Part III

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Financial Liberalisation and Integration in East Asia

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A number of studies on the European economic integration process have shown that an expansion of trade among a group of countries over time could lead to synchronisation of business cycles across the members of the group.[1] Synchronisation of business cycles would be more pronounced, if intra-industry trade accounts for most trade. This finding suggests that regional trade integration within similar industries could then develop conditions favourable for establishing a common currency area for the regional trading partners. A similar development has taken place in East Asia, where the ongoing trade liberalisation has contributed to a substantial increase in intra-regional trade, raising expectations that the recent movement toward free trade would generate market pressures for policy coordination for stable exchange rates of regional currencies and eventually for adopting a common currency for the region.

With the spread of the liberal ideology of the Washington Consensus, many countries in East Asia, in particular more advanced ones including Thailand, Indonesia, and Malaysia, have been reducing restrictions on capital account transactions and barriers to entry of foreign financial institutions into local markets and to trade in financial services since the early 1990s (Eichengreen and Mussa 1998). After the 1997-98 crisis, the speed and scope of penetration of foreign financial institutions, except for Malaysia, has increased in

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1 See, for example, Rose and Frankel (1998).

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East Asia.[2] In removing restrictions on entry, these East Asian countries have been motivated by their desire to build efficient and stable financial systems befitting an open foreign trade and investment regime that are resilient enough to forestall future crises. According to the IMF (2000), the removal of entry restrictions have also been triggered by the need to help reduce the costs of restructuring and recapitalising banks following a major crisis (p.158). If indeed this was one of their objectives of liberalisation, it appears few of the crisis countries in East Asia have succeeded in this regard.

In view of the thrust of financial liberalisation that has been directed to market opening since the 1997-98 crisis, one would presume that greater capital mobility through capital account liberalisation and opening of financial services industries may have tightened financial linkages between individual countries, thereby promoting the creation of integrated regional financial markets in East Asia.

The purpose of this chapter is to analyse East Asia's experiences with financial liberalisation and innovation with a view to assessing the extent to which liberal financial policies have contributed to economic integration in East Asia. Section 1 discusses some of the reasons why financially integrated countries would be more disposed to joining a common currency area. Section 2 analyses the progress East Asian countries have made in liberalising and opening their financial markets. It will be shown that when financial markets are liberalised and open, countries with different structural characteristics or asynchronous business cycles would have more incentives to integrate with one another than countries with similar characteristics have. This leads to the conclusion that the ongoing capital account liberalisation is likely to develop closer ties between East Asian and global financial markets (globalisation), rather than between the markets of individual countries in the region. Section 3 then examines empirically whether East Asian countries have gravitated to regional or global integration. Our conclusion is that East Asian countries have developed stronger financial ties with advanced countries than with one another in the process of financial

[2] The IMF (2000) argues, however, that the degree of foreign participation in domestic financial markets has been lower than originally expected in Korea and Taiwan.

opening. Section 4 provides some of the reasons for East Asia's global financial linkages, one of them being penetration by western financial institutions of East Asian financial markets. Section 5 analyses causes of the dominance of western financial institutions in East Asia. This is followed in Section 6 by a discussion of future prospects for regional integration in East Asia. Concluding remarks are in a final section.

1 Financial Market Integration and Common Currency Area

Benefits of Financial Liberalisation

Trade liberalisation is likely to result in more closely correlated business cycles across countries, especially if the liberalisation promotes trade within similar industries. Therefore, countries that establish close economic ties through trade liberalisation are likely to be members of a common currency area in the sense that the similar business cycles make it easier for them to accommodate a common monetary policy regime.

There is general consensus that economic liberalisation in emerging market economies should begin with trade liberalisation, to be followed by deregulation of domestic financial markets, before lifting restrictions on capital account transactions and on entry of foreign financial institutions. This sequencing strategy suggests that countries would go through the process of financial market integration before adopting a common currency: that is, creation of a common currency area would take place at the last stage of full economic integration in any region or a group of countries.

However, there is no theory predicting that liberalisation of the trade regime would subsequently produce market pressure for liberalisation of financial markets and capital account transactions to follow. Indeed, East Asian countries started lowering tariffs and non-tariff barriers long before taking steps to liberalise and open their financial markets. Furthermore, the sequencing strategy does not explain whether financial deregulation and opening among a group of countries such as the ASEAN+3 will also pave the way for financial and monetary integration within the group. As will be shown below, countries that establish close financial linkages through financial market liberalisation would benefit from joining a common currency

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area. However, these financially integrated countries do not necessarily satisfy the traditional criteria for potential candidates of a common currency area.

Financial market deregulation and opening facilitate migration of real capital in the long run and cross-border financing of current account imbalances in the short run, thereby reducing the costs of adjustment to shocks to demand and supply. Financial liberalisation also allows extensive sharing of the risks associated with macroeconomic shocks across countries, as it broadens the range of portfolio diversification by including foreign bonds and equities in individual portfolios. It follows then that the countries with close financial ties would benefit more from financial liberalisation by forming a common currency area among them, as monetary integration lowers costs of financial transactions and eliminates exchange rate risks. However, the financially integrated countries are likely to be heterogeneous in terms of their economic structures and exposed to asymmetrical shocks. One important implication of financial liberalisation and integration is that contrary to the traditional argument, heterogeneous countries are as well qualified as potential candidates for a common currency area as countries are.

Capital Mobility and External Financing

An increase in capital mobility (factor migration in general) between countries could relieve a country's external deficit as well as unemployment that reflect its internal imbalance. An adverse demand or supply shock to a given industry of a country may require shifts in labour and capital to other industries. After all adjustments have been made within the country including a fall in factor prices, some factors of production are likely to remain unemployed. In this case, capital account liberalisation facilitates migration of capital to other countries, thereby mitigating the burden of adjustment through changes in factor prices and employment. That is, real capital mobility can be a partial substitute for price-wage flexibility.[3]

[3] Financial market liberalisation and opening facilitate real capital mobility as it increases the availability of external financing for trade in both used and new capital goods. Some of the firms in a country that sustains a demand or supply shock may move their production facilities such as machines and equipment to other countries. Alternatively, some of the investment planned by these firms may

However, in the short run, real capital mobility is low and as a result only in the long run could ease difficulties of adjustment to demand and supply shocks. In the absence of price and wage flexibility, an adverse supply shock such as an oil price increase may result in a deficit on the current account in addition to both an increase in unemployment and decrease in factor prices. Countries with an open financial regime have better access to both regional and global capital markets, so that it would be easier and less costly for them to borrow to finance their current account deficits. External borrowing could make the real adjustment smaller or unnecessary if the deficit is transitory and hence reversible.[4]

Risk Sharing Through International Portfolio Diversification

With financial market opening, domestic residents can diversify their portfolios in terms of assets issued by firms and financial institutions of other countries in addition to domestic ones. This possibility of enhancing portfolio diversification across a large array of assets means that a country suffering an adverse terms of trade shock could share some of the loss with other countries to the extent that it holds claims on their output. The amount of the loss that could be shared would increase, if this country holds diversified portfolios of bonds and equities of those countries with different structural characteristics, that is, with lower business cycle correlations of macroeconomic variables.

The presence of currency risk under free floating, however, increases the cost of international portfolio diversification in terms of foreign securities: free floating would inhibit countries from cross-holding of securities, thereby bottling up the cost of the shock in the country in which the shock originated.

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be relocated in other countries in the form of foreign direct investment as a result of the adverse shock, a possibility that is rather limited in a controlled capital account regime.

[4] If the deficit reflects changes in economic fundamentals instead, external borrowing would simply mask the imbalances that require real sector adjustments.

Does Homogeneity Really Matter for a Common Currency Area?

Financial liberalisation and integration may call in question some of the criteria for a successful common currency area focusing on similarity of business cycles. In contrast to the earlier literature, the benefits of financial liberalisation imply that countries with asymmetric shocks and dissimilar structural characteristics may find it easier to integrate financially with one another and can be potential candidates for a common currency area.

Mundell (1973) showed, contradicting his earlier argument, that reserve pooling and international portfolio diversification could mitigate asymmetric shocks, because a country suffering an adverse shock could minimise its loss by drawing down on its claims on or borrowing from other countries in the common currency area. Portfolio diversification for risk sharing could then be better served by establishing a common currency area that includes a large number of structurally heterogeneous countries.[5]

To elaborate further on this point, consider a group of economies in which business cycles are synchronised across countries. The traditional argument is that the member countries in such a group may readily yield their monetary independence to a supranational authority, because they are likely to pursue a similar monetary policy. However, once financial integration is taken into consideration, synchronisation of business cycles may no longer be a critical criterion for identifying potential common currency area candidates, as the following example illustrates.

Suppose the group of countries with symmetric shocks is hit by an adverse shock such as an oil price increase. Because of the similarity of their economic structures, all of the countries in the group will suffer from the shock with the consequence of a group-wide slowdown. This group-wide slump then leads to a decrease in intra-group trade, which in turn aggravates further the downturn in each country. That is, the slump in one country amplifies output contraction in other countries through the trade channel.[6] Since all of the member countries suffer from the same shock, they cannot

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[5] For a recent analysis on risk sharing through international portfolio diversification, see McKinnon (2001).

[6] The effects of the supply shock in one country could be much more contagious to other countries when they are more homogeneous (Park and Song, 2001).

supplement their output and income losses by liquidating their claims on the other countries. Under these circumstances, there is also little room for capital to move between countries.

Most of the countries in the group may also experience deterioration in their current accounts. As a result, the deficit countries may find it difficult to borrow from the other countries in the group. For the group as a whole, the deficit financing to be secured from outside of the group would be larger and hence more costly. This example therefore implies that the impact of the shock would, other things being equal, be much less severe and hence more manageable, if the members of the group have different structural characteristics. That is, heterogeneity of the members of a common currency area could reduce the burden of adjustment to external shocks because it increases the scope of factor mobility and also eases financing of current account deficits from the countries unaffected by the shock. The risk sharing through asset diversification also suggests that countries with similar economic structures would not gain from joining a common currency area. This is because the adverse supply shock is likely to impinge on most of the firms in the group, and thus market values of securities issued by them will fall at the same time.

From the point of view of portfolio diversification in a liberalised and open financial environment, larger currency unions with more heterogeneous countries are likely to be more successful than smaller ones with homogeneous members: as far as financial integration is concerned, countries with asynchronous macroeconomic shocks would make better candidates for a common currency area. In searching for potential partners for a common currency area, therefore, emerging market economies would prefer tying themselves up with advanced countries whose bonds and equities are relatively more secure and carry high rates of return adjusted for default and liquidity risks, such as US Treasury bonds. That is, globalisation may be a better strategy than regionalisation including forming a common currency area for a large number of small countries: dollarisation, or euroisation, may make more sense to many emerging market economies than forming a currency union among them.

In a recent paper, Heathcote and Perri (2002) argue that the decline in the correlations of output, investment, employment, and consumption between the United States and the rest of the world comprising Europe, Japan, and Canada between the two post-

Bretton Wood periods they observe (1972-86 and 1986-2000) could in part be explained by a decrease in the correlation of exogenous shocks, but also by financial globalisation. The emergence of global financial markets increases opportunities for inter-temporal specialisation in production that, in turn, contributes to lowering the correlation of factor supplies as the globalisation increases the scope of international portfolio diversification.

In terms of an infinite horizon model, Heathcote and Perri (2002) demonstrate that a decline in the correlation of shocks leads to greater international portfolio diversification, which then further reduces international correlations of macroeconomic variables. Calibrating the model, the authors also show that a combination of the decline in the shock correlation and the resulting endogenous growth in international trade in financial assets, jointly accounts for most of the observed decline in the correlation of international business cycles during the post-Bretton Wood period between the United States and the rest of the industrial countries.

One of the implications of the analysis of Heathcote and Perri (2002) is that capital account liberalisation – an exogenous development – could reduce the business cycle correlation of output, investment, and employment in East Asia, if it has not already. Another implication is that growing similarity of business cycles among the East Asian countries through trade expansion may encourage global diversification of portfolios including assets issued by corporations and financial institutions of advanced countries and hence integration of East Asian financial markets into global financial markets.

How significant are then the benefits associated with financial market opening such as the international risk sharing quantitatively? There are few empirical studies that shed light on this question. The well-known home bias in asset holding suggests that the benefit would not be as large as the theory would predict. Despite the ongoing financial liberalisation stretching over more than two decades, the increase in international diversification in assets, in particular bonds, across countries has been relatively small. McKinnon (2002) points to the principal-agent problem as the main cause of limited global portfolio diversification.

In a recent study, however, Park and Bea (2002) present empirical evidence that since the early 1990s most East Asian countries embarked on deregulation of capital account transactions and entry

of foreign financial institutions. East Asian capital markets have been integrating into global financial markets rather than forging clear linkages with one another. This development has become more pronounced after the 1997-98 financial crisis.

2 Financial Liberalisation and Integration in East Asia

Liberalisation

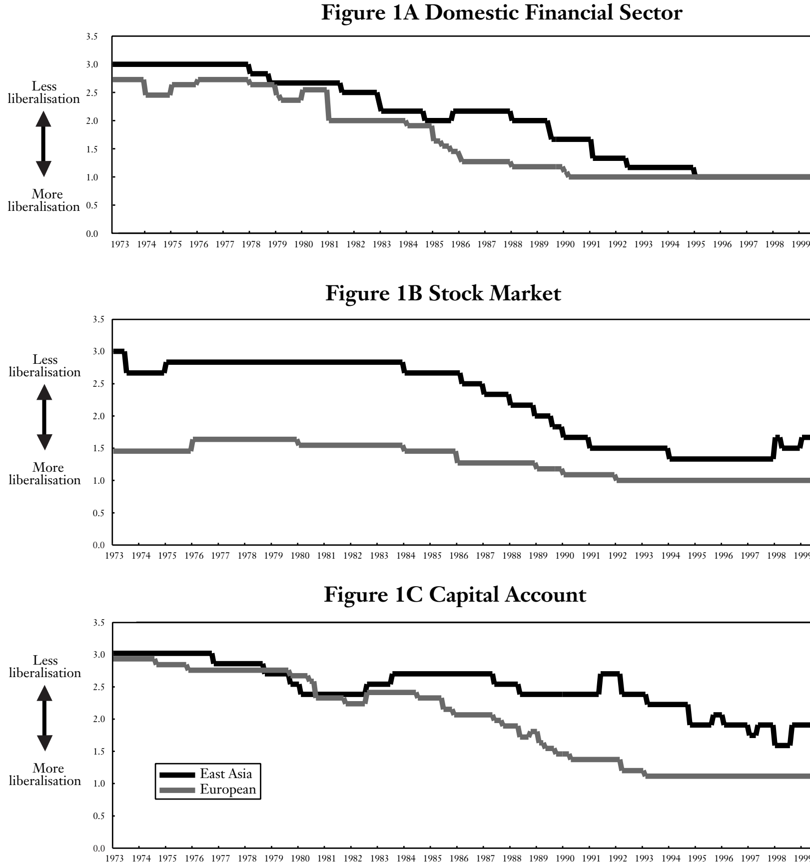
Financial liberalisation often refers to: (i) domestic financial market deregulation such as decontrol of the interest rate; (ii) removal of restrictions on capital account transactions that will increase mobility of capital between countries; and (iii) opening of the financial services industry to foreign competition. In a recent paper, Kaminsky and Schmukler (2002) devise a monthly index for overall financial liberalisation, which jointly evaluates the liberalisation of the capital account, the stock market, and the domestic financial sector. The index takes values between 1 and 3: fully liberalised (1), partially liberalised (2), and repressed (3). To measure the extent of financial liberalisation, the authors track the evolution of the regulatory regime covering all three sectors over the 1973-99 period. The East Asian countries covered in their study include: Hong Kong, Indonesia, Malaysia, the Philippines, Korea, Taiwan, and Thailand.

As shown in Figures 1A-1C, the indices for the East Asian countries show that they made considerable progress in deregulating their domestic financial sectors and the stock market, but only partially in liberalising capital account transactions. By 1995, compared to the nine sample European countries, the seven East Asian economies achieved on average the same level of domestic financial sector liberalisation. As for the stock market, the sample East Asian countries were slow in market deregulation, reaching the European level of liberalisation in the mid-1980s, and the same is true for capital account deregulation.

Financial Integration

From the perspective of this study, the usefulness of the indices of the degree of overall financial liberalisation and capital account liberalisation is rather limited in that these measures by themselves

Figure 1 Indices of Financial Liberalisation by Sector



Notes:
Liberalisation index: 3 = high restrictions, 2 = partial liberalisation, and 1 = full liberalisation.
European countries include: Denmark, Finland, France, Germany, Ireland, Italy, Portugal, Spain, Sweden.
East Asian emerging market economies include: Hong Kong, Indonesia, Korea, Malaysia, the Philippines, Taiwan, and Thailand.
Source: Kaminsky and Schmukler (2002).

do not indicate whether capital account deregulation has been associated with financial integration at the regional level in East Asia or at the global level. One of the conclusions of the preceding section is that financial liberalisation in East Asian countries would steer in the direction of developing closer financial linkages between East

Asian and global financial markets rather than similar linkages among financial markets of individual countries in the region. This and the following two sections are devoted to an empirical examination of this hypothesis.

Before turning to this issue, conceptual clarification of regional versus global financial integration in the East Asian context may be in order. Suppose that financial markets of individual East Asian countries are being integrated into global financial markets as a result of financial liberalisation. Does this development not bring about the concomitant financial integration in the region? In our view it does not, in the sense that financial market liberalisation in individual countries may not support the development of regionally integrated financial markets where financial instruments denominated in regional currencies are traded; in fact, it is likely to encourage and expand financial transactions between these countries through global financial markets located in New York and London. In a graphic sense, New York and London are the financial hub whereas individual financial markets of East Asia are spokes.

In order to determine the direction of financial integration in East Asia (regional vs. global), we present three types of evidence:

1. Capital flows within East Asia and between East Asia and other regions, to examine the extent to which East Asian portfolios have been globally diversified (this section);
2. Decomposition of error variances of stock returns and interest rates in both East Asia and Europe, to gauge the relative significance of global capital markets in influencing stock prices and interest rates in East Asia (Section 3); and
3. The degree of commercial presence of foreign financial institutions in East Asia, as a measure of globalisation of East Asian financial markets (Section 4).

Intra-Regional Capital Movements in East Asia

For a measure of regional integration in East Asia, one would need information on intra-regional capital flows in East Asia relative to inter-regional flows between East Asia and the rest of the world. Reliable data on intra- or inter-regional capital flows are not available. As East Asia is defined to include the ASEAN members, Taiwan, Hong Kong, China, Korea, and Japan, it has always been a net saver to the rest of the world. This balance of payment

characteristic, together with underdevelopment of financial markets, which we discuss in Section 5, suggests that the level of financial transactions, including bank lending and trade in regional securities, between different countries in East Asia is likely to have been relatively small, in particular when Japanese bank lending to and direct investment in other East Asian countries are excluded.

Furthermore, since the outbreak of the 1997-98 crisis, Japanese bank lending and FDI to other East Asian countries have fallen dramatically (see Table 2 and 3; all tables are at the end of this chapter). Korea's and Taiwan's FDIs in other East Asian countries also decreased sharply (see Table 4 and 5). Singapore's FDI data are rather sketchy, but its FDI in Malaysia and Indonesia declined during the post-crisis period from 1997 to 1999 (see Table 6). As a result, it would be reasonable to assume that intra-regional financial flows in East Asia have been smaller than inter-regional flows between East Asia on the one hand and North America and Europe on the other. This feature of inter-regional capital movements has become more visible with the increase in current account surpluses of Indonesia, Malaysia, Korea, and Thailand (see Table 1) and provides a piece of indirect evidence that East Asian countries have forged tighter financial links with North America and Europe than with their neighbouring economies in the process of financial liberalisation.

Throughout the 1980s and until the mid-1990s the ASEAN members and Korea were net borrowers, as they were running deficits on their current accounts. China, Taiwan, and Japan were, on the other hand, accumulating huge amounts of current account surpluses, which made East Asia as a whole a net lender financing the bulk of current account deficits of the US and the rest of the world. External financing for East Asia's deficit countries therefore ultimately came from the three East Asian surplus countries (on a net basis). However, the East Asian deficit countries borrowed in part from regional but mostly from global financial markets to finance their current account imbalances. This pattern of external financing established East Asian linkages with global financial markets well before the region went on to liberalise and open its financial markets.

Since the 1997 crisis, all four East Asian crisis countries have generated large surpluses on their current accounts and are likely to continue to do so for the next several years (see Table 1). Together with China, Taiwan and Japan, East Asia as a whole has become a larger net saver of the global economy than before. Current account

surpluses have been added to foreign reserve holdings of these countries. In managing their reserve portfolios, the East Asian countries have traditionally preferred liquid and safe foreign securities such as US Treasury bills in addition to holding major international currencies.

However, some of these countries have in recent years sought to diversify their reserve portfolios by adding short-term European government bonds and even private bonds and equities. And the growing surplus position in recent years has increased opportunities for diversification of foreign reserves in East Asia through the international financial hub in New York and London. This increase is likely to have contributed to East Asia's tighter financial links with developed countries. It is also reasonable to assume that East Asian savers have been placing an increasing share of their savings in bonds and equities issued by western corporations and financial institutions in diversifying their portfolios.

3 Decomposition of Error Variances

The Model and the Data

Given the extent to which the East Asian countries have managed to liberalise their capital account transactions in recent years, one might expect that financial markets of these economies may have become more closely linked with one another than in the past. However, the available empirical evidence does not support this expectation. Regionally integrated financial markets are yet to emerge and prospects for further financial liberalisation in East Asia are not promising (Park and Song 2001).[7]

[7] A World Bank study (1997) uses three different measures to determine the extent to which countries are financially integrated. In constructing an overall index of integration the World Bank study uses the access to international financial markets, the ability to attract private external financing, and the level of diversification of financing in terms of the composition of financial flows. The same study shows that changes in the degree of financial integration between 1992-94 were high in Indonesia, Korea, Malaysia, Philippines, and Thailand, but it does not examine whether these countries were more integrated financially with one another than before.

The Model

In a given region, financial liberalisation and market opening would, other things being equal, lead to an increase in cross-border banking and securities transactions between the countries of the region as well as those between the region and the rest of the world. According to our discussion in Section 1, with deepening financial liberalisation, financial prices in East Asia would react more sharply to shocks originating in the global rather than regional markets. In order to examine whether the financial data of East Asia and Europe bear out this prediction, this section analyses the extent to which financial prices such as the interest rate and stock return are influenced by shocks that are global, regional, or country specific in the two regions.

For this purpose, changes in the interest rate and stock return of each country in East Asia and Europe are decomposed into three components: a world-common, a region-common, and a country-specific component. The world-common component is a factor that affects changes in the financial variables of all countries in both regions; a region-common factor influences only the countries belonging to either region; and the effect of the country-specific factor is restricted to a country in question. The decomposition is carried out in terms of a structural Vector Autoregression (VAR) model, which is described in Appendix 1 at the end of this chapter.

More specially, in this empirical test, the error variances of the stock market return (the US dollarised total market return index) and the interest rate of each of the 7 sample East Asian and 13 European countries for one through four-week ahead forecasts are explained by domestic, regional, and global factors. Regional factors are represented by the shocks originating in the Japanese market for East Asia and in the EMU market for Europe (a value weighted return index for the EMU). Global factors are the shocks from the US market. In order to examine whether there has been any change in the relative importance of both regional and global factors, the sample period is divided into two sub-periods before and after the 1997-98 crisis in East Asia.

The Data

Empirical estimation of the model uses weakly stock market price

index data of seven East Asian and 13 European countries plus Japan and the US from DataStream International for the period from 1/3/90 to 8/21/02. In this estimation, a weakly interval is chosen, because daily price data suffer from market frictions such as bid-ask bounce and non-synchronous trading hours between the East Asian countries and the US. All price series are adjusted for dividends and expressed in the US dollar. Weakly compounded stock returns are then estimated by taking the log of price ratios.

As for the interest rates, this study uses daily interest rates of all sample countries plus Japan and the US from DataStream International (see Appendix 2). A daily interval is chosen to minimise the effects of changes in the exchange rate on the interest rate.

Estimation Results

Stock Returns

Table 7 presents a decomposition of the error variance of the dollarised stock market index return of each East Asian country for one-week through four-week ahead forecasts. The first column is the forecast period. The second through fourth columns represent proportions of the forecast error variance of an East Asian country explained by the performance of the market returns of the US (global factor), Japan (regional factor), and the East Asian country itself (local factor) respectively before the 1997-98 crisis (1/3/90–4/30/97) and the fifth through seventh after the crisis (1/6/99–8/21/02). The explanatory power of each shock is measured in percentage so that the horizontal sum of each row is 100.

The results show that, in all seven markets, forecast error variances of the market index returns are largely explained by local markets' own performance in both periods. However, the dominance of the local market performance declined during the post-crisis period in East Asia except for Malaysia. In both periods, the shocks originating in the US market played a more significant role than that in Japan in explaining variations of all East Asian market returns over a four-week horizon.

On average, 89.5 percent of forecast error variances of the East Asian market index returns are attributable to the innovations in the local markets, 7.8 percent to the US market, and 2.6 percent to the Japanese market, respectively, during the pre-crisis period. Since the

outbreak of the 1997-98 crisis, the relative importance of the three factors has changed considerably. During the post-crisis period (1/6/99–8/21/02), the proportion of the local factor fell by more than 8 percentage points to 81 percent, giving rise to the gains of both the global and regional factors. In all East Asian sample countries except for Malaysia, the relative share of the US factor rose during the post-crisis period. The East Asian average of the share of the US factor almost doubled to 14.2 percent, whereas the same figure for the Japanese factor went up by about 2 percentage points to 4.5 percent.

Except for Indonesia and Malaysia, all other sample East Asian countries saw a large increase in the share of the US factor during the post-crisis period. In the case of Korea, the proportion jumped to 18.6 percent from 2.0 percent before the crisis. For Hong Kong, the increase was more pronounced to 30.9 percent from less than 12 percent. In contrast, however, the Japanese influence declined in Malaysia, the Philippines, and Singapore, although the region's average has risen as a result of the large increase in Hong Kong and Korea. These results suggest that changes in the US market exert a stronger influence on the East Asian stock markets than the Japanese one, supporting in part our argument that financial market opening has led to growing integration of East Asian financial markets into global financial markets.

It would be reasonable to assume that unlike in East Asia, in Europe the regional factor figures more importantly in influencing stock prices than the global factor (represented by the shock originating in the US market) in view of the long and carefully managed process of economic integration that culminated in the creation of a common currency area in Europe. This assumption is borne out by the data (in Table 8). The results of the variance decomposition of stock returns for Europe reflect the consequences of the successful financial integration in the region. Except for Ireland, Sweden, and the UK, regional shocks measured by a value weighted return index for the EMU markets as a whole dominate error variances of the dollarised stock returns of the sample European countries.

Interest Rates

The variance decomposition analysis is carried out for the interest rates of the sample East Asian and European countries. The results of

this estimation are presented in Table 9. Unlike in the case of the stock market, the influences of foreign market shocks on the interest rates are very low in all East Asian countries except for Hong Kong before or after the crisis. In fact, the local factor accounts on average for more than 95 percent of forecast error variances in East Asia during both sub-periods.

For the region as a whole, the importance of the US factor rose to 3.9 percent after the crisis from 2.3 percent before, but the increase is negligible to have any implications for financial integration in East Asia. The insignificance of the external factors in influencing interest rates in East Asia is not surprising. As will be discussed in a later section, bond markets of individual East Asian countries are fragmented, narrow in terms of maturity and variety and closed to foreign investors compared to their equity markets. Furthermore, the short-term interest rates are intermediate targets of monetary policy, which are frequently adjusted for the attainment of domestic policy objectives in these countries. The Japanese interest rate, which is used to represent changes in the regional factor, has been very low and showed little fluctuations during much of the post-crisis period in East Asia. These developments may account for the relative insulation of East Asian markets for financial assets other than equities from external shocks.

The Maastricht Treaty of 1991, which was an important step toward the formation of the European Monetary Union, may have affected the nature of financial integration in Europe. To account for this change, this study examines the relative importance of the global and regional factor in influencing European interest rates in two sub-periods, before (1/1/85–12/31/90) and after (1/1/94–8/30/02) the Maastricht Treaty. Because of the unavailability of reliable data, a similar test cannot be done for the stock markets.

As shown in Table 10, compared to East Asian countries, in Europe both the global and regional factors are more important in explaining error variances of the interest rates, although the domestic factor still dominates. Table 10 also shows that the relative influence of global and regional factors has risen in the 1990s, but the increase is not large enough to indicate any significant changes in the financial market structure of Europe.

4 Financial Liberalisation and Penetration of Foreign Financial Institutions of East Asian Financial Markets

According to the definition of the General Agreement on Trade in Services (GATS), financial services include commercial banking, investment banking, securities brokerage, insurance, and insurance-related services. The financial services industry is in general made up of activities in various fields of finance including commercial banking, investment banking (notably underwriting and trading), insurance, derivatives, merger and acquisition, financial leasing, management consulting, asset management, accounting and auditing, financial data processing, and even law and telecommunication. Listing the full range of financial services is almost an impossible task as new financial services are being created and provided. It will be shown that few of the East Asian financial institutions appear to have comparative advantage in supplying these variegated and sophisticated services.

Banking Institutions

As shown in the IMF survey of international capital markets (2000), there has been a dramatic increase in foreign ownership of banks in most emerging market economies during the second half of the 1990s. Due largely to severe restrictions on entry, foreign banks penetration was traditionally low in East Asia. However, this has changed since the 1997-98 crisis (see Table 11). Notwithstanding the initial low degree of penetration, foreign bank control over assets of local banks jumped to 4.3 percent in 1999 from less than one percent in Korea in 1994. In Thailand, it rose by more than ten times to 11.5 percent during the same period. On average, the foreign control in Korea, Malaysia and Thailand shot up to 6 percent in 1999 from 1.6 percent five years earlier.

A similar development can be found in the lending behaviour of BIS reporting foreign banks in East Asia. Lending in both local and foreign currencies of BIS reporting foreign banks in the nine East Asian countries are shown in Figures 2 to 4. As shown in Figure 2, between 1991 and 2001, foreign banks' credit as a share of total bank credit more than doubled in Malaysia: it rose to more than 40 percent after the 1997 crisis from an average of less than 20 percent over the 1990-96 period. In the Philippines the share

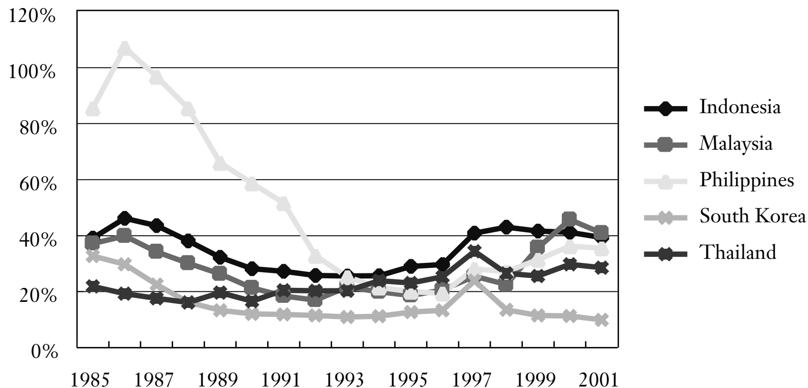
jumped to 35.5 percent in 2001 after a sustained decline during the first half of the 1990s. In Thailand, the increase in foreign banks' share has been rather gradual.

Figure 3 depicts a substantial gain of foreign banks' loan market share, which reached almost 30 percent in Malaysia in 2001. Only in Taiwan and Korea, foreign banks have not been able to increase their loan market shares. Much of the increase in the market share of foreign banks in the South-East Asian countries has come from the large increase in their local currency lending, as shown in Figure 4. Except for Malaysia, in all of the East Asian countries the absolute amounts of international claims of the foreign banks have declined, thereby lifting the ratios of local currency to international claims.

Provision of Capital Market Services

While foreign bank penetration in East Asia is still lagging behind that in other emerging market economies, western investment banks, in particular American and European ones, have established a monopoly position in providing two major services in the capital markets in East Asia: (i) underwriting in the primary market and (ii) trading and consulting in the secondary market. While there are many areas of financial services other than securities underwriting and trading, it is hard to quantify the value of financial services

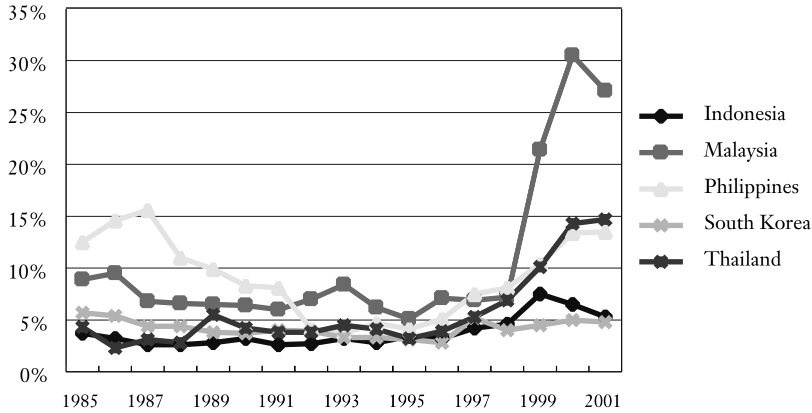
Figure 2 Foreign Bank Credit / Total Bank Credit
(in percentages)



Source: BIS (2002).

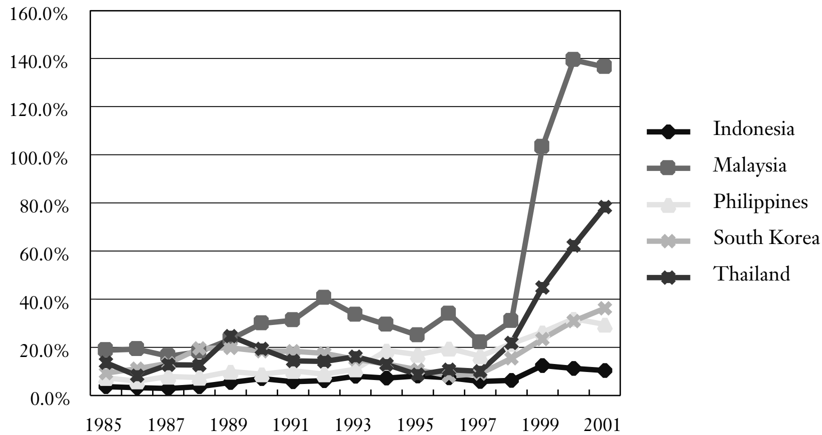
From: Financial Stability and Growth in Emerging Economies
FONDAD, September 2003, www.fondad.org

Figure 3 Foreign Banks Local Claims / Domestic Bank Credit
(in percentages)



Source: BIS (2002).

Figure 4 Foreign Banks Local Claims / International Claims
(in percentages)



Source: BIS (2002).

From: Financial Stability and Growth in Emerging Economies
FONDAD, September 2003, www.fondad.org

provided by financial institutions and in many cases relevant data are difficult to find. For these reasons, the data related to the investment banking are presented to show the dominance of American and European capital market financial institutions in providing capital market services in East Asia.

Western financial institutions, in particular American ones, have been by far the largest providers of financial services in global investment banking. This was confirmed by Euromoney's 1996 poll of polls, which selects the top 20 investment banks on the basis of 70 Euromoney polls and league tables produced in 1995: 18 out of the 20 selected investment banks were either American or European, the other two were Japanese. Six years later, this dominance remained; only one Japanese investment bank made it to the list. In fact, American and European institutions held dominance in providing the entire range of financial services. US-based financial institutions led in every category of services, followed by British-based ones. Not one single financial institution was based in Asia with the exception of Japan, and even then, the Japanese institutions were ranked dead last. According to the Euromoney polls in 2002, American investment banks have solidified their dominance further; Japanese investment banks have been largely driven out of the market for capital market services since 1995.

From the perspective of East Asia, a more pertinent issue to examine in regard to the role of western investment banks is their dominance in East Asian international financing. The amount of international financing for East Asian countries before the crisis grew rapidly (Table 13-1), but it was not local financial institutions but rather American and European financial institutions which managed to control the vast share of the market for underwriting and distribution of the new issues. Table 1 classifies the capital market instruments issued in the five Asian countries during the 1991-2001 period by nationality of the lead managers or book runners who sponsored the new issues. It can be seen that out of US$31.96 billion that was financed through capital markets for the 1998-2001 period by the six countries, 74 percent was undertaken by American and European investment banks, and 6 percent by Japanese institutions. The cumulative figures for the 1991-1997 period show that western institutions managed 69 percent of the capital market financing, compared to 31 percent managed by East Asian investment banks.

As shown in Table 15, the distribution of lead managers by their

parent country and each type of instrument issued in the six Asian countries during 1991-2001 period is also lopsided: American and European institutions accounted for more than 70 percent of all capital market financing, while Japanese institutions for only 9 percent. Table 16 lists the top 20 lead managers or book runners in the management of debt and equity issues. The total amount underwritten shows a similar pattern of western dominance, the American and European institutions representing 90 percent and the East Asian institutions only 10 percent. Table 17 divides the list of top 20 lead managers into the two sub-periods, before (1991-97) and after (1998-2001) the crisis; there was little change in the dominance of western lead managers.

Financial institutions and corporates worldwide are making increasing use of financial derivatives. Exchange-traded derivatives are currently estimated to be in the magnitude of several trillion dollars, compared with several hundred billion dollars in the late 1980s. Trading volume of over-the-counter derivatives is even larger than exchange-traded derivatives. Financial institutions and corporates in East Asian countries are also increasingly relying on the use of derivative products to meet their diverse needs for hedging instruments.

It is, however, American and European institutions that dominate in the roles of brokers and dealers of derivative transactions. This is so even in the transaction of East Asian derivatives including Asian interest rate swaps, and currency swaps, currency options, not to mention the derivative products traded in more developed markets. According to *Risk Magazine* (November 1996), most of the first-tiered derivative broker and dealer were either American or European institutions when evaluated on the basis of pricing ability, market-making reliability, liquidity, innovation and speed of transactions before the 1997-98 crisis.

In fact, it was reported that no local financial institution was ranked as active brokers or dealers of Asian derivatives. Moreover, the role of providing tailor-made derivative products according to customer's needs, which requires highly developed financial expertise and sophisticated financial technology and becomes an increasingly important area of financial service industry, is entirely played by American and European institutions. The East Asian financial crisis and the non-performing loan problems of Japanese banks have curtailed so much the lending and provision of capital market services

by East Asian financial institutions, that western financial institutions could enter the East Asian market without encountering much competition in recent years.

5 Causes of Foreign Dominance in Capital Market Services in East Asia

Overview

The discussion in the preceding section raises important questions as to how western financial institutions have been able to establish such a dominant commercial presence in East Asian finance and what effects this dominance would have on efficiency and stability of East Asian financial systems. More than anything else, the dismal state of East Asian finance in the aftermath of the 1997-98 crisis has combined with market deregulation to increase opportunities for western financial institutions to carve out a large share of the East Asian financial services industry. Saddled with large amounts of non-performing loans, many banks and non-bank financial institutions have been forced to curtail their lending operations and supply of other financial services At the end of 2000, in Indonesia more than 70 percent of the assets of financial institutions was held by state-owned institutions; in Korea this was roughly 50 percent. Prospects of these countries for privatising the state-owned financial institutions are not promising because viable buyers, foreign or domestic, have yet to be found. Institutional reform for the improvement of risk management and corporate governance of financial institutions has been carried on intermittently and by and large at the snail's pace. Financial markets have displayed considerable instability and remain susceptible to swings in investor sentiment. To complicate the difficulty of East Asian finance, there appears to be no end in sight for the resolution of the Japanese banking crisis.

As shown in the preceding section, however, even before the crisis, western financial institutions had already controlled a commanding market share in the provision of a number of financial services, in particular capital market related ones. From a longer-term perspective, therefore, underdevelopment of financial markets and institutions, in particular capital markets, in an environment of rapid financial globalisation, has given a large competitive edge to

foreign institutions in serving East Asian local customers. Finally, many East Asian countries have been running large surpluses on their capital accounts. In providing services for investing these surpluses in foreign securities, western financial institutions have been able to win over their East Asian counterparts as they have more experience and expertise in placing funds in global financial markets.

Financial Globalisation

To western market participants, the growing presence of western financial institutions in East Asia may be a natural consequence of financial globalisation. An overwhelming share of East Asia's international financial transactions is denominated in terms of key currencies, mostly the US dollar, and conducted through the international financial hub of New York and London. Except for Japanese banks, most of the banks in other East Asian countries have a limited access to international capital markets, relatively limited experience in international corporate banking, and a small region wide branch network in East Asia. By and large, their customer bases are confined to domestic borrowers and lenders. Bond markets still remain relatively small in size and narrow in terms of maturity and issues. And the markets for financial derivatives have only recently begun to emerge. There are few domestic investment banks, securities firms, and mutual funds that are efficient enough to compete with their counterparts from the developed countries in international financial markets.

In the absence of these securities market institutions, therefore, it comes as no surprise that American and European investment banks have been able to dominate underwriting securities in international capital markets, organising large syndicated loans, and negotiating multinational mergers and acquisitions and the provision of other financial services in East Asia, and more so since East Asian countries took steps to open their financial markets in the early 1990s.[8]

The financial services industry is an industry that is very intensive

[8] Even in banking, Japanese banks, which were active in lending to other East Asian countries and accounted for the bulk of syndicated loans to these countries before the crisis, have withdrawn drastically their lending to Asian countries: East Asia accounted for less than 6% of their total external lending in 2001 (see Table 2).

in information, communication, and computation. The ongoing IT revolution has formed the basis of numerous innovations in financial technology; the costs of supplying financial services have in turn declined dramatically, thereby creating economies of scale and scope in the financial services industry. In order to take advantage of scale and scope economics, financial institutions including banks and securities institutions throughout the world have come under increasing competitive pressure to capture a large market share, leading them to diversify their activities geographically and also to move into new service areas.

Financial market deregulation and opening in both developed and developing countries that began in the 1980s has also increased substantially the share of capital market financing relative to bank lending in global financial markets. Beginning in the early 1990s, emerging market economies in East Asia have increasingly sought to raise funds from capital markets rather than relying on syndicated loans or interbank short-term loans. This change in the financing structure has led to a large increase in the demand for capital market services. Trade and financial liberalisation in East Asian emerging market economies has also increased the demand for new financial services and products such as instruments for hedging exposure to currency and commercial risks and derivative products – options, swaps, and futures – for portfolio diversification and better risk management.

However, after long periods of financial repression, which had inhibited development of capital markets, East Asian economies did not have any comparative advantage in supplying capital market and other new financial services when their financial markets were opened. As a result, financial institutions in East Asia have been losing out in competition vis-à-vis their competitors from the West, despite the fact that they enjoy information and home bias advantage in local finance. Even in commercial banking where the home bias is of significant advantage, East Asian countries have seen their banking market share chipped away, albeit slowly, largely because East Asian banks have not been able to move out of traditional deposit taking and lending business into capital market, insurance, and other new services. That is, East Asian banks have been slow and inefficient in adapting to universalisation of banking services. In recent years, western financial institutions have increasingly filled up the vacuum of services created by this slow adjustment.

Under these circumstances, it is not surprising that large corporations with an investment grade rating in East Asia have migrated to the international financial hub where they could tap into wider investor bases and also obtain funds at lower costs and better terms. East Asian savers have also moved to New York and London markets, as part of their international diversification strategy to add to their portfolios the stocks and banks of advanced countries, where financial markets are more open and legal systems protect shareholder rights better than in their own countries.

Several measures of internationalisation of stock market activities (the relative market capitalisation of firms listed abroad, the ratio of value traded abroad to GDP, and the ratio of value traded abroad to value traded domestically) all show the growing trend of migration of issuance and trading of equities in emerging market economies, as (Claessens, Klingebiel, and Schmukler (2002) argue. According to them, the migration of stocks from emerging market economies to international financial centres depends on the overall development of the economy, the degree of shareholder protection, and trading costs. Improvement in economic fundamentals of emerging market economies has been the major driving force behind the migration.

Services offered by stock markets in New York and London are easily accessible from anywhere in the world. Large liquidity further increases the value of transactions at these markets. Global harmonisation of accounting, auditing, disclosure, and corporate governance is likely to accelerate financial globalisation. As Claessens, Klingebiel, and Schmukler (2002) argue, in an age of financial globalisation the functions and forms of stock exchanges in many emerging economies may need to be reconsidered.

Underdevelopment of Capital Markets

There is little doubt that underdevelopment of the financial sector, in particular that of capital markets, has been largely responsible for the dominance of western financial institutions in providing capital market services in East Asia. What are then the causes of the financial underdevelopment in East Asia? They are well known and mostly pertain to financial restriction and to the bank or financial intermediary-oriented financial system that have delayed and interfered with the building of the legal, regulatory, and information infrastructure that could support the development of efficient capital markets.

Post-war financial development, prior to the 1997-98 crisis in East Asia, had been characterised by regulation of interest rates at below-market levels, restricted entry of new financial institutions, segmentation of financial markets, insularity of domestic finance from the world financial markets, and system safety at the expense of competition. The increasing complexity and technological sophistication of financial industries required a high-quality information and telecommunication infrastructure and placed new demands on the labour force. However, the intermediary orientation of the financial system coupled with the financial repression had discouraged the requisite institution building, thereby holding up the development of competitive markets for bonds, equities and financial derivatives before the onset of financial liberalisation in the early 1990s. Since the 1997-98 crisis, most of the East Asian countries have taken measures to strengthen and improve the efficiency of their capital markets, including the government bond markets, realising that resilient and efficient capital markets are key to the prevention of future crises and that they should rely less on the banking sector than before.

Legal and Regulatory Inefficiency

La Porta, Lopez-de-Silanes, and Vishny (1999) argue that the legal environment for investor protection and contract enforcement is the most critical determinant of the level and quality of financial services and that it is critical to the development of both financial intermediary and markets. One implication of this legal approach to finance is that the development of equity markets will be facilitated if the legal system provides a strong protection of shareholder rights such as the right to vote on key corporate matters, to select corporate directors, or to sue the directors and the firm. Efficient corporate bond markets would thrive if they are supported by a legal system that ensures public confidence by protecting investors from fraud, insider trading, and market manipulation and by bringing civil and criminal enforcement actions against violators of securities laws.

In a banking-oriented system, regulation is directed to discouraging and limiting excessive risk taking on the part of individual banks to prevent a systemic banking crisis. Regulations such as capital adequacy requirements and limits on loan concentration are all designed for the banking system safety and foreign currency exposure. In contrast, in a market-oriented system

the regulatory system places its emphasis on enforcing compliance with the securities laws with regard to licensing of issues, ensuring due diligence process, and other rules concerning accounting, auditing, and disclosure to protect the interests of public investors. Effective enforcement rules and regulation is crucial to nurturing investors' confidence in the capital markets.

Although reform efforts have been made for improvement, the regulatory systems in many East Asian countries have not been successful in keeping abreast of rapid innovations in the financial industry, developing the necessary skills to assess the complexity and potential risks associated with new financial services, and in strengthening the regulation of securities markets. The lack of shareholder and creditor rights in most East Asian capital markets has made external reporting a low priority, which has in part been responsible for relatively low standards of accounting and disclosure systems.

Paucity of Institutional Investors

The nature of the shareholder population in East Asian countries also has constrained the development of capital markets as a source of corporate financing of the financial services industry. In financial markets of developed economies, a large proportion of listed companies tend to be owned by a diverse shareholder population, in which institutional investors such as pension funds, mutual funds and insurance companies predominate. Such a diverse shareholder population facilitates the development of well-functioning capital markets and related financial services, such as securities trading, consulting, merger and acquisition, and asset management.

In contrast, a large proportion of East Asian companies is owner-managed, or at least feature a congruence of interests of shareholders and management in the form of 'proprietor capitalism'. In Malaysia, Hong Kong, Thailand, and Indonesia, a family group – often Chinese – who staff many of the senior positions and also own a large proportion, if not the majority, of shares, usually controls many companies. In countries such as Korea and Japan, listed corporate groups tend to be large conglomerates, often far too big to be controlled by a single family. However, although the founding family may no longer have a controlling stake, this does not mean that a floating population of institutional investors, as in the West, holds

the shares. Rather, the bulk of a company's shares tend to be held for the long term by friendly institutions with which strong business ties exist, such as banks, life insurance firms and other industrial companies. This ownership concentration has been one of the obstacles to the development of the requisite institutional infrastructure for capital market and related services.

Absence of Government Bond and Financial Derivative Markets and Other Market Supporting Institutions

The government bond market provides a reliable benchmark yield curve of risk-free interest rates, on which pricing of corporate bonds is based. In part because most of the East Asian governments have been able to maintain balanced government budgets, borrowing requirements have been relatively small, limiting the growth of government bond markets. Financial derivative markets such as forward, interest rate swaps, options, and bond future markets are important complements to capital market development as they facilitate risk management and also enhance market liquidity. These markets are in the early stage of their development in East Asia.

The bank dominance of East Asian financial systems has also delayed the development of such institutions as credit rating agencies, clearing and settlement systems, and investment banking firms that constitute the important elements of supporting institutions for mature capital markets. The absence of reliable credit rating agencies has meant that firms and financial institutions have not been able to obtain credit ratings. In the absence of efficient investment banking, there have been few financial institutions capable of assuming full responsibility for selling entire issues of new stocks and bonds. Firms and financial institutions wishing to raise funds through bonds thus bear all the risks of potential price fluctuations.

Integration Into Global Financial Markets

External financing for the East Asia's deficit countries it was arranged and managed in part by Japanese banks, but mostly by western financial institutions. That is, East Asian savers and investors were intermediated by western financial institutions at financial markets in New York and London.

Since the 1997 crisis, together with China, Taiwan, and Japan, East Asia as a whole has become a larger net saver in the global economy than before (Table 1). In investing their surpluses, East Asian countries have sought the services of western financial institutions, simply because institutions with a global reach and network are more efficient in allocating East Asian savings. The growing surplus position in recent years has expanded East Asia's lending to the rest of the world through the international financial hub in New York and London.

However, in diversifying their portfolios, East Asian savers seem to have been placing at least some of their savings in bonds and equities issued by other East Asian corporations and financial institutions. But again, it is reasonable to assume that the brokerage services for investing in foreign securities have been mostly provided by western financial institutions. This may be corroborated by the fact that equity markets have been expanding rapidly in terms of market capitalisation and the variety of stocks listed in most of the East Asian exchanges, and have attracted a growing number of investors from outside of the region since the early 1990s.

Hong Kong and Singapore have been two important regional financial centres in East Asia, but they do not appear to have played an important rolle in advancing financial integration in East Asia with the onset of financial liberalisation in the region. Moreover, iIt should be noted that they were serving East Asian borrowers and lenders well before financial market opening got underway in the region. These two centres are essentially outposts of major international capital markets headquartered in advanced countries. The crisis in 1997, which almost brought Hong Kong to the brink of collapse, has undermined their importance of these two centres as the a regional financial centres, as East Asian corporations and banks have increasingly migrated to the New York and London markets for their financial service needs. In this process, Hong Kong and Singapore may have gravitated more toward linking financially East Asian economies with advanced economies than integrating them with one another.

Foreign financial institutions now receive a national treatment, which provides a level playing field when they enter financial markets of East Asian countries. Many western banks have established a wide network of branches and subsidiaries throughout East Asia, and so have western securities firms, investment banks, insurance

companies, and other non-bank financial institutions. There are numerous emerging market funds operating out of New York to invest in East Asian securities. There is little doubt that the hold of western financial institutions in East Asia has increased since the early 1990s. This pervasive presence of western financial institutions is likely to expand and strengthen East Asia's financial ties with advanced countries, given the continuing financial liberalisation in the region.

Over time, local investment banks and other financial institutions may become more competitive and new markets for financial derivatives may emerge to the extent that, compared to western institutions, they enjoy advantage in collecting and assessing local information. However, such an advantage will diminish with advances in information and communication technology, while the gap in financial technology and expertise between East Asian and western financial institutions will remain. As a result, borrowers and lenders from East Asia will have more incentives to go to the New York and London markets than before, thereby speeding up integration of East Asian financial markets into global financial centres.

6 Prospects for Regional Financial Integration in East Asia

Implications of Financial Liberalisation for Regional Integration

There has been a substantial increase in intra-regional trade in East Asia. Emergence of China as a major trading partner and its entry into the WTO are likely to accelerate trade integration in the region. The APEC agreement on trade liberalisation and a recent proliferation of bilateral free trade negotiations will gather forces for a further expansion of trade in East Asia. This expansion is in turn expected to lead to market pressures on East Asian policymakers for closer coordination of economic policies, including exchange rate policy.

In contrast, however, financial liberalisation and innovation in East Asia do not appear to have strengthened financial linkages among financial markets of individual East Asian countries. Instead, the financial market opening has led to global diversification of asset portfolios and strengthening of financial ties with major international

financial markets in East Asia. Trade liberalisation has unleashed market forces gravitating East Asian economies to regional integration; financial liberalisation has led to global financial integration. The difficulty of harmonising and coordinating institutional reform has slowed down further financial integration in East Asia.

While individual East Asian countries have made considerable progress in deregulating and opening their financial markets, collectively they have achieved little in harmonising the legal systems for bankruptcy procedures and protection of minority stockholders, regulatory systems for financial stability and soundness, and tax treatments of cross-border financial transactions. Equally slow has been the setting of common standards of banking, accounting, auditing, disclosure, and corporate governance at the regional level. In the meantime, East Asian countries have come under pressure to adopt codes and standards for financial sector regulations, accounting and corporate governance set by advanced countries. Whatever its rationale, the effort of the advanced countries to graft the western systems and standards on East Asia may have contributed to East Asia's integration into global financial markets.

In the long run, financial liberalisation would facilitate the mobility of real capital between countries in East Asia, as evidenced by a large increase in intra-regional foreign direct investment prior to the 1997 crisis, in particular Japanese investment, in China and ASEAN states. At the same time, however, the growing dominance of western financial institutions, together with the benefits of globalisation of finance, would diversify and deepen the region's ties with global financial markets. Combining these two developments, it is difficult to predict whether the collective efforts at financial cooperation through the Chiang Mai Initiative could be sustained in East Asia.

In fact, financial market opening in East Asia in itself may not produce incentives to establish regional financial arrangements such as the Asian Monetary Fund and to replicate the European monetary integration. As far as finance is concerned, most of the East Asian countries may benefit more from joining the US dollar bloc than an East Asian currency union. Realisation of this possibility may in part explain why the ASEAN+3 have not been able to make much progress in their negotiations for increasing the number of bilateral swap contracts, casting clouds over the prospects for further expansion and consolidation of the Chiang Mai Initiative.

As in trade, however, causality may run from currency union to financial integration: that is, a political decision to consolidate the Chiang Mai Initiative or to form a common currency area could anchor exchange rate expectations so that it could deepen financial integration as it creates incentives to establish regional capital markets, thereby forging closer financial linkages among East Asian countries. However, these cooperative efforts are not likely to weaken East Asia's financial linkages with global financial markets. In deciding whether to expand the Chiang Mai Initiative or to form a regional common currency area, East Asian countries may therefore have to examine closely whether their cooperative efforts would lead to the development of stable and efficient regional financial markets that could survive competition with other global financial markets.

Benefits and Costs of Establishing Regional Financial Markets

Since the 1997-98 crisis, there have been repeated calls for promoting regional financial markets in East Asia, where bonds and equities denominated in local as well as key international currencies are issued and traded, as part of the strategy to deepen financial integration in the region. This movement has raised two fundamental questions related to benefits and costs of building regional financial institutions and markets. Will the proposed regional capital markets help improve allocation of resources in East Asia? Will they reduce the likelihood of recurrence of financial crises in the future?

As noted earlier, the lack of professional expertise in securities business, the poor financial infrastructure including legal and regulatory systems, inadequate standards of accounting, auditing and disclosure systems, and non-transparent corporate governance all have plagued the development of efficient capital markets in East Asia. The cost of developing these legal, regulatory and informational infrastructures could be very high and hence may not justify the development of capital markets in small economies which are not likely to obtain scale economies and hence efficiency. The increasing migration of stocks to the main international financial centres increases the fixed overhead cost of maintaining market regulation, clearing, and settlements systems; it also reduces an order flow for local brokerage houses and business for local investment banks, accounting firms and credit rating agencies.

This cost consideration has generated interest in establishing an East Asian regional stock exchange and an East Asian regional bond market. These markets may overcome inefficiency of individual capital markets and enable some of the East Asian countries to borrow in their own currencies. At this stage, however, there is no guarantee that a regional bond market based in East Asia will be large and efficient enough to survive competition with global bond markets. Furthermore, a viable East Asian bond market will require support of a regional financial infrastructure that includes regional credit agencies, clearing and settlement systems, cross-border securities borrowing and lending mechanisms, credit enhancement and guarantee agencies, and regional trading mechanisms (ADBI, 2001). Tax treatments for securities transactions will also have to be harmonised at the regional level.

Starting from scratch it will take many years, if not many decades, for the East Asian countries with diverse legal and regulatory systems and at different stages of financial development to construct the requisite financial infrastructures for efficient regional capital markets. And many countries in East Asia will be hesitant in issuing bonds in their own currencies for fear that trading in these bonds could entail the currency mismatch problem.

In East Asia, Tokyo is a logical candidate for the location of a regional bond market, and the Japanese yen could serve as a key currency, given Japan's status as the second largest economy in the world. However, Tokyo has not been able to build the infrastructure that could support such a regional market and the prospects for internationalisation of the yen as an international transactions and reserve currency do not appear to be promising (ADBI, 2001).

There is also the question of whether the proposed East Asian bond market could be more efficient in diversifying sources of corporate financing and opening new investment opportunities than global bond markets. The presumption is that participants in this market would have better access to a large amount of more accurate information about prospects of economic and financial conditions of firms and financial institutions in the region than participants in global bond markets. However, this advantage may not be as significant as it may appear in view of the increased accessibility to not only macroeconomic but also sectoral and corporate information throughout East Asia as a result of the improvement in corporate governance, disclosure, and information technology.

While the advantage in gathering and assessing regional market information has become less important than before, the cost of raising funds through regional capital markets is likely to be higher in East Asia compared to global capital markets, as evidenced by recent developments in the Japanese Samurai (foreign and yen denominated) and Shogun (foreign currency denominated) bond markets. Although it is expected that foreign borrowers would take advantage of the low interest rates and continuing deflation in Japan, the issuance of Samurai bonds has not reached the pre-crisis peak level (¥37.9 trillion) in 1996, while no Shogun bonds have been issued since 1994. One of the most important reasons for these inactivities is simply the higher cost of borrowing through these markets than the Euro-yen, Euro bond, or Yankee bond markets. Rhee (2001) shows that the difference in all-in-cost to a sovereign borrower of ¥20 billion between the Samurai and Euroyen bonds is about 7 basis points (¥14 million). The lead time required from mandate to launch takes a few days in the Euro-yen issue, whereas it takes two to three months in the Samurai bond issue.

Inefficiency of the clearing and settlement process is another reason for the high cost of borrowing through the Samurai bond market. The Euro-yen bond market can clear through international clearing houses such as EURO-CLEAR and CEDEL, whereas the Samurai bond market is not eligible for such a global clearing. Furthermore, a regional clearing network in East Asia is yet to be created to link the Tokyo's clearing system with the region's financial centres such as Hong Kong and Singapore. As Rhee (2001) points out, one of the key issues related to the development of a regional bond market in East Asia may be the creation of a single central securities depository in East Asia for safekeeping, clearance, and settlements for all securities traded in the region.

There is also no reason to believe that the East Asian bond market will be better placed to safeguard the countries in the region from the recurrence of financial crisis in the future, unless it can be shown that this market will be less susceptible to speculation, herding and other market failures than international financial markets. Finally, efficiency considerations may in the end require integration of the East Asian regional bond market with global bond markets. Given the size and efficiency disadvantages, it is difficult to argue that such a regional bond market could weather through the competitive pressure of global bond markets.

As noted earlier, for smaller emerging market economies in East Asia, the cost of developing legal, regulatory, and other supporting infrastructure for efficient capital markets would be prohibitively expensive. Claessens, Klingebiel, and Schmakler (2002) show that the process of developing capital markets itself could increase access for domestic firms to international financial centres, where the investor base is large, market liquidity is abundant, and the cost of capital is relatively lower. With the continuing deregulation of capital account transactions, a growing number of large and efficient firms will migrate to international financial centres for their capital market services. This migration will result in a smaller availability of liquidity to the firms remaining in local markets and hence reducing incentives further to develop local bond and equity markets: a vicious circle could set in.

With the improvement in access to information, harmonisation of legal and regulatory systems and standards, and advances in financial technology that allow remote access to capital market services offered by international financial centres, future prospects for developing robust capital markets in East Asian countries are not promising. One of the implications of globalisation of finance is that East Asian countries will find it difficult to convert their bank-oriented financial systems into market-oriented ones. Another implication is that these bank-oriented systems will be increasingly specialised in catering to the credit needs of small and medium-sized firms and households. This is because a growing number of firms will leave the banking sector as they gain access to local capital markets. Some of these first comers will then migrate to international capital markets as they grow and meet requirements for cross-listing on and capital raising from international exchanges.

7 Concluding Remarks

One could argue that East Asia's integration into global financial markets is a natural as well as a desirable development, since the ultimate objective of economic liberalisation is, after all, the creation of globally integrated markets for goods and services, including financial services. Why should then globalisation of finance raise any consternation in East Asia, or for that matter, anywhere else? It does because globalisation has raised a number of concerns to East Asian

policymakers that have not been adequately addressed in the discussion of reform of the international financial system.

One concern is that financial liberalisation may not necessarily help improve efficiency and competitiveness of the financial service industry in East Asia through the process of learning and acquiring new and more sophisticated financial technologies, certainly not in the foreseeable future. Because the gap in financial technology and expertise between East Asian emerging market economies and advanced developed countries is so large and building legal, regulatory, and other financial infrastructures is costly and takes so much time, that the East Asian countries may never be able to catch up with their western competitors, and in fact may fall in a trap of low technology banking while the provision of other more sophisticated financial services is dominated by foreign financial institutions.

This specialisation may not pose any serious problems to the East Asian countries, if efficiency and stability of the global financial system could be enhanced so as to reduce the incidence of financial crisis and help emerging market economies withstand better both internal and external shocks by instituting an effective system of liquidity provision and prudential regulation of financial institutions and markets at the global level.

Despite the long and protracted discussion of reform of the international financial system, in the eyes of many East Asian policymakers not much has been accomplished in addressing the interests of emerging market economies.[9] There is no reliable global or regional lender of last resort, which could provide liquidity support to emerging market economies in case they suffer from a short-run balance of payments problem. It is also highly unlikely that the global community could agree on establishing a global regulatory authority. From the perspectives of East Asian emerging market economies, advanced countries with developed financial markets have not devoted much effort to expanding and strengthening cross-border financial supervision and regulation.

The absence of effective cross-border prudential supervision of foreign financial institutions operating out of East Asian financial markets has created a number of problems. As the IMF (2000) report points out, there is no effective mechanism of monitoring large

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[9] On limited progress on international financial reform, see Griffith-Jones and Ocampo (2002).

foreign financial institutions providing a large number of different financial services to local customers in emerging market economies including those in East Asia. Many of the sophisticated derivative products developed by these foreign institutions could easily be used to evade taxes and regulations.

Most important of all, to East Asian policymakers, it is difficult to predict how branches or subsidiaries of foreign financial institutions and their parent institutions would behave in times of financial difficulties and crises in emerging market economies. Would they panic and move out all at once at the first sign of crisis as they did in the fall of 1997? Most of the East Asian countries have not been able to borrow from international capital markets in their own currencies although they have been removing many restrictions on capital movements, and they are not likely anytime soon. This means that they will be continuously exposed to the currency and term mismatch problems that triggered the crisis in 1997. A macroeconomic policy framework focusing on free floating and inflation targeting has not been tested for its effectiveness in sustaining financial stability with robust growth in emerging market economies.

These concerns and competitive disadvantages in producing financial services together with the region's desire to build its own mechanism of defense against future financial crises led to the discussion of establishing regional financial arrangements in East Asia, culminating in the Chiang Mai Initiative in May, 2000. As long as these issues remain unresolved, they will continue to rally East Asian countries in their ongoing movement toward financial integration.

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Appendix 1 A Vector Autoregression (VAR) Model

Let $R_{j,t}$, $R_{US,t}$, and $R_{JP,t}$ be the daily stock returns or interest rates at time t of the market portfolio of an East Asian or European country j, US, and Japan, respectively. Then, for each East Asian or European market, the following trivariate VAR model is constructed:

$$Y(t) = D(T) + \sum_{s=1}^{m} B(s)Y(t-s) + u(t), \quad t = 1,.....T \quad (1)$$

where $Y(t)$ is a 3x1 vector consisting of $R(t)$. $D(t)$ is a 3x1 vector of constants, $B(s)$ a 3x3 coefficient matrix, and $u(t)$ a 3x1 vector of serially uncorrelated random residuals with a zero mean and finite variance.

The VAR specification defines $u(t)$ as an innovation in $Y(t)$ in that it is the component of $Y(t)$ that cannot be predicted from past values of the variables in the system. The moving average representation (MAR) is obtained by a successive substitution on the right hand side of equation (1) as

$$Y(t) = F(t) + \sum_{s=0}^{\infty} A(s)u(t-s) \quad (2)$$

where $F(t)$ is the corresponding 3x1 vector of constants and $A(s)$ is a 3x3 matrix of coefficients. The MAR represents $Y(t)$ as a linear combination of current and past one-step-ahead forecast errors.

While the estimated coefficients $B(s)$ of the VAR provide little insights into the dynamic interactions among the variables, equation 2 (MAR) presents the information equivalent to that contained in the original estimates, but in a form relatively easy to understand. That is,

$$\sum_{s=0}^{\infty} A(s)u(t-s) = \sum_{s=0}^{\infty} A(s)(HH^{-1})u(t-s) = \sum_{s=0}^{\infty} C(s)e(t-s), \quad (3)$$

where $C(s)=A(s)H$, $e(t)=H^{1}u(t)$ and the matrix H are such that HH' is a factorisation of the covariance matrix $u(t)$ by the Choleski decomposition method. With daily data, the k-week ahead forecast error of $Y(t+k)$ at time t is

$$C(k-1)e(t+1)+C(k-2)e(t-2)+........+C(0)e(t+k)= \sum_{s=0}^{k-1} C(s)\mathrm{e}(t+k-s). \quad (4)$$

The variance of the *k*-week ahead forecast error is

$\sum_{j=1}^{n} \sum_{s=0}^{k-1} [C^{i,j}(s)]^2$. Then, $\sum_{s=0}^{k-1} [C^{i,j}(s)]^2 / \sum_{j=1}^{n} \sum_{s=0}^{k-1} [C^{i,j}(s)]^2$ is

a component of the error variance in the *k*-week ahead forecast of Y^i, which is accounted for by the innovation in Y^i.

Equation 1 is estimated with two lags and a constant term for the deterministic part *D(t)*. In view of the cross-equation nature of the hypothesis, it is also estimated with alternative lags of one, three, and four. The results are qualitatively similar, however. In order to find a measure of the overall relative importance of weekly returns (or daily interest rates) of the US and Japan in generating the stock market return or the interest rate of each sample country belonging to both the East Asian and European group, the variance of *k*-week ahead forecast error of the market return (or the interest rate) is computed with the MAR and decomposed into innovations in the US, Japan (an EMU market index for Europe), and the local market returns (or the interest rates). In order to isolate the shocks, they are orthogonalised. The orthogonalised innovations are uncorrelated both across time and the equation.

Appendix 2 Definition of Interest Rates

Europe	
Austria	discount 'dead' – middle rate
Belgium	euro-franc 3 month (LDN: FT) – middle rate
Denmark	euro-krone 3 month (LDN: FT) – middle rate
France	money market 3 month 'dead' – middle rate
Germany	euro-mark 3 month (LDN: FT) – middle rate
Ireland	interbank 3 month – offered rate
Italy	euro-lire 3 month (LDN: FT) – middle rate
Netherlands	Neth. corp. yield (ECON) 'dead' – middle rate
Norway	interbank T/N (nominal) – middle rate
Sweden	bond yield corporate (ECON) – middle rate
Switzerland	euro-franc 3 month (LDN: FT) – middle rate
UK	discount market overnight – middle rate
East Asia	
Hong Kong	deposit call – 3 month – middle rate
Indonesia	call money (pipu) – deposit 3 month – middle rate
Japan	call overnight – 3 month – middle rate
Korea	corp. bond AA no guarantee 3 year – middle rate
Malaysia	interbank 3 month – middle rate
Philippines	Manilla treasury bill 91 D – middle rate
Singapore	deposit call 3 month – middle rate
Thailand	interbank on call – middle rate
United States	federal funds – middle rate

Table 1 Five Asian Economies*: External Financing
(in billions of dollars)

	1978	1979	1980	1981	1982	1983	1984	1985	1986
Current account balance	-6	-7.9	-8.9	-15.5	-17.6	-18.4	-8.7	-5.3	1
External financing, net	3.4	10.6	11.3	18.1	23.4	21.2	12.8	10.2	-3.9
Private flows, net	*1.7*	*7.3*	*7.7*	*11.8*	*14.5*	*14.8*	*8.7*	*6.4*	*-5.5*
Equity investment, net	0.2	0.4	0.5	1.1	0.6	0.9	1	1	1.2
Direct investment, net									
Portfolio investment, net									
Private creditors, net	1.5	6.9	7.2	10.7	13.8	13.9	7.7	5.5	-6.6
Commercial banks, net	1.5	6.1	5.5	9.9	11.8	8.3	6.1	1.9	-6.8
Non-banks, net	0.1	0.8	1.7	0.8	2	5.5	1.6	3.6	0.2
Official flows, net	*1.7*	*3.3*	*3.7*	*6.3*	*9*	*6.4*	*4.1*	*3.7*	*1.6*
IFIs	1.4	1.3	1.9	3.2	2.1	4	1.7	1.3	0.9
Bilateral creditors	0.3	2	1.8	3	6.8	2.4	2.3	2.4	0.7
Resident lending/ other, net **	-0.7	0.5	0.8	-3.3	-8.4	-1.6	-0.5	-4.3	2.4
Reserves (- = increase)	-0.6	-3.2	-3.3	0.6	2.6	-1.2	-3.6	-0.6	0.4

Notes:
* Indonesia, Malaysia, the Philippines, South Korea and Thailand.
** Including net lending, monetary gold, and errors and omissions.
Source: Institute for International Finance (IIF) data.

Table 2 Japan's International Bank Lending
(in millions of dollars and percentages)

	1995.6		1996.6		1999.12		2001.6	
	Amount	Share	Amount	Share	Amount	Share	Amount	Share
Developed Countries	30,308	0.182	26,526	0.159	528,335	0.667	728,725	0.752
Asia	107,976	0.649	115,471	0.693	65,050	0.082	51,934	0.054
Indonesia	20,512	0.123	21,622	0.130	12,491	0.016	9,626	0.010
Korea	20,874	0.125	22,512	0.135	12,592	0.016	10,110	0.010
Malaysia	6,091	0.037	8,131	0.049	6,029	0.008	5,843	0.006
Philippines	1,147	0.007	1,402	0.008	2,921	0.004	3,066	0.003
Thailand	32,628	0.196	37,552	0.225	13,075	0.016	7,979	0.008
Sub total	81,252	0.488	91,219	0.547	47,108	0.059	36,624	0.038
Total	166,368		166,701		792,676		969,425	

Source: Bank for International Settlements, *The BIS Consolidated International Banking Statistics*, various issues.

Table 3 Japan's Overseas Direct Investment by Region*
(in millions of dollars)

	1997	1998	1999	2000	2001 (first half)
Asia	12,181	6,528	7,162	5,931	2,762
Korea	442	303	980	813	355
Hong Kong	695	602	971	936	92
Taiwan	450	224	285	510	146
Singapore	1,824	636	962	424	418
Thailand	1,867	1,371	816	931	512
Philippines	524	379	617	458	93
Indonesia	2,514	1,076	918	414	191
Malaysia	791	514	526	232	104
China	1,987	1,065	751	995	752
Vietnam	311	51	99	21	49
India	434	257	208	168	36
Sri Lanka	270	36	19	11	13
Pakistan	62	9	-	-	-
N-America	21,389	10,943	24,770	12,271	3,223
Lat.-America	6,336	6,463	7,437	5,232	2,245
Middle East	471	146	113	19	1
Europe	11,204	14,010	25,804	24,406	4,966
Africa	332	444	515	53	123
Oceania	2,058	2,213	893	667	380
Total	53,972	40,747	66,694	48,580	13,699

Note:
* Report-Accepted Basis.
Source: JETRO, *Jetro Investment White Paper*, 2000 and 2002.

Table 4 Korea's Overseas Direct Investment by Region*
(in millions of dollars)

	1997	1998	1999	2000	2001	Outstanding at the end of 2001
Asia	1,575	1,531	857	849	-317	10,882
Malaysia	-7	21	2	-13	10	323
Vietnam	92	50	15	36	31	638
Singapore	23	129	154	72	20	508
India	105	115	14	15	8	475
Indonesia	154	58	75	61	-363	1,061
Japan	62	22	34	34	75	527
China	695	665	221	307	-274	4,382
Thailand	184	89	4	17	28	500
Philippines	30	33	77	62	42	505
Hong Kong	52	371	203	239	72	1,269
Middle East	68	6	0.9	27	17	246
North America	826	686	935	1,179	342	8,286
Latin America	251	224	183	1,411	76	2,722
Europe	357	1,033	204	139	1,741	5,387
Africa	92	91	20	20	13	515
Oceania	120	102	36	61	11	669
Total	3,289	3,674	2,236	3,686	1,883	28,706

Note:
* Actual Investment.
Source: The Export-Import Bank of Korea (2002), *Overseas Direct Investment Statistics Yearbook, 2002.*

Table 5 Taiwan's Overseas Direct Investment by Region*
(in millions of dollars)

	1997	1998	1999	2000	2001
Asia	819	581	836	851	815
Hong Kong	214	69	122	111	96
Japan	32	30	122	312	169
Singapore	230	158	325	220	378
Philippines	127	39	29	13	46
Indonesia	56	20	7	34	6
Thailand	58	131	113	50	16
Vietnam	85	110	35	54	31
Korea	0.3	2	81	93	12
America	1,916	2,637	2,268	3,946	3,461
Europe	59	34	61	62	46
Oceania	28	8	41	148	63
Africa	-	36	41	7	6
Total	2,894	3,296	3,269	5,077	4,391

Note:
* Approval Basis.
Source: Investment Commission, MOEA of Taiwan. *Statistics on Overseas Chinese & Foreign Investment*, *Outward Investment*, *Indirect Mainland Investment*, 2001/12.

Table 6 Singapore's Investment Abroad, 1997-1999
(in millions of dollars)

	1997	1998	1999
Total	158,566	177,949	191,031
Total Direct investment	75,807	75,622	84,219
Direct Equity investment	57,191	53,211	58,754
Direct investment	41,478	39,899	45,293
Portfolio investment	23,277	36,155	35,965
Other Foreign Assets	59,482	66,172	70,847

Destination of Singapore's Total Direct Investment Abroad
Top 8 Investment Destination Based on 1999 (Stock as at Year-End)

	1997	1998	1999
China	10,477	12,186	12,625
Hong Kong	8,113	7,668	8,399
Malaysia	8,908	8,610	7,940
Belgium	1,751	3,261	6,151
Indonesia	6,519	4,485	4,517
British Virgin Islands	2,901	3,993	4,368
United States	2,905	3,064	4,285
Mauritius	2,485	3,222	4,072

Source: Singapore Department of Statistics.

Table 7 VAR Decomposition of East Asian Stock Prices
(weekly dollar index)*

Period	1/ 3/ 90 ~ 4/30/97			1/ 6/ 99 ~ 8/21/02		
Shock	Global	Regional	Country	Global	Regional	Country
			Hong Kong			
1	11.81547	0.551633	87.63290	29.37337	7.361128	63.26550
2	11.84875	0.641289	87.50996	31.28107	7.092248	61.62668
3	11.74604	0.640663	87.61330	30.90170	7.222633	61.87567
4	11.74676	0.647848	87.60540	30.89759	7.236009	61.86640
			Indonesia			
1	0.514037	0.022548	99.46341	0.153653	0.990592	98.85576
2	0.530492	0.080252	99.38926	0.180802	1.317838	98.50136
3	0.852544	1.201549	97.94591	0.188271	1.331859	98.47987
4	0.869937	1.309453	97.82061	0.189255	1.336095	98.47465
			Korea			
1	1.857645	1.290440	96.85191	16.15357	5.103949	78.74248
2	2.055302	1.469221	96.47548	18.97168	9.104634	71.92369
3	2.043870	1.966944	95.98919	18.35919	13.33941	68.30140
4	2.045702	1.969084	95.98521	18.62073	13.29491	68.08436
			Malaysia			
1	8.720180	1.796037	89.48378	6.619883	0.000570	93.37955
2	10.40599	1.900747	87.69326	6.569100	0.560231	92.87067
3	10.34695	1.991289	87.66176	6.577603	1.134615	92.28778
4	10.37380	2.013665	87.61254	6.578612	1.134506	92.28688
			Philippines			
1	4.333805	0.187880	95.47831	6.314236	0.186250	93.49951
2	6.744170	0.882054	92.37378	7.883241	0.439348	91.67741
3	6.906731	0.961260	92.13201	11.71351	0.493182	87.79331
4	6.939220	0.960077	92.10070	11.75481	0.492699	87.75249
			Singapore			
1	14.34621	7.612955	78.04084	18.51377	3.222573	78.26366
2	15.93102	7.462130	76.60685	20.31242	3.082938	76.60464
3	15.74236	8.755126	75.50251	20.67759	3.155843	76.16656
4	15.75407	8.771754	75.47417	20.67528	3.163149	76.16157
			Thailand			
1	6.180099	0.235447	93.58445	9.390497	0.358787	90.25072
2	6.813609	0.954562	92.23183	11.22046	1.338870	87.44067
3	7.107116	2.721726	90.17116	10.79652	4.871466	84.33202
4	7.106599	2.728698	90.16470	10.81709	4.872960	84.30995
			Average across countries in period 4			
	7.833727	2.628654	89.53762	14.21905	4.504333	81.27661

Note: * This table presents the results of variance decomposition of East Asian market returns using the estimates of trivariate VAR for the US, Japan, and each of the East Asian markets. Estimation is based on a weekly dollar return index of each country. The return index data are from DataStream International.

Table 8 VAR Decomposition of EU Stock Prices
(weekly dollar index)*

Forecast Period	1/3/1990~8/21/2002		
	Global shock	Regional shock	Country shock
		Austria	
1	6.647274	25.92117	67.43156
2	6.709909	25.88374	67.40635
3	7.002183	25.79909	67.19872
4	7.009582	25.79814	67.19228
		Belgium	
1	14.97513	29.29040	55.73447
2	15.00695	29.58801	55.40504
3	15.27961	29.50389	55.21650
4	15.28966	29.50303	55.20731
		Denmark	
1	10.61022	29.09709	60.29268
2	10.70731	28.92995	60.36274
3	10.90243	28.90157	60.19600
4	10.90720	28.89882	60.19399
		Finland	
1	19.29257	10.99099	69.71644
2	19.37823	11.13095	69.49082
3	19.55892	11.08780	69.35328
4	19.56437	11.08748	69.34815
		France	
1	30.53955	51.88161	17.57884
2	30.86205	51.66236	17.47559
3	31.28831	51.35359	17.35810
4	31.29836	51.34576	17.35589
		Germany	
1	28.78945	51.55460	19.65595
2	28.39232	51.43619	20.17149
3	28.50102	51.33116	20.16783
4	28.50627	51.32725	20.16647
		Ireland	
1	16.92309	17.72883	65.34808
2	17.04189	17.53927	65.41884
3	17.47764	17.46170	65.06066
4	17.48791	17.46638	65.04571

Table 8 (continued)

Forecast Period	1/3/1990~8/21/2002		
	Global shock	Regional shock	Country shock
	Italy		
1	15.53691	38.32677	46.13632
2	15.55041	38.46852	45.98107
3	15.61792	38.63925	45.74283
4	15.62166	38.63841	45.73994
	Netherlands		
1	30.55973	42.00199	27.43828
2	30.06335	41.70098	28.23568
3	30.68545	41.19582	28.11873
4	30.71460	41.17469	28.11071
	Portugal		
1	5.023863	18.90529	76.07085
2	5.035442	18.90736	76.05720
3	5.168920	19.04828	75.78280
4	5.170355	19.04948	75.78017
	Spain		
1	23.19103	38.69052	38.11844
2	23.13295	38.84912	38.01793
3	23.16078	38.82539	38.01383
4	23.16234	38.82461	38.01305
	Sweden		
1	28.86423	21.30764	49.82812
2	28.94635	21.37666	49.67699
3	29.35966	21.30291	49.33742
4	29.36817	21.30586	49.32597
	United Kingdom		
1	32.94921	25.89883	41.15197
2	32.99670	26.02761	40.97569
3	33.43264	25.91782	40.64954
4	33.44185	25.92327	40.63487
	Average across countries in period 4		
	20.580179	30.7956292	48.6241931

Note:
* This table presents the results of variance decomposition using the estimates of trivariate VAR for the US, EMU (value weighted return index), and each of the European markets estimated for the periods from 1/3/1990 to 8/21/2002. The estimation is based on a Weekly US-dollarised return index of each country. The data are from DataStream International.

Table 9 VAR Decomposition of East Asian Interest Rates*

Forecast Period	1/ 1/ 94 ~ 4/31/97			1/ 1/ 99 ~ 8/31/02		
Shock	Global	Regional	Country	Global	Regional	Country
			Hong Kong			
5	4.85	0.03	95.10	9.39	0.06	90.54
10	9.73	0.06	90.19	11.16	0.23	88.60
15	15.24	0.20	84.55	12.22	0.42	87.34
20	20.89	0.42	78.67	13.10	0.59	86.29
			Indonesia			
5	0.05	0.40	99.54	0.68	0.23	99.08
10	0.54	0.62	98.82	0.75	0.90	98.34
15	1.81	0.85	97.32	0.79	1.50	97.69
20	3.83	1.07	95.08	0.84	1.96	97.19
			Malaysia			
5	0.11	0.09	99.79	0.005	0.0007	99.99
10	0.23	0.22	99.53	0.003	0.0004	99.99
15	0.40	0.40	99.19	0.002	0.0005	99.99
20	0.61	0.61	98.77	0.002	0.0007	99.99
			Philippines			
5	0.25	0.08	99.65	0.09	0.30	99.59
10	0.37	0.11	99.51	0.07	1.23	98.69
15	0.49	0.13	99.37	0.05	2.20	97.74
20	0.62	0.16	99.20	0.04	3.03	96.91
			Korea			
5	0.02	0.12	99.84	0.11	0.01	99.87
10	0.06	0.56	99.37	0.11	0.06	99.82
15	0.19	1.32	98.47	0.12	0.13	99.74
20	0.41	2.39	97.18	0.12	0.20	99.66
			Thailand			
5	0.18	0.06	99.75	0.004	0.86	99.13
10	0.14	0.07	99.77	0.01	2.73	97.25
15	0.15	0.08	99.75	0.01	4.08	95.90
20	0.21	0.09	99.69	0.01	4.79	95.19
			Singapore			
5	0.94	0.52	98.53	0.45	0.31	99.22
10	0.92	0.47	98.59	0.88	1.09	98.01
15	0.84	0.44	98.71	1.39	1.93	96.67
20	0.72	0.40	98.83	1.99	2.66	95.33
			Average across countries in period 20			
	2.30	1.89	95.79	3.90	0.74	95.34

Note: * This table presents the results of variance decomposition of interest rates using the estimates of trivariate VAR for the US, Japan, and each of the East Asian markets. Estimation based on daily interest rate data from DataStream International.

Table 10 VAR Decomposition of the Interest Rates Before and After the Maastricht Treaty in Europe

Forecast Period	1/ 1/ 85 ~ 12/31/90			1/1/94 ~ 8/30/02		
Shock	Global	Regional	Country	Global	Regional	Country
			Austria			
5	0.04	1.84	98.10	0.431	1.48	98.08
10	0.03	4.68	95.27	0.67	5.03	94.29
15	0.09	8.62	91.28	0.92	10.09	88.98
20	0.19	13.42	86.37	1.15	15.74	83.09
			Belgium			
5	0.29	0.34	99.35	1.56	12.41	86.02
10	0.65	0.53	98.81	1.96	14.72	83.31
15	0.98	0.76	98.25	2.27	17.24	80.47
20	1.26	1.06	97.67	2.57	19.81	77.61
			Denmark			
5	1.58	0.27	98.13	0.50	1.44	98.05
10	2.74	0.48	96.76	0.72	2.16	97.10
15	3.47	0.70	95.82	0.93	3.00	96.06
20	3.91	0.92	95.16	1.17	3.94	94.88
			France			
5	0.02	3.78	96.18	1.68	2.55	95.75
10	0.08	5.00	94.91	2.07	3.06	94.85
15	0.16	6.18	93.64	2.31	3.56	94.11
20	0.25	7.47	92.26	2.52	4.09	93.37
			Ireland			
5	0.04	0.35	99.60	1.98	1.08	96.93
10	0.07	0.54	99.37	2.36	1.11	96.52
15	0.14	0.72	99.13	2.58	1.15	96.26
20	0.18	0.91	98.89	2.77	1.19	96.03
			Italy			
5	0.21	0.06	99.72	0.07	0.003	99.91
10	0.97	0.04	98.98	0.09	0.01	99.88
15	1.75	0.03	98.20	0.11	0.04	99.83
20	2.39	0.03	97.57	0.14	0.07	99.77
			Netherlands			
5	0.05	0.47	99.47	7.95	22.12	69.92
10	0.10	0.87	99.01	9.09	23.15	67.75
15	0.22	1.42	98.35	9.58	23.89	66.51
20	0.36	2.13	97.50	9.93	24.53	65.52

Table 10 (continued)

Forecast Period	1/ 1/ 85 ~ 12/31/90			1/1/94 ~ 8/30/02		
Shock	Global	Regional	Country	Global	Regional	Country
			Norway			
5	1.63	0.01	98.34	0.04	0.03	99.92
10	4.24	0.05	95.69	0.03	0.02	99.93
15	5.38	0.17	94.43	0.03	0.02	99.94
20	5.78	0.38	93.83	0.02	0.02	99.95
			Sweden			
5	0.23	0.15	99.60	1.56	0.39	98.04
10	0.73	0.09	99.17	1.76	0.53	97.69
15	1.15	0.07	98.76	1.85	0.68	97.45
20	1.46	0.09	98.44	1.92	0.86	97.21
			Switzerland			
5	1.14	20.91	77.94	2.58	3.23	94.17
10	1.70	23.54	74.75	3.04	3.78	93.17
15	2.13	25.76	72.10	3.34	4.29	92.35
20	2.47	27.91	69.61	3.62	4.79	91.57
			United Kingdom			
5	1.87	0.74	97.37	4.47	0.84	94.67
10	3.81	2.74	93.44	5.18	0.88	93.93
15	4.67	5.35	89.97	5.61	0.88	93.49
20	4.98	8.13	86.87	5.98	0.87	93.13
			Average across countries in period 20			
	2.11	5.68	92.20	2.89	6.90	90.19

Note:
* This table presents the results of variance decomposition of daily interest rates using the estimates of trivariate VAR for the US, Germany, and each of the European markets estimated for each of the two sub periods (before 1/ 1/ 85 ~ 12/31/90, and after 1/1/94 ~ 8/30/02), respectively. The interest rate data are from DataStream.

Table 11 Foreign Bank Ownership in Selected Emerging Markets[1]
(in millions of dollars and percentages)

	Total Assets December 1994	Foreign Control[2] December 1994	Total Assets December 1999	Foreign Participation December 1999	Foreign Control[3] December 1999	Foreign Control[4] December 1999
Central Europe						
Czech Republic	46.6	5.8	63.4	47.3	49.3	50.7
Hungary	26.8	19.8	32.6	59.5	56.6	80.4
Poland	39.4	2.1	91.1	36.3	52.8	52.8
Total	112.8	7.8	187.1	44.0	52.3	56.9
Latin America						
Argentina	73.2	17.9	157.0	41.7	48.6	48.6
Brazil	487.0	8.4	732.3	18.2	16.8	17.7
Chile	41.4	16.3	112.3	48.4	53.6	53.6
Colombia	28.3	6.2	45.3	16.2	17.8	17.8
Mexico	210.2	1.0	204.5	18.6	18.8	18.8
Asia						
Korea	638.0	0.8	642.4	11.2	4.3	16.2
Malaysia	149.7	6.8	220.6	14.4	11.5	11.5
Thailand	192.8	0.5	198.8	6.0	5.6	5.6
Total	980.5	1.6	1061.8	10.9	6.0	13.2

Notes:
[1] Ownership data reflected changes up to December 1999 while balance sheet data are the most recent available in Fitch IBCA's BankScope.
[2] Ratio of assets of banks where foreigners own more that 50 percent of total equity to total bank assets.
[3] For central Europe and Asia available balance sheet data are in most cases for December 1998.
[4] Same as footnote 2 but at 40 percent level.
Source: IMF (2000).

Table 12 The Top 20 Investment Banks by Parent Country
(numbers in parentheses are percentages)

Function	Overall Results		Underwriting		Trading		Advisory	
Parent Country of Investment Banks	1996	2002	1996	2002	1996	2002	1996	2002
US	8	11	8	9	8	10	8	10
	(40)	(55)	(40)	(45)	(40)	(50)	(40)	(50)
UK	3	3	2	3	5	3	6	3
	(15)	(15)	(10)	(15)	(25)	(15)	(30)	(15)
Europe	7	5	7	6	6	7	6	7
	(35)	(25)	(35)	(30)	(30)	(35)	(30)	(35)
Japan	2	1	3	2	1	0	0	0
	(10)	(5)	(15)	(10)	(5)	(0)	(0)	(0)
Total no. of Investment Bank	20	20	20	20	20	20	20	20
	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)

Source: Euromoney, January 1996 and 2002.

Table 13-1 Distribution of International Financing by Country and by Financial Instrument
(in millions of dollars and percentages)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	Total	%
Capital market financing (A)													
Indonesia	242	100	285	1591	1545	1232	3223	0	767	76	450	9511	8.7
Malaysia	0	0	475	1325	3509	749	3000	89	591	556	1600	11894	10.9
Philippines	12	403	928	1112	1543	3020	2644	1919	623	1431	700	14335	13.2
South Korea	693	1179	2938	3214	9644	8533	4769	2137	4166	4304	3302	44880	41.2
Taiwan	139	1131	0	1766	1634	1051	1484	682	1502	3448	1693	14530	13.3
Thailand	1378	84	2095	1782	1809	1358	3421	708	661	0	555	13852	12.7
Total (A)	2464	2897	6722	10790	19683	15943	18543	5535	8310	9814	8300	109002	100.0
Loan financing (B)													
Indonesia	2171	2903	1652	5600	6255	5792	7094	0	0	0	0	31467	25.8
Malaysia	1161	1994	3493	1913	4227	5315	2975	600	0	0	0	21678	17.8
Philippines	0	57	1486	578	471	2402	2269	0	0	0	0	7263	6.0
South Korea	3369	1246	701	4772	3046	4467	5058	0	0	0	0	22658	18.6
Taiwan	850	498	611	270	1152	4075	7479	995	0	129	0	16058	13.2
Thailand	1559	2840	5326	2809	4975	3764	1531	0	0	0	0	22804	18.7
Total (B)	9110	9538	13268	15942	20126	25815	26405	1595	0	129	0	121928	100.0
Total													
Total (C)=A+B	11574	12435	19990	26732	39809	41758	44948	7130	8310	9943	8300	230929	
Proportion of capital market financing A/C	21.3	23.3	33.6	40.4	49.4	38.2	41.3	77.6	100.0	98.7	100.0	47.2	

Note:
The table presents the distribution of international financing proceeds financed in six Asian countries during the period of 1991-2001 by country and by instrument. The financing schemes are categorised into capital market financing and loan financing. Capital market financing instruments include: (i) Bond (bond with warrants, convertible bond, plain bond); (ii) Medium Term Note; and (iii) Equity (ordinary shares, preference shares, warrants). Loan financing instruments include syndicate loans.
Source: Thomson Financial SDC database.

Table 13-2 International Financing by Year and Financial Instrument
(in millions of dollars and percentages)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	Total
Capital Market Financing												
Bond	866	929	5058	7065	9177	3835	8818	2551	2460	4721	7177	52657
%	7.48	7.47	25.30	26.43	23.05	9.18	19.62	35.78	29.60	47.48	86.47	22.80
Equity	1598	1919	764	3568	5713	6962	2298	2976	3850	3584	989	34221
%	13.81	15.43	3.82	13.35	14.35	16.67	5.11	41.74	46.33	36.05	11.92	14.82
MTN	0	50	900	157	4794	5146	7427	8	2000	1509	133	22124
%	0	0.40	4.50	0.59	12.04	12.32	16.52	0.11	24.07	15.18	1.60	9.58
Total	2464	2898	6722	10790	19684	15943	18543	5535	8310	9814	8299	109002
%	21.29	23.31	33.63	40.36	49.45	38.18	41.25	77.63	100	98.70	99.99	47.20
Loan Financing												
Loan	9110	9538	13268	15942	20126	25815	26405	1595	0	129	0	121928
%	78.71	76.70	66.37	59.64	50.56	61.82	58.75	22.37	0	1.30	0	52.80
Total												
Total	11574	12435	19990	26732	39809	41758	44948	7130	8310	9943	8300	230929
%	100	100	100	100	100	100	100	100	100	100	100	100

Table 14 Distribution of Lead Managers by their Parent Countries and Year

	1991	1992	1993	1994	1995	1996	1997	'91-'97	1998	1999	2000	2001	'98 -2001	Total
Capital Market Financing														
US	100	0	756	412	2589	4614	5230	13700	1665	3469	4299	1396	10829	24529
UK	576	1790	2460	6102	8009	4298	8656	31890	1595	1668	3068	2995	9327	41217
Swiss	108	83	129	359	153	50	356	1238	18	0	0	0	18	1256
Other Europe	70	533	911	185	867	2412	1027	6005	252	543	556	2117	3468	9473
West Total	854	2406	4256	7058	11618	11374	15268	52834	3530	5680	7923	6508	23641	76475
%	34.65	83.08	63.31	65.41	59.02	71.34	82.34	68.58	63.77	68.35	80.72	78.40	73.97	70.16
Japan	114	0	1592	494	2528	1616	1832	8177	100	781	200	919	2001	10177
Singapore	15	0	102	179	698	943	150	2087	317	385	1211	224	2137	4223
Hong Kong	724	406	722	2327	2115	1194	819	8308	231	692	259	175	1356	9664
Other Asia	758	84	50	732	2725	815	473	5637	1357	772	222	475	2825	8462
Asia Total	1611	490	2466	3732	8066	4568	3274	24208	2005	2630	1892	1793	8319	32527
%	65.35	16.92	36.69	34.59	40.98	28.66	17.66	31.42	36.23	31.65	19.28	21.60	26.03	29.84
Total	2465	2896	6722	10790	19683	15942	18543	77042	5535	8310	9815	8301	31960	109002
%	100	100	100	100	100	100	100	100	100	100	100	100	100	100
Loan Financing														
US	597	458	2556	1047	253	932	1371	7213	0	0	0	0	0	7213
UK	2342	2342	655	1211	1004	1298	697	7391	0	0	0	0	0	7391
Swiss	0	80	25	220	291	2451	0	3068	0	0	0	0	0	3068
Other Europe	556	663	1053	3046	4297	4297	3685	16526	0	0	0	0	0	16526
West Total	3495	1384	4288	5525	5845	7908	5753	34197	0	0	0	0	0	34197
%	38.36	14.51	32.32	34.66	29.04	30.63	21.79	28.45	0	—	0	—	0	28.05
Japan	630	3081	4496	879	1172	2317	2864	15440	0	0	0	0	0	15440
Singapore	1200	2150	1186	2080	3047	3228	2181	15072	0	0	0	0	0	15072
Hong Kong	1385	1664	2511	4461	3128	2904	2114	18167	0	0	0	0	0	18167
Other Asia	2400	1259	786	2998	6935	9457	13492	37328	1595	0	129	0	1724	39052
Asia Total	5615	8154	8980	10417	14281	17907	20652	86006	1595	0	129	0	1724	87730
%	61.64	85.49	67.68	65.34	70.96	69.37	78.21	71.55	100	—	100	—	100	71.95
Total														
Total	9110	9538	13268	15942	20126	25815	26405	120204	1595	0	129	0	1724	121927
%	100	100	100	100	100	100	100	100	100	—	100	—	100	100

Note:
Distribution of international financing proceeds financed in six Asian countries during the period of 1991-2001 by parent country of a lead manager. The financing schemes are categorised into capital market financing and loan financing. Capital market financing instruments include i) Bond (bond with warrants, convertible bond, plain bond), ii) Medium Term Note, iii) Equity (ordinary shares, preference shares, warrants). Loan financing instruments include syndicate loans.
Source: Thomson Financial SDC database.

Table 15 Distribution of Lead Managers by their Parent Country and Financial Instrument
(in millions of dollars and percentages)

	Capital market financing				Loan financing	
	Bond	Equity	MTN	Total	Loan	Total
US	12234	7795	4500	24529	7213	31742
UK	18268	9849	13100	41217	7391	48608
Swiss	1019	237	0	1256	3068	4324
Other Europe	3864	1691	3917	9472	16526	25998
West Total	35385	19572	21517	76474	34197	110671
%	67.20	57.19	97.26	70.16	28.05	47.92
Japan	8841	1337	0	10178	15440	25618
Singapore	1209	3015	0	4224	15072	19296
Hong Kong	5207	3908	550	9665	18167	27832
Other Asia	2014	6390	57	8461	39052	47513
Asia Total	17271	14650	607	32528	87730	120258
%	32.80	42.81	2.74	29.84	71.95	52.08
Total	52657	34222	22124	109003	121927	230930
%	100	100	100	100	100	100

Note:
The distribution of international financing proceeds financed in six Asian countries during the period of 1991-2001 by the parent country of a lead manager. The financing schemes are categorised into capital market financing and loan financing. Capital market financing instruments include i) Bond (bond with warrants, convertible bond, plain bond), ii) Medium Term Note, and iii) Equity (ordinary shares, preference shares, warrants). Loan financing instruments include syndicate loans.
Source: Thomson Financial SDC database.

Table 16 List of Top 20 Lead Managers
(in millions of dollars and percentages)

Lead Manager	Amount	Parent Company
Merrill Lynch International Ltd	8741	US
Lehman Brothers	6050	US
JP Morgan Securities Ltd	3819	US
Morgan Stanley Dean Witter & Co	3606	US
Daiwa Securities Co Ltd	3414	Japan
Goldman Sachs (Asia)	2485	US
Salomon Brothers Inc	2464	US
SBC Warburg	2392	UK
Warburg Dillon Read	2382	UK
CS First Boston Limited	2344	US
Nomura Securities Co Ltd	2300	Japan
JP Morgan & Co Inc	1965	US
Merrill Lynch & Co Inc	1941	US
Deutsche Morgan Grenfell	1739	Germany
Morgan Stanley International Ltd	1728	US
Goldman Sachs International	1649	US
Baring Brothers & Co Ltd	1543	UK
UBS Securities Inc	1515	Swiss
Credit Suisse First Boston Inc	1500	Swiss
Jardine Fleming	1325	UK

Country	Amount	No.	%
US	36792	11	61.11
UK	7641	4	22.22
Swiss	3015	2	11.11
Other Europe	1739	1	5.56
West Total	49186	18	90.00
Japan	5714	2	10.00
Singapore	0	0	0.00
Hong Kong	0	0	0.00
Other Asia	0	0	0.00
Asia Total	5714	2	10.00
Total	54900	20	100.00

Note:
The table presents the list of top 20 lead managers ranked by the issue proceeds financed in six Asian countries during the period of 1991-2001. The financial instruments used include (i) Bond (bond with warrants, convertible bond, plain bond); (ii) Medium Term Note; and (iii) Equity (ordinary shares, preference shares, warrants).
Source: Thomson Financial SDC database.

Table 17 List of Top 20 Lead Managers Before and After the East Asian Currency Crisis
(in millions of dollars and percentages)

	1991-1997		
Country	Amount	No.	%
US	23780	10	50
UK	7733	5	25
Swiss	1515	1	5
Other Europe	1739	1	5
West Total	34767	17	85
Japan	5164	2	10
Singapore	0	0	0
Hong Kong	0	0	0
Other Asia	1186	1	5
Asia Total	6351	3	15
Total	41118	20	100
	1998-2001		
Country	Amount	No.	
US	16026	12	60
UK	2086	3	15
Swiss	2322	2	10
Other Europe	500	1	5
West Total	20934	18	90
Japan	550	1	5
Singapore	0	0	0
Hong Kong	0	0	0
Other Asia	704	1	5
Asia Total	1254	2	10
Total	22188	20	100

Note:
The table presents the list of top 20 lead managers before and after the Asian currency crisis. Lead managers are ranked by the issue proceeds financed in six Asian countries during the each period of 1991-1997 and 1998 2001, respectively. The financial instruments used include: (i) Bond (bond with warrants, convertible bond, plain bond); (ii) Medium Term Note; and (iii) Equity (ordinary shares, preference shares, warrants).
Source: Thomson Financial SDC database.

Table 18 Non Performing Loans of Crisis-Affected Countries
(in percentages of total loans)

	1997	1998	1999				2000			
	Dec.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Latest
Indonesia[a]	-	-	-	-	-	64.0	62.4	63.5	61.7	58.8 (Nov)
Excl. IBRA	7.2	48.6	58.7	39	38.9	32.9	32.1	30	26.9	23.9 (Nov)
Korea[b]	8.0	16.1	17.0	16.4	15.9	15.8	17.9	18.9	17.9	
Excl. KAMCO/KDIC	5.9	10.4	11.4	11.3	10.1	10.9	10.9	13.6	12.3	
Malaysia[c]	6.0	22.6	22.7	23.4	23.6	23.6	23.3	23.2	-	
Excl. Danaharta	-	18.9	18.2	18.1	17.8	16.7	16.7	16.2	16.1	15.3 (Dec)
Philippines[d]	4.7	10.4	13.2	13.1	13.4	12.5	14.4	14.6	15.3	15.1 (Dec)
Thailand[e]	-	45.0	47.0	47.4	44.7	41.5	39.8	34.8	30.6	26.5 (Dec)
Excl. AMCs	-	45	47	47.4	44.7	38.9	37.2	32	22.6	17.7 (Dec)

Notes:
[a] The first line uses the "stringent" definition of an NPL; the second line excludes transfer to IBRA.
[b] NPL figures use the BLC.
[c] Figures include commercial banks, finance companies, merchant banks, and Danaharta.
[d] Figures are for commercial banks.
[e] Commercial banks. First line includes commercial banks, finance companies, and the estimated amount of NPLs transferred to wholly-owned private AMCs.

Source: World Bank (2001).

11

Comment on Yung Chul Park and Kee Hong Bea

Heiner Flassbeck

Professor Parks' chapter raises a number of new issues challenging the conventional wisdom of an old debate, the optimum currency area (OCA) or common currency area (CCA) theory. Financial integration has indeed, up to now, not been considered as one of the classical criteria for OCA's or CCA's. Although favouring a regional currency arrangement in Asia, Professor Park asks whether the development of the financial markets and the dominance of foreign companies in financial relations, i.e. the globalisation of the Asian financial markets, is not driving the region into the wrong direction. In other words, will financial globalisation render regional cooperation in the end much more difficult?

Park presents striking evidence showing that foreigners run important parts of the financial business in Asia thereby intensifying the links with the western world instead of strengthening the collaboration in the region itself. However, Professor Park only briefly mentions the crucial question of causality: Are agents from the western world driving Asia's finance because they are dominant or competitive *per se*, or are they dominant because Asia has never tried to expand its regional ties and to stimulate an inward orientation by a political decision to cooperate and to financially integrate?

At a certain point Park seems to suggest that any decision in this direction would be useless as the dominance of western suppliers of financial services would *a priori* prevent closer collaboration in Asia. This, obviously, means stressing the old "owners problem" which, in

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most cases in economics, does not lead anywhere. Would rather efficient western financial companies not be able and willing to assist national governments in Asia in an attempt to create a regional currency arrangement?

Moreover, Professor Park stresses that there are only a few of these companies (two rating agencies, five investment banks etc.) on a global scale, reinforcing his argument about monopolistic power of western firms. This argument too, in my opinion, is not very convincing. There are a lot of small numbers on this economic planet beyond financial services which would not lead us to argue in favour of dismantling the regional concentration of the small number of suppliers of certain goods. Roughly, there are only ten producers of globally sold cars, three of sophisticated computer chips, two of machinery for printing etc. His argument, seen from the trade perspective, amounts to asking: Does the dominance of western suppliers of cars, railways and airplanes prevent Asian policymakers from cooperating in terms of transnational traffic routes? Additionally, every good German "Mittelständler" (medium-sized company) tries to be the global leader in his specific niche on the world market. The United States have very few companies being world leader in manufacturing and engineering, I do not mind if they have some world leaders in financial consulting.

There is another small number which will become more and more important in the globalised economy: three currencies. It may well be that a number of decades from now we end up with three currencies instead of the 50 to 100 which are still around. I think, Professor Park, in trying to make the case for regional cooperation in Asia would have been more convincing if he would have asked why countries are desperately searching a solution to their currency problem instead of putting the emphasis on a new criterion in the OCA/CCA debate. The whole debate about semi-fixed exchange rates or soft pegs, in my opinion, is flawed as the OCA/CCA theory is based on the assumption that there is always a viable alternative to pegging the rate, namely to float the rate. But if, in reality, this alternative is not attractive at all for developing countries, the OCA theory is useless and soft pegs are unavoidable as long as the world as a whole is not an optimum currency area.

Exchange rate volatility, gyrations and misalignments seem to have far more serious consequences for developing countries with small and open economies, and with a relatively large stock of

external debt denominated in reserve currencies, than for big closed economies like the US, EU and Japan. However, the mainstream economic thinking blames the soft pegs in Asia and elsewhere to have provoked the shocks leading to frequent crisis. Their advise, in case that a common currency area with centralised institutions is not available, is to choose between free floating on the one hand and locking into a reserve currency through a currency board, dollarisation, or a hard peg, on the other hand. But these "corner solutions" may mean to be stuck between the famous rock and a hard place.

The political reason underpinning the widespread fascination about the corners is easy to understand: they seem to offer unilateral monetary solutions in the multilateral framework of a globalised economy. They seem to allow for a world of total market integration without any kind of "cooperation and coordination" at the level of governments and to exclude discretion of governments concerning the external price level. In addition, whereas global solutions in the trade area are about the retreat of governments, global or multilateral solutions in the field of money and currencies are about government interventions.

The corner solution idea is inconsistent, even in theory, if it is applied to a single country in a world of many different solutions including the two corners. If flexible exchange rates would work in a transparent manner and would bring about smooth adjustment, as expected by their advocates, the whole globalised world would have to go for this solution to make it work efficiently. With some countries adopting the idea and others not, the relations between countries would be easily distorted as it would be extremely difficult to equilibrate the competitive positions of countries with and without flexible exchange rates at hand. As the price level as a whole cannot be as flexible as the price level of tradable goods in countries with flexible rates, the countries with fixed rates can be easily pushed out of their markets by means of a depreciation of the currencies of the flex-rate advocates.[1] Argentina and Brazil are a sad proof of this

1 In a recent article Dilip K. Das from the Asian Development Bank argues that fixed rates "are difficult to sustain in a world of increasing capital mobility" as they may come under speculative attack. But, at the same time, he admits that a country with "significant policy autonomy" under flexible rates may "have trouble gaining credibility in international financial markets" (p. 19). Obviously, the same effects may apply in both systems. A fixed rate may not be credible and policy with flexible

point. The spiralling depreciation of many countries in Latin America after the collapse of the Argentine currency board is proving the inconsistency of the "free float" corner even more impressively.

Developing countries fear free floating as they expect excessive and unmanageable volatility. That is why many developing countries and transition economies have used a nominal anchor in order to bring down inflation and to avoid being a punching ball for international speculation. But the soft pegs like free floating often resulted in erratic capital flows and overshooting of exchange rates. In general, while many countries dis-inflated successfully, orderly exits from such regimes proved to be a main stumbling block. For an individual developing country with low and stable inflation, an intermediate regime targeting real effective exchange rate supported by strict controls on inflows and outflows may provide a temporary alternative. But most developing countries are already committed to close integration into the global financial system and, under pressure from the G-7 and international institutions, opened their markets more or less irreversibly.

Since global arrangements for a stable soft peg system are not forthcoming, regional mechanisms provide the only realistic solution. The EU experience since the collapse of the Bretton Woods system holds useful lessons in this respect. While it is a successful example of anchoring and a soft peg, culminating in the hard peg of monetary union, it is crucially different from unilateral dollarisation and currency boards. There have been mutual responsibilities by a reserve currency and collective mechanisms and institutions designed for this purpose, including implicit or explicit lender-of-last-resort facilities and orderly exit strategies. However, even these arrangements have not been without problems in a world of free capital movements. They required monetary convergence preventing inflation differentials. They also required a certain degree of real convergence, i.e. of overall growth and macroeconomic performance.

Moreover, even if convergence is guaranteed, regional mechanisms are not easy to replicate among developing countries

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rates may not be credible. Speculation may test a commitment to defend a rate or lead to overshooting and thereby harm the economic policy objectives of governments. These kind of arguments lead to nowhere if the interaction of prices, wages, interest rates and exchange rates are not explicitly analysed. Dilip K. Das, "Asian Crisis: Distilling Critical Lessons", UNCTAD Discussion Papers No. 152, December, 2000.

alone. While intra-regional trade within developing country groupings such as ASEAN or Mercosur is growing rapidly, the trade of such regions with the rest of the world, notably with industrial countries, is much more important than that of the EU. Thus, the scope for them to collectively float vis-à-vis the rest of the world is more limited than for the EU. While appropriate regional arrangements among developing countries may increase the stability of the regional pattern of exchange rates, they do not eliminate the question of what regime to adopt vis-à-vis reserve currencies, but raise it at the regional level.

A better arrangement would be to involve major reserve currency countries in such regional arrangements, as in the EU which included emerging markets (Portugal, Greece, Spain and Ireland) alongside Germany, with mutual responsibilities and appropriate institutions. This could be realised in East Asia at this very moment only if Japan decided to play a dominant role. The United States are not interested in monetary union or regional monetary arrangements with others, and it would be difficult to extend the EU arrangements to Africa and the Middle East. Hence, a global system of a small number of regional monetary arrangements built around major reserve currencies, together with close cooperation among them as global stability is still far away.

The European Case

Seen from a European perspective, Professor Parks "benefits" of a common currency, focusing on capital mobility in face of little wage and price flexibility, have not been very prominent for the European decision to unify in terms of monetary policy. He stresses easy access to cheap capital as a substitute for real adjustment of wages. In my opinion it is just the other way around: the adjustment of nominal wages and prices to external (oil price hikes) and internal shocks (loss of competitiveness vis-à-vis other members of the system) is much more ambitious and strict under a well-designed system of fixed rates and the need to refinance current account deficits much more limited than under floating.[2]

[2] See H. Flassbeck, "The Exchange Rate: Economic Policy Tool or Market Price?", UNCTAD Discussion Paper No. 157, November, 2001.

The main arguments for a soft peg European style have different roots. First of all, multilaterally secured soft pegs representing the transitional stage to the corner of a unified currency, as implemented in Europe in the last 30 years, have to be treated quite differently from the unilaterally introduced soft pegs in Asia and South America. In the former case monetary policy is dedicated to the domestic goal of reducing the inflation rate to the level compatible with the convergence needed to reach low inflation and a stable external value of money. The temporarily fixed exchange rate underpins this target by putting pressure on the domestic price setting through the import price channel. One-way-bets, however, on the interest rate of the converging high-inflation economy should be excluded by orderly depreciation restoring competitiveness and normalising the returns on financial assets time and again.

Paradoxically, Europe never adhered to the corner solution thesis although it has reached now the corner of fully fixed exchange rates. But the countries involved did not jump from one corner to the other. Europe took a long and winding adjustment path to finally reach the corner. Nevertheless, the search for a solution for the region as a whole incorporated many advantages. All the countries sacrificed part of their economic policy power, attributing the leading role to Germany as the anchor of the system. But, at the same time, the group as a whole gained autonomy vis-à-vis the power of markets and the influence of multilateral international organisations like the IMF. The German central bank *de facto* acted as lender of last resort for the system, although this role has never been explicitly assigned to her.

But there have been storms and shocks in Europe nevertheless. An anchoring country in which the overall inflation performance is quite similar to the one in the anchor country, is in an easy position from the beginning. Austria in its relation to Germany is a good example. The general inflationary performance in normal times is one thing, but the real test for a successfully anchoring country comes when the anchor reacts to different kinds of shocks.

The most famous and most clear-cut example of an unsustainable peg was the attempt of Italy and the United Kingdom to fix their currencies vis-à-vis the D-Mark already in 1988, i.e. at a very early stage on the way to the monetary union which at that time appeared at the horizon. After the stock market crash in autumn 1987 the central banks in the United States and in Europe had trimmed their

interest rates to historical lows despite the fact that the effects of the crash on the real economy were rather limited. Thus, the monetary stimulation at a rather late stage of the recovery gave new momentum to the world economy and world investment. The growth performances of the countries under consideration after the shock were more or less identical. All the countries reached growth rates of 4 percent or more with the United Kingdom being the best performer at the end of the 1980s and Germany outpacing the others at the beginning of the 1990s following the unification boom.

The inflation performance was quite different, however. Whereas the traditional low-inflation countries including the United States remained below an inflation rate of 4 percent, Italy and the UK moved up to 8 percent or more. Even more pronounced were the differences in the growth rates of unit labour costs. Germany, Austria and France experienced a very slow and moderate reaction of wages to falling unemployment and rising growth, the rise in labour costs remained subdued and below the rise in prices. In Italy and the UK, however, growth rates of unit labour costs jumped from 4 to close to 10 percent, outpacing the others and price inflation. Thus, compared with the anchor country the two newcomers in the European Monetary System (EMS), Italy and the UK, lost ground in the direct external competition with Germany, Austria and France. With fixed nominal exchange rates, the real exchange rate (in terms of unit labour costs) of Italy vis-à-vis Germany appreciated from 1987 to 1991 by 23 percent, and the real exchange rate of the UK by 28 percent. The loss of competitive power in these two countries was reflected in a huge swing in the current account from surplus to deficit whereas the surpluses in the stable countries mushroomed.

If the UK and Italy wanted to avoid a deflationary spiral a depreciation of their currencies and the decision to quit the EMS was the only way out. It is easy to understand why the decision of France not to give in to the pressure coming from the "markets" in 1992 was justified. France as well as Austria were able to preserve their competitive position in the aftermath of the positive demand shock. France had been under pressure from the markets because the overall economic situation at that time was rather gloomy compared to Germany or Austria so that a depreciation would have been an easy way out of the recession. But the decision of the French government – with the assistance of most other members of the EMS – to stick to the "unwritten" rules of the game, namely to use depreciation only in

case of an external disequilibrium, proved to be right. The other way around, the pressure of the markets in the case of France, was fully unjustified whereas in the case of the UK and Italy it was justified.

This case of a currency crisis in Europe highlights the role which controls and interventions in the market for short-term capital can play and, at the same time, which role they cannot play. To stop capital from fleeing the British pound and the French franc in 1992 would have been justified as a massive and uncontrolled flight was by no means justified in either case. A thorough analysis of the authorities in both countries would have shown what the evidence proves, namely there was a limited need to adjust the pound and no need at all to adjust the franc. There was no reason for panic or any fear of a total collapse of the EMS and controls could have helped to avoid a big and unjustified unrest on the market. But with or without controls the British and the Italian problem had to be solved.

The most important policy lesson to be learned from this event in Europe concerns the short-term macroeconomic steering of the system. A better "early warning system" inside the EMS could have prevented the systemic crisis. If the authorities of the EMS, as well as the national authorities of all the countries involved, would have realised at a much earlier stage that the situation of the lira and the pound was becoming unsustainable, they could have reacted much earlier and could have depreciated the currencies of the two high-inflation countries in 1989 or 1990 already, thereby avoiding the worst troubles of the crisis and avoiding that a country like France became victim of the contagion effects of a general speculation against currencies with fixed exchange rates.

Another fundamental objection has been raised against a simple regional arrangement with a hegemonial currency as anchor. External and internal stability of the price level is just a tool to better accomplish the relevant targets of economic policy, namely more employment and higher growth rates in real income. An anchoring country gives away the tools to achieve these targets too. Thus, its overall economic policy success depends on the anchor country's success. The anchor country's policy, however, may be perfect under the circumstances prevailing in this country, but it does not imply that it is a perfect policy for the whole group formed by the anchor country and its surrounding satellites.

This was one of the main problems in Europe in the last two decades. Germany's monetary policy may have been an adequate

policy for Germany. But the German central bank, the Deutsche Bundesbank, was forced by law just to take into account the economic environment in Germany to underpin its decisions – although the D-mark was part of an exchange rate system, the EMS. Germany adopted an economic policy approach which was directed mainly towards gaining additional market shares in the world market by reducing the domestic cost level and the tax burden. For Europe as a whole or the countries now forming the European Monetary Union (EMU) this policy approach, obviously, was not adequate. Europe's openness is only a third of the German one (10 percent) and to move the overall European economy by stimulating exports means to wag the dog by the tail. Hence, the full fledged change to a consistent monetary system for Europe as a whole was unavoidable in the last analysis. With the EMU created in 1999 the European Union has made this final step. As a consequence, this step was not just the result of the attempt of the French government not to be dominated politically by Germany into infinity, as many have argued. From an economic point of view, it was a fully justified step too, given the fact that Germany's monetary policy for systemic reasons could not concur with the European needs.

For very small, extremely open economies, forming just satellites of the anchor country, the anchor approach can be adopted for a very long time if, by and large, the anchor country's economic policy follows reasonable principles and takes the existence of the satellites with benign neglect. But for any larger group and for countries of equal size or economic power, the anchor approach can only be a transitional stage on the way to a monetary union. A consistent monetary policy is only possible for the group as a whole and thus can only be perceived by a united central bank. The transitional phase, however, can last very long. From the first steps to the last it took Europe 30 years.

The Global Solution

The idea of a globalised market is to preserve on a multilateral basis a level playing field to all parties involved. Multilateral trade rules shall apply to every party in the same manner. Deviations from these rules are object of multilateral negotiations. The monetary system cannot be excluded from the definition of the level playing field. Hence, the

main idea behind the foundation of the International Monetary Fund in the 1940s was a sound one and is still valid today. An international institution is needed to avoid competitive depreciations in a world where countries have to struggle with unilateral solutions to the currency problem.

Whenever a worldwide crisis began to brew, upward or downward fluctuations in the real exchange rate – that is, changes in the competitive positions of entire national economies or untenable constellations of interest rates – played a pivotal role. In principle, only a new global monetary system can remedy this situation. It must guarantee that the relative competitiveness of national economies remains unchanged, and that enterprises can operate in healthy competition on a level playing field. Strong fluctuations of exchange rates which go beyond the balancing of inflation differentials cause similar distortions in the allocation of resources and investment decisions as unexpected fluctuations of the internal value of a currency or tariffs and quotas on trade. In a new world monetary order exchange rates must be firm enough to permit rational economic decision-making; but, at the same time, they need to be flexible enough to maintain the competitiveness of all nations. This can only be achieved by intense cooperation between the leading industrialised nations and the developing world.

Among countries or groups of countries which have jointly sworn off inflation as an instrument of economic policy, there is no need for exchange rate fluctuations. This is currently true, for example, of the United States, Japan, and Europe. The inflation rates and the growth rates in per-unit labour costs have been very low on both sides of the Atlantic and Japan for some years now. Nevertheless, huge changes in the real exchange rates between the big blocs occurred. The temporary weakness of the euro and the unjustified strength of the yen against the dollar and the quick reversal of these movements can only be viewed as a fundamental mis-evaluation on the part of the market. Such a misalignment does not only distort trade between the big blocs, but, at the same time, trade within the developing world and trade of developing countries with the "G-3". The Asian crisis in part has to be attributed to such a huge misalignment. Thus, the ideas brought forward to stabilise the real value of the G-3 currencies cannot be left aside in the interest of developing as well as industrialised countries. A global approach to tackle the problem, like it had been the case in the system of Bretton Woods, obviously offers

the superior solution.

But if the globalised world is not able to cope with the global challenge the cooperation of regions with close trade ties is clearly better than any national corner solution or cutting all trade ties. Asia, for example, despite strong trade relations with the United States, has some potential to follow Europe on the road to monetary union and thereby to create a tripolar global monetary system in the long run. The trade ties in Asia are rather close. If Japan is included the intra-Asian exports before the crisis amounted to nearly 50 percent of overall trade. In Europe intra-trade has a share in overall trade of 65 percent. The trade links with the rest of the world are well balanced, with Europe and the United States being with equal shares the most important trading partners although the overall share of trade with the US is very high in several countries in relation to GDP. But even without Japan and China the intra-Asian exports are as high as a third of overall trade. Intra-trade of the NAFTA countries is much less.

The transforming Eastern European countries are trying to get access to the European Monetary Union as soon as possible. Some of them will be successful in a rather short period of time. The others will form an anchoring system around the EMU and head for full access later. South America is in a much more difficult situation. Some countries have already adopted the US dollar as currency, others have currency boards or informal pegs vis-à-vis the dollar. A Pan-American solution with the USA as anchor seems to be improbable as long as the experiments with different regimes are on their way. But the preconditions to go for a genuine South American approach are not optimal with trade ties not being as close as in Asia and Europe. But there are a few alternatives to monetary cooperation and some may prove to be untenable in due course. Thus, there is hardly an alternative to regional cooperation even under unfavourable circumstances.

Regional cooperation up to a regional monetary union can be an answer to the challenges coming up with globalisation and liberalisation. But even regional monetary systems do not prevent crisis and turmoil on the capital market once and for all. Given the unresolvable conflicts in a world of different nation states in any monetary system that has been tried out after World War II, the Bretton Woods system just as much as the European Monetary System of the 1980s and early 1990s, recurring crisis-like phenomena that forced governments and central banks to intervene have been

unavoidable. But destabilising capital movements are less likely to occur, because the markets have been given clear guidelines, and because untenable interest constellations and massive real under- or over-evaluation should be avoided. If there are such guidelines, this system can minimise though not fully avoid surveillance and intervention into the capital account.

Conclusion

Some writers, including implicitly Professor Park ("currency and term mismatches that triggered the crisis", Section 7), are creating *a priori* dilemmas for developing countries by assuming something like the "original sin" of Eichengreen and Hausmann. They argue that maturity mismatches and/or currency mismatches constrain the development of poorer countries as these countries are lacking a deep and stable financial market. Hence, these countries would be unable to integrate financially and need, in one way or the other, capital inflows which are reducing the choice for a currency regime to the corners. This could be a crucial point. ... The Eichengreen-Hausmann thesis hints to an underlying theoretical problem the exchange rate discussion is burdened with. The original sin thesis makes sense if open economies are forced to borrow abroad to meet development and investment needs.

Developing countries may have experienced current account deficits and thus net capital inflows. As current account balances on the macro level are just the aggregation of the accounts on the micro level the same rules of sustainability apply as in the case of deficits of households and companies. But, and this is the crucial difference, a "country" or a region, even a poor region, in general consisting of the same economic entities as any other country *a priori* does not "need" foreign capital.[3] It is only true in a certain theoretical (neoclassical)

[3] This fact, which is, according to the above reasoning, the normal outcome has, after the publication of a paper by Horioka and Feldstein (1983), been the basis of many misleading speculations concerning international capital mobility. Feldstein/Horioka argued that the high slope coefficient is evidence for a rather small mobility of capital or restrictions for capital mobility even in the group of industrial countries as otherwise capital should be free to move and "... to seek out the most productive investment opportunities worldwide" (Obstfeld/Rogoff, 1996, p. 162). This is a fundamental misunderstanding. It is just the other way around:

model that countries can suffer from a lack of savings. In different (Keynesian) theoretical models it is a strange idea to believe that poor countries with little savings of private households simply can "draw" on the "existing" savings of industrialised regions to finance their investment without reducing domestic savings – out of profits – at the same time.

In the latter world currency mismatches are not a central issue. Maturity mismatches are of importance only if domestic saving (as non-consumption) determines domestic investment. If it is the other way round, if the level of investment determines the level of saving, the maturity mismatch can be neglected as an economic policy problem too. This is a crucial question and probably the most important one. If the economic world is dominated by the autonomous decision of private agents to choose between spending or saving (consumption today or consumption tomorrow), the maturity mismatch as well as the currency mismatch and, as a consequence, the corner solutions have their merits. One of the arguments the IMF brought forward in transition and in developing countries to defend the anchor approach and/or high interest rates was indeed the "lack of capital" in these countries. According to this orthodox view, an inflow of capital from outside or the mobilisation of domestic savings by high interest rates only could fill the "savings gap" and thus allow for a sufficient amount of investment in fixed capital. But if this is not the relevant theoretical model the whole approach falls apart.

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the more similar in their structure and the more open the countries under consideration are, the smaller will be the net movements of capital (the balances) between them. Such a finding has no direct implications for gross movements. These can be extremely important and their movement may lead, without the "contradiction" seen by Obstfeld/Rogoff, to "... the remarkable closeness of the interest rates that comparable assets offer despite being located in different industrial countries" (Obstfeld/Rogoff, 1996, p. 162). The "country" is usually no category of importance in the markets nor in economics if we are not dealing with interferences into the market by national governments.

[4] At a very early stage of economics as a science, however, this problem was addressed and a preliminary solution was found: The only way to finance additional investment and growth of the overall economy is the artificial creation of additional money. Additional money, so many early writers, including Schumpeter (1912) and von Hayek (1933), would allow increasing investment without negative repercussions from the capital market. This idea found its expression in the phrase of "forced saving" which had occupied many economists in the 1930s.

Saving out of real income, i.e. saving as the deliberate decision not to consume, is pivotal in theoretical models with given (exogenous) real income. If real income is endogenous, i.e. if we are dealing with economic models bound to explain why and how real income is generated or not, the causal nexus of saving and investment is just the other way around. If saving does not create investment but investment creates saving, then the original sin is pointless. In a non-neoclassical, a Keynesian, or better a Schumpeterian, view, the existence of neoclassical savings does not foster the process of development. In this world just the opposite is true. "The decision not to have dinner today ..." (J.M. Keynes) does not stimulate but discourage the creation of capital as demand and profits will fall.[4] In Schumpeter's words, what is needed in these cases is not capital in the sense of realised and unconsumed income but just money to prefinance a process in which capital is created by investment and financed, in the last analysis, by saving which is the result of an unforeseen growth in real income.[5] This is the main reason, in my opinion, for the disastrous results of the IMF's attempt to stimulate the creation of capital in the transforming economies by a policy of austerity including high real interest rates. It is exactly the opposite of the reasonable in a Schumpeterian world.[6]

Hence, I fundamentally disagree with Professor Park's conclusion that "A macroeconomic policy framework focusing on free floating and inflation targeting has not been tested for its effectiveness in sustaining financial stability with robust growth in emerging market

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[5] The importance of money had been clearly recognised at the beginning of this century by J.A. Schumpeter in his "Theory of Economic Development" of 1911 (cf. Schumpeter, 1964). Hayek (1933) joined his view that only abundant money will allow high growth rates and a quick development of nations. For Schumpeter it is explicitly a potentially inflationary policy which spurs economic development. Monetary policy has to "prefinance" the process of development without knowing with certainty that the additional money will be used for real growth. This explains why catching-up processes are usually endangered by inflationary acceleration. The whole process is potentially inflationary without becoming inflationary in the least analysis. While a lot of studies deal with the microeconomics of Schumpeter's theory, the even more important macroeconomics are neglected.

[6] As money saving in the economy as a whole is necessarily zero, the notion of "saving" which is needed to "finance" investment is not useful at all. Investment is highly correlated with the dynamics of the overall economy. The overall economy, however, is stimulated and not depressed by a fall in the savings rate of private households.

economies." Obviously, neither floating nor inflation targeting are new ideas. If it would be so simple to find a solution, the test would have been made successfully a lot of times somewhere in the world in the last three decades. But, as far as I see, there is not one developing or developed country with free floating which, additionally, is surrounded by other free floaters without producing enormous friction. The few examples of (more or less dirty) successful floating all happened in the niches left by some sort of fix-rate system (like the UK or Switzerland in relation to the European monetary systems) or in countries attached to one big trading partner like Canada to the United States.

12

Asian Cooperation and the End of Pax Americana

Eisuke Sakakibara

It has been said by many, particularly in the United States, that the world will never be the same again after September 11, 2001. Nevertheless, it is hard to believe that one incident, however grave, could so suddenly and drastically affect the entire world. Indeed, September 11 has changed our perception of the world, but the process seems to have originated earlier – in the latter half of the 1990s.

This change in perception is particularly noticeable in the United States. To the Americans, the terrorist attacks on the World Trade Center and the Pentagon brought home powerfully that they, too, are vulnerable to a direct foreign attack and that the far-flung web of forward bastions the United States maintains around the globe is no longer sufficient for its defense. The Americans, in other words, recognise that they are in the same boat as the rest of the world.

With regard to the global governance system, there are some irreversible aspects of this ongoing change. First, the age of international economics, or the age of global capitalism, seems to be moving toward the age of international politics. In other words, we are witnessing the beginning of the end of "Pax Americana", or global capitalism under American hegemony. True, the United States is still a dominant power, both militarily and economically, but it is apparent that the international governance system that was led by the United States, the G-7, and international organisations, such as the IMF and the World Bank, has started to change.

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Just as in 1914 or 1915 World War I signalled the end of Pax Britannica, the new global war against terrorism seems to be the symbolic event that historians may one day designate as the beginning of the end of Pax Americana. However, in my view we have been witnessing the beginning of the end of Pax Americana since the mid-1990s. The United States is gradually losing its position as the hub of the world. This has consequences for other regions of the world, including Asia, and may act as another stimulus for the promotion of regional cooperation.

In this chapter, I will discuss what type of regional cooperation is feasible in Asia. But before getting into the current state of, and future prospects for, regional cooperation in Asia, I would like to share with you my long-term perspective on the Asian economy. I wish to do this not only because I am proud of Asia's history, but also because I think it is quite important to understand the legacy of Asia in building a new regional cooperative scheme.

1 Asia as the Centre of the World

As you may know, between the 8th and 18th centuries, Asia was the centre of the world economy and of world trade. According to Angus Maddison, even as late as 1820, that is some decades after the industrial revolution started in Europe, China and India together accounted for as much as 46 percent of world GDP and 55 percent of the world's population.[1]

Except for the last 150 years when the West and later Japan were dominant, Asian countries, especially China, India and the Islamic empires, were the centre of the world economy. I am not saying this out of arrogance as an Asian, but am emphasising this historical fact to remind you that the infrastructure for global trading and investment was created in Asia a long time ago.

Hard and soft infrastructure for global trading and investment has been present in Asia for centuries. Hard infrastructure has existed in the form of well-organised ports, sea lanes, roads, and various kinds of river transportation, while the equally important soft infrastructure has been there in the form of entrepreneurship, commercial

[1] Angus Maddison, *The World Economy: A Millennial Perspective*, OECD Development Centre, Paris, 2001.

minds, and networks of Chinese and Indians living overseas (i.e. diasporas). Even during the period of colonisation, the British and others used the existing infrastructure quite skilfully to engage in global trading. So, historically Asia has been the hub of globalism.

We have already begun to see a shift in economic power to countries like China and India. China's economy has been growing at almost 10 percent a year since the late 1970s. India is expected to register a 4.4 percent growth rate in 2002, surpassing the expected ASEAN growth rate of around 3 percent. China, India, and a few other Asian countries combined account for more than half of the world's population and generate a significant portion of world savings. It will not be long before production in these countries increases commensurate with the size of their populations and savings. From a long-term perspective, these developments point to a reorientation of the world economy from West to East.

China should not be overestimated in the area of technology, but in manufacturing China will no doubt emerge as a major force and will fundamentally change the international division of labour both in Asia and in the rest of the world. China will become a key player in the Asian economy as well as in the world economy. The Chinese have been sleeping for the last 200 years, but they have now awakened and have the capacity and the entrepreneurship to again become the centre of the world.

Since World War II, particularly in the 1970s and 1980s, Asian countries have used very well their existing hard and soft infrastructure to establish Asia as a global economic entity. If you look at the export-import structure and direct investment patterns in Asian countries, you will notice that they are quite global. This is not unnatural. In addition to a dramatic increase in intra-regional trade and investment over the last few decades, investment from and trade with the United States and Europe have risen significantly. Asia has become virtually a global manufacturing site for the world.

2 Asian Cooperation and the Role of China

There are some regional organisations in Asia (for example, ASEAN) whose formation was politically motivated. ASEAN was formed in the 1960s, at the time of the Vietnam war, as a political coalition against communism. Eventually, the ASEAN organisation came to

promote two types of cooperation – political and economic. Although an ASEAN Free Trade Area (AFTA) has been established, in general the integration process has been very slow. ASEAN remains essentially a political forum for discussions among heads of state under the principles of the "ASEAN way", which is characterised as voluntary, non-binding, and consensual.

There is another regional forum, APEC, which comprises the United States and other Pacific-rim countries, including Australia and New Zealand. This is not a genuine regional organisation either. APEC's major function has been to promote global deregulation, the GATT and the WTO, an activity wherein it has played a significant role. But the enthusiasm for APEC has subsided since the Clinton Administration lost interest in the organisation.

Until two years ago, China, Korea, and Japan were the only major countries in the world that were not involved in any regional cooperative scheme. We were excluded from Asian regionalism because we functioned as its hub.

Why have intra-regional trade and investment increased in Asia despite the global nature of Asian countries? Basically this was triggered by Japan's investment in East and South Asian countries in the late 1980s, followed by similar moves of the so-called Asian Tigers (i.e. Korea, Taiwan, Hong Kong, and Singapore). This phenomenon was called the "Flying Geese Formation" with Japan at the forefront followed by the Four Tigers and then by the ASEAN countries. It established a fairly exquisite division of labour in manufacturing in the Asian region.

This Flying Geese Formation existed up until quite recently and has resulted in an increase in intra-regional trade, which naturally followed the direct investment. Intra-regional trade was preceded by the direct investment of, first, Japanese corporations and, then, the multinationals of the United States, Europe, Korea, Taiwan, and others. This investment was the major stimulus for a dramatic increase in intra-regional trade over the course of the last few decades. And regional integration will progress as Taiwan, Japan, Singapore, Hong Kong, and others invest in China and in other Asian countries. However, the global nature of Asia's trade and investment will not change, but will continue as before.

Except for Japan, most of the East Asian and South Asian countries have an export-to-GDP ratio of more than 20 percent. Countries like Singapore and Malaysia have an even higher ratio of

over 100 percent. Asian countries are very open and global, and because of that, there has not been much interest in regional cooperation in Asia until recently. Globalisation has benefited Asia. Asia has probably been the major beneficiary of global deregulation and liberalisation that took place in the 1960s, 1970s and 1980s. That was most likely the major cause of what has been called the "Asian miracle".

As I stated before, the global nature of trade and investment in Asia will not change – even though there has been an increase in intra-regional trade and investment. China will continue to attract investment both from Europe and the United States, because these major global players need to have factories in China. About a month ago, I was told by the CEO of Thyssen, the German Steel Company, that they have developed the technology for a high-speed train that can run 500 km per hour – double the speed of the Eurostar and the Japanese Bled train. The original intention was to connect Munich and Cologne by this high-speed train, but for some reason the company was unable to do that. So they reached an agreement with the Chinese government to construct a network for the train between Shanghai and other major cities. The operation was to start January 1, 2003, and by 2008, the year the Olympics is to be held in Beijing, the high-speed train, which runs at half the speed of an airplane, would connect Shanghai and Beijing.

China has been very savvy in importing technology which cannot be used in Europe, so China is not only a country of labour-intensive industries but also one with a variety of high-tech industries that drive a number of regional industrial clusters in the country.

A major change that has been witnessed over the last four or five years is, as I already mentioned, the emergence of China as a global manufacturing centre. The Flying Geese Formation is now being quickly realigned – with China in the lead. A number of industrial clusters are being created in China, e.g. in Shanghai, Hong Kong, Beijing, and Dalian. Furthermore, those industrial clusters have started to interact with the rest of Asia resulting in increased contact between Asia and various regions within China.

Most major Taiwanese companies have now established a foothold in mainland China. Singapore has gone into China as well. And many Japanese corporations are now relocating their production sites to various parts of China.

Recently, I was told by the CEO of a very well-known Japanese

company, "Until now, Sakakibara, we have been very successful in China, but all those goods produced in China were for export while we have continued to produce goods for consumption in Japan in our Japanese factory. However, the quality of the goods produced in China is the same as that in Japan, but the cost is about one-third in China." Naturally I asked him why he continues to produce goods for Japanese consumers in Japan, to which he replied, "It is a social obligation for the corporation to maintain employment in Japan."

His company is very famous for its lifetime employment system and is profoundly concerned for its employees' security and the quality of their employment. But even he has had to change his mind and confessed to me that from now he must move his Japanese factories to China.

This is the major structural change that is now taking place in Asia, including Japan, and it will eventually reach Europe as well. It is very likely that China will fundamentally change the division of labour in manufacturing in Asia and the world. As I said, the Chinese have been sleeping for the last 200 years, but they have now awakened and have the capacity and the entrepreneurship to again become the centre of the world.

It is important to understand the key concept for China, which is competition. There is strong competition taking place everywhere in China. Japan and Germany are more socialistic than China. There exists a higher degree of entrepreneurship and competition in China than in these two countries. China is a very energetic country.

Of course, the Chinese have many problems; e.g. non-performing asset problems and SOE problems. At the time of the Cultural Revolution China was a communist country without any competition. It has transformed that structure within a matter of 10 to 15 years and, in the process, has created huge problems in some areas. The non-performing asset problem is much larger than that of Japan. However, China is undergoing major structural changes.

3 Lessons of the Asian Crisis

After the East Asian crisis of 1997-98, Asian countries strongly perceived the vulnerability of their region, which does not have any viable regional cooperative scheme. They recognised that there is no global lender of last resort, that international organisations like the

IMF and the World Bank were not of much use in preventing or addressing the crisis, and that the United States did not infuse much in the way of resources into Asian countries when the crisis broke. The United States provided resources to Brazil and Mexico, of course, but never to Korea or Indonesia.

The United States has its own national and regional interests, and that is understandable. But we in Asia did not realise this fact before the East Asian crisis erupted. I am not critical of the United States, because the United States is not a lender of last resort. The United States is a nation-state which has its own national interest. So the East Asian crisis brought to Asian people the awareness that the so-called hub-and-spoke relationship does not have a genuine hub. The hub country is a nation-state which has its own interests – national and regional.

The East Asian crisis of 1997-98 has also given rise to the recognition of imperfections or the lack of governance in globalised markets. The Asian miracle, to a significant degree a result of the open and global nature of this region, suddenly turned into the Asian crisis. Not only global institutions, like the IMF and the World Bank, but also regional organisations, like ASEAN and APEC, were unable to play a useful role in stopping the contagion of the crisis.

Also, initial prescriptions by the IMF were misguided and might have actually aggravated the crisis rather than arresting it. It is not only the policy recommendations made during the crisis, but also those made before the crisis, that need to be re-examined. The strong pressure to deregulate, particularly in international finance, without comparable strengthening of financial supervision, exposed many countries in the region to a degree of risk unmanageable by national governments. International organisations could not substitute for national governments in managing these new market risks. What is necessary is not the substitution of market for government but rather the redefinition of the role of government in view of the rapidly changing international environment. In his book, *Rethinking the East Asian Miracle*, Joseph Stiglitz correctly points out what needs to be done in the future.

> "Just as before they were misled by the chimera of deregulation – they should have asked instead what is the *right* regulatory structure for their current situation – so too in the future, they will have to resist accepting without question the current mantras of

> the global marketplace of ideas. There will have to be *strengthened* regulation of securities markets and an improved overall legal environment, especially in areas such as corporate governance and bankruptcy. The legal structures will have to comport with international standards, yet be adapted to their own special situations; wholesale borrowing will not work."[2]

Policy efforts must be largely national. However, the question here in relation to regional cooperation is whether genuine regional institutions, similar to the EU, would help national governments in Asia to accelerate their efforts in the right direction. Or should we leave these matters to global international organisations, such as the IMF and the WTO.

I endorse the establishment of a genuine regional organisation in Asia, or at least in East Asia, on several grounds. First, existing global institutions are strongly biased toward market fundamentalism or the neoclassical paradigm, and their past records in international capital and finance are very poor. The establishment of a genuine regional organisation could provide a countervailing force and would contribute to reforming international institutions. Indeed, international institutions are necessary, but healthy competition among global and regional institutions would help improve their performance.

Second, international organisations, politically dominated by Western countries and staffed largely by Western economists, often lack sufficient knowledge of regional values, culture, and history and tend to impose their own views on, or try to "Westernise", the country in question. Indeed, international standards need to be adhered to, but standards should reflect existing diversities of culture and institutions. Regional organisations can supplement global ones effectively in such areas.

Third, as in the case of the EU, necessary structural reforms, such as those mentioned by Stiglitz, can be more smoothly and willingly implemented if such reforms are deemed essential for regional integration. There has been increasing resistance to externally

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[2] Joseph Stiglitz, "From Miracle to Crisis to Recovery: Lessons from Four Decades of East Asian Experience," In: Joseph Stiglitz and Shahid Yusuf (eds.), *Rethinking the East Asian Miracle*, Oxford University Press, New York, 2001, p. 523.

imposed reforms. Regional cooperation or integration (even slow integration) is a more effective way to internalise reforms.

Fourth, the lack of global governance, including a global lender of last resort and international financial regulation, is not expected to be remedied in the near future. However, rather than relying solely on national governance, there seems to be a role for regional governance, even though in a region like Asia where there is enormous diversity, regional governance is more difficult than in Europe, for example. However, more flexible and softer cooperation could be developed.

Fifth, regional integration has been proceeding quickly in Europe and a little more slowly in the Americas, although there also it is rapidly accelerating. Is it politically feasible or desirable for Asia to be as open and global as in the past? Might not Asia be victimised by these two predatory empires in the future, as it was in the 19th and 20th centuries? This is a rather defensive posture, but it has been a major driving force recently for regional cooperation in Asia.

4 Financial Cooperation in Asia

In Asia, there is a strong case to be made for expediting financial cooperation by way of foreign exchange cooperation. This may seem strange, because usually financial cooperation comes at the end of the regional integration effort – as the process in Europe illustrates. But in the case of Asia, the creation of a common currency, or some kind of currency union, is the type of regional cooperation that should be pursued. Because as regional interaction in trade and foreign investment accelerates, Japan, Korea, and China will become not only complementary but also competitive in their imports.

At this moment, Korea and Japan are competing in steel and ship building. Depending upon the movements of the dollar-yen rate or the won-yen rate, industries in both these countries have at times been hit very hard. In this case, stabilising the won-yen rate would alleviate the situation. This could also apply to the emerging steel market in China. Korea, China, and Japan will be the major players in the global steel market, along with Brazil and a few other countries. This supports the case for stabilising intra-regional exchange rates.

Of course, it is difficult to immediately create an Asian currency

union, but regional coordination of monetary intervention policy, at least, is possible now. As a matter of fact, Yung Chul Park informed me recently that when Japan aggressively intervened in the market during the last two weeks of June 2002, the Japanese government had consulted with both the Korean and Chinese governments concerning the intervention. It is probable that the Koreans and the Chinese imposed some restrictions on the mode of the intervention. To my knowledge, this is the first time the Japanese authorities had consulted the Korean and Chinese authorities concerning an intervention.

Having been deeply involved in the foreign currency market myself, I have never believed in the concept of "free floating", because every floating currency is managed to some extent. The degree of management differs depending upon the country, but the floating rate is always managed. In attempting to coordinate the management of floating rate currencies, the major difficulty at this point is with China's currency which still has a *de facto* fixed rate. But as China gradually deregulates foreign exchange controls and starts to move to a managed float, cooperation between China, Japan, and Korea could develop. China most likely does not need technical assistance because the Bank of China is well known for its delivery operations in the foreign markets, which indicates its familiarity with the technology. Thus, coordination among the three countries would be most beneficial in the area of foreign exchange.

Initial moves have already taken place. A target of 10-15 years from now could be set for the formation of a currency union among the three countries. At this point it is important to start by exchanging information. In my time, when we intervened in the yen-dollar market, the only financial authority we informed was the US Federal Reserve because it was an intervention vis-à-vis the dollar. Likewise, when the intervention involved the yen and the euro, we informed only the European Central Bank. Never did we contact Korean or Chinese authorities. However, officials are beginning to take that step now.

We have discussed in this conference the issue of formulating an exit policy for the currency board system and have agreed that this could be very difficult. Hong Kong has a currency board system, and China seems to cooperate with Hong Kong in that system. So, some kind of exit policy is necessary both for China and Hong Kong. A regional cooperative effort could facilitate the exit from a currency board.

The currency board system in Hong Kong is based on the US dollar. For a cooperative scheme among China, Japan, and Korea we should target the formation of some kind of Asian Monetary System, similar to the EMS, within 10 to 15 years. I agree with Charles Wyplosz that creating a common basket of currencies is not desirable. Instead, we should move directly to a currency union or to pragmatic cooperation among the authorities in coordinating our exchange rates. We could start there and later target the formation of a currency union, but not a common basket.

I don't know why so many Japanese economists like the common currency basket. It does not make sense because the yen would be included in the basket with the dollar and the euro; however, the yen has to be coordinated with the won and the yuan. We need to jointly float our currencies vis-à-vis the US dollar and the euro, thus, the Japanese yen must be on the side of the Asian currencies, not on the dollar/euro side.

One other thing that has been pointed out in our discussions relative to regional cooperation is that it is necessary to have the political will to form a regional cooperative scheme, particularly if a common currency is the goal. Not a great deal has been accomplished yet in this area, but some gradual progress has been made.

China and Japan together are the key to developing a common political will in Asia. The role of China and Japan in East Asia's integration process is synonymous with that of France and Germany in Europe's integration process. Korea could be a very effective mediator in the cultivation of a common will between China and Japan. In a broader context, the cultivation of a common will involving a wider group of Asian countries would necessitate the inclusion of Japan as a counter-balancing power vis-à-vis China. This is because most Asian countries fear being absorbed by China based on experiences of 150 years ago. That is another historical legacy.

The formulation of a common policy among China, Japan, and Korea would be the key to regional cooperation in the monetary and foreign exchange area in this region. Another key issue concerns the type of institution that is appropriate for the region – which countries should be its members and what issues should it address? A survey of existing regional institutions in East Asia seems to indicate that ASEAN+3 (ASEAN countries plus China, Korea and Japan) may be the appropriate one for development into a genuine regional organisation.

ASEAN+3 could be extended to include Australia and New Zealand. The complementary nature of these two economies with those of Japan, Korea, and China could make cooperation and integration more rewarding than if only ASEAN+3 countries were involved.

In terms of coverage, regional interest is quite strong in the area of international finance, as evidenced by the Chiang Mai Initiative, in addition to trade. It is my view that cooperation, and ultimately integration, should proceed simultaneously rather than sequentially in trade, FDI, and international finance, which differs from the process that took place in Europe.

China and the ASEAN countries agreed in late 2001 to form an free trade area within ten years, allowing for some preferential treatment for less developed ASEAN countries. Korea and Japan could join that arrangement making it an ASEAN+3 free trade area. Given the diverse nature of the participating countries, the free trade area could, and should, include some exceptions and preferential treatment at least in the initial stage. A pragmatic rather than purist approach is required here. The formulation of parallel and reciprocal FDI agreements should proceed simultaneously with trade liberalisation.

In the area of international finance, there are two major items on the agenda for the Asian region. First, coordination of foreign exchange policies to stabilise the relationship among currencies of the region seems long overdue. If the won-yen rate, yuan-yen rate and baht-yen rate, for example, move within a relatively narrow range, coordinating the foreign exchange policies of Korea, China, Thailand, and Japan could contribute to the stability of these economies. Eventually, cooperation should progress to the formation of an Asian currency unit (ACU) with a flexible snake around the central value, similar to the ECU and the snake – that is, the joint floating of Asian currencies vis-à-vis the US dollar and euro with a relatively wide band around the central rate. Although the creation of a common currency à la the euro may not be feasible in the short run, a soft and flexible form of currency union with an ACU should be possible and beneficial. It would enhance and accelerate integration through trade and FDI.

Speculative attacks are a realistic possibility, but with a wide and flexible band Asian countries should be able to fend off such speculation using the huge foreign reserves at their disposal, as long

as effective coordination of macro policies accompanies joint foreign exchange interventions.

The need to jointly defend an ACU with a wide band logically leads to the extension of the Chiang Mai Initiative into an Asian Monetary Fund (AMF), which would pool a portion of the foreign reserves of participating countries and conduct macroeconomic surveillance. Participating countries can conduct joint intervention and coordination of macro policies with the AMF as the Secretariat. Articles of the AMF can provide the modality and modus operandi of coordination and intervention.

We could designate a different name for the AMF, but I would propose to have some kind of a G-7-like regular meeting among ASEAN+3 countries. We need some type of forum to coordinate the exchange rate policies and macro policies and should have regular meetings three or four times a year. The Asian Monetary Fund should perform in a manner similar to that of the G-7 and provide a similar kind of surveillance of the countries involved.

Let me emphasise that the concrete proposal I have outlined is just one possibility, and the process of forming a genuine regional organisation should be gradual and pragmatic. As in the case of China's national policy, structural reform needs to proceed simultaneously with opening or liberalisation. The moves need to be gradual and simultaneous on all fronts.

5 Conclusions

In concluding, let me reiterate that in the medium- to long-term the spotlight of the world economy seems to be shifting from West to East, and Asian countries need to build appropriate institutional infrastructure to pave the way for this change. Establishment of regional mechanisms consistent with existing global institutions seems to be the best strategy, at least for the immediate future.

Given the global nature and historical legacy of the countries in this region, it would be advisable for regional cooperation to focus on foreign exchange and monetary policies. The eventual target in 10 to 15 years is the creation of a common currency. Immediate steps to be taken are the initiation of some form of effective coordination of foreign exchange policies among Korea, Japan, and China and other advanced Asian countries and the development of some type of new

forum for an Asian G-7, including the creation of a Secretariat. The Secretariat could be small and named something other than "Asian Monetary Fund", if that is preferred.

At the height of the crisis in East Asia, I proposed the formation of an Asian Monetary Fund (AMF). There was considerable enthusiastic support for the idea among Asian countries, but I made a strategic mistake. I had to draft the proposal in haste and, as a result, did not consult the Chinese as would have been sensible. I probably hurt their pride and that was a major mistake on my part. Another problem was that the United States did not favour the idea. When I talked about the idea with Kunio Saito, then head of the IMF's regional office for Asia and the Pacific, he initially agreed with me but was later swayed by some lobby causing him to reject the "Asian Monetary Fund" name.

However, even after the AMF idea was abandoned, primarily because of opposition from the United States for their own good reasons, there remains in Asia an interest in regional financial cooperation. What is more crucial than anything else, is the formation of a commonwealth among China, Korea, and Japan.

13

Comment on Eisuke Sakakibara

Amar Bhattacharya

Professor Sakakibara's discussion of regional cooperation follows quite nicely on the discussion on Eastern Europe, where deep integration is taken for granted. It has already happened in trade, and now the micro and macro alignment in finance is quite far advanced. The only remaining issue is whether the terminal monetary integration will happen in 2006 or 2008.

This shows you how far at least in one region things have gone. In Latin America, we did not discuss integration but the Free Trade Arrangement for the Americas (FTAA). There is a political commitment to launch that by 2005, although it is not clear whether it would lead to a single currency type arrangement. There are also questions about the way the FTAA will relate to sub-regional arrangements such as Mercosur.

East Asia stands out for its relative lack of regional institutions, which is, as Professor Sakakibara points out, is abnormal given the scale of Asia. He cites some numbers to make this point, but it is even more striking if you run the clock a little bit fast forward. If you take a long view, by 2020 China will be fast approaching the US as the largest economy of the world. South East Asia as a whole will also exceed the size of many G-7 countries if it resumes growth at 5 or 6 percent annually.

The other thing Professor Sakakibara points out is that Asia is very open, that its share of world exports is already about 27 percent and that this number will increase, especially with China entering the WTO. In terms of the international financial system, as Professor Park points out, East Asia has more than 1.1 trillion of foreign

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exchange reserves, much of which is intermediated elsewhere.

All this is impressive, and raises the question of why East Asia has not seen a more rapid pace of regional integration and does not occupy a more prominent place in the multilateral order. As Professor Sakakibara said, it has to do with politics, and with the issue of governance of the global system. I will focus more on the economic side, raising four different issues.

My first point is on trade. It is not just that East Asia is benefiting from global market places, as Professor Sakakibara mentioned, but it is that East Asia stands to gain the most from a multilateral approach to trade – more than any other region in the world. Our calculations at the World Bank, for example, show that if there were full-scale multilateral trade liberalisation, the increment to income for East Asia would be 2 percent, a huge amount compared to 1.2 percent for other developing countries and compared to 0.5 percent for the rich countries. East Asia's approach to the trade agenda has to be therefore quite different given its large stake in the global trading system.

My second point, to put the trade picture in perspective, is that the world today in terms of trade barriers is very different than when Europe was contemplating its trade integration or even when Mexico and the US were contemplating their trade integration. Against that background, there is a lot of discussion in East Asia about regional trade arrangements. There is a whole variety of regional proposals – there is ASEAN+3, there is ASEAN+3 + New Zealand + Australia, there is APEC Preferential Free Trade Area, there is APEC MFN-based liberalisation – and the important point about all these arrangements is that the benefit is the greater the larger the number and more diverse the membership is.

Using just the example that Professor Sakakibara mentions in his chapter, ASEAN+3 as a basis for trade liberalisation would give global gains on the order of 11 billion dollars. For APEC the increase approaches something like 48 billion dollars in terms of global welfare.

Again, the important point is that East Asia benefits much more from multilateral trade liberalisation than it does from sub-regional or bilateral arrangements. Does this mean that there is no role then for regional action? No, there is a role, but the actions are much more in the area of trade facilitation, in the area of harmonisation and in the area of investment policy. This is one of the objectives of the

non-discriminatory free trade arrangements that some countries have been pursuing on a bilateral basis in the region.

My third point is on finance. As Professor Park mentioned, capital markets are global, which has implications for the nature and scope for regional action. Certainly the formation of a currency union can be a powerful catalyst for trade and financial integration. But it works also as a political driver of integration, in the sense of getting finance at the micro and the macro level right. However, as Professor Sakakibara said, the building of a currency union will inevitably take time in East Asia, so there are things you can do in the short run such as improving coordination in terms of exchange rate regimes.

The second aspect of financial integration where there is potential for regional action has to do with financial stability, where Professor Sakakibara has proposed better regional arrangements to deal with contagion risks. There are some difficult issues here. One is covariance risk. Inevitably the risks will be greater within the region, and it is not clear that regional arrangements will necessarily be the best approach for risk pooling. Another difficult issue that arises is the need to make a determination on the balance between financing and adjustment and how to "bail-in" the private sector. These judgments and agreements will be most effective if all actors are involved, globally and regionally. The fundamental point therefore is, that while you could think of a regional financial stability arrangement as a complementary to international mechanisms, as indeed the Chiang Mai Initiative has been conceived as, it is very difficult to think of it as an alternative, which is implicit in the chapter of Professor Sakakibara and which seems to be implicit in his presentation.

So I would argue that if you have global financial markets, then you have to have global arrangements – obviously reinforced through regional mechanisms.

The fourth point Professor Sakakibara did not mention, and where I think there is scope for regional cooperation, is regional infrastructure. Professor Park mentioned that there is a big risk that Asia will be over-run by foreign financial institutions. The answer he provided is not to keep foreign institutions out, but to develop the market infrastructure, to develop the standards and to develop the human capital so that you are able to compete. Indeed, I would argue that is the key, rather than to be concerned about ownership and keep the foreigners out.

Professor Sakakibara is right that there are weaknesses in the global governance system, but it would be a mistake to withdraw to a regional system. If anything, Asia is now well equipped to play a large role and it should seek a larger role in global governance. The entry of China into the WTO shifted the balance of trade in favour of Asia. Given the changing role of Asia in trade and finance, it is entirely appropriate that Asia is seeking a greater role in international financial institutions and, indeed, in global financial governance.

So the agenda on enhancing regional cooperation in a globalising world rests on three pillars. First, Asia should seek a greater role in the global financial governance system, just as it strengthens regional arrangements. Second, I would argue very strongly that Asia has a disproportionate interest in a multilateral system of trade. There is a big risk that there could be a spaghetti bowl of confusion if Asia goes for multiple regional trade arrangements and multiple bilateral free trade arrangements, which are potentially inconsistent and can detract from the attention and span of policymakers. Third, in the financial arena, while there is considerable scope to pursue regional initiatives, such as in developing bond markets, these should be seen as complementary to strengthening the international financial architecture if we are to address the concerns on crisis prevention and resolution in globally integrated capital markets.

14

Comment on Eisuke Sakakibara

Barbara Stallings

From his post in the Japanese Finance Ministry, Eisuke Sakakibara was a major player in global economic policy making in the 1990s, so his views on this topic area are of particular interest. In his paper for this volume, those views are expressed through personal reflections on Asia's historical place in the world economy, projections about the future shape of the international political economy, and policy proposals with emphasis on financial cooperation in the Asian region. Given the subject matter of the volume, the third aspect is most relevant, so my comments will centre of that part of the paper. Their main aim is to locate Professor Sakakibara's ideas in the more general discussion of Asian economic cooperation and to identify some questions that need further clarification.

The Status Quo Ante

Sakakibara's discussion of recent developments in Asia dates from the Plaza Accords of 1985, which led to a surge of Japanese investment in other Asian countries. He refers to this process by the commonly used phrase "Flying Geese Formation', whereby Japan was alleged to transfer its technological prowess to its less developed neighbours in a staged process. Although used with great frequency in the literature, this concept is nonetheless controversial since (a) it takes for granted the role of Japan as "lead goose" and (b) assumes that the other "geese" are all adopting the same features.[1] Both assumptions

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will become relevant in analysing the proposals for increased financial integration below. Another characteristic of the flying geese model is that this form of regional integration, which centred on foreign direct investment and trade, was governed by market mechanisms rather than inter-state treaties. Indeed, Asian integration schemes in general have been less institutionalised than their western counterparts in Europe or the developing world. This tradition would be scrapped in the proposals that we will examine below.

Reasons for Change

Asian growth rates in the post-war period were spectacular, exceeding those of other regions by a substantial amount. Exactly what role the Flying Geese Formation played in the success of Asia's development may be debated, but other regions increasingly looked to East Asia for an example of a national development model, including the regional integration component.[2] All of this came to an abrupt halt in 1997-98, as a financial crisis hit the region. Among the side effects of the crisis was a reconsideration of the nature of regional integration; Sakakibara's discussion of reasons for change derives to a large extent from experiences during the crisis. These centre on the policy conditionality accompanying loans by the International Monetary Fund (IMF) to Korea, Thailand, and Indonesia as well as the failure of the United States to take an active role in dealing with the Asian crisis in contrast to similar situations in Latin America. Beyond the crisis, however, geopolitical changes were also taking place as Japanese economic power declined, while that of China rose rapidly. The decade-long recession in Japan has reduced the resources the country can invest abroad, while China's dramatic growth has raised its profile in economic as well as political and military terms. The resulting disequilibria with respect to the Flying Wild Geese scheme clearly require some kind of restructuring.

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[1] For a critique, see Mitchell Bernard and John Ravenhill, "Beyond Product Cycles and Flying Geese: Regionalization, Hierarchy, and the Industrialization of East Asia", In: *World Politics*, Vol. 47, January, 1995. pp. 171-209.

[2] See, for example, Michael Mortimore, "Flying Geese or Sitting Ducks? Transnationals and Industry in Developing Countries", In: *CEPAL Review 51*, December, 1993, pp. 15-34.

The Actors

The processes already mentioned imply a necessary shift in the cast of characters in the regional drama – and in their relative importance. Taking the mid-1980s as a starting point, a study of the literature reveals almost total concentration on Japan, on the one hand, and the "four tigers" (Korea, Taiwan, Hong Kong, and Singapore), on the other. By the late 1980s and early 1990s, South-East Asia was beginning to attract attention, but in an essentially passive role as a recipient of investment from Japan and the four tigers. China (and Indochina) were still on the sidelines. A dramatic indication of the failure to take China into account is Sakakibara's admission that he did not even consult China before announcing his proposal for an Asian Monetary Fund (AMF) in 1997. Now, however, he appears to be moving in the opposite direction and according China a (the?) central place in his new proposals. When he says that "the Flying Geese Formation is now being quickly realigned – with China in the lead", it is not clear if he means that China will replace Japan as the lead goose or if China is simply taking the lead in forcing change more generally. In either case, China has joined Japan as the dominant actors in the new scheme that he proposes although, as will be discussed below, the relationship is far from harmonious. The other key player is South Korea, to which Sakakibara assigns the awkward role as "mediator in the cultivation of a common will between China and Japan".

The Proposals

The discussion thus far has provided background for this section on the proposals *per se* for a new regional integration system in East Asia. Sakakibara's paper is confined to a presentation of his own views. As mentioned earlier, these are the views of an informed and influential policymaker, but they do not exist in a vacuum. It is thus useful to consider his proposals in light of the extensive literature that has emerged on this topic since Malaysian prime minister Mohamad Mahathir proposed the East Asian Economic Caucus in the early 1990s. Obviously not all of it can be discussed in these brief comments, but some other proposals can be compared with those of Professor Sakakibara.

Sakakibara's main message is that East Asian countries need to move forward rapidly in the area of financial integration, not waiting for trade integration to develop further. Specifically, he says, "it is my view that cooperation, and ultimately integration, should proceed simultaneously rather than sequentially in trade, FDI, and international finance, which differs from the process that took place in Europe". In order to achieve this goal, he proposes two main tasks. First is coordination of foreign exchange policy, leading to the formation of an Asian currency unit (ACU) that would float within a flexible band, similar to the ECU and the snake. The need to defend the value of the ACU leads to the second task, which is the creation of an institution to pool the region's huge foreign exchange reserves. As the reincarnation of his earlier proposal for an Asian Monetary Fund, the new institution would be based on the so-called Chiang Mai Initiative of 2000. The Chiang Mai Initiative, with its ASEAN+3 (Japan, China, and Korea) membership, is an agreement to provide bilateral swaps in the event of a member needing access to foreign exchange. The new institution would meet regularly to coordinate policies and conduct surveillance of each other's economies.

How does this set of proposals relate to others that have been put forward, both in Asia and elsewhere in the world? Two differences merit consideration. First, the Sakakibara proposals are more optimistic, but less clear, than most others. A recent paper by two influential economists from the United States (Fred Bergsten, director of the Institute for International Economics) and Korea (Yung Chul Park, professor at Korea University and former government official) strongly supports greater financial integration in Asia but is more doubtful about chances for success.[3] In particular, they are concerned about the "looming economic rivalry" between Japan and China (p.78), to which Professor Sakakibara pays little attention. Furthermore, they place much more stress than does Sakakibara on the need for a regional surveillance mechanism among member countries to monitor policies that might have negative ramifications for the region as a whole and to avoid moral hazard in lending. A related paper, published by Bergsten's institute, "conditionally" supports the Chiang Mai Initiative, expressing

[3] C. Fred Bergsten and Yung Chul Park, *Toward Creating a Regional Monetary Arrangement in East Asia*, Research Paper No. 50, Asian Development Bank Institute, Tokyo, 2002.

approval about the fact that it is much more modest than the AMF proposal.[4] The author also emphasises the necessity to get support from, and to cooperate with, the IMF. The relationship with the IMF was a major stumbling block for the AMF, over the issue of whether a new regional institution would be a substitute or complement. Unfortunately, Sakakibara does not spell out his position on this issue, although he implies that he now favours a regional financial institution that would complement the IMF. His rather oblique comment in the concluding section of the paper is: "Establishment of regional mechanisms consistent with existing global institutions seems to be the best strategy, at least for the immediate future."

A second difference between Sakakibara's proposal and others in the literature is their relative scope. Sakakibara focuses exclusively on government-to-government relations, while others usefully add in proposals for private sector development and the strengthening of existing financial institutions. One such proposal is that of Thai prime minister, Thaksin Shinawatra, to establish an Asian Bond Fund. Regional governments would contribute a small percentage of their international reserves to a fund dedicated to purchasing bonds of member countries and thus strengthening national bond markets – a concern of most Asian governments after the financial crisis.[5] This proposal was put into effect in June 2003. While small in scale, some see it as an initial step that could become more important in the future. A second proposal is the one by Yung Chul Park in this volume, which focuses on the need to develop locally based private sector institutions in financial services, such as commercial banks, investment banks, insurance, derivatives, and merger and acquisition firms. Currently, Park argues, such institutions are heavily dominated by foreign firms, which leaves the region vulnerable to the whims of outsiders. These proposals dealing with private sector institutions could, of course, be combined with an inter-governmental institution as proposed by Sakakibara.

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[4] C. Randall Henning, *East Asian Financial Cooperation*, Institute for International Economics, Washington D.C., 2002.

[5] See discussion by Ramkishen Rajan, "A Bond Fund for Asia", In: *Far Eastern Economic Review*, March 20, 2003, p. 43.

Implications for Other Regions

Although Professor Sakakibara has no reason to mention it, the debate on East Asian regionalism is resonating beyond the borders of the countries directly involved. This is especially true in Latin America, but also in South Asia and Africa to a lesser extent. Central and Eastern Europe, of course, have already begun the process to join the European Union, so the regionalism debate has been resolved there. In Latin America, regionalism has mainly focused on trade until now. Recently, however, discussion has begun within the sub-regional associations, especially Mercosur, about macroeconomic coordination and even a common currency. Likewise, more emphasis has been accorded to regional financial institutions, several of which already exist in Latin America. The two most important are the Andean Development Fund (CAF), which lends money for investment projects to members of the Andean regional group, and the Latin American Reserve Fund (FLAR), which provides balance-of-payments support to member countries.[6] Both are fairly small-scale operations, but there have been proposals to expand their scope. In this context, Latin America has been an interested observer of the Asian debates about financial integration, but it might also be useful for East Asia to study the successes and shortcomings of CAF and FLAR. Such dialogue has already begun. An important example is the Interregional Meeting on Financing for Development, organised by the Regional Commissions of the United Nations as a preparatory forum for the Monterrey Conference in March 2002, which gave major consideration to regional financial institutions.[7] Continued interchange would be useful for all.

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[6] For a description of these institutions, see Daniel Titelman, *Multilateral Banking and Development Financing in a Context of Financial Volatility*, Financiamiento del Desarrollo Series No. 121, Section V, 2002.

[7] See "Summary of Conclusions", Interregional Meeting on Financing for Development, Mexico City, Section II.5, January 2002.

Barbara Stallings

15

Floor Discussion of "Asia: A New Agenda of Financial Reform and Regional Cooperation"

The Park Paper

Age Bakker of the central bank of the Netherlands, wondered what problem Yung Chul Park was addressing in his paper. "The paper has lots of statistics, but I lack a definition of the problem," he said. "What exactly is the problem for Asia? Is the problem that exchange rate movements vis-à-vis the dollar are not the same? Is the problem that exchange rate movements hamper regional trade integration? Is the problem that you are not able to define your own monetary policy? It is not clear to me what the starting point is of the discussion."

Bakker added that in Europe, monetary integration was motivated by the fact that trade integration was indeed hampered by intra-regional exchange rate fluctuations. But in the case of Asia, regional trade integration seemed to be moving very well. So if Professor Park saw the challenge as one of regional financial integration, Bakker was afraid he was choosing the wrong road. "Regional financial integration is not going to help Asia, because financial integration, by definition, is a global phenomenon. Capital is fungible, it can flow anywhere, and in Europe we have never opted for first having European financial integration and then opening up to the outside world, because according to our analysis, that is an impossible route. There will always be escape routes."

A second point raised by Bakker was the purpose of the Chiang

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Mai Initiative and whether the envisaged reserve funds would be large enough. "With regard to the reserve funds, the European experience shows that you need to have a very clear purpose before it will do anything tangible. An Asian Monetary Fund is not going to impress the financial markets if it is unclear what it is trying to achieve. If it is trying to achieve stabilisation of Asian currencies vis-à-vis the dollar, then you will need tremendous funds. But if its purpose is to help regional countries that will be hit by contagion and by financial crisis, then you first need to define what sort of exchange rate relations you would like to have among yourselves. There, the European experience shows that a starting point would be to agree politically that your bilateral exchange rates are a matter of mutual interest. Now, for that you don't need statistics. What you need is political willingness. You might even need a hub, for instance Japan."

Eisuke Sakakibara, former vice minister of Finance of Japan, suggested that Yung Chul Park's view reflected a nationalistic and xenophobic backlash against foreign investment banks all over Asia. "We had this backlash in Japan as well," he said. "Several American investment banks received harsh penalties for minor violations of the law. But basically this is a reflection of the sense of insecurity and the sense of vulnerability of the Asian countries. I am not surprised by the statistics that Yung Chul has given us. This hub-and-spoke relationship has existed between Asia and the United States for decades. Look at the national security arrangement between the US and Japan, this is also a hub-and-spoke arrangement. It is the nature of the Asian economies, being dependent on the US. This strong relationship between the US interest rates and money supply and our domestic interest rates and money supply is not surprising. Even after floating, we continue to manage our exchange rates vis-à-vis the dollar. There is no market between the Korean won and the Japanese yen, there is only a yen/dollar market and a won/dollar market, and we have managed those floats through intervention vis-à-vis the dollar. However, it is important to realise that after the East Asian crisis in 1997, Asia has become aware of its heavy dependence on the US and that it may give rise to increasing vulnerability of the countries in the region because it is an inherently unstable relationship. This is why the fever for regional cooperation has intensified after 1997. After the crisis people came to recognise this very heavy dependence on all fronts on the US."

Sakakibara told of an experience on an Advisory Board which was

chaired by Henry Kissinger. "When I started to talk about ASEAN+3 and regional economic cooperation among China, Korea and Japan, Kissinger jumped and said: 'Sakakibara, are you choosing China over the US? Then we have to rearrange all of the things we have agreed on in our security relationship with you and the rest of Asia'. That's the very typical American perception, a hub-and-spoke relationship in all fronts with Asian countries. My perception is that time has come to gradually change that relationship vis-à-vis the US. Maybe it is still too early to create a won/yen market, but we can at least coordinate our intervention efforts or our management of the floating rate vis-à-vis the dollar between Korea and Japan."

Marek Dabrowski, a former vice minister of Finance of Poland, said that Park and Sakakibara were not talking about an exclusive Asian problem. "All financial transactions are, in fact, going through a very small number of global financial centres. It is the same in Eastern Europe and in Europe in general, where most of the transactions are going through London and New York. This is the natural organisation of financial markets. For technical reasons, this market is much more centralised than the markets of goods or services. We must live with it."

Dabrowski stressed that, if Asians were thinking about building a new regional currency, one of the key questions was whether it could sustain competition with currencies like the dollar and the euro. Another key question was, in his view, that "in order to build any kind of regional currency you must have a minimal political commitment and some supranational political institution. If you take the political decision to build a monetary union, this helps to eliminate asymmetric shocks, synchronise business cycles and promote trade and capital flows inside the future common currency area. Political readiness to run common monetary policies is very important. I don't know of any historical experience where a monetary union could be sustained without political commitment."

Zdeněk Drábek, of the WTO, also wondered what problem Park was discussing in his paper. "The one interesting answer that I was trying to give to myself," he said, "is that there must be a big difference between integrating trade as opposed to integrating financial institutions. I am very encouraged to see that the Asians are integrating on the trade level. At the same time, I am not surprised at all that the financial integration is not taking place as you would like to think. But I would like to pursue the question further and go

beyond the variance analysis. If you ask, what really are the impediments to the fact that the syndicated loans are not run by Japanese banks or Thai banks, you will find interesting answers. Maybe it is the fact that there are five investment banks that dominate the capital markets, or the fact that there are three major world currencies. Those are the major issues, but at the same time I ask myself if it really matters. Ten years ago we were all worried that we were going to be taken up by Japanese banks. How quickly things can change. So I would not worry so much about the fact that regional financial integration has not proceeded as fast as you would have wished."

Rogério Studart, of ECLAC, thought that the problem of financial globalisation was not so much a question of ownership of capital, nor the oligopolistic characteristic of it, but the clash of institutional settings. "Every country has developed a certain type of financial institution that was functional to the process of development. For many years in East Asia, the banks were machines for financing investment and trade. In the 1990s, this institutional setting lost a little bit of its functionality with financial deregulation when the existing institutions began failing for competitive reasons or for other reasons. This led to a situation where the institutional setting that was once functional, began to disintegrate. What I see in the 1990s in East Asia is that the problem was no so much financial integration but the fact that financial deregulation destroyed some of the institutional settings that had been created within the financial system to finance investment and trade and nothing was put there to replace them."

Stephany Griffith-Jones, of the Institute of Development Studies, thought that she understood very well what problem Yung Chul Park was trying to solve through Asian monetary cooperation, namely the serious problem of the vulnerability of developing countries to large international capital flows. "But what I don't really understand," she said, "is why the Asians just don't go ahead with monetary cooperation, because as Yung Chul has pointed out so clearly in previous Fondad meetings, the reserves that are available in the Asian countries are very large, more than 1000 billions dollars."

Griffith-Jones also wondered why the Asians should worry about security arrangements with the United States. "If the Americans had said the same things to the Europeans, as Kissinger has said to Sakakibara, I don't think the Europeans would have worried so much about it."

Charles Wyplosz followed up on Sakakibara's comment that Park's paper was about nationalism and pointed to the importance of political movements. "I suspect that in Argentina after the crisis there might also be a rise of nationalism," he said.

"Anybody who knows what nationalism is, would not say that," Yung Chul Park retorted. "You are turning my paper into a paper about nationalism..."

"That is not what I am saying," Wyplosz replied, "I am saying that nationalism is playing a role and that this is something we should be concerned about because we are talking about multilateralism and financial integration. For us, as economists, financial integration makes a lot of sense, it is about efficiency and so on, but if the people down in the street see it as foreign interference, then the whole thing would collapse. We already went through the opening up and closing down of the international financial system once (in the first half of 20th century), under deep political pressure, and that's why I became scared by Eisuke Sakakibara's interpretation. I see that Yung Chul doesn't like this interpretation, but he should not complain to me but to Eisuke."

Wouter Raab, of the Dutch Ministry of Finance, did not like the term nationalism and moved the discussion in another direction. "Part of the answer to Yung Chul Park's question of why liberalisation of financial markets has not automatically led to integration of financial markets, is that you need an awful lot of regulation and an awful lot of harmonisation before that takes place. Financial integration does not follow automatically by opening up, you need to do a lot of hard work. This is even more so than in the case of trade, because even when there are numerous non-trade barriers, you can still ship goods from one country to the other. But in the financial sector, to give you an example from the Netherlands, you are not allowed to offer any financial products to, for instance, Germany. There are still a lot of barriers that have to be broken down."

In his reply to the comments, Yung Chul Park expressed amazement that so many people suggested that the problem he addressed in his paper was unclear. "I am trying to write a scientific paper. It has nothing to do with politics, with nationalism or anything else. That is the last thing I have in mind. If you read some of the recent papers by Andrew Rose and his associates, the empirical evidence is clear that the formation of a currency union among a

number of countries leads to a substantial increases in trade, and that it is a welfare gaining activity. There is no doubt about it. Second, the formation of a currency union is not a stumbling block, but a building block for global integration. My point is that in East Asia, 13countries have been working together to establish a regional financial arrangement with the long-term objective of creating its own currency, and this objective has nothing to do with nationalism or anything else. If you look at the trade side, you see that the 13countries are clearly moving toward a currency union. Within 5 or 10 years the 13 countries will be able to agree on monetary integration if you only look at the trade side, and there will be a lot of gains to be made by fixing their exchange rates or creating their own currency."

Park mentioned some of these gains by recalling the "crazy fact" that the 13 countries of East Asia are running a financial surplus and are financing deficits of the rest of the world, including the US, while none of these Asian countries, except Japan, has been able to borrow from international financial markets in their own currencies. "If you create your own currency and currency union, then securities denominated in regional currencies will automatically spring up. And if these countries can establish regional financial markets, then regional financial markets may be able to finance more of investment in East Asia."

Park concluded: "As for the definition of the problem, I have many definitional problems, but let us not forget that economics is a definitional problem to begin with. I don't understand how what I am saying can be interpreted as nationalistic. I am not against financial globalisation, I am saying that we can have financial globalisation and, at the same time, regional financial integration. These two can go together. In Europe, you have Europe-based financial markets and Europe-based financial integration and that is not inconsistent with globalisation."

The Sakakibara Paper

In the discussion on Sakakibara's paper, Yung Chul Park returned to the criticism of Europeans to Asia's efforts at regional financial cooperation. "Why is the formation of a regional arrangement in East Asia receiving such a hostile reception from Europeans, who

worked for many years to come to where they are now?" wondered Park. "I would think that the European Union would be supporting an East Asian regional arrangement more than any other country or grouping of the world. But that is not the case. And why is Europe so anxious to expand its territory (to the east) and its influence at the same time?"

Following up on Sakakibara's paper, Park addressed the question of whether the Chiang Mai Initiative or the bilateral swap arrangements were going to be a substitute or a complement to global arrangements from institutions like the IMF. "It should obviously be a substitute," he said. "After the East Asian crisis, most of the crises are going to be current account crises and what you need in such crises is immediate, large amounts of liquidity without any conditions. You can worry about conditionality later. In the case of Korea, it took 10 days to agree to the IMF conditionality. But if there are any symptoms of a currency crisis, you need an immediate supply of a large amount of liquidity and this can only be provided at the regional level. Even though East Asia is not one of the richest regions in terms of living standards, it is one of the richest regions in terms of savings with more than 1 trillion dollars in reserves. Isn't it a crime that we are lending these dollars to the US? We could lend it for better purposes, we could lend it to Africa, to Latin America maybe even to Central Europe."

José Antonio Ocampo, of ECLAC, stressed that regional institutions should not only be complementary but also competitive to global institutions. "There are three arguments for competition. The first one is what I have called the federalist argument – a heterogeneous community will not always want to have an all powerful central power. This is why Europe would never have allowed the crisis of the EMS to be managed by the International Monetary Fund. The second argument has to do with the problem of control over the global institutions. Global institutions are not democratic. Since there are specific interests behind the world institutions, it is good to have competition. A third argument relates to small players. Small players always like competition, that is the traditional neo-classical argument. So why not have competition in the supply of financial safety nets? If a small country like Honduras goes into a crisis, it is better off with three or four alternative institutions supplying it with financial support rather than one."

Charles Wyplosz supported José Antonio Ocampo's plea for

competition by regional institutions, and gave an additional argument. "The IMF, like any institution, is bound to make mistakes in its analysis, but when the IMF makes mistakes, it doesn't pay the price and the costs can be huge for the countries that have to go through their conditions. A good reason for competition by regional institutions is that it would increase the competition for ideas. So when the IMF says: 'We think Korea should do this' or 'Argentina should do that', a competing Fund could say: 'No, this is wrong', and a healthy debate will be triggered. However, in a crisis situation you can't discuss too long."

Roy Culpeper, of the North-South Institute, thought that both Eisuke Sakakibara and Yung Chul Park (as well as José Antonio Ocampo and Stephany Griffith-Jones) had clearly demonstrated the weaknesses of the global financial system as well as the rationale for regional solutions. "I see the strengthening of regional cooperation as a strategy for trying to remedy what the global architecture has been unable to do. Since 1997, we have seen discussions about collective actions clauses, about debt standstills, and recently there was a glimmer of hope with the debt work-out arrangements that Anne Krueger put on the table in the IMF. But all of these proposals have been on hold and this has contributed to a sense of frustration both in Latin America as well as in Asia. Let's be honest about it: it is global real-politik that determines how global institutions work. And if regions of the world want a financial architecture that really does look after their interests, they have to look to a regional solution."

Culpeper went back to the question of what one really gains with financial and capital market liberalisation and said that the answer was not yet clear. "Amar Bhattacharya gave some numbers for the gains of trade liberalisation, but even on the cause of the relationship between trade openness and economic growth, the jury is still out. But the jury is certainly out on issues of financial sector liberalisation. All of the evidence and analyses that I have seen suggest that the gains from financial sector liberalisation and capital account opening are very questionable, perhaps even negative.

I am reminded of some work that Martin Feldstein and Charles Horioka did over a decade ago, which pointed to high correlations between domestic savings and investment. They were actually talking about how little the world capital market was integrated and this is reinforced in large part by the work of people like Dani Rodrik who argued that, if you are concerned about growth and development and

poverty reduction, basically what you have to do is increase your savings rate and your domestic investment. That is what it is all about."

Heiner Flassbeck, of UNCTAD, thought that Roy Culpeper stated it too simply. "I agree that there are a lot of disputable assumptions in the theory that opening everything would be the best for the world, but to go to the other extreme and say, 'Don't care about capital markets and just promote your savings and investment', is too simple because what will happen is that countries will not stop trading but will start having trade wars and the like. You will have shocks of huge dimensions coming from devaluation, which is the best instrument you have to promote exports, and from subsidies and other instruments you have to promote exports such as lowering taxes. We need solutions for some problems, we have to try to find common rules for certain kinds of interventions by governments in the market. Saying that you can just rely on your national powers and abilities, is going a step too far."

In his reply, Eisuke Sakakibara stressed that one of the major motivations for the creation of an institution like the Asian Monetary Fund is that the globalising financial market is inheritably unstable without a global lender of last resort and without a global regulator. "In Asia," he said, "the idea is: If we are accumulating 1 trillion dollars of reserves, why not pool the reserves regionally and create a regional lender of last resort? Let's pool half of it and come up with a joint strategy in terms of crisis management and stabilisation of exchange rates."

Sakakibara warned that if financial markets are fully liberalised without having a lender of last resort and global regulator, the world is left with a completely unstable financial system. "The crises will hit us over and over again as globalisation proceeds. If the IMF could play the function of a lender of last resort to some extent, it would be a different story, but it has proven that it cannot do that nor does it have the political mandate to do that. We have gone through all kinds of discussions on the international financial architecture, I myself have been involved in the discussions and I respect the efforts that have been made, but not much has ever come from it.

We need competition to reform international financial institutions. I am not against financial integration or financial liberalisation. You should let the market proceed, provided that we have some public mechanism of lender of last resort and regulation,

provided that competition policy is imposed in those institutions, and provided that conflicts of interest of accounting firms, rating agencies and so on be pointed out and that these firms are regularly inspected. Let the public institutions develop either globally or regionally to stabilise inherently unstable global financial institutions.

What we try to promote in Asia is horizontal networking. Japan has no intention of becoming a hub in Asia, we can't, we don't have the capacity nor the attitude to be a hub in Asia – if anything China could be hub. One of my favourite jokes these days is that within 10 to 20 years, Japan may become the 51st state of the US or the far East province of China. What we need is networking and horizontal cooperation, not hierarchy.

The time for G-7 is over. Europe has now been integrated into one unity. There is no reason to have Italians, French and Germans separately in the G-7, you should have one European country. Other fora are needed that include Europe, the US, China and India along with Japan and Russia.

We need a completely different type of organisation, we need an international negotiating forum. I have participated in G-7 processes for about a decade but the effectiveness of G-7 has declined throughout this period. The effectiveness of – and I'm sorry to say this – the IMF and the World Bank has also declined throughout this decade. So some other international financial and development infrastructure is now required."

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