor were their

economic policies divergent, meant that should any one economy in the region happen to come under duress, the stage was already set for the other economies in the same region to be prone to the same kind of debilitating conditions. This was indeed the case when Thailand's national currency came under speculative pressure until the country eventually had to abandon its exchange rate regime in 1997. Other regional countries with resembling economic structures and exchange rate systems were then observed to be similarly affected. A national economic and financial crisis thus became regionalized in the end.

A Lack of Regional Financial Cooperation

Regional cooperation in Asia has been continuously strengthened via economic consolidation. For South East Asia, the Association of South East Asian Nations or ASEAN has been the framework within which member countries strive to reduce trade barriers within the group so as to increase trade and investment among themselves. The effort has been met with moderate success as reflected by the growth in intraregional trade. Cooperation in financial areas however still leaves much to be desired. Financial illiquidity of Asian countries during and immediately following the crisis is sufficient evidence. The interregional trade and financial arrangements of Asian countries had created bilateral dependency, mostly with the United States. Consequently, Asia's external borrowings were principally denominated in United States dollars. When a depreciation in the value of a local currency precipitated a loss of confidence on the part of foreign investors and creditors in that local currency, short-term external loans were recalled and massive capital flights witnessed. Many Asian countries became short of dollar assets, and external debt repayment difficulty mounted. It became increasingly apparent how lacking Asian countries had been in cooperative mechanisms to render financial support to one another. The only option remaining at the time was hence to

turn to economic superpowers and international financial institutions, such as, the International Monetary Fund (IMF) and the World Bank for assistance.

The Plight of the Crisis-Inflicted Countries

Pursuant to the economic and financial crisis, Thailand, Indonesia, and South Korea each inevitably had to come under the IMF technical and financial assistance program. Meanwhile, the Philippines, which had by the time of the 1997 financial crisis been under the IMF umbrella for 35 years already, also had to request for further funds under the IMF's standy-by credit agreement for 2 additional years. In so doing, the fiscal and monetary policies of the Asian countries had to be confined to the IMF's framework of conditionalities. During the early stages of coping with the crisis, stringent fiscal and monetary policies were implemented following IMF recommendations, thereby plunging the economies concerned into deeper recessions. Only until almost a year later did the IMF agree to reverse its approach by allowing the governments of the countries under the IMF rehabilitation program to relax their fiscal and monetary policies. Countries not under the IMF program, such as, Malaysia, Japan, and China, also began to adopt more loosened macroeconomic policies. A result of the expansionary policy stance was a revitalization in foreign trade, particularly in the intraregional context, which in turn stimulated a recovery of the regional economies within a short timespan.

Tendency Towards Intra-Regionalism

The major reason for highlighting such intraregional rather than interregional developments vis-à-vis North American and European Union countries lies in the yet to be fully documented phenomenon that the degree of intraregional dependencies, both in trade and finance, has

increased relatively more than that of the interegional relationships, a situation that is opposite to that of the pre-crisis years. In fact, it can be demonstrated that in addition to a complete reversal to expansionary fiscal policies in Malaysia, Japan, China, and the three countries under the International Monetary Fund Program (Thailand, South Korea and Indonesia) since mid-1998, the increasing trade in merchandise and tourism among East Asian countries under a relatively stable exchange rate environment has provided the strongest impetus for much faster than expected recovery of the real economies of Asia since April 1999.

The crisis taught Asian countries how much they need to have self-help and support mechanisms amid emergencies, rather than to rely exclusively on outside parties with their own agenda. A number of analysts have argued that remedial action taken in the form of lender-of-last-resort facilities from international financial institutions had in fact worked to deepen the crisis because of the overly stringent conditions and fiscal disciplines that were imposed. Further, it is argued that the liquidity support that was eventually provided was “too little and too late” to deal effectively with the crisis because it was provided in relatively small amounts spread out over an extended period of time. After all, any global application of a one-size-fit-all policy approach would inevitably neglect to take into consideration sufficiently issues specific to a particular region. In fact, the former Managing Director of the IMF himself admitted to the effect that it is not possible for the IMF to look after countries in all corners of the world thoroughly. Members of smaller regional groupings should indeed arrange to have their own systems of mutual assistance.

A desired regional financial landscape to be conceived for East Asia must come from a visionary design, deeply rooted in shared values, and steadfast commitment to the principle of self-help and support. Success in the design implementation will in turn hinge on coherent

and disciplined policy conduct on the part of all parties concerned. A deliberate plan for an efficient regional financial system that would be conducive to economic growth and stability should consist of at least 3 clear, transparent, and mutually agreed upon key components. The first is a common target, possibly that of a single currency for East Asia. The second is the required technical know-how to be further developed, through research work such as the one at hand, and to eventually be disseminated throughout the region to facilitate the target achievement. Certain segments of ASEAN, particularly Singapore and Malaysia, are already quite well equipped with the mentioned technical know-how. Finally, there is the matter of financial resource management during the transition period of enhancing monetary and financial cooperation towards an efficient regional financial system for East Asia.

The Chiang Mai Initiative (CMI), as it continues to exist today, has set forth new and improved arrangements, especially as regards financial resource management during "***war time***," in a specific economic and financial context that is to be elaborated upon later in this study. Expanding the CMI to complete the existing design of a network of regional financial cooperation is desirable in the short term of less than a year. Experiencing a visionary and effective economic integration of East Asia with a common currency may possibly represent the region's target in the long term of perhaps much beyond a five-year horizon. **Exploring ways to enhance the functions of the Chiang Mai Initiative in the medium term** is however the subject matter at hand for special treatment and therefore the focus of the present research study. The ways toward functioning enhancements of the CMI is to be explored with a view of enabling the existing arrangements to better serve the region's "***peace time***" needs, intended here as an economic and financial expression to be expounded upon further in this study. The enabling enhancements are in turn to be achieved by way of improving upon the current design of the system during the period of the next three to five years.

Contrary to conventional wisdom, nobody devalues in a currency crisis solely for trade purposes. In practice, they all do it when they run out of international liquidity, a reason no one would really wish to brag about. Trade arguments are retroactively resorted to simply as a façade. On the verge of the Asian financial crisis, the national currency of Thailand, the country in which the so-called "Tom Yum Kung Disease" has been said to have originated, came under downward pressure. The event was in part a consequence of international hedge funds' buying dollars and selling baht in the spot and forward offshore markets. The Bank of Thailand (BOT) tried in response to defend the value of the baht by matching the currency trading in the opposite direction in the same spot and forward markets. The BOT thereby entered into a financial battle that eventually, for a variety of reasons to be discussed below, developed into a protracted "economic war" that lasted for many years. Unfortunately, many of the international banks happened to be privy to the information on the actual net foreign asset position of the BOT, especially as the BOT had been attempting to conceal that position by creating "fake" additional dollar holdings through effecting swap arrangements with those very banks overseas. The fact that, apart from the "borrowed reserves" recorded on the books of the BOT, there were not very much "earned reserves" left naturally became available information to the international currency speculators who happened to operate closely with the above-mentioned international banks. The event represented a classic case of information asymmetry, where the odds in this instance were stacked up against the defense of the currency under attack. Financial resource mismanagement and depletion eventually forced the BOT to switch to a different currency regime.

It is therefore of no wonder that considerations regarding a *design for efficient and effective regional liquidity management* have become undeniably crucial at the bottom of all monetary authorities' minds; elements of a "war time" mentality in a monetary and financial setting

continue to reign across the region. However, these design considerations cannot be made in a vacuum. Indeed, they are *not independent of the given exchange rate regimes* of the parties concerned. **Enhanced monetary and financial cooperation by way of appropriately making available the region's financial resources for effective deployment would inherently need to be designed and achieved in conjunction with a specific vision of a coordinated exchange rate arrangement for the region.** Deployment of resources for foreign exchange market intervention to stabilize the value of a regional currency would be triggered when the exchange rate moves out of the permissible limits. Such limits define the fluctuation range for any regional currency, which in turn is to be stipulated under an agreed upon coordinated currency regime. This stipulation then must be consistent with the exchange rate band of allowable fluctuation, beyond which resource deployment would be activated, under a conceived, multilateral system of coordinated reserve management. *If a single currency area was decidedly to be the chosen vision for East Asia in the long term, then the appropriate and therefore the desired transitional exchange rate arrangements in the medium term must be those that would facilitate the developments in regional monetary and financial cooperation towards achieving such an end*. Promotion of regional trade, investment, and financial transactions – partly in the form of cross-border stock and bond market trading – is expected to be an essential component in the architecture as well as a consequence of the resulting regional financial development. Therefore, *a more integrated currency and monetary coordination will become both an architectural necessity and a consequential reality*. After all, the adoption of a currency regime is best assessed in the light of both capital account liberalization and developments in the domestic financial sector.[1]

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[1] A. F. P. Bakker, *The Liberalization of Capital Movements in Europe*, Kluwer Academic Publishers, 1996.

Financial Policy Targets of Monetary Authorities

In this context, it is not surprising that international reserve holdings and the exchange rate are in fact amongst the three major targets of central bank governors, the third being the interest rate target. In the case of the Bank of Thailand, the priority target appears to be that of the interest rate, whereby the BOT manipulates the 14-day bond repurchase rate in its conduct of monetary policy. The new governor of the BOT, immediately upon assuming his post in mid-2001, quickly augmented the policy rate of interest to 2.5 per cent. The purpose was multidimensional. It was intended to correct the misalignment in the levels of the various domestic interest rates vis-à-vis one another as well as vis-à-vis the world interest rates. Meanwhile, the London Interbank Offered Rate came down to around 2.5 per cent. Hence, chances were that commercial banks' foreign assets, which had theretofore left the country in search of higher returns, would likely come home to roost. Foreign exchange accumulation at the BOT for ready deployment under a "managed" floating exchange rate regime was apparently an intended by-product of the interest rate policy. The Bank of Thailand's approach to financial management has therefore been rather consistent with the assertion that the functioning of the financial sector, especially as regards banking operations, is a decisive factor for a successful currency regime.[2]

The choice of a priority target, however, may well vary from one central bank to another. Professor Ronald I. McKinnon of the University of California at Los Angeles contends that some countries that were afflicted by the Asian economic and financial crisis, such as, the

[2] G. L. Kaminsky and C. M. Reinhart, "The Twin Crises: The Causes of Banking and Balance of Payments Problems," *American Economic Review*, Vol. 89, pp. 473-500.

Republic of Korea, have been observed to have reverted to *de facto* reserve accumulation and pegging their currencies to a single currency, notably the US dollar. Some of the reasons that have been articulated for this observed phenomenon of a *de facto* restoration of a US dollar-based exchange rate system include the mimicking of one's neighbors' behavior, distancing one's currency from a strong Japanese yen, or simply being accustomed to and thus having a tendency to cling on to old habits of liking and to a sense of comfort with the US dollar. In any case, the behavior has been observed to have relative disregard to interest rates. However, the observed behavior of the central monetary authorities, which is tantamount to a return to an older model of fixed exchange rates, might not necessarily be a deliberate or explicit policy act, an area that could be subjected to further investigation. Such central bank behavior should incidentally be well distinguished from the cases of "dollarization" that are prevalent in certain ASEAN member countries, such as, Cambodia and, perhaps to a lesser extent, the Lao People's Democratic Republic, and Vietnam.

Apart from the above explicit or revealed preference in monetary and financial management depending on which central bank behavior is being described, diversity has also been exhibited in private sector behavior regarding foreign asset and liability management. The so-called "double mismatch" occurs when local financial intermediaries create their assets and liabilities in different currencies, thus giving rise to a "currency mismatch." At the same time, their foreign borrowings and domestic lendings are allowed to have different repayment durations, thus giving rise to a "maturity mismatch." This "double mismatch" was characteristic of the financial scene prior to a financial crisis in the case of many Latin American countries. This was not always the case in East Asia, particularly for Thailand, where there was "maturity mismatch" but no "currency mismatch" by banks, even though the borrowing customers might take the exchange risk by taking the currency mismatch themselves. Commercial banks in Thailand have endeavored to square their foreign

exchange positions as much as possible, aiming to profit mostly just from intermediation. Foreign exchange risk management by the banks has in this instance been relatively prudent.

Section 2

Reviewing the Chiang Mai Initiative

Once the Asian economy emerges from the trough of a cyclical downturn and enters the rehabilitation stage, regional countries begin to take a more serious introspective approach. The necessity to expedite the establishment of a system of intraregional financial cooperation also begins to receive mounting recognition and credence, apart from the already existing system of intraregional trade cooperation. The idea is not totally new. In fact, efforts in such a direction have overtime produced some considerable results.

Given the initial rejection of the Asian Monetary Fund concept as proposed by Japan in Manila immediately after the outbreak of the Asian financial crisis and the relatively large financial contributions of Japan and other Asian countries less adversely affected by the foreign exchange crisis, both directly and indirectly through multilateral international organizations, to help shore up the foreign exchange reserves of the crisis-hit countries, non-Asian countries are naturally less objecting to the so-called “Chiang Mai Initiative” (CMI) as proposed by the ASEAN plus 3 (China, Japan, and South Korea) countries. The CMI arose out of a meeting of ASEAN+3 finance ministers and central bank governors at the Asian Development Bank (ADB) Board of Governors Annual Meeting in Chiang Mai, Thailand, in May 2000. It involves multilateral and bilateral foreign currency swap arrangements among Asian central banks. In fact, history will probably reveal that the 1997 financial crisis of Asia necessitated international financial adjustments of the crisis-hit countries. The willingness of Japan and other Asian countries to help out, despite their own domestic problems, has greatly encouraged further degree of dependencies in intraregional trade and finance, and will lead ultimately to some form of coordinated intraregional financial policy framework and

shared financial resources, something that might be close to a new international financial architecture for Asia. Exactly what the "Chiang Mai Initiative" will transpire in terms of operationally feasible and meaningful cooperation and coordination among the governments and private sectors of East Asian countries remains to be implemented by policymakers and market players within the region and to be seen by observers from outside the region.

Following the 1997–1998 Asian financial crisis, there has been intensified interest within the region in increased economic cooperation. Macroeconomic cooperation can take different forms: information sharing and surveillance, liquidity provision, and exchange rate coordination. Of these, progress within the region has been most evident in liquidity provision. Following the adoption of the Chiang Mai initiative (CMI) and the associated multilateral intra-Association of Southeast Asian Nations (ASEAN) currency swap agreement among the ASEAN+3 countries,[3] a series of bilateral currency swap agreements had already been formalized by mid-2002

At present, the ASEAN+3 swap arrangements are subject to the limitation that 90% of the resources available can be drawn only on condition that the borrowing country has carried out an adjustment program supported by the International Monetary Fund (IMF). A key issue to be considered in this paper for the short and medium term, therefore, is whether these arrangements should be delinked from a country's participation in an IMF-supported adjustment program and, if so, under what alternative conditions those resources should be made available. In particular, should an expanded set of conditions — different from the "traditional" IMF norms — be designed for ASEAN+3 swap arrangements that may be more

[3] ASEAN+3 consists of ASEAN's 10 member countries — Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam — plus the People's Republic of China, Japan, and the Republic of Korea.

suitable for confronting the type of “capital account-induced” instability that characterized the 1997–1998 crisis?

A logical follow-up question is whether the CMI should eventually be superseded by more ambitious regional arrangements for liquidity provision, i.e., can the financial authorities of Northeast and Southeast Asian countries pool enough financial resources to effectively counteract any speculative attacks that they might face in the future? If so, how should such a resource pool be administered? Should it be centralized or decentralized in structure? And what are the conditions, both *ex ante* and *ex post*, that will minimize the risk of moral hazard and assure that the resources are used for legitimate purposes and are then repaid after the crisis is averted or successfully resolved?

Looking into the longer term, if ASEAN+3 countries (except Japan) adopt a regional exchange rate arrangement, what type of resource pooling and resource provision arrangements would be most effective in defending the coordinated currency peg regime? What are the relative sizes of the pooled financial resource requirements for the leading alternatives among possible regimes — e.g., a hard peg (100%) against a single major currency (e.g., the US dollar) or a triangular basket peg against three major currencies (US dollar, yen, and euro)?

Based on the experiences of many East Asian countries before and after the 1997 crisis as well as on the reaction of financial authorities — including the formation of ASEAN+3, the CMI, ongoing discussions at the regional level from leadership summit meetings down to technical cooperation and joint studies — there appears to be sufficient political and technical consensus in the region to proceed proactively in all of these areas. As data and experience are further accumulated, the collective political leadership can take a series of concrete

actions. It is hoped that this study will provide another stone in the path toward a new ASEAN+3 financial infrastructure and perhaps, in the more distant future, toward a common currency area and full integration of trade and investment in East Asia.

Going forward toward achieving a long-term financial architecture for the region, discussion must first begin on how the CMI and the conditionality attached to drawings from regional swap arrangements can be modified in the medium term. The CMI was intended to provide financial assistance to countries in the region through a series of multilateral and bilateral currency swap arrangements from which any member country can theoretically borrow hard currency from the other signatories in times of financial distress. Some bilateral swap agreements, e.g., that between the People's Republic of China (PRC) and Japan, do not involve the US dollar but only the currencies of the two signatories. Significantly, a condition attached to the standard bilateral agreements is that in order to utilize more than 10% of the agreed swap lines (say, of $3 billion equivalent), the borrowing country must enter into an IMF-support program first.

Section 3

Departures from the Suppositions Underlying the Existing CMI Configuration

There has of late been a definite paradigm shift in the global economic environment. Much of what used to be taken for granted can no longer be so. The dominant US dollar as the foremost key and reserve currency of the world, for one, does not possess some of the necessary attributes it once did – such as, the confidence it used to command that stem much from its strength and stature. The financial landscape of the East Asian region has meanwhile been much transformed. Coming out of the 1997 financial crisis, East Asia was weary, ramshackle, and disparaged. That picture is quickly fading away, though. At least in the last couple of years, there has been encouraging signs of a transition from "war time" to "peace time" economic and financial conditions in the region that is clearly translating into sustained growth with stability.

To begin with, international reserve depletion is now passé and has been replaced by an over-abundance of reserves. East Asia's current account surpluses have led to reserve accumulations, which have in turn been mostly invested in US Treasury securities. Meanwhile, the US twin deficits have increasingly been pointing to a secular decline of the US dollar vis-à-vis the currencies of East Asia as a whole. The capital value of the reserve assets of Asia, which on the most part are heavily denominated in the US dollar, is therefore subjected to the risk of losing value in terms of the respective domestic currencies. The required currency diversification into the yen and euro in itself falls short of an adequate solution. For effective reserve management, a new asset class therefore needs to be

created. Local currency-denominated assets – specifically Asian bonds and composites thereof – can provide such a viable alternative.

The Changing Global Financial Landscape

During the one-year period from November 2002 to October 2003, 45% of the total additional US Treasury securities (of about US$400 billion) that were being sold was absorbed by 5 countries of East Asia: Japan (32%), China (8.9%), and major East Asian countries such as Taiwan, Hong Kong, and Korea (4.1%). These countries allocated most of their foreign reserve increases to such buying. Thailand, Malaysia, and Singapore were the exceptions, but their cases were surely not without implications. They reduced their holdings of US Treasury securities in 2003, despite their continuing current account surpluses and increasing FX reserves. While their actions may be said to have been rather deliberate, it is perhaps worthwhile to remark here that it was the nature of the relatively small-country, non-key, and non-internationalized currency status of each of the countries concerned that has made possible the portfolio adjustments in the currency compositions of reserve holdings to have been executed successfully and to have gone quite unnoticed.

France (by both its official and private institutions) also reduced its holdings of the US Treasury securities, while Germany and the Netherlands increased theirs. On the whole, 12 members of the Euro-Zone financed only 3.9% of the US fiscal deficit in 2003. The UK and Canada, on the other hand, financed 8.3% and 2.4% of the same deficit, despite the chronic current account deficit of the UK. The remaining 40.4% of the US fiscal deficit was financed by the rest of the world's increased purchases of the US Treasuries (6.4%) and by the increased purchases of the American public itself (only 34%).

Among other countries, India stands out, because its international reserves have increased so fast due to large net capital inflows. At the end of October 2003, India's stock of official reserves amounted to US$ 88.7 billion -- twice that of the United Kingdom, 3 times that of Canada, and almost 4 times that of Australia. India also allocated about 20 percent of its reserve increase to buying additional US Treasury securities. The magnitude of India's US Government bond purchase in 2003, worth US$ 5.6 billion, is comparable to that of the purchase made by each the economies of Taiwan, Hong Kong, and Korea. A strategic shift in the management of reserves of developing Asian countries, when including India together with China, Taiwan, Hong Kong, Korea, and other East Asian countries, if it were to take place, could assume a magnitude that can have a major impact on global financial markets in general and on the foreign exchange market and currency values in particular. The possibility of such a strategic shift in reserve management behavior will now be discussed.

A number of closely interrelated and intertwined issues has become hot topics for discussion among policy advisers and capital market participants at least since around the beginning of 2004: the global concern about the US fiscal and current account deficits, the high dependency on foreign funds to finance most of the US twin deficits, possible withdrawals of foreign investors and central banks from the US capital market, the effects of such withdrawals on a US dollar collapse and the consequential turmoil in the global currency markets leading to a US and world recession**.** To reflect the degree of intensity of the on-going heated discussion on the above matters**,** we hereby summarize a sample of reports and analyses that have so far been ignored or brushed aside as inconsequential by key members of the Bush Administration and the Federal Reserve System. How long will such concerns continue to fall on deaf ears of the policy makers such that financial market reactions will end up becoming self-fulfilling remains to be seen. In the words of the *Asian*

*Wall Street Journal (AWSJ)***,** one of the most influential economic and business newspapers owned and operated by an American conglomerate with a high standard of free market principles:

> "*Were foreign investors to flee the US, it would depress the dollar further and faster*. Reduced foreign purchases of US stocks could cause the market to tumble. Decreasing foreign purchases of US bonds could boost the interest rates set in bond markets. If foreign flight were severe enough, *it could push the US back into recession*." (From a story entitled "Foreign Investors' Zest for the US is Less Certain" in the AWSJ dated January 16, 20004.)

The International Monetary Fund (IMF), in its 60-page report entitled "US Fiscal Policies and Policies for Long-Run Stability," released on January 7, 2004, sounds off an alarm bell on the state of the US finances. (In contrast, its alarm bell made to the Thai Government prior to the 1997 Asian financial crisis, regarding the looming 6% ratio of current account deficit to GDP and the consequential need to devalue the baht, was not made public until much after the event.) The report warns that **the large US budget and current account deficits (the twin deficits) pose "significant risks" for the US and the rest of the world**. The rising US external debt will be at an "unprecedented level" and could destabilize international financial markets. The US current account deficits currently absorb about three quarters of the world's surpluses. The concomitant rise in US demand for finances from the rest of the world, coupled with an anticipated decline in the value of the US dollar, could possibly lead to a collapse in international investor (and central bank) confidence in the US dollar. The resulting upward pressure on interest rates in the US and the world would then lead to cutbacks in investment and a rapid slowdown in the world economy.

Similar views relating to the expanding twin deficits of the US and their likely effects on the US dollar value, world currency turmoil, and a possible global recession are shared by private sector economists and analysts both from European banks (e.g., BNP Paribas or BNPP[4]) and American securities houses (e.g., Merrill Lynch[5]).

America's current-account deficit stands at 5% of GDP, and most economists reckon that this percentage needs to be reduced by at least half. That would stabilize the ratio of America's foreign liabilities to GDP, which has surged in recent years. So far the dollar has fallen considerably in trade-weighted terms against a broad basket of currencies. Nevertheless, after adjusting for inflation, its value is still close to its 30-year average. It may need to fall by another 20% over the next few years if the current-account deficit is to be halved.

American policymakers seem happy to let the dollar slide. Europeans, however, complain that the burden of adjustment has fallen disproportionately on their currency, the euro. As the euro has soared against the dollar, central banks in Japan, China, and other Asian countries have bought dollars to hold down the value of their own currencies. By doing so, they end up financing over half of America's current-account deficit in 2003. Without that money the dollar would have fallen further.

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[4] BNP Paribas, "Orderly Dollar Decline or Collapse: 2004 Currency Projection," 6 January 2004.
[5] Merrill Lynch, "The Weak Dollar: How Low, and for How Long?" 8 January 2004.

Asia under a New Economic Paradigm

Historically, there has been a series of paradigm shifts in the development of macroeconomic policy. Some seventy years or so ago, the *Great Depression* of the 1930's led to widespread private debt and ample excess industrial capacity in England. To wait for supply to create its own demand in the long run as *Say's Law* would have it was untenable. John Maynard Keynes with his *General Theory of Employment, Interest and Money* then proposed a new and alternative framework for macroeconomic policy analysis in the context of a closed, single economy. He introduced the active role of the government and the multiplier concept in creating the necessary demand to lift an economy out of the depression. After World War II, Sir John Hicks, Paul A. Samuelson, James E. Meade, and Bertil G. Ohlin subsequently popularized Lord Keynes' approach by introducing international trade among open economies and the discovery of what is known today as modern macroeconomics. More importantly, the theory was proven successful when put into practice. The *New Deal*, under which came the advent of the Tennessee Valley Authority with the aim to create employment and income, was a prime and well-known example of policy application of Keynesian economics by President Franklin D. Roosevelt of the United States of America.

Around a quarter of a century ago, a newer concept emerged, whereby a multi-country perspective and international trade were added on, in a significant manner, to the understanding of how the world economy functioned. The three major blocs of the world's foremost economic powers consisting of the United States, Western Europe, and Japan were together regarded as the sole engines of growth for the entire world. Whatever happens to this **Group of Three**, otherwise known as the **G-3**, would also happen to the dependent, developing world. It was believed that East Asia and the rest of the developing world could

not possibly experience economic growth without the required external demand from and thus the necessary growth in the G-3 economies, hence emerged the “Locomotive-wagon” policy paradigm of international macroeconomics, which is still widely held today.

A new macroeconomic policy paradigm has since been born in Asia. The belief in the combined G-3 engine of growth to be the only source and determinant of world prosperity and without which the future would not hold for anyone else is however being refuted as new quantitative evidence coming out of Asia is beginning to undermine its validity. In this light, the G-3 “Locomotive-wagon” paradigm will hence need modification. A major catalyst that has been driving changes leading to the latest paradigm shift in the way the workings of the world economy is to be understood and appreciated is undeniably the miraculous progress made by the Chinese economy during the last fifteen years. The People’s Republic of China has been increasingly making its presence felt on the world scene. Its impact on world trade in particular will be even stronger in the years to follow with China’s accession to the World Trade Organization (WTO) now already a *faite accompli*. While India’s foreign sector is still not all that large given the sizes of its economy and population, it is inevitable that the economic role and influence of India will sooner or later become another important force to be considered and analyzed, at least in the Asian context.

In East Asia, China is found to have resorted to domestic demand stimulation through investment and consumption spendings in parallel with export promotion for at least a decade without articulating the policy approach as “*dual track*,” a concept that will be further defined and elaborated upon below. The Republic of Korea has been adhering to a similar policy line since the 1997 Asian financial crisis broke out. The same holds true with the policy strand that runs through Malaysia’s New Economic Policy, before and after the 1997 crisis. If a country was to pursue a dual track policy on its own all by itself, the effect that a collective

and coordinated force would be able to muster up would sure to be missing. The impact of such a policy taken in isolation can be limited and in any case fall far short of what could be expected from the cooperative action of a critical mass of a number of economies simultaneously applying similar domestic demand stimulus packages. As it turns out, there are *at least* four countries that can be clearly identified as having followed a dual track policy – namely, China, Malaysia, South Korea, and Thailand.

Dual Track Policy and the Asia Cooperation Dialogue

That a slowdown in exports due to slackening external demand would be met with a boost in domestic demand through government policy measures and conversely that domestic demand stimulation would be held back when exports pick up in an effort to maintain stable economic growth constitute the essence of the "*Dual Track Policy*" of Dr. Thaksin Shinawatra, the Prime Minister of Thailand. This specific policy approach, together with the Prime Minister's initiated Asia Cooperation Dialogue (ACD), has of late significantly contributed to the most recent major paradigm shift in the understanding of how the international economy actually operates today and in the immediate years to come. The explicit policy focus on the duality of the export and the domestic sectors to bring economic growth with stability, through the actively supportive role of the public sector in a multi-country context not necessarily dependent on the traditional economic powers of the world, adds a new dimension to the nature of the international economy that has hitherto been understood or assumed to be under outdated paradigms.

The current Government of Thailand is able to articulate and popularize what has been practiced by at least 3 other countries in East Asia. Reinforcement of this pattern of policy

application can be expected well beyond East Asia, also to include member countries of the Thai Government-initiated Asia Cooperation Dialogue (ACD), such as, the Philippines, Indonesia, and India. Both the ACD and the ASEAN+3 forums, which include Japan, China, and South Korea, have served as venues for not only policy dialogues among leaders of Asia but also platforms to coordinate action plans, such as, the ASEAN+3 ***currency swap*** arrangements, the ***Asian bond*** implementation steps, and the ***bilateral free trade*** agreements.

On the Asian bond plan in particular, the 21 members of the Asia Cooperation Dialogue **(**ACD**)** have already pledged their political support to a comprehensive **Asian bond market development initiative** in its June 2003 Chiang Mai Declaration. The member countries *of this open and voluntary forum* can carry out a set of actions to implement the Asian bond market development on a voluntary and mutually beneficial basis**.** Thailand**,** as Chairman of the **Regional Financial Cooperation Group of the ACD,** has been enthusiastic in working with other member countries to carry out actions that will lead to the Asian bond market development as quickly as possible. To this effect, the Thai Government has already decided to set up a secretariat to coordinate and implement actions with institutions from the other member countries of the ACD, both government agencies as well as private sector institutions. The Asian Bond Secretariat will work for the Regional Financial Cooperation Group**,** and coordinates the required functions and actions with the respective institutions of the member countries and participants from the world capital market to implement all aspects of the Asian bond market development initiative as spelled out in the Chiang Mai Declaration.

Relative to East Asia, the **G-3** economies as well as their external trade – both imports and exports – have not recently been experiencing high growth. The relatively high rates of growth for East Asia in *both* real GDP and US dollar value (and real) imports are self-confirming, given the well established, positive, empirical relationship between real imports, real output, and real income for practically all countries of the world. The theory relating to the traditional "Locomotive-wagon" paradigm of course cannot explain the fact that currently the economic growth rate of East Asia as a bloc significantly exceeds that of the G-3 bloc. What empirical evidence suggests however renders the observation totally unsurprising. With high growth in intra-regional trade, intra-East Asian trade shares have increased substantially during the last few years since the 1997 Asian financial crisis, as have been well documented by many economists and analysts. The intra-East Asian (in this case, including Japan) merchandise trade alone has come to account for no less than half of the region's entire foreign merchandise trade world-wide, not to mention the impact of the recent interests in both intra-regional investment and tourism cooperation.

The case of Thailand is illustrative of such widely observed, but not yet appreciated, phenomenon. The magnitude of Thailand's foreign trade with East Asia excluding Japan has more than doubled that of its foreign trade with Japan. Thailand's import shares from other countries of East Asia and from the G-3 countries change even more dramatically as the interdependent nature of the intra-East Asian trade increases, ironically thanks partly to the 1997 financial crisis that resulted in marked declines in the currency values of most East Asian countries relative to the US dollar, except China and Hong Kong. Studies of other East Asian countries' trade patterns by many scholars and analysts have arrived at the same conclusion as in the case of Thailand.

Macroeconomic and Microeconomic Reasons for the New Paradigm

While imports into the G-3 economies have not gained much for East Asia lately, both exports and imports of the East Asian economies on the whole have managed to leap during the same time period. The trade expansion of the latter has evidently not been at the expense of one another. An important **macroeconomic** explanation for the phenomenon is obviously the success of the coordinated intra-regional demand stimulation measures undertaken within the dual track policy framework in many East Asian countries. A **microeconomic** explanation can also be found in the nature of the production and exchange that has evolved within the region. A large share of the additional exports of East Asia is no longer destined to end up in the G-3 markets in order to find the necessary outlets. As industries in the region grow more and more *vertically integrated* across countries, the domestic value added to be reaped in each of the regional economies that participate in a particular line of product manufacturing – such as, information and communications technology (ICT) and electrical and automotive goods – is shared and dispersed more equitably. Thus, the *value chain* involved in such an activity increasingly completes much of its *international production and consumption network* well within the region itself, resulting in a natural enhancement and augmentation of intra-regional trade. Under an environment of overall world slowdown, East Asia has managed to generate sufficient intra-regional demand such that its rate of economic expansion actually outpaces that of the traditional "Locomotives" by a clear and decisive margin. East Asia has, in other words, developed the capability to sustain its own growth. A new "Locomotive," known as East Asia, thus may have just arrived on the world scene.

In modeling the paradigm shift that is enhanced by the concerted application of the dual track policy in the context of East Asian regional cooperation and coordination, the Fiscal Policy Research Institute (FPRI) of the Thai Ministry of Finance has developed a world macroeconomic model linking domestic economies through international trade flows of goods and services. The model is to be used in conjunction with the institute's own Thailand macroeconomic model. The forecasting and simulation exercises for the Thai economy as published in the *ThailandOutlook.com* Web site are based on the FPRI Thailand Country Model, which is in turn linked up with the FPRI World Model.

TABLE 1

Real GDP Growth Rates (%Year-on-Year)
for the Economies of East Asia-9 and G-3 in 2002

	Q1	Q2	Q3	Q4 (e)
East Asia-9	3.0	4.5	4.8	5.0
China	7.6	7.8	7.9	8.0
Hong Kong	-0.5	0.8	3.3	3.3
Indonesia	2.2	3.8	3.9	4.5
Korea	5.8	6.4	5.8	6.0
Malaysia	1.1	4.0	5.6	5.5
Philippines	3.7	4.8	3.8	4.5
Singapore	-1.5	3.8	3.9	3.9
Taiwan	1.2	4.0	4.8	4.6
Thailand	3.9	5.1	5.8	5.6
G-3	-0.3	0.9	2.1	2.2
USA	1.4	2.2	3.2	3.3
EU	0.3	0.6	0.8	1.0
Japan	-3.1	-0.8	1.3	1.3

Source: various. e = estimates as of January 15, 2003.

Table 2

US$ Merchandise Export Growth Rates (%Year-on-Year)
for the Economies of East Asia-9 and G-3 in 2002

	Q1	Q2	Q3	October	November	December	Q4 (e)
East Asia-9	-5.4	8.6	16.1	12.9	18.8	16.9^{e}	15.8
China	10.0	17.5	28.2	31.4	30.4	31.2	31.0
Hong Kong	-6.5	3.3	8.3	12.9	17.3	10.0^{e}	13.4
Indonesia	-13.1	1.2	5.6	17.8	5.3	10.0^{e}	11.0
Korea	-10.5	4.8	16.8	25.0	24.1	27.4	25.5
Malaysia	-4.3	5.2	14.3	11.2	9.9	10.0^{e}	10.4
Philippines	-5.0	15.2	17.8	2.6	18.0	14.0^{e}	11.5
Singapore	-15.2	3.0	12.3	8.4	16.4	4.4^{e}	9.8
Taiwan	-8.0	5.7	19.8	0.6	17.4	14.8	10.9
Thailand	-6.3	3.4	11.3	18.0	15.9	16.0^{e}	15.2
G-3	-12.0	-0.8	6.6	6.6	9.4^{e}	8.8^{e}	8.3
USA	-14.1	-6.9	1.3	1.3	1.0^{e}	4.0^{e}	2.1
EU	-6.1	7.2	13.7	10.0^{e}	10.0^{e}	10.0^{e}	10.0
Japan	-13.3	2.3	9.2	11.9	20.0	15.0^{e}	15.6

Source: various. *e = estimates as of January 15, 2003.*

TABLE 3

US$ Merchandise Import Growth Rates (%Year-on-Year)
for the Economies of East Asia-9 and G-3 in 2002

	Q1	Q2	Q3	October	November	December	Q4 (e)
East Asia-9	-8.1	6.2	16.2	19.0	20.7	20.4[e]	19.8
China	6.1	15.5	29.5	33.3	37.8	28.3	33.1
Hong Kong	-9.5	0.7	1.5	13.4	15.2	12.0[e]	13.5
Indonesia	-28.0	-14.0	21.0	51.3	36.6	40.0[e]	42.6
Korea	-11.0	8.0	13.0	20.1	22.1	28.0	23.4
Malaysia	-5.0	10.1	20.2	11.1	4.9	10.0[e]	8.7
Philippines	-3.3	10.5	18.3	17.6	18.0[e]	18.0[e]	17.9
Singapore	-16.2	3.7	6.7	5.7	10.0	7.0[e]	7.6
Taiwan	-16.5	3.3	23.2	5.0	17.5	18.2	13.6
Thailand	-10.2	2.3	12.7	20.1	22.1	24.0[e]	22.1
G-3	-14.4	-1.9	5.9	4.8	7.3[e]	7.3[e]	7.0
USA	-13.1	1.0	6.7	5.6	4.0[e]	7.0[e]	5.5
EU	-12.8	0.1	6.7	7.0[e]	7.0[e]	7.0[e]	7.0
Japan	-17.5	-7.5	4.1	1.9	11.0	8.0[e]	7.0

Source: various. *e = estimates as of January 15, 2003.*

A series of in-depth analyses of changes in economic agent behaviors and expectations, market and competitive structures, policy contents and global environments indicate that *the Thai economy is undergoing a major shift in strategic direction for the first time after the financial shock of 1997*. The Thai economy is currently in the process of shifting from an *old period* to a *new period*. *The former* is epitomized by damage controls, repairs, reforms, restructures, and refills through aggregate demand management measures. In this time interval, the industrial capacity utilization rate rose from an all-time low of 52% in 1998 to a practical full-employment rate of about 75% by the first quarter of 2004. *The latter* on the other hand will be typified by capacity expansions, quality orientations, productivity improvements, competitive enhancements, better employment opportunities, higher incomes, and better quality of life for all segments of the Thai population within a thriving regional environment during the next 5 years.

Major Objectives of the New Economy

While real GDP or output growth rate of the economy – the higher the rate, the faster the economy would be able to utilize the unused industrial capacity and reach the full potential of the pre-crisis economy – was all important for the period of refills and restorations to achieve full capacity as quickly as possible. Once full capacity utilization was reached by early 2004, an actually realized GDP growth rate will become much less important an indicator of policy objective and national priority toward which all efforts and measures would be directed. When full utilization of productive capacity is reached, it does not matter that much whether the economy grows at 5, 6, or 7 percent a year so long as all inputs are fully utilized in the most productive and competitive manner. In addition, productive capacity building requires

more investments in human and physical capital including education and basic infrastructure. Some of these investments have very long gestation periods before potentialities are turned into more and better quality goods and services to be bought within the country and by foreign consumers. It can be argued that national priority and objective should be shifted towards quantity and quality of labor employment and investments in capacity building to assure that the economy can turn potential capacities into sustained development in the many years to come.

Three important milestones to assure financial stability of the new economy will be the enforcement of annual government budget balance, low inflation rate, and international current account balance. If a current account deficit should occur as a result of temporary export shortfalls beyond the control of the Thai economy, the ratio of current account deficit to GDP will not be allowed to exceed 2% and corrective actions to increase domestic savings and/or to slow down investments will be undertaken immediately. In fact, *a preemptive policy to increase household savings through long-term, contractual savings under the social security, corporate provident fund and individual retirement arrangements for the self-employed systems will assure that no current account deficit would ever develop even with more domestic requirements during the next 5 years*. At present, Thailand has a current account surplus of about 5 billion US dollars a year, or about 3% of GDP. It would take more than a few years and with a total neglect of domestic savings mobilization policy to generate a return to the current account deficit situation, something that no fiscal and monetary authority will allow to happen. A more relevant question will be *how to mobilize domestic savings and how to finance investment requirements in a market-friendly manner and from willing and able savers/investors both within the country and from abroad*.

It is the policy of the Thai government to enter into as many **free trade agreements** with its trading partners as possible. This is to assure that unrestricted trade and tourism will benefit not only consumers, but also bring forward industrial restructuring and adjustment so that most productive sectors of the Thai economy are regionally and globally competitive and create values that can satisfy the needs of domestic and international consumers. Equally important is the fact that **free and fair trade in goods and services must go hand in hand with cross-border financial transactions.** As bank-based financial intermediations across countries rely almost exclusively on the major currencies and are short-term in nature, the double mismatch in currency and maturity of cross-border transactions, which partially gave rise to the 1997 Asian financial crisis, have prompted many analysts and policy makers to propose the Asian bond market development initiative as an alternative to bank-based financing. Bonds are long-term instruments and, when denominated in local currencies, help reduce the double mismatch problem, because borrowers can pay back their borrowings without taking the foreign exchange risks. As Asian currencies become stronger due to persistent current account surpluses, investments in *Asian currency-denominated bonds represent a new choice of portfolio diversification for Asian and international investors*. **Domestic policy initiatives which will take place in Thailand must, therefore, be consistent with the free-trade policy and the Asian bond market development initiative.**

When combined, total current price investments in the Thai economy are likely to grow at the rate of about 20 percent per year during the next 3-5 years, practically the same rate of growth in 2004, the year in which investments began to speed up but there was no apparent negative impact on inflation or the current account. In fact, the current account surplus remained high at 5-6 billion US dollars or 3% - 4% of GDP, thanks partly to the high earnings from tourism and high export prices.

The next 5 years represent a challenging period for the Thai economy, which has just exited from a temporary set-back after the 1997 financial crisis. Enough lessons have been learned by all segments of the Thai population such that the pains of the post-1997 period would enable avoidance of a recurrence thereof. A balanced policy and strategy of threading the middle path with equal emphasis placed on both national investment and domestic saving is likely to allow the country to accumulate quality human and physical capital for sustained development without violating any of the financial stability constraints that must be observed in a highly interdependent and interrelated world. The recent past and foreseeable outlook for Thailand serves clearly as refutation of the “war time” economic and financial suppositions that underlie the existing Chiang Mai Initiative configuration. The experience is of course not limited to just Thailand, a country that is used as a case study. Similar experiences that can be studied and documented in a like manner are surely observable elsewhere, particularly in East Asia. “Peace time" has definitely dawned on the region.

Section 4

A Proposed Medium-Term Revision to Improve the CMI for "Peace Time" Purposes

1. Size of the Borrowing Facility and Relaxation of the "War Time" Conditionality

The current bilateral currency swap arrangement, the major financial cooperation modality under the CMI as it now stands, has developed into a network of bilateral agreements with a combined value that on the surface seems rather sizable. In this respect, the spirit of regional financial cooperation appears forthcoming and encouraging; no further action seems to be called for here. The proposal for short-term improvements in the CMI meanwhile relates to expanding only the network of bilateral currency swaps or the overall pool of resources committed to the CMI, and not necessarily the magnitude of each individual bilateral agreement. Likewise, neither is the proposal for the medium term, as will be delineated in more detail below, specifically meant to suggest any increase in the "nominal" total size of each individual bilateral swap facility.

2. "War Time" IMF Conditionality Attached to Swap Facility Activation

Unfortunately, the size that is effectively available for drawing under the bilateral currency swap facility amounts to a mere 10% of the "nominal" total size of the facility as agreed upon itself. In other words, no more than one-tenth of the total facility can readily and singly be approved for disbursement by the sole discretion of the swap providing country. Beyond this

rather limited effective amount, any drawdown can only be considered upon the swap requesting country's entry into the IMF rehabilitation program.

3. Macroeconomic Surveillance and Monitoring

The rationale behind the "war time" IMF conditionality arrangement was understandably the relative lack of macroeconomic surveillance and monitoring capability within the region without which there would be insufficient basis for determining the appropriateness of releasing funds under the 90% portion of the swap facility at any given point in time. What appears to have been a "one-size-fits-all" policy prescription of the IMF in the past, in dealing with "war time" situations in member countries in diverse corners of the world with disparaging local peculiarities in each of the problem cases, has contributed to the not always memorable experience on the part of the countries being "rescued."

The analysis on the recent economic and financial state of affairs of the ASEAN+3 region, as presented extensively above in this study, would point to a definitive direction through time of a rapid and steady transition from "war time" to "peace time" in more and more countries of the region. The fundamental economic conditions in each of the regional countries also suggest that a "war time" situation to which many were subjected a few years back is quickly becoming increasingly remote a possibility as time goes by and needs to be seriously reviewed. Therefore, it is probably high time to begin to consider in all earnest the application of "peace time" conditionality, which has heretofore been in effect limited to just the first 10% portion of the currency swap facility under the CMI, to the remaining 90% portion as well. The outdated "war time" mindset, one which has become increasingly out of touch with the realities of the day, would thereby be removed altogether. In this vein of argument, the importance of accelerating the process of developing and establishing

effective macroeconomic surveillance and monitoring mechanisms for the region cannot of course be overemphasized. In addition to seeking further intensification of the surveillance system based on peer review, the region must also develop other supplementary monitoring tools. One such tool is the registration system for flows of short-term portfolio capital or otherwise often casually referred to as "hot money" that was once in active practice in Thailand but has now more or less gone out of use and needs to be somewhat revived and rejuvenated, the details of which are presented below in a broader framework of discussion. In this context, the dissatisfaction in the region with the speed of disbursement of IMF funds and the conditions attached to IMF lending raises the question of whether there are alternative and superior forms of conditionality that would also address the problem of moral hazard associated with the activation of the swaps.

Many analysts concluded that the major source of financial instability during the 1997–1998 Asian financial crisis, as manifested in Asian currencies' rapid depreciations against the US dollar, was volatile short-term portfolio capital inflows and outflows induced by global fund managers ("hot money"), rather than the relatively predictable "fundamental" export/import trade flows or long-term foreign direct investment flows (see, for example, Yoshitomi and Shirai [2000]).[6] This interpretation of the role of "hot money" flows is widely held within the region. Thus, in considering alternative conditionality, it must be kept in mind that *the objective of the regional financial swap agreements in East Asia has been both to prevent and to react to the extreme exchange rate instabilities caused by disruptive short-term portfolio capital inflows and outflows.*

[6] Masaru Yoshitomi and Sayuri Shirai, "Policy Recommendations for Preventing Another Capital Account Crisis," *ADB Institute Working Paper Series*, Tokyo, July 2000.

One implication of this objective is that countries that are potential lenders in regional swap arrangements will have an interest in determining the extent to which the need for resources by the potential borrowers in such arrangements has been caused by the effects of volatile exogenous flows. Thus, unless and until countries in the region are able to monitor these short-term inflows and outflows with sufficient accuracy to identify their role in the emergence of instability, potential lenders will not feel comfortable with their obligations under swap arrangements. While they may be willing to provide resources in response to shocks arising from exogenous changes in the disposition of "hot money," they will be reluctant to do so in response to internally generated imbalances for fear that the borrowing countries will misuse the resources provided. To part from or improve upon IMF conditions, this fear must be squarely acknowledged and properly addressed, rather than left understood but not articulated clearly.

A careful monitoring of capital flows is the first condition for the departure from a link to IMF conditionality in regional swap arrangements. The implication is that the first *ex ante* condition for a departure from IMF conditionality must be that each member country's financial authority develops an effective capital account monitoring system capable of identifying and distinguishing short-term portfolio inflows/outflows from desirable long-term capital flows on a weekly or monthly basis. Without some legal framework for exchange control procedures, no matter how limited, as practiced in most ASEAN countries (such as Malaysia, Singapore, and Thailand from 1950 to the mid-1990s), it would be difficult to monitor short-term capital movements through banking and capital market registrations and reports. The original purpose of these registrations is to facilitate repatriations of capital for foreign portfolio investors. By the early 1990s, many countries were already abolishing or planning to abolish these reports under the new wave of full capital account liberalization (e.g., Indonesia, the Republic of Korea, and the Philippines). In light of the aforementioned

reason, *it is advisable for newer members of ASEAN, such as, Cambodia, Lao People's Democratic Republic, Myanmar, and Viet Nam to bring in this reporting system and, for those that no longer possess it, to reinstate some form of reporting either through banking or stock/bond market registrations.*

We believe that Malaysia and Thailand still have a reporting system of this type that can be studied and replicated by other developing East Asian countries, even though their stock markets may not yet appear on the radar screen of global portfolio investors. Even for Japan, whose currency is already internationalized, this report should also be compiled in the same manner as carried out by the US Treasury, which publishes its report on foreigners' portfolio transactions in its monthly statistical release.[7]

A second condition is designed to protect countries in the region from the effects of such flows, thereby reducing the magnitude of "hot money" shocks. It involves the imposition of *limitations on residents' holdings of financial assets and liabilities denominated in foreign currencies and nonresidents' holdings of similar instruments denominated in the local currency*. A set of rules to this effect must be spelled out clearly and enforced by the financial authorities. Malaysia and Thailand have the most detailed systems of this type, and these can be modified to suit other countries' requirements—so long, of course, as the full internationalization of the local currency is not an immediate objective. The effects of such conditions would be to diminish the size of the shocks to which drawings on swap lines would be intended to respond.

A third condition is a *step-by-step program to regionalize domestic currencies*. This will serve as a useful starting point for the final internationalization of the currency. Unless and until a

[7] See Table CM-V-4 of the *US Treasury Bulletin*, US Government Printing Office, March 2002.

regional clearing system is established, even the use of regional currencies as a medium of exchange cannot be realized. The use of these currencies as a store of value can follow quickly if the capital flow restrictions allow for some international capital transactions *among nations in East Asia*. If equities and bonds are to be traded across countries, the stock markets and securities and exchange commissions must also be brought in, to develop international settlement/clearing systems for these financial instruments.

Once all these conditions are met and full monitoring in each country is possible, it will become easier for a small regional secretariat to oversee the free flow of information across countries and to identify the major sources of instabilities in the foreign exchange markets when they arise. If it is monitored and confirmed that the exchange rate fluctuations are caused by disruptive short-term capital flows, the use of pooled financial resources can be activated quickly without linking such use to the activation of an IMF-supported program.

In short, what is proposed is the use of regional swap facilities in a lender-of-last-resort role in a context in which the region's financial links with the rest of the world are weakened. Such facilities would be available regionally to confront liquidity crises, rather than solvency problems. It is clear that if instabilities were caused by fundamental disequilibria in the current account as a result of over-expansionary fiscal policy or cost-push domestic inflation, for example, this pooled resource would not be activated without policy conditionality. In the latter case, use of the pooled resource would be subject to realignment of the currency values and other IMF-style policy adjustments before the newly aligned currency peg is defended again.

4. A Two-Way Borrowing Agreement

In the context of "peace time" activation of the bilateral currency swap, when division between the 10% and the 90% tranches of the borrowing facility has already been completely done away with, it then becomes obvious that the key reason for maintaining the facility is simply to smooth out by bridging over occasional short-term external difficulties of the Type 2 variety of balance of payments problem as defined and elaborated upon below. Logic would carry further then that the bilateral cooperative relationship between any pair of ASEAN+3 countries need not be restricted to a one-way nature, whereby one country is designated to be the swap requesting and the other the swap providing party to the swap agreement from the first day all the way through to the day the agreement expires. The short-term financial accommodation can conceivably be extended by any one country for any other country under the CMI umbrella. Hence, a two-way approach, whereby either party to a cooperating agreement can perform either the borrowing or the lending function in a bilateral currency swap relationship as the situation may require, would constitute more generalized and, for that reason, perhaps more desirable a form of regional financial cooperation and coordination. The approach would incidentally ring well with and in fact reinforce the validity of the concept of "joint partnership in cooperation."

A purpose of such a regional financial arrangement scheme as the CMI is to provide short-term financial assistance to the member countries that are in need of balance of payments support, particularly under conditions that can prevent a capital-account crisis. Meanwhile, all the three major financial policy targets of central banks as discussed earlier above are closely intertwined with balance of payments situations. Therefore, the first task here is to

define the term balance of payments difficulties. In this study, balance of payments difficulties are classified into 2 types:

1) The current-account type or Type 1 balance of payments difficulties occurs from a small shortfall in the current account that may result from a temporary decline (rise) in export earnings (in import costs). The eligibility requirements for accessing the international financing facilities to deal with this type of balance of payments difficulties are as follows. (1) The export shortfall and/or excess in import cost must be considered temporary, i.e., a deviation from a trend that is expected to be self-correcting. (2) The shortfall/excess must be attributable to factors largely beyond the control of the authorities. (3) The member country has to have a balance of payments need due to inadequate international reserves to meet the shortfall. (4) In case the member country has a balance of payments problem above and beyond the effect of the shortfall, it is expected to cooperate with other member countries in an effort to address its balance of payments difficulties.[8] Traditional IMF rescue facilities focus on this Type 1 balance of payments difficulties.

2) The capital-account type or Type 2 balance of payments difficulties arises from unforeseen net short-term capital outflows, in successive periods of more than one to three months. The case of Thailand in the first half of 1997 is an example of the Type 2 balance of payments difficulty. After the sporadic events in currency speculation in the latter half of 1996 that continued into the early months of 1997, the Bank of Thailand decided to intervene in the spot currency market in Singapore for the first time in February 1997. It did so by venturing into spot buying of the Thai baht against the US dollar in order to prop up the value of the baht. The move proved effective in halting the speculation earlier in the game, and was continued in increasing volumes both in spot and forward transactions. Meanwhile,

[8] The term is defined in the same manner as that of the International Monetary Fund (IMF).

rumors were being spread that the baht would be devalued against the US dollar. They were being received with growing credibility such that the Minister of Finance, who was abroad at the time, felt compelled to make an overseas telephone call to deny the validity of the rumors.

Speculative attacks and attempts to counter-attack then went on. The pressure on the baht value continued to mount during the 4 months prior to May 17, 1997, when the two-tier currency system was established, severing the link between the onshore and the offshore baht markets. This is equivalent to a "de-internationalization" of the baht. The international hedge funds that were involved in the fight were consequently inflicted with losses, as they could not come up with the baht amounts, via short-term borrowings in baht from Bangkok-based commercial banks, required to settle the contracts. The two-tier system appeared to work during the period of roughly a month and a half after its inception.[9] The Thai government, however, decided to float the baht on July 2, 1997, thereby formally setting in motion the Asian contagion. It is precisely during that time span – namely, from about February 1997 to the end of June 1997 – that an effective financing facility, had it existed, could have come in handy. With budgetary surpluses maintained for nine years running, balance of payments surpluses because of massive capital inflows almost every year for eleven years, and inflation rates well under control, the fact that the baht was nonetheless still subjected to increasing pressure was evidence of perhaps a classic case of Type 2 balance of payments crisis in the making. *Thailand's monetary authorities were hence faced with a "war time" situation in all earnest. Much of the rest of East Asia was about to experience a similar situation shortly thereafter.* The region came to be at war, one that it was completely unprepared to fight. There was no meaningful regional financial rescue facility to speak of

[9] For an authoritative account of the events that took place during that period of time, see *The Analysis and Diagnosis of the Facts Regarding the Economic Crisis Situation*, A Report of the Committee to Study and Recommend Measures to Improve the Efficiency in Managing the Financial System of the Country (popularly referred to as "The Nukul Report"), March 31, 1998. And Paul Blustein, *The Chastening*, PublicAffairs, 2001.

that was capable to deal with the external speculative onslaught of that nature and magnitude.

While an envisioned regional financial arrangement, in its most ambitious and all-encompassing form, would be designed to provide financing assistance to both the Type 1 and Type 2 balance of payments difficulties, the immediate focus here is however more on the latter. Indeed, *the CMI was essentially crafted to handle the Type 2 balance of payments difficulties*. It is encouraging to note that, after the Asian crisis, the IMF now also has financing facilities to deal with the Type 2 balance of payments difficulties. As these facilities fall in the same vein as that proposed for East Asia, regional facilities will be able to enhance and play a supplementary role to the facilities of the IMF. The availability of financing facilities from both of the sources offers a choice to a potential borrower country. Choosing to benefit from both simultaneously also remains a possibility. If a choice was really to be made, it could conceivably be done on the basis of (i) relative quickness of disbursement to prevent a crisis from erupting and (ii) the conditionality that is relatively more sensible in the given local context.

5. Borrowing in Local Currencies

In the spirit of regional self-help and support as well as in the global context of changing economic realities of today as analyzed in detail above, a two-way borrowing agreement should be made to involve the local currencies of east Asia. After all, bilateral swap agreements among ASEAN+3 countries under the CMI that involve local currencies are not exactly unheard of. The agreement between China and Japan, for instance, is merely one case in point. There are of course others as well. A US dollar-denominated borrowing would

in any case be immediately sold through the commercial banking system in exchange for local currency in the swap requesting country. Thus, it would in effect be perceived as a local currency borrowing in the eyes of the borrower anyhow.

An improved bilateral agreement should then relax the existing stipulation on currency denomination to allow for the borrowed funds to be denominated in either the US dollar as before or in any other local currency that may be mutually agreed upon by the cooperating parties to an accord. If the "war time" IMF-type conditionality is to continue to remain intact, at least the 10% portion should be open to local currency denomination. Cross-border borrowing in local currencies would have the effect of taking the region a long way in its effort to erase the stained image of being regarded as a region of weak and unstable currencies. Such a lingering portrayal of the region would counteract any measure to reinstate investor and trader confidence into the region. Confidence was, not to be forgotten so quickly, catalytic in the instigation of the abrupt and massive reversal in the pattern of international capital flows that sent Asia reeling right into a financial crisis some seven years ago, from which time a "war time" situation hung over the region for many a year.

6. Government Guarantees

The existing one-way arrangement is such that a US dollar borrowing is guaranteed by the ministry of finance of a swap requesting country. The borrowing country by the sheer act of guaranteeing the loan itself instantaneously creates additional public debt for itself by the amount it guarantees, certainly not a situation that any country would choose to find itself in unnecessarily. For Thailand, for example, the notion of avoiding further public debt creation as a proportion of GDP is reflected in the government's policy now for the Ministry of Finance

to not even wish to guarantee state enterprise borrowings. It is proposed that a better approach would be to deal with the immediate issue at hand by using the government bonds issued by the lending country but owned by the borrowing country to guarantee against the loan instead. A possible half-way house improvement measure for the CMI in the more immediate future, while still in keeping with the one-way US dollar swap arrangement, might therefore be for the funds drawn down to be guaranteed (or repurchased) by Japanese government yen-denominated bonds, Chinese government renminbi-denominated bonds, Korean government won-denominated bonds, or US Treasury bonds. In this case, the interest earned on these bonds would still belong to the swap requesting bank. This possible approach, while still representing an improvement to the present system, would be tantamount to no more than a half-hearted effort anyway.

In light of the ideas suggested in much of the foregoing passages, a more determined effort to explore ways to enhance the functions of the CMI in the medium term should be set in the context of a two-way, local currency swap arrangement. A full-fledged version of such an arrangement may in turn involve swaps that are guaranteed by a pledging of the funds providing country's government securities that are owned by the funds requesting central bank against the borrowed funds. As an example, if the Bank of Thailand (BOT) is the funds requesting central bank in the arrangement, the pledging process can be completed either at the BOT itself or at the Thailand Securities Deposit Company Limited (TSD), under the Stock Exchange of Thailand (SET), for the newer generations of Thai government bonds. The Asian bond market development initiative that began more than two years ago is a phenomenon that has been designed, *inter alia*, to enhance directly the role of local currencies in regional financial cooperation and coordination and *vice versa*. Local currency-denominated Asian bonds issued by governments in the region are also intended to serve as guarantees against the borrowed funds. This proposed change to enhance the CMI in the

medium term, if it is still considered overly ambitious in the meantime to be applied to the entirety of a given currency swap facility, it might first be applied to the 10% tranche, and not until later on further down the road when the spirit of regional cooperation is sufficiently ripe will it be applied to the remainder of the swap facility that in practice has heretofore been merely “nominal” and hence ineffective.

7. A Concluding Note: Multilateralization of the CMI Currrency Swap Arrangement

Exploring ways to enhance the functions of the CMI in the medium term as proposed above involves to a large part institutional changes in the qualitative aspects of developing the network of bilateral currency swaps. A quantitative aspect that has not been touched much in the study relates to the interest rate to be applied upon activation of the swap facility, which is currently expressed as a spread over the London Interbank Offered Rate (LIBOR). At least the issue as to the appropriateness today of the rate structure still awaits further deliberation by a forum of the ASEAN+3 membership. Another relevant quantitative aspect is the “nominal” total size of the bilateral currency swap facility under the CMI. The matter is treated here as a short-term issue of expanding the combination of pairs of bilateral agreements to build up an effectively integrated network of regional financial cooperation, with the possibility of its growth continuing into a much longer time dimension.

Another major qualitative institutional change that can be carried out in the more distant future is a vision of a regional financial system the design and construction of which go much beyond the piecemeal approach to improvements in the CMI in the medium term as is the focus of the present study. While the present study deals essentially with exploring ways to enhance the CMI as a collection of individual inter-country financial support agreements,

ASEAN+3 should not lose sight of a wider and longer view of a possible eventual unified setup that can qualify as being truly regional. Such an eventuality will likely be multilateral in form. An Asian Monetary Fund (AMF) as was once put forward is a possible version involving multilateralism, one that is not altogether incompatible with our proposed Asian Currency Fund (ACF).