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Promoting Financial Cooperation within the ASEAN+3

Hanafi Sofyan

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Hanafi Sofyan*

**Visiting Research Fellow
APEC Study Center
Institute of Developing Economies, JETRO**

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I. Perspectives

The global effort to resolve economic and financial crisis recognized the diverse circumstances and priorities of individual economies at different stages of development. But it focuses too much on national and international aspects and little attention has been given to the role of regional institutions during the financial crisis. Although there was an understanding that because of the inability of the IMF to act swiftly, there is a need to strengthen and review the roles of international financial institutions such the IMF to improve their capacity and capability to contain and resolve crises. At the same time, IMF should have a strong presence in and an understanding of Asia; if not, Asians must create an institution that can quickly and rightly respond to their problems.

But the lack of substantial regional initiatives within the Asian region is a stumbling block in achieving concerted action. For example, a proposal on the Asian Monetary Fund initiated by Japan, and supported by the ADB and some East-Asian countries, disappeared after the US voiced its disapproval. On the other hand, academic discussions in the region have not been able to produce any tangible results, and official meetings becoming a talk-shop, cannot go beyond the Manila Framework. The key elements of Manila Framework were strengthening of the IMF crisis management capacity, a cooperative financing arrangement to supplement IMF resources and creation of a regional early warning system.

Although Manila Framework measures have been taken at a regional level, little sustained consideration has been given as to whether regional institutions should be formed in ways that can enable them to play a decisive role in national and global measures for protecting Asia from future financial instability.

The period of the economic miracle has seen ASEAN economies increasingly adopting outward-looking strategies and embracing global economic integration.

Regional cooperation bodies such as the AFTA and APEC have managed to create an agenda and have solved some issues in the area of trade liberalization and investment. But the crisis of 1997-98 has led to increased questioning of the national vulnerabilities and costs of globalization. ASEAN regional grouping failed to help members prevent regional financial crises or reduce the severity and spread of such because it was caught unprepared and had limited resources for regional self-help. Financial assistance was given on a bilateral rather than coordinated regional basis. None of the cooperation in the financial area has been institutionalized. Regular meetings among Central Bankers and Finance Ministers and initiatives such as the Miyazawa Plan can be seen as a good start but in order to make the meetings more effective will require an institution, funding and secretariat to formulate regional policy, and come up with short-term, mid-term and long-term strategies.

Unlike the trade agenda in the region, the collective action problem in finance lies in regulating the market, rather than in liberalizing it. Despite the region's large foreign exchange reserves, APEC is not a financial institution and has no special access to funds that could be mobilized in a crisis. ASEAN has hardly gone beyond AFTA, and functional cooperation had only additional role with the establishment of ASEAN Foundation to support human resources development. ASEAN has no meaningful financial cooperation. Until March 1997 not even a single ASEAN Finance Ministers meeting had been held. For example, when the Thai baht was targeted by speculative attacks in 1997, neither ASEAN initiative nor full-fledged cooperation in the region established to cope with the problem.¹

In order to contain the contagious effects, Asia needs a “lender of the last resort”. This new institution would attempt to stop the panic by injecting liquidity into the system and to allay investor fears that otherwise might lead to their withdrawal of their capital. An Asian institution is needed to act as a credible guarantor of financial stability and liquidity, and at the same

¹ Asian central banks intervened in support of the baht against another speculative attack, but the fund provided by the Bank of Thailand and not by their own fund.

time, to serve to underpin investor confidence in the region. ASEAN needs to have a more formal dialogue process for identifying region specific issues and promoting concerted policy actions with important players such as Japan, China and Korea. ²

II. Issues

In order to manage currency risks associated with yen-dollar fluctuations and protect against the uncertainties and instabilities inherent in a multiple currency system, some Asian countries have suggested cooperation in monetary and financial sectors such as the creation of mechanisms to provide liquidity support and exchange of financial market information. Can such cooperation work where Europe, Japan and the United States are major players in monetary and financial affairs? Can Asia achieve stability and maintain a cooperative spirit without the dominance of these three economic powers?

This paper examines prospects for monetary and financial cooperation in the Asian region. It looks at how the impact of different policies within the United States, Europe and Japan affects policy choices and attempts at monetary and financial cooperation in the region.

This paper considers strategic interaction associated with the provision of regional collective goods in the monetary and financial arenas. The problems of collective action appear to be relatively important in Asian monetary and financial cooperation. Strategic interaction between the United States and Japan may influence the outcome, and the inability of Japan to replace the United States in the Asian provides a leeway for Asian governments to use their initiative and advance their interests — such as

² China's efforts not to devaluing the renminbi during the crisis have been applauded, and it shows that Asian can save Asia from another crisis.

stability of exchange rates and free flow of capital — in a cooperative manner.

Any evaluation of the likelihood of regional cooperation must take into account two factors: the domestic politics of nations' foreign policies, and strategic interaction among potentially cooperating nations (Putnam, 1988). National interests, in this context, vary widely along with the interests of those in national polities. It is helpful to focus on national priorities, as determined by domestic interests and institutions, to see what they might imply for the success of regional financial and monetary cooperation.

International monetary cooperation enhances economic welfare, but is difficult to sustain. The reason for this difficulty is systemic, and has to do with the intrinsic incompatibility of three key desiderata of governments: exchange rate stability, capital mobility, and national policy autonomy. Cohen (1993) called these three values a kind of 'Unholy Trinity' that operate to erode collective commitments to monetary collaboration. Groups favorable to international monetary and financial cooperation are nonetheless gaining ground in Asian countries.

This paper explores the nature of cooperation, and its domestic dimensions. Cooperation issues, especially in the Asian region in finance and monetary areas are discussed.

III. Frameworks

1. Monetary Regimes

International monetary regimes have traditionally been a function of the hegemonic state influencing monetary policy and imposing sanctions on other countries. Since the end of the Bretton Woods system, however, there has been no hegemonic power that could guarantee the stability of international monetary affairs, since no single nation has the capacity to dominate domestic interests across the world economy, as was the case in the

past.

Economic and political externalities create market failure and necessitate the creation of cooperative regimes to cope with instability. Cooper (1975:64) defines a monetary regime as a particular set of rules and conventions governing monetary and financial relations between countries. The rules themselves evolve from the influence of economic outcomes that are derived from the interaction of policy and private behavior under the current rules. Cooper considers the difficulty of attaining international consensus stems from (1) disagreements on the desirability of distributional consequences of alternative regimes, (2) different weight attached to competing criteria, (3) differences in national circumstances, (4) disagreement over the effectiveness of alternative means to achieve a particular objective, and (5) uncertainty about the trustworthiness of other countries within any chosen regime.

If a new regime is to be adopted, the ongoing regime must be in an impasse serious enough to make the pay-off structure of a new regime attractive for prospective participants. International monetary reform is more likely to come about as an inevitable reaction to a crisis than as the outcome of a well-planned blueprint. Regime changes take place more as a result of unfavorable external disturbances to the ongoing system that make the *status quo* intolerable to many participants, than as a result of well calculated plans for the ideal reform.

Under fixed rates, the nature of policy interdependence was relatively simple: price levels of the countries in the world economy had a tendency to converge. The policy game under fixed rates exhibits the structure of the Prisoner's Dilemma: the non-cooperative behaviour of central banks leads to a more inflationary or deflationary outcome, depending on whether world liquidity is more or less than the desirable amount (Hamada, 1985). Under fixed rates, cooperation in monetary policy is indispensable.

In the policy game under flexible rates, the direction of the influence of

the monetary policy of other countries may be positive or negative, depending on the nature of the interdependence. If positive spillover effects are dominant, non-cooperative behavior will lead to a situation where every country pursues a less expansionary policy than is required to attain a cooperative solution. On the other hand, if the negative spill-over effects are stronger, the non-cooperative situation will be such that every country pursues a more expansionary policy than is required to attain a cooperative solution (Canzoneri and Gray, 1985).

The weaker degree of interdependence under more flexible exchange rates enables monetary authorities to enjoy a greater degree of monetary autonomy. As the Asia-Pacific political economy is in the midst of structural and institutional change, an institutional basis for handling the regional political economy on a multilateral basis is rapidly being developed, with the result that the prior dominance of bilateral negotiations is coming undone. These developments are taking place in a context in which East Asian countries have tended to favor looser types of cooperation, such as those among APEC Finance Ministers Meeting and the Executive Meeting of East Asia and Pacific Central Banks (EMEAP).

2. International Cooperation

Cooperation is identified with a mutual adjustment of national policy behavior in a particular issue area, achieved through an implicit or explicit process of inter-state bargaining (Keohane, 1984). Coordination and joint or collective decision-making will be treated as essentially synonymous in meaning. Conceptually, international or regional cooperation may take many forms, ranging from simple consultation among governments or occasional crisis management to partial or even full collaboration in the formulation and implementation of policy.

In the issue area of international monetary relations, the theoretical case for policy cooperation is quite straightforward (Cooper, 1985). It begins with intensified interdependence across much of the world economy. In

recent decades, states have become increasingly linked through the integration of markets for goods, services, and capital, as in the case of the EU and NAFTA. Structurally, greater openness of economies tends to erode each country's insulation from commercial or financial developments elsewhere. The basic rationale for monetary cooperation is that it can internalize these externalities by giving each government partial control over the actions of others, thus relieving the shortage of instruments that prevents each one separately from reaching its chosen targets on its own. Asia-Pacific countries are bound to find their individual policy behavior increasingly constrained. The question is where that external authority will come from — and whether it will be the result of voluntary, mutually accommodating, or unilateral decisions.

At least two sets of goals may be pursued. First, cooperation may be treated as a vehicle by which countries together move closer to their individual policy targets. Kenen (1988:43) calls this the policy-optimizing approach to cooperation. Second, mutual adjustments can also be made in pursuit of broader collective goals, such as the defense of existing international arrangements or institutions against the threat of economic or political shocks. Kenen calls this the regime preserving or public-goods approach to cooperation. Both approaches derive from the same facts of structural and policy interdependence.

For Asian region, however, problems with the dollar–yen rate have a negative impact on their economies. In order to control the damage, Asia-Pacific countries therefore tend to favour cooperation in monetary and financial areas, despite the reservations about Japanese dominance in monetary affairs. Monetary cooperation is necessary to stabilize exchange rates and establish a common price level for tradable goods among Japan, the United States and East Asian countries. It can be suggested that in the Asian region, both the policy-optimizing approach and public-goods approach in cooperative efforts can be applied at the same time.

3. External factors in Asean+3 financial cooperation

The main concern for monetary and financial relations in Asian region is that they may become unstable, which in turn may dampen the regional flow of goods and capital. Most scenarios for such a breakdown involve concern over Japanese and American international monetary and financial policies.

A pessimistic scenario is that Japanese refusal to play a more prominent role in regional money and finance may precipitate an American refusal to continue its leadership, and initiate an era of hostility and conflict between the two nations. Japanese–American conflict in monetary and financial realms would almost certainly reduce the level of trans-Pacific financial flows in the region, increase the unpredictability of exchange rates, and hamper trade. This would presumably result in negative consequences for the economic and political stability of the region.

The optimistic scenario is cooperation between Japan, Europe and the United States at 2 levels: first in global cooperation with the world's leading nations on whatever issues may be important at the global level; and second in regional cooperation within the Asia-Pacific region, to ensure a favorable environment for regional financial flows, and to provide generally predictable regional exchange rates. The optimistic scenario would appear to require that the Japanese government play a more important role in global or regional financial policy. In other words, the two governments would either participate in joint management of global money and finance, or would themselves jointly manage the region's monetary and financial affairs. Either way, the outcome would be cooperative: the 'joint ness' of the management would guard against conflict among governments, while the management itself would provide economic and policy predictability.

All international financial actors gain from the stability cooperative supervision can provide. However, all countries have an incentive to skimp on supervisory expenses and supervisory requirements in order to gain an

advantage in international competition. These conditions also apply to the role of national monetary authorities when providing liquidity during times of international financial difficulty.

In any case, most visions of the future of Asia-Pacific monetary and financial cooperation involve an implicit model of the provision (or under-provision) of these public goods. As APEC and other forums demonstrate, regional sentiments are motivated by the expectation that the region's nations recognize the gains associated with the cooperative provision of these collective goods and will act accordingly. They might do it as a joint US–Japan–East Asia consortium, for the Asia-Pacific region; or globally, for the world as a whole. In subsequent analysis, the focus will be on the Asia-Pacific region.

The problems associated with inter-state cooperation may arise due to the perils of collective actions. Where these perils are reduced — where accurate information is available, where commitment mechanisms reduce the risk of cheating, and where it is possible to provide selective incentives to co-operators — regional cooperation is more likely to be forthcoming.

The inference that can be drawn is that entrenched domestic interests can impede the evolution of government policies to help stabilize international money and financial difficulties — even in a country that dominates international monetary and financial systems. This makes it crucially important to understand the political balance of power among various domestic economic interest groups in countries faced with important international policy choices such as these. For example, Japan has come to play an important role in international money and financial markets, and international conditions have become extremely important to Japanese firms. Temporary difficulties can slow this process, but they are unlikely to alter the trend: Japan's role in Asia-Pacific financial and investment flows is likely to grow.

The possibilities for a regionalist Japanese sphere of monetary and

financial influence in East Asia have been discussed in many forums such as the ASEAN+3. Most of the evidence, looked at from the political and economic standpoint taken here, does not seem to favor such an outcome. Although the concentration of Japanese loans and investment in Asia increased in the 1990s, Japanese FDI has remained much higher in other regions (Tavlas and Ozeki, 1991). This implies that policies that might cut Japan off from the European or North American markets in favor of an exclusively East Asian region are unlikely to be supported by major externally-oriented sectors.

There are indications that Japan's domestic political economy has become more hospitable to the country's playing an important role in regional and international monetary and financial policy-making. The policy shifts in 1994 and 1997 in favor of yen internationalization, enable Japan to play a more active role in the region. Those who stand to benefit directly from Japanese provision of collective goods in these areas have become more numerous, more economically important, and more politically influential, though there remain plenty of obstacles to ongoing Japanese commitment to these policies. If current trends continue, however, Japan is likely to move into a position of leadership in regional money and finance and, together with the United States and Germany, in global money and finance.

The Plaza Accord was an institutional step in the history of the international monetary system for several reasons. One is that the officials responsible for the monetary policies of major countries — Germany, Japan, France, the United Kingdom and the United States — acknowledged for the first time that the foreign exchange market does not necessarily reflect economic fundamentals. They also shared the view that the then-prevailing foreign exchange rates did not reflect economic fundamentals, and committed themselves to coordinated actions to drive up other major currencies against the dollar, to what they considered more appropriate levels.

Another meaningful result of the Plaza Accord was that it clearly illustrated that a stable foreign exchange market, duly reflecting economic fundamentals, is achievable only when coordination of macro-economic policies and coordinated market operations is a target. The Plaza communiqué, stating detailed policies of each member country, both in micro- and macro-economic terms, strongly impressed currency-market players with the G5's firm determination to make policy coordination work.

Various proposals for reform have been made. A report by the Bretton Woods Commission, has attracted considerable attention among economists, and provided a timely reminder of the need to look more seriously at how to improve the international monetary system (Bretton Woods Commission, 1994). The Bretton Woods Commission, or the so-called Volcker Commission, proposed on 6 July 1994 a flexible exchange rate band to restrict the fluctuations of currencies within a certain range, through policy coordination among developed countries.

This proposal has been taken seriously in Japan. Japan's export-oriented industries are the greatest victims of erratic moves of the dollar against the yen, and can no longer effectively counter sharp foreign exchange movements through streamlining or restructuring. It was this state of affairs which led Shoichiro Toyoda, Chairman of the Japan Federation of Economic Organizations (*Keidanren*), to meet with then Prime Minister Murayama in March 1995, to ask him to consider the introduction of a flexible exchange rate band (*Nikkei Shimbun*, 19 March 1995). With the weakening of the yen, this proposal has lost impetus.

Any coordination requires a strong commitment from industrialized countries. In practice, it is not easy for a country to abide by the discipline of such an arrangement, especially if domestic politics require otherwise. A greater Japanese role in the world economy is expected. It requires Japan to be more attuned to the international and regional responsibilities that its economic strength presses upon it, even when this means putting domestic

interests at a disadvantage.

4. The Needs for Cooperation within the ASEAN+3

The integration of regional economies will take some time to achieve. Rather than a formal institution, an informal forum is preferred. The MOF, for example, organized a meeting of senior financial officials of Hong Kong, Singapore and Australia in 1992. Such meetings promise to become a regular forum, in which the MOF can make its views known.

In search of alternatives, the calls for closer monetary cooperation among Asia-Pacific countries have been becoming louder. There has been more formal consultation between governments within the APEC and ASEAN forums. For example, APEC has agreed to harmonize macro-economic policies among member countries, and at meetings of APEC Finance Ministers in Bali (1995), it was agreed that the region should promote cooperation among finance ministries and central banks in the area of currency stability. Most recently, at a gathering of Asian monetary authorities in February 1996, an agreement was reached that Australia, Hong Kong and Singapore will intervene on the Bank of Japan's behalf to support the dollar. These central banks have not, however, agreed to use their own reserves to support the Bank of Japan, but merely to act on its behalf. The agreement allows the BOJ to ask its Asian counterparts to intervene in dollar-yen trading. The monetary authorities of Australia, Hong Kong, Singapore and Japan believe that these arrangements will contribute to exchange rate stability, and that they are likely to develop cooperation in the market.

Various types of cooperation have been and can be established. Discussions on Japan's market intervention schemes are underway with China and other Asian countries within the APEC framework. The APEC Finance Ministers Meeting in 1996 called for harmonisation of financial regulation and standardization of financial disclosure. Also, central banks in

East Asia have started moving toward the formation of an East Asian central bank institution, to provide a wide range of financial and investment services to central banks in the region, and provide economic and financial analysis: an East Asian Bank of International Settlements (Fraser, 1995).

In November 1995, the central banks of Australia, Indonesia, Hong Kong, Malaysia, the Philippines, and Thailand established mechanisms to provide liquidity support to each other (*AFR* 21 November 1995). Japan joined the agreement in April 1996. This agreement was motivated by a concern that international financial institutions, which are dominated by the United States and European Union, may be less able or less disposed to provide immediate and substantial assistance to East Asian countries which may experience short-term financial problems. Liquidity support is provided at the discretion of central banks by bilateral repurchase agreements of US government securities. While the agreement is a step forward in cooperation, it also formalizes existing arrangements. Central banks in the region already have a series of bilateral foreign exchange intervention arrangements in place, for example, between Hong Kong, Singapore and Japan, between Singapore and Indonesia, between Singapore and Thailand, and between Hong Kong and the Philippines. Although Japan took the initiative by holding the first meeting of an East Asian BIS in 1991, the formulation and strongest push came from Australia (*AFR* 21 November 1995). Such agreements are the first step towards achieving the vision of a regional central bank institution, which would mount joint strategies to protect their currencies from yen-dollar fluctuations. Although Japan participates in these meetings, it could not initially decide whether to join the forum formally. This reflects the conflict of interests between the Bank of Japan and the Ministry of Finance, a feature of traditional bureaucratic rivalry in that country. The MOF was concerned that the forum would unduly increase the status of the BOJ. In respect of the liquidity arrangement, the BOJ acts not on its own authority but as an agent of the MOF. Japan finally became a

party to the agreement on April 25, 1996, later than the other countries (*Asia Times*, 11 September 1996).

In the light of growing interdependence in trade and investment among regional economies and the globalization of financial markets, this agreement reaffirmed the importance for the central banks to enhance cooperation to maintain currency stability and improve the integrity and stability of the banking system itself.

Cooperation among Asian Pacific monetary authorities in the currency market has become increasingly important, in view of the rapid development of financial markets in the region, and the lessons of the Mexican crisis in early 1995. In a departure from the traditional competition regional authorities display toward each other, Asians' central banks pooled their resource assets, and canvassed measures needed to prevent similar shocks (*AFR* 21 November 1995). The agreement underlines the deep concern across the region about the so-called 'exotic' currencies — semi-hard currencies considered vulnerable by international speculators in the wake of the Mexican peso crisis. The Thai baht has recently been subject to such pressure. Hong Kong is also particularly vulnerable, because the exchange rate is artificially maintained in a tight range centered on \$HK7.8 to the US dollar, and faces looming uncertainty due to re-unification with China and the death of Deng Xiaoping. This agreement allows the banks to borrow cash from each other by pledging their securities as collateral (*AFR*, 24 January 1995).

The rescue package for the Thai baht agreed in August 1997 represents the first substantial and practical application of these agreements. The IMF-organized US\$15 billion package comprised loans from seven Asia-Pacific region countries. The Australian contribution was in the form of a swap by the Reserve Bank of Australia to Thailand's central bank (*AFR*, 12 August 1997).

It may be wise for Asian central banks to sign bilateral agreements

with the US Federal Reserve Bank, since most of their reserves are in the form of American government securities. If there is a currency crisis in Asia, they can then avoid systemic problems by using dollars from the Federal Reserve Bank. Each member of the group would be able to borrow US dollars from the others to buy its own currency in the market and thereby keep its value stable. This would then protect them from an occurrence like the Mexican crisis.

Other regional cooperation is in the area of liquidity and repurchase (REPO) arrangements. The region's central banks have discussed the possibilities of entering into this type of liquidity arrangement. Liquidity support between central banks has been one way of responding to volatile short-term capital flows that are part and parcel of the globalization of currency and financial markets. These flows can react quickly to changes in market expectations and news, often independently of changes in economic fundamentals, and often in response to developments outside the region. The Bank for International Settlements (BIS) is a promising model in this context. Its members (shareholders) are exclusively central banks, and it has become the principal forum for discussion, consultation and cooperation among central banks in Western countries. Its main drawback, from an Asian perspective, is that its membership is international only in a quite narrow sense. The plan is to create a regional central banking institution as a way of overcoming the Euro-centric nature of the existing international central bank cooperative framework. The BOJ first discussed this plan in 1991, during an informal meeting among central bank officials of East Asian countries. Most of the big changes in banking supervision have been made by the Committee on Banking Supervision, established 20 years ago by the G10 countries, under the aegis of the BIS. A regional institution might help to make the views of countries in the Asian region better known to bodies like the BIS and its committee on banking supervision. More importantly, it could facilitate cooperation on the growing international element in financial

surveillance, as banks and other financial institutions spread beyond national boundaries.

A new regional institution modeled on the BIS would be able to offer member (and non-member) central banks a range of financial and investment services. It would be a bank for central banks, like the BIS. Some 100 central banks hold short-term deposits with the BIS; these are estimated to account for approximately about 10 per cent of global foreign exchange reserves, and include substantial sums from central banks in the Asian region. The spread which the BIS makes on these deposits and transactions not only covers its operational expenses, but also generates profits and dividends for its central bank shareholder.

The region has also created the so-called EMEAP (Executive Meeting of East Asia and Pacific Central Banks) regional central bank group September 1995. Central banks are not the only policy makers, but they also play a pivotal role in most countries. Such a regional institution provides for more structured and sustained discussion, experience sharing, monitoring, research and cooperation in these policy areas than is possible under existing, informal arrangements.

Since no existing institution could expect to match the particular focus or immediacy of a regionally-based institution dedicated to central bank cooperation, however, some new kind of new institution, or a substantial reformation of an existing institution, would be required to address these needs. An alternative to a new institution might be the enhancement of the non-institutional EMEAP arrangements, however, as valuable as the EMEAP arrangements are, deeper and ongoing central bank cooperation will require a proper institutional framework. For that to materialize, a sufficient number of central banks would need to be satisfied that the potential benefits outweigh the costs.

The EMEAP country economies, on average, have grown about three times faster than the average of OECD economies over the past decade. The

total foreign exchange reserves of the seven EMEAP countries with the largest reserves also more than match the total of the G7, widely regarded as the world's most influential economic group (see Table 1). Given their generally high saving ratios, and growing intra-regional trade and investment ties, their relatively rapid growth rates are likely to continue. In this environment, the task of maintaining growth and controlling inflation will become more difficult, with additional constraints on the operation of monetary policy, especially where exchange rates are fixed or 'sticky' as they are in several Asian countries. The central banks have reviewed developments in financial markets and examined the opportunities for further cooperation. The economies represented have a combined GNP of US\$7,615 billion and foreign exchange reserves of US\$471 billion (see Table 8.1). They have also discussed ways to improve cooperation amongst the central banks, to deal with volatile capital flows. They agreed that one useful form of cooperation was the exchange of information and liquidity enhancement in the form of bilateral repurchase (REPO) agreement between central banks.

Table 1: Comparison between East Asian and European Union

	EMEAP	EU
Population (million)	1728	369
GNP — US\$ billion (1993)	7615	6171
Average growth 1992–94 (%)	6.7	1.1
National saving ratio — Average	35.0	18.2
Foreign exchange reserves — US\$ billion	471	343

Note: 1 Calculated on the basis of purchasing power parity exchanges rates.

Source: Reserve Bank of Australia, *Bulletin*, October 1995.

At the ASEM Finance Ministers meeting in Bangkok on 19 September 1997, Japan proposed an Asian Monetary Fund to prevent the recurrence of the

Asian currency crisis and to institutionalise financial cooperation among the countries within the region. The Japanese proposal on Asian Monetary Fund (AMF) originally will play a role as a 'regional lender of last resort'. America opposed the concept because the US and the IMF viewed the fund as a move to evade the strict conditions that go hand-in-hand with IMF-dispensed aid. The US was concerned that the AMF might weaken the existing international financial architecture under the IMF. Although the proposal was shot-down by the US, it was never entirely discarded and has since got considerable attention. In fact, during the APEC meeting in Vancouver in November 1997, the idea was disguised as the so-called 'APEC Fund' and the role is to supplement the IMF.

While the ASEAN is experiencing difficulties in dealing with the socialist members – non-affected economies – to reach a consensus during the crisis, and with its non-interventionist principal, ASEAN cannot be expected to develop a strong agenda without the involvement of Japan, China and Korea. Meanwhile, cooperation in East Asian countries has improved. In the ASEM meeting, Asian membership coincided with the Mahathir's proposal of EAEC. The Shanghai Executive Meeting of East Asia-Pacific Central Banks (EMEAP), the APEC Finance Ministers meeting in Manila November 1997 and the first East Asian Summit in December 1997 in Kuala Lumpur paved the way for ASEAN+3 cooperation. During the 2nd Informal Meeting of ASEAN+3 Leaders meeting in December 1998, the Chinese delegation called for a meeting of East Asian nations on financial problems at the Finance Vice Minister/Central Bank Vice Governors level. The ASEAN+3 forum on financial affairs exemplified by a meeting of vice ministers and deputy governors of central bank 18 March 1999 in Hanoi, and in conjunction with ASEAN Finance Ministers meeting.

Following the meeting, Vietnam proposed holding a meeting of the finance ministers of the ASEAN+3 nations at the Annual Meeting of the

ADB to be held in Manila in April, and ASEAN Secretariat serving as the meeting secretariat managed to round-up 13 Finance Ministers in Manila. ASEAN has set up a regional surveillance mechanism to provide up-to-date information to identify the early warning signals of impending problems. The 3rd informal Meeting of ASEAN+3 Leaders in Manila in November 1999, issued a joint statement that also covered monetary and financial fields, with a focus on macroeconomic risk management, corporate governance, bolstering banking and financial systems, restructuring the international financial system and strengthening of self-help and support mechanisms in East Asia through the ASEAN+3 framework. In conjunction with the ASEAN Finance Ministers meeting in Brunei in March 2000, finance ministers and central bank governors of the ASEAN+3 again held a meeting of this kind.

They recognized the need to establish a regional financial arrangement that will supplement the existing international system and agreed to study what kind of arrangement would be most suitable for the East Asian region. On April 25 and 26, the ADB and ASEAN Secretariat jointly held workshop on the “Monitoring of Private Capital Flow in ASEAN+3 countries”. The workshop addressed approaches to establish a monitoring framework in East Asia. The 2nd Finance Ministers meeting was held in Chang Mai Thailand, concurrently with the Annual General Meeting of ADB. Delegates discussed economic and financial conditions in the East Asian region and the possibility for cooperation in the monetary and financial area, involving issues such as monitoring capital flow, regional surveillance, self-help and support mechanisms and cooperation towards enhancing human resources. The ministers agreed to strengthen the existing framework for cooperation among the monetary authorities and this agreement was dubbed as the “Chiang Mai Initiatives.” This initiatives includes:

- expanding ASEAN Swap Arrangement that includes all ASEAN-member nations, and;
- establishing a network of bilateral swap arrangements and Repurchase Agreements among ASEAN nations, China, Japan and South Korea.

The network of swap arrangements can be modelled as US dollar repurchase agreement between Japan with South Korea and Malaysia under the New Miyazawa Plan. The Ministers also agreed to study other appropriate mechanism, and the ASEAN Secretariat was asked to lead and coordinate a study other than the Chiang Mai Initiative that could enhance ASEAN+3's ability to provide sufficient and timely financial support in order to secure financial stability in the East Asian region.³

IV. The Urgency

A downturn in the US economy could once again trigger a sell-off of Asia's currencies. One of the urgent tasks confronting Asia is to build a regional framework that can respond to, and prevent the recurrence of a currency crisis. National interests can no longer be pursued in isolation, but are dependent on cooperative action in deference to common goods. This involves no loss of sovereignty but rather a pooling of sovereignty, and in the absence of a hegemonic power or a substitute for the dollar, East Asians can do two things: first, the region's central bankers might reconsider their traditional attachment to the dollar. At the same time, Asian governments might join concerned authorities in the region in a lobbying effort to persuade the

³ The first bilateral currency swap agreements under the Chiang Mai initiative is expected to be completed before ASEAN+3 meeting in May 2001. (Jakarta Post, March 31,2001)

United States of the virtues of domestic economic discipline, controlling its budget deficits and increasing savings rates.

Second, East Asian monetary authorities could cooperate with Japan in supporting the US dollar in order to maintain stability of the US dollar *vis-à-vis* their own currencies. Given that Japan suffers greatly from large fluctuations of exchange rates, it might lead to establishing a framework for cooperation to achieve exchange rate stability and promote cooperation in the Asia-Pacific region.

In the Asia-Pacific context, the uncertainty about the future role of the yen has led some countries in East Asia to be more inclined to cooperate in order to avoid the risks from dollar–yen fluctuations. Given the disadvantage of large fluctuation of the yen exchange rate, Japan is now eager to establish a framework for regional cooperation in order to manage exchange rate stability.

With the retreat of US financial power, there is an opportunity for the region to cooperate on an equal footing. The intervention to support the Thai central bank in August 1997 is a significant step forward, which could be taken further in the context of APEC. By choosing to cooperate on various monetary issues, Asia and the Pacific region can have more predictability and certainty in the area of capital flows, and liquidity support, in managing exchange rates among themselves, and in exchanging information among central banks to support these objectives.

ASEAN+3 needs to study the feasibility of establishing an Asian currency and exchange rate system. The ASEM Finance Ministers meeting in Kobe in mid-January 2001 agreed to study exchange rate regimes for emerging markets and developing countries. Japan intends to promote the Asian currency basket system, which would link the currencies of emerging economies to the US dollar, the yen and the Euro. The meeting also established the Kobe Research Project that will engage in studies focusing on

currency stabilization and anti-crisis measures.

The ASEM Finance Ministers meeting will begin the process of intra-regional cooperation, where Asian lack of financial initiatives can be assisted by Europeans who have successfully implemented a common currency, and will share their knowledge and experiences in monetary and financial cooperation. Europe has been expressing concerns regarding dependence on the US dollar and its influence on the movement of regional currency values since the 1970s, and have worked together in strengthening regional financial systems in order to provide protection against speculative attacks and external influences.

Looking back at the history of European Monetary Union, Asian is in the early process of regional monetary cooperation. In light of the financial crisis, finance was also taken out for many decades of community building in Europe. In Asia, the topic of and open dialogue on finance is a new experience, and it is premature to suggest coordination and joint action will ensue. It is only after many more years of dialogues and closely interaction with each other in finance and monetary issues that they can begin to consider in what specific areas they can cooperate, and where they can mutually support each other. Dialogue and exchange of information have intensified and are becoming a regular agenda within regional events. Through the annual ASEM Finance Ministers meetings, Asia can learn from European experience on how to prevent and respond to currency crises.

The framework of cooperation agreed to in the meeting of ASEAN+3 finance ministers is based on strengthening the existing arrangements and differs from the idea of creating new multilateral regional institutions such as the Asian Monetary Fund concept discussed earlier on in the Asian monetary crisis. Asia's economy is now beginning to recover from the currency crisis with strong recoveries, but for economic growth to continue, the importance of policy dialogues and cooperation under ASEAN+3 framework and the momentum will need to be maintained. To restore

confidence, it is necessary to regenerate economic growth and create stability through maintaining sound macroeconomic and financial policies as well as strengthening financial systems. With the current trend of economic recession in the US and the weaker dollar, Asia should formalized financial cooperation by establishing an institution to tackle issues regionally. ASEAN+3 should promote regional financial cooperation by closer consultation to avoid future disturbances.

V. The Relevance

For Asia, a huge proportion of the region's enormous currency reserves — up to 90 per cent in some countries — is denominated in US dollars. Any serious weakening of the dollar cuts into Asian savings and increases debt, and there are no easy defenses against the fall-out from the dollar's decline. Many Asian governments now borrow more money directly from Japan. Also, many companies in Asia have debts denominated in yen. As the yen has gained strength, payments of interest and principal have become more onerous in terms of the borrower's local currency. It is the relative yen-dollar rates that cause these problems. Countries, which are granted yen loans usually repay them on a yen basis, and with the high-yen and low-dollar trend (*endaka-doruyasu*), such repayments have become a heavier burden than expected.

The Asian debt problem arises from the fact that a relatively high proportion of the total foreign debt of various Asian countries is denominated in yen, while in most cases their exchange rates are managed according to a formula that tracks the currency of their largest single market — the United States.

Theoretically, in order to avoid foreign exchange losses resulting from yen-denominated borrowing, borrowers must hedge their risk by purchasing forward yen contracts. However, this pushes up costs in the longer term. Several countries — and particularly China — have actively placed hedging orders to ensure that their positions would not further decline with a rise in

the yen, as they have effectively bet on the yen's continuing appreciation. However, by buying short on the yen, the Chinese reportedly suffered severe losses from these hedge bets as the dollar surged in 1994 (*AWSJ*, 6–7 January 1995).

Since Japanese loans have about 30-year maturation, it can be argued that yen loans are not easily hedged. There are no Japanese government bonds or yen-denominated instruments, which mature over such a long period. Hedging and rollover are also costly. Further, because of complicated regulations on Japanese bonds, such bonds do not satisfy the Asian central banks' requirements.

In this case, therefore, borrowers can either face a large exchange-rate risk, by exchanging their own currency for yen to meet the continuing stream of interest payments and eventual principal repayment, or they can seek yen-denominated receipts, in the form of exports to Japan, to raise the necessary yen amounts.

The burden of repaying these loans has been mounting inexorably, even though many of them are on concessional terms and despite the fact that on a cash-flow basis, many of the borrowing countries have been kept solvent by large inflows of direct foreign investment from Japan.

Debt management in terms of the yen is not always easy. The long-term solution to Asian countries' debt problem is for them to build up larger yen holdings in their foreign exchange reserves, which they can be expected to do as the level of their trade with Japan increases. It also very much depends on the Japanese position on the use of yen in international trade financing. The next section will discuss the implications of yen appreciation on foreign exchange reserves.

As Asian countries are believed to have altered their basket currency mix, and other central banks are also thought to be quietly moving to reduce their dollar balances, it is natural for central banks to want to preserve the value of their reserves by adjusting their portfolios according to currency fluctuations. Such moves could reflect a change in investment strategy, as

central banks switch their emphasis gradually to other units such as the mark and the yen, and even smaller but more stable currencies such as the Singapore dollar.

The lack of short-term markets — the absence of a secondary market in yen Treasury bills — has, however, discouraged Asian central banks from holding a higher proportion of their reserves in yen.

VI. Questioning Japan's Leadership

Disappointment with the lack of initiatives from Japan during the early part of the crisis, Asian leaders had questioned where the leadership was when it was needed before it escalated into a full-scale crisis. Unlike the U.S. intervention in the 1995 peso crisis in Mexico for example, Japan should have known how the situation could have been better handled. Japan did attempt to take the initiative by introducing standing facility known as the Asian Monetary Fund.⁴ But Japan withdrew the proposal after objections from the United States, which apparently feared that Japanese-proposed Asian institution acting independently of the IMF could undermine U.S. leverage in the region. While the U.S. opposed the proposal, Asia could compromise the "conditionality" principle of IMF assistance, they were still considered IMF conditional ties (for aid) to be either extremely harsh or ill designed.

Japan proved incapable of bringing the depreciation of the yen to a halt until the summer of 1998, which hampered Asian nations' efforts to increase their exports. Asian leaders even suspected that Japan was trying to pursue an export-oriented recovery of its own at the expense of Asia. Japan was struggling with its own financial crisis, triggered by the

⁴ It was intended to serve as an Asian version of the International Monetary Fund and supply trade finance and balance of payments funds to crisis-hit Asian economies, while also acting as a pooled reserve to defend under-pressure currencies.

November 1997 collapses of the Hokkaido Takushoku Bank and Yamaichi Securities. In July of that year, Prime Minister Ryutaro Hashimoto was forced to step down after his Liberal Democratic Party suffered a humiliating defeat in the Upper House election as voters displayed their discontent with the economic slump. The yen would have risen if the Bank of Japan had raised its discount rate, but tightening monetary policy at that point would have been simply impossible. Things would not have been substantially different if Japan's AMF proposal had been implemented. True, the IMF made a mistake in its initial diagnosis of the crisis, but it should not be held entirely to blame because nobody grasped the realities. The question is whether the cause of the crisis is correctly understood, and whether simply creating a new institution will solve the problem.

The recent weakening of the US economy sent a second warning to the Asian countries and concern was raised over the reoccurrence of another financial crisis. The impact on the currency values of Asia and the prospect of economic recovery is again haunting the policy makers and private sectors in Asia.

Meanwhile, efforts to forge regional economic agreements to strengthen trade and financial links among neighboring countries have proliferated, but it will take sometime to see the results. There has been a noticeable preferential trading arrangements to promote regional economic integration in East Asia, despite continuing reliance on non-discriminatory economic liberalization as main policy strategy. But trade integration or a free trade area is not the same as cooperation in financial or currency area.

Intra-regional trade and capital flows within East Asia have increased, but have not been accompanied by the development of regional financial markets. Japan as the center of regional development and can influence the direction of regional economy did not do much during Asian financial crisis.

VII. Searching for Optimum Exchange Rate Policies for Asia

In formulating exchange rate policies, Asian countries have focused on the bilateral rates between local currencies and the US dollar, a reflection of the scale of continuing trade and economic relations with the United States. For a developing country such as Indonesia, pegging its currency to a devalued dollar may stimulate demand for exports.

Table 2: Exchange Rate Arrangements in East Asian Countries

	A peg to		Managed floating	Independently floating
Country (Currency)	The US dollar	A composite currency		
Korea (Won)			MAR (closely linked to the US\$)	
Singapore (S\$)			Monitor (trade-weighted basket)	
Hong Kong (HK\$)	✓			
Malaysia (Ringgit)			Monitor (trade-weighted basket)	
Thailand (Baht)		Trade-weighted basket		
Indonesia (Rupiah)			A basket of weighted currencies	
Philippines (Peso)				✓
China (Renminbi)			(Closely linked to the US dollar)	
Australia (A\$)				✓
New Zealand (NZ\$)				✓
Taiwan (NT\$)				✓

Source: IMF, Exchange Arrangements and Exchange Restrictions, 1995. For Taiwan, *Asian Economy 1995*, Economic Planning Agency. IMF International Financial Statistics, 1996

Asian currencies are basically determined on the basis of demand and supply conditions in the exchange market, although most countries try to stabilize their currencies *vis-à-vis* the US dollar or a basket of major trading partners' currencies. In most countries, the US dollar is the sole intervention currency (see Table 2). In the discussion following, information

is drawn from IMF sources and some publications from the region's central banks.

Korea: In March 1990, Korea moved from a multi-currency basket peg system (MCBP) to a market average rate system (MAR), so as to give market forces a greater role in the determination of exchange rates, and to prepare for the internationalization of the foreign exchange market in Korea. Under the MCBP system, introduced in 1980, the exchange rate of the Korean won against the US dollar was determined as the weighted average of two basket rates — an SDR basket and a trade-weighted basket — with the additional influence of an adjustment factor determined by the Bank of Korea, the central bank. Since the introduction of a market average rate (MAR) system, the Korean won–US dollar exchange rate in the interbank market is ± 0.5 percent against the MAR during each business day (Frankel, 1989). The exchange rates of the won against currencies other than the US dollar are determined in relation to the exchange rate of the US dollar against these currencies in the international market.

Singapore: The Monetary Authority of Singapore (MAS) monitors the external value of the Singapore dollar against an undisclosed trade-weighted basket of currencies, with the objective of maintaining a low and stable domestic inflation rate. The authorities explicitly control the inflation rate by letting the exchange rate appreciate. Rates for other currencies are available throughout the working day, and are based on their cross rates against the US dollar in international markets. Singapore has given a much heavier weighting to the yen than the US dollar in its currency basket since the late 1980s, although it is also heavily dependent on the US market (*FEER*, 11 Oct, 1990). Debate is intensifying in Singapore about the approach that country should adopt in the future: whether to attempt to maintain export competitiveness by keeping the Singapore dollar linked to the US dollar, or whether to focus on holding down inflation by letting the local currency float

more freely.

Hong Kong: Hong Kong shifted to peg to the dollar in October 1983 from a floating exchange rate in operation since 1974. Hong Kong's peg to the dollar was based on political considerations (Goto and Hamada, 1994). The US dollar peg will remain politically and economically important after June 1997.

Malaysia: Bank Negara Malaysia, the central bank of Malaysia, intervenes only to avoid excessive fluctuations in the value of the ringgit, which is fully convertible in relation to a basket of currencies weighted in terms of Malaysia's major trading partners and the currencies of settlement, with the Japanese yen, Singapore dollar and US dollar accounting for the heaviest weighting. Rates for all other currencies are determined on the basis of the ringgit-dollar rate and the US dollar rates for those currencies in markets abroad. Malaysia had tied its currency more closely to the yen in 1987, and has encouraged the denomination of more of its trade in yen (*FEER*, 11 October, 1990).

Thailand: Thailand's exchange rate system has been relatively stable over the course of the country's development. The baht peg to the US dollar was removed in 1984 and replaced by a system of pegging against a basket of currencies. The Thai government does not publicize the make-up of its basket or the formula underlying the basket, but it is made up predominantly of the currencies of Thailand's major trading partners: US dollars, yen, deutschmarks, a lesser amount of sterling, and other European and other East Asian currencies. The baht basket was not specifically trade-weighted but more formally fixed. Absolute levels affect its composition in each currency, by the magnitude of changes in the currencies, and to some extent by other subjective influences. For instance, during January 1995, when the dollar was weakening against the yen, it appears that the basket was under-adjusted as the dollar depreciated. After the heavy speculation against the baht in early 1997, the baht was 'floated' in

July 1997 and substantially devalued.

Indonesia: Since November 1978, the exchange value of the rupiah has been determined by Bank of Indonesia under a managed float against a trade-weighted basket of foreign currencies. The exact composition of the basket is not made public, but the US dollar has a significant weighting. The US dollar is the intervention currency. Exchange rates for certain other currencies are determined on the basis of rates in the bourse for the US dollar and rates for the currencies concerned in international markets. As a matter of policy, Indonesia's currency is maintained at a semi-fixed 'real' exchange rate relative to the US dollar. In other words, the nominal exchange rate is allowed to depreciate in line with the approximate difference between US and Indonesian inflation rates.

China: A system of dual exchange rates prevailed until the beginning of 1994. Monetary policy in China was a hostage of government fiscal policy; the official rate was merely a policy instrument for promoting trade. As a result, the renminbi was devalued several times. In January 1994, the official rate was adjusted to the market rate. Before that, both the official rate and the market rate were used, and the official exchange rate was adjusted according to movements in the value of a basket of international currencies. The central bank now quotes the midpoint rate against the US dollar, based on the previous day's prevailing rate in the interbank foreign exchange rates. The determination to change the People's Bank of China (PBoC) into an independent central bank led the government to promise to make the renminbi (yuan) fully convertible before 2000.

The Philippines: The peso exchange rate is now determined by supply and demand in the foreign exchange market. However, whenever the exchange rate deviates 1.5 per cent in either direction from the previous closing rate, the Bankers Association of the Philippines stops trading for two hours. During those two hours, the central bank assesses the situation and can choose to intervene. Trading normally resumes two hours after the

cessation of trading activities. The authorities intervene when necessary to maintain orderly conditions in the exchange market, and in the light of other policy objectives in the medium term. The Philippine peso has no formal links with other currencies, but in practice it has been pegged to the US dollar (*FEER*, 11 October, 1990).

Taiwan: IMF data does not include Taiwan, as the country is not a member of the IMF. Up until 1990, the exchange rate between the NT dollar and foreign currencies was determined daily by nine major authorized foreign exchange banks, on the basis of the weighted average rate of inter-bank transactions on the previous day. Since 1990, each authorized Taiwanese bank has been free to set its own buying and selling levels. The NT dollar is non-convertible. It cannot be traded outside Taiwan, as foreign institutions are not permitted to trade the currency. Consequently, the NT dollar is a purely domestic currency.

Moreno (1994) considers how exchange rate regime shifts in Taiwan and Korea affected their domestic vulnerability to external shocks. Both countries maintained adjustable pegs to the US dollar for most of the 1970s. In the case of Taiwan, large current account surpluses, together with the liberalisation of international transactions, necessitated a change to a managed float against the dollar in 1979. Korea also allowed its exchange rate to adjust more flexibly by adopting a basket currency peg in the 1980s, followed by a more explicit managed float against the dollar in 1990. The Bank of Korea was able to sterilize almost all of the effects of foreign reserve changes and to achieve its monetary policy goals. According to Kwack (1994), part of this success is attributable to remaining restrictions on capital mobility. Moreno finds that domestic prices in Korea and Taiwan appear to be more insulated from foreign shocks as a result of the choice of greater exchange rate flexibility.

Although most countries in the Asia-Pacific economy have moved towards greater exchange rate flexibility, virtually all central banks in the

region actively intervene in the foreign exchange market. The extent to which a central bank can pursue an exchange rate intervention policy independently of monetary policy depends on its ability to sterilize or offset the effects of international reserve changes on the monetary base.

Glick and Hutchison (1994) analyze the Bank of Japan's (BOJ) intervention policy and its impact on the control of money aggregates over the post-Bretton Woods period. They show that the BOJ has actively intervened in the foreign exchange market over most of the floating-rate period. They find that the degree of sterilization is high in the short run but much lower in the long run.

Since the appreciation of the yen after the Plaza Agreement, there has been a growing discrepancy between the real exchange rate movement of East Asian NIEs and Japan. This was caused by the sharp depreciation of the US dollar against other currencies, such as the yen and the deutschmark, after 1985. On the other hand, the East Asian NIEs maintained either a *de facto* peg to the US dollar, or appreciated significantly less against the US dollar than the yen did, leading to depreciation of the currencies of the NIEs in real terms.

In contrast, for ASEAN countries, stabilizing output would require stimulating production by devaluing the domestic currency when the yen appreciates against the dollar, and revaluing it when the yen depreciates. Kwan (1994) has suggested pegging to a basket of currencies would help to stabilize output.

At this stage, East Asian currencies are unofficially pegged solely to the dollar; none is pegged officially to the yen. But, officially or *de facto*, many link their currencies to a basket of major currencies. Typically, they do not announce the weights they assign to various currencies, or even the currency composition of their baskets, but the US dollar and Japanese yen are clearly weighted more heavily than European currencies. It appears that the most effective policy for East Asian countries is to peg their currencies to

a basket of currencies. Given that it is less likely for countries in the region to peg their currency to the yen, it is difficult to see a yen currency area in the near future.

Park and Park (1991) emphasize that:

Any exchange rate arrangement between small middle-income countries and a large industrial (reserve-currency) country is bound to become asymmetrical. Japan would keep monetary independence and the four East Asian NIEs would peg their currencies to the yen. By pegging to a single currency, floating rates among key currencies destabilize the effective exchange rates and increase the macro-economic effects of external shocks for the East Asian NIEs, as theoretical and empirical evidence on the optimal peg has abundantly shown (Black, 1976). With a peg to the yen, the NIEs would find themselves forced to revalue their currencies against non-yen currencies if the yen appreciated sharply in the foreign exchange market. By pegging to a trade-weighted basket instead, the NIEs can reduce the effect on their international trade of large swings in the value of the currencies in the basket.

The basket pegs

The diversity of exchange rate systems in use among East Asian nations reflects differences in their trade structures, trade and financial liberalization and policy objectives. Pegging to a basket of currencies is the best policy to stabilize against external shocks in East Asia. If East Asian countries were looking to form a currency area, they might try to stabilize the foreign exchange value of their currencies. As shown above, officially only a few of these countries are pegged uniquely to the US dollar, and none is pegged solely to the yen. However, most of them do actually tend to link their currencies to the major foreign currency, the US dollar. This reflects the fact that the US dollar continues to be the primary target currency in the region, and since this role seems to remain unchanged in most countries, the suggestion (Kwan 1994) of the growing importance of the yen as an anchor

currency may be exaggerated.

The composition of the East Asian currency baskets tends to fluctuate with appreciation of the yen or depreciation of the dollar. For example, in mid-1995, the weight given to the yen increased, and that to the US dollar decreased significantly, due to the appreciation of the yen in the first half of 1995. Some countries in the region shifted their weights about 10 per cent in favor of the yen. It is estimated that the Indonesian rupiah basket assigned between 50–60 per cent to the US dollar, 30–40 per cent to the yen, 5–10 per cent to deutschmarks and 0–5 per cent to the Swiss franc and Singapore dollar. Thailand assigned 60–70 per cent to the dollar, and 20–30 per cent to the yen. The weights for Malaysian ringgit are 35–40 per cent for the yen, 30 per cent for the dollar, 15–20 per cent for deutschmark, and 15 per cent for Singapore dollar and Sterling. The weights for the Singapore dollar are 50 per cent for the dollar, 40 per cent for the yen, 10 per cent for the deutschmark and others. For the New Taiwan dollar, the weights are 50 per cent for the dollar, 30 per cent for the yen, and 20 per cent for the deutschemark and Swiss franc.

Fluctuations in the value of the currency to which a particular currency is pegged would matter little so long as most foreign exchange transactions in trade and services (including foreign debt service) were denominated in the pegged currency. This is clearly not the case for the East Asian economy in respect of the yen, nor is it likely to be true in the foreseeable future. There has recently been rapid integration of trade and foreign direct investment in East Asia. Japan is shifting assembly and production bases to the East Asian region at a rapid pace.

Moreover, similar production structures, considerable supply diversification and proven adjustment flexibility reduce the need for swings in the real exchange rates exclusively among Korea, Taiwan and Japan. Some countries are still commodity-dependent (Malaysia and Indonesia), or are dependent on these countries (Singapore), or form a special political case

(Hong Kong). The different trade and economic structures of these countries fail to protect them from divergent swings in real exchange rates in response to external shocks. Hence, there is little scope for monetary integration in East Asia, with or without Japan.

In summary, the optimal exchange rate regime in the region involves a system of managed floating with a degree of intervention that allows the external economy of the East Asian NIEs to serve as the most efficient buffer for the domestic economy (Frankel, 1993). Many countries in East Asia still consider that they are a part of the US dollar bloc, since America still provides a considerably larger market than Japan for Asian goods. In spite of an increase in the trade of these countries with Japan, there is no indication that the yen has gained weight in exchange rate targeting region wide. The Asian countries have, up to now, focused on the bilateral rates between their domestic currencies and the US dollar when formulating exchange rate policies, because of their traditional dependence on the US economy. The dollar's role remains unchanged in most countries, suggesting that any perception of the growing importance of the yen as a target currency (an anchor) may be premature. The US dollar is still the targeted currency, although real currency values against the yen became more stable than against the US dollar in some countries in the 1980s.

VIII. The Yen As Nominal Anchor?

The economic integration in Europe and North America has caused East Asian countries to become concerned about the future of the international market place, encouraging them to explore deeper internal economic transactions within the region. In the process of forming closer regional economic links, financial linkage takes on a growing importance.

Capital is relatively mobile in the region; that is, intra-regional direct

foreign investment and other financial flows have been increasing markedly, and international trade as well as financial transactions have already become quite concentrated in the region.

There is little basis for the yen to become a nominal anchor for Asian countries: as of 1992, inflation rates had not converged, and the commodity composition of output and trade differed greatly between Japan and other East Asian countries. A simultaneous movement of the yen, ringgit, and rupiah would do nothing to assist in adjusting to terms of trade changes, be they of petroleum, agricultural commodities or other goods. Japan still imports significant volumes of primary commodities from Southeast Asian countries and exports manufacture goods to them. If Malaysia, Indonesia or Thailand used the yen as an anchor, those countries would need to achieve a degree of price stability similar to that of Japan, and simultaneously find other mechanisms for adjusting to trade shocks.

There are important developments that warrant a new look at optimal exchange regimes in East Asia. While the growing trade and production integration between East Asian and Japan has turned the earlier *de facto* peg to the US dollar into a destabilizing arrangement, the same pitfalls would hold for a peg to the yen. The yen's appreciation strengthens the linkages between it and other Asian currencies, and a regional currency arrangement could possibly emerge as the outcome. While the majority of newly developing Asian economies has traditionally linked their currencies to the dollar, Japan is now the provider of the bulk of their capital goods and intermediate supplies. The yen's appreciation against the dollar is, therefore, a serious direct threat to their cost structures and overall economic performance.

As these Asian governments seek to minimize the risks involved in the volatility of their respective currencies against the yen, increasingly larger proportions of their fund-raising and investment activities will begin to be conducted directly in yen form. The yen portion of their foreign-exchange

reserves may also increase, and their exchange rate management may become geared to closer links with the yen.

On the other hand, fixed nominal rates have become obsolete for other reasons, namely, the growing capital mobility caused by financial liberalization, and the need for long-term appreciation of real exchange rates in the process of catching up. Assuming that the East Asian will be subject to both foreign monetary and real domestic shocks, there appear to be inexorable pressures towards a managed float as the best policy response.

Deepening economic interchange will require further growth of financial flow. Financial integration has been supported steadily by the emergence of Hong Kong and Singapore as international financial centers for an increasing number of investors and transactions in the East Asian region. Under these circumstances, financial capital from all over the world moves as profitable opportunities arise. Whether the yen and Japanese interest rates are the target of arbitrary transactions by East Asian countries depends on the Japanese financial market and the attractiveness of the yen, including the openness and transparency of the Japanese financial system (De Brouwer, 1996).

The benefits from the formation of a currency area arise from the reduction in transaction costs, uncertainty and monetary discipline. The cost is the absence of conditions necessary for a successful currency area — for example, lack of labor mobility may lead to a long-lasting adjustment process. Criteria for an East Asian currency area do not seem to be being met satisfactorily, since labor is relatively immobile, intra-regional and intra-industrial trade take place to a lesser extent than in the EU, and intra-regional trade does not seem to have intensified particularly relative to trade with other areas since the 1980s. On the other hand, capital is relatively mobile, and intra-regional FDI and other financial flow have been increasing remarkably. International trade is already quite concentrated in the region. Hence, it is likely that further economic development and

deepening economic relationships among East Asian economies will lead to the relevant criteria — factor mobility in the form of capital flows, price flexibility, interdependence and similar economic structure within the region — more likely to be met in the future.

IX. Yen in Asia

Melvin, Ormiston, and Peiers (1994) evaluate the portfolio demand for international currencies and assess the desirability of forming a yen currency area from the point of view of investors in the region. Their portfolio analysis indicates that investors generally prefer the distribution of returns associated with holding assets denominated in US dollars.

Given the nature and characteristics of the political economy of the yen and the dollar in Asia, the prospects for the yen to play a leading role in the future are not promising. A first step is to consider whether East Asia is an optimum currency area and the yen a potential anchor currency. Relevant considerations are: 1) East Asian countries have not been trying to keep the exchange rates of their currencies against the Japanese yen stable; 2) Country-specific real disturbances are strong, that is, changes in real exchange rates which reflect real disturbances show large and persistent fluctuations; 3) The East Asian economies behave asymmetrically, that is, intra-regional macro-economic variables are not highly correlated, especially with the Japanese economy, supposedly the anchor of the system.

Although the value of the US dollar has been declining, it continues to play a role as the intervention and vehicle currency. The yen is still very much a 'local' currency. The use of the yen as an international currency will depend on the liberalization of Japanese financial markets in a manner that makes them comparable with London and New York. It also depends on the willingness of East Asian countries to increase the use of yen as a

transaction and reserve currency.

For a yen to play a larger role, at least three conditions must be met. First, the countries in East Asia need to be sufficiently economically cohesive. Second, Japan must want to organize and lead it. Third, the countries involved must accept being so led. So far, none of those conditions has been met. The question now is to what extent these conditions will develop.

X. Agenda

The need to strengthen regional financial architecture to promote economic stability and sustainable growth in the region has been discussed in many regional forums. Various measures to prevent future financial crisis, and the policy discussion on regional approaches to financial arrangements are now gathering pace.

The discussion has been complex, reflecting many different arguments and motivations. The debate has raised questions of how countries should deal with the inherent instability of financial markets: which exchange rate regime is most suitable; what the optimum degree of financial openness is; and what the connection between trade reform and monetary integration is. From the discussions and debates, we can now set two agendas:

- Financial cooperation in the ASEAN + 3
- Financial cooperation of the ASEAN + 3

The former cooperation will look at the forms and means that entail an analysis of instruments and techniques for financial cooperation. The transparency of these groups and the criteria of eligibility and conditionality, and the relationship between bilateral and multilateral arrangements are all

issues of importance.

Surveillance mechanisms are a necessary part of an economic and financial monitoring system. An assessment of the capital market developments that are needed to allow emerging countries in the region to enjoy full and stable access to international financial markets include questions about the development of regional bond markets, the role of development banks in leading emerging market economies' access to the world markets, and the role of institutional investors, including mutual funds and hedge funds.

Common currency arrangements have been proposed for East Asia. Some in Japan have strongly advocated that some ASEAN countries manage their currencies against a combination of the US dollar, yen and euro. This issue is complex. Before such an arrangement is set up, it is important to have a solid grasp of how exchange rates in the region affect trade, investment, output, inflation, and financial prices and structure. Views are mixed as to the effects of exchange rate volatility, and empirical study on the effects of exchange rate volatility on trade, investment, outputs, financial prices, and business and consumer expectations.

The later type of cooperation is more a strategic implication. East Asian countries wish to improve their leverage over IMF, which they see as dominated by the United States and Europe, and thereby reduce their reliance on the US. Other factors include the strategic benefits to improving China-Japan-Korea relations, Japan's intent to boost its international status and more generally, the assertion of 'new Asian regionalism.'

The discussion has so far focused on the need to improve cooperative financing arrangements in the region. ASEAN + 3 finance ministers will set up a system of currency swaps. Three interrelated areas can be advanced to promote regional financial cooperation. The first is policy dialogue, the second is instruments and institutions for financial cooperation, and the third is common currency arrangements. It is timely to study the optimal

number of groups for successful policy dialogue, and to assess the relative value of the bilateral and multilateral forums.

These are important issues, not only because they deal with economic and financial structures in Asia, but also because they are manifestations of a movement toward greater regional integration and policy coordination.

Taking into account the invaluable experience of the recent crisis, what perspectives and expectations does Asia have as regards financial cooperation and the ideal foreign exchange rate system in Asia as well as the role of Japan, China, the United States and Europe in the region.

How will Japan try to establish the yen as the key currency of Asia? What vision Japan does have of the monetary and financial system in Asia, and what about relations between yen and renminbi?

Three important topics, which are at the core of the current reflection on the reform of the international financial system:

- **The need for reducing volatility of capital flows**
- **The choice of exchange rate regime**
- **The governance of the international monetary and financial system**

First, one of the most effective recipes for countering herd behavior that has been observed in the recent financial turmoil, is full transparency of each particular entity, of each particular country, of each particular borrower. Full and reliable transparency is needed to allow a proper judgment of the merits of each case.

Reducing moral hazard is a crucial condition for lenders and borrowers to be more prudent. Recent crises have emphasized the need to improve the approach of the international community to financial crisis prevention and resolution. In particular, there is a need to provide the private sector with a clear framework indicating that it will bear the consequences of its risk taking decisions.

Second, the first reaction to the financial crisis in Asia viewed that the exchange rate pegs are inherently unstable and that either firm fixing or free floating are

preferable to any intermediate regime. There is no ideal exchange rate regime that can meet the needs for countries that widely differ in terms of economic and financial conditions. An exchange rate regime should be assessed on the basis of its ability to contribute, in the specific circumstances of a given country, to a stable macro-economic environment by supporting an exchange rate level consistent with underlying fundamentals and expectations.

The recent financial crisis have highlighted that macroeconomic discipline alone does not suffice to sustain pegs and thus must be accompanied by sound financial systems, good corporate governance, effective regulation and supervision, as well as greater transparency in monetary and financial policies. Although requirements for sustaining pegs have become very demanding intermediate solutions might still remain a relevant option for a number of countries, notably small open economies with a dominant trading partner that maintains price stability. Anchoring the currency contributes to monetary and financial stability.

Financial cooperation *in* Asia is about the openness of domestic financial systems to the rest of the region *vis-à-vis* the world, while financial cooperation *of* Asia discusses the possibility of emerging financial grouping in the region. This issue should be handled in the proper analysis and approaches. There is a tendency of financial cooperation in Asia to copy the European literature and paradigm, which focused on cooperation and integration *of* Europe. Hence some analysts address issues such as which country dominates the regional monetary and financial system and how monetary integration should be achieved.

In the case of Europe, European countries were aimed at economic convergence; that is common economic growth, inflation and structural features such as budget and debt ratios based on anchoring their economies to that of Germany. In Asia, economic integration is not yet an issue since there is no aim to achieve convergence by structurally aligning and

anchoring economies to Japan or China.

XI. Some Policy Considerations

This paper sets out some reflections on wide ranging issues on financial cooperation in Asian region. One issue that emerged is whether there is “another financial crisis in Asia” as the US economy start to show indication of declining in to recession. This implies a cooperation to anticipate markets ‘herd behavior’ or mad market disease and irrational behavior of speculators. Some official direction can stabilize markets and prevent price bubbles.

It is important that policy makers do not sacrifice domestic stability for what may only be temporary international stability. The responsibility of national governments – and not regional or international institutions – need to ensure that standards and risk-assessment systems are in place in financial institutions. For example, the bad debts and credit control are main problems for banking systems in number countries. This is something that cannot be solved by regional institutions but by supervisory authorities and the banks of the countries concerned. In this situation, bailout is not always the answer. Institutions and investors enter the markets knowing the risk and expect higher returns. The discipline of the market should work both ways – to discipline governments and pressure them to institute sound, sustainable policy, and to discipline markets and force them to play by the rules of the risk-return tradeoff.

That said, domestic and regional financial crises do occur and governments need to have systems to deal with them. Technological advances and the internationalization of banking and finance have meant that the response of markets to events is faster, and the response of policy needs to be faster also. The development of emergency funding lines between central banks in Asia is move along this line. With the prospect that a crisis

in one country will spread to others, cooperation may be necessary, even if the crisis is the 'fault' of the country.

Internationalization of finance and banking mean that standards, risk-assessment systems and regulations should be standardized as much as possible, so that institutions can work on a level of playing field and can be prevented from creating and exploiting loopholes in supervision that may exist between jurisdictions.

The dilemma Asian countries faced in 1997 is largely of their own making: it originated from the bubble-burst resulting from economic recession, a series of corporate bankruptcies, mounting bad loans in financial institutions, blundering economic policies, over-capacities, cronyism and many more besides. There were also external factors as most Asian countries adopted dollar-linked foreign exchange rate system. To prevent the recurrence of currency crisis in Asia, Asian countries have not only continue dealing with economic restructuring, but also prepare a system to ease fluctuation of foreign exchange rate and fend off speculative capital outflow. Asian countries must dedicate to create currency stabilization system in the region, then co-implement economic policies and seek common benefits in the region.

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