

Reflections on Financial and Monetary Developments in Asia

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The economies of Asia are again a focus of the attention of international economic organizations, multinational enterprises, investment banks, and hedge funds. After having been thought of as a dynamic growth pole in the early and mid-1990s, the region was somewhat forgotten, at least as a place to invest one's capital, in the immediate aftermath of the financial crisis of 1997–98. Now, as China has grown to become the fourth largest economy in the world and continues to grow at breakneck speed, as Japan appears to be coming out of a decade-long economic slump, and as other economies in the region are showing signs of healthy growth, the region is back on the radar screen of international investors and commentators.

With the rise of China as a major manufacturing hub, the region has seen a remarkable increase in economic integration as measured by trade in goods. For example, since the late 1990s, intraregional trade has accounted for over half the growth in the exports of the emerging economies in the region (Zebregs 2004). While the integration of financial markets is lagging, important initiatives are being proposed, and concrete actions have been taken to deepen this integration. Further developments are likely to lead to significant changes in financial relationships among the economies in the region in the years to come. Although full monetary integration is still only a distant possibility, the deepening of financial links has important implications for how the transition to closer monetary cooperation among central banks in the region should proceed.

This essay will focus on three aspects of financial developments and relations in East Asia: the process of financial integration and its implications for financial stability, the consequences of greater financial integration for the process of monetary integration, and the growth of official international reserves and what this may mean for reserve management.

As will become clear in the course of the discussion, these topics are closely related to each other and to the integration of the region with financial markets in the rest of the world. What I propose in this essay is not a detailed blueprint for efforts to promote and manage the integration process, but a vignette of the developments I see shaping progress and debates in the region in the coming years.

The case for financial integration in East Asia

Concrete steps are being taken to further financial integration in Asia because financial integration is felt to contribute to a more efficient allocation of resources in the region, thereby supporting continued economic growth. Moreover, integration also contributes to greater financial stability.

The fundamental characteristic of financial integration is that net savers in an economy may have access to any investment vehicle regardless of the geographical location of the saver or the issuer of the investment product. Similarly, entrepreneurs seeking funds to finance capital expenditure plans may, in a financially integrated area, have access to sources of credit irrespective of geographic location.

Financial integration permits the efficient transfer of funds between economic units that have savings in excess of their investment plans to economic units for which the opposite is true.

As a result, net savers will receive the highest return on their funds, and investors will obtain credit on the lowest available terms. In addition, financial integration enhances competition in each locality since savers and investors are not constrained to deal only with local suppliers of financial services, but may search for the most efficient supplier in the entire integrated area.

It is uncontroversial to suggest that financial integration within a given jurisdiction will be beneficial for the economy as a whole. Few would question that financial integration within the United States, for example, has made a positive contribution to that country's economy. Similarly, expanding financial links across provinces in China would make the mobilization of the high savings and the allocation of capital there more efficient, leading to sustained economic dynamism. But the benefits of financial integration need not occur only within a single jurisdiction. Observing from afar the process of economic integration in Europe, it is clear that financial integration across national borders will make a positive contribution to the region's economic development.

Financial integration across economies here in Asia has not proceeded as far as it has in Europe and North America, even though the degree of economic (particularly trade) integration within the region has been rising sharply. In the financial sphere, Asian economies are less integrated with each other than they are with economies in the rest of the world. I believe that economic integration brought about by market forces and reflecting comparative advantages in production within the region can best be served by a level of financial integration that is similar.

It is difficult to provide empirical evidence to support the hypothesis that the optimal degree of financial integration is the same as or close to the degree of economic integration within a region. There are theoretical difficulties in identifying measures of optimality. There is no established measure of the actual degree of financial integration, let alone the degree of economic integration.

Lack of empirical evidence notwithstanding, it seems unproblematic to suppose that the synergy driving economic integration can best be harnessed financially by the stakeholders themselves, who know better what they are doing and take a longer-term view, rather than by people who are motivated largely by relatively short-term financial rates of return and who are acting in accordance with credit assessments conducted many miles from where the action is.

Regrettably, for a variety of reasons, financial integration in Asia lags considerably behind economic integration. Currently, a sizable portion of gross savings in Asia finds its way into the debt instruments of governmental and quasi-governmental issuers in industrialized economies, while investment in Asia is financed, to a significant extent, through capital from those same countries. This state of affairs seems incongruous and is a reflection of the relative lack of integration between financial markets in Asian economies. It seems to me quite likely that the cost of capital for enterprises in Asia would be lower if there were a deep and well-functioning corporate bond market in the region to tap the considerable pool of savings, much of which now flows instead to industrial countries.

The dependence of regional investment on funds from external sources is not only incongruous; it also exposes the region to the sudden stop phenomenon, whereby the flows of capital dry up abruptly, wreaking havoc among real economic activities. This well-documented feature of international capital flows, which is especially costly to emerging market economies, has led to greater policy conservatism toward financial openness at least in this region. This has limited and slowed the pace of financial integration. I argue that it is for precisely this reason that financial integration in Asia should be pursued more vigorously.

A large and financially integrated regional market is an effective defense against volatile

global financial flows. There is, I believe, a nonlinear relationship between vulnerability to financial instability and the size of financial markets. The small financial markets are not attractive to international capital because of their lack of liquidity; so, there is little volatility generated by the inflow and outflow of international capital. At the other extreme, where financial markets are very large relative to international capital, sudden movements of the latter will only lead to ripples that are not big enough to cause any concern about financial stability. The most vulnerable financial markets are the medium-sized ones. They have adequate liquidity to attract international capital, but they are small enough so that short-term trends are dictated by larger operators who are looking for short-term gains.¹ There is also the temptation, for some, to engage in manipulative behavior, amplifying volatility and vulnerability to financial instability.

Of course, merely increasing the effective size of a financial market cannot substitute for sound macroeconomic policies as a guard against volatile capital flows. Indeed, I believe that the authorities in the region are committed to prudent monetary, exchange rate, and fiscal policies. But I am also convinced that expanding the effective size of Asian financial markets through greater integration across jurisdictions may increase the ability of our economies to absorb the volatility of international capital as effectively as the U.S. and European markets. It is therefore heartening to observe that several official initiatives toward greater financial links in the region are bearing fruit, notably the Chiang Mai Initiative and the Asian Bond Fund initiative. The former was created partly with the objective of allowing central banks to hold back on the accumulation of international reserves, a topic I will discuss elsewhere in this essay. The Asian Bond Fund has been created specifically to encourage the development of bond markets in Asian economies and ultimately to establish an integrated regional market. The process leading up to the agreements related to Asian Bond Fund 1 and 2 has shown that cooperation between central banks in the region can successfully deal with technical and conceptual issues. This bodes well for the development of the initiatives.

Articulating the economic case is necessary, but not sufficient to convince participants that increased financial integration is a worthwhile objective. Other, practical steps must also be taken. First, links must be established between jurisdictions across the whole infrastructure—the trading, payment, clearing, settlement, and custodian systems—for money and for financial instruments. This would facilitate the movement of savings between jurisdictions and make crossborder transactions more efficient. These links are not difficult or costly to establish. The technology—electronic messaging platforms of acceptable security—is already available and in international use.

The second element involves the relaxation of nonsupervisory restrictions on the access by foreign financial intermediaries to domestic financial markets. The size of financial intermediaries as measured, for example, in terms of capital, is often a barrier to market access, but, as we know, size is not necessarily a good indicator of quality. Measures of capital adequacy that are assessed objectively according to risk provide a better safeguard. Greater competition, no matter from where it comes, enhances efficiency, although, in the interest of financial stability, allowance should be made to enable weaker domestic institutions to cope.

The third element is the harmonization of standards in the financial system. Harmonization, at least the adoption of minimum acceptable international standards, is essential for improving investor confidence and enriching the flow of capital within the region. It would also be conducive to the stability and integrity of the financial system. I would emphasize the word international in terms of the standards. There is no reason to develop regional standards that are different from the standards that have already been developed by international financial

institutions, professional bodies, and supervisory agencies.

The fourth element concerns the strengthening of cooperative efforts in financial system development. In Asia, we have been making good progress in our efforts to develop the domestic and regional debt markets through various regional forums and involving international financial institutions. In the context of developing Asian Bond Fund 2, for example, we have achieved a few firsts, including introducing the first exchange-traded bond index fund in Asia, arranging matters so that two Asian markets now allow exchange-traded funds, and opening up the yuan interbank bond market to foreign investors.

The final step toward creating an integrated Asian financial market requires the relaxation of statutory restrictions on crossborder capital flows. This is likely to be the most difficult step, in part because it depends on the ability of the financial system in individual jurisdictions to cope with the risks.

This raises the issue of the need for a strong and efficient regulatory framework. Greater financial integration across jurisdictions creates two new sources of risk for domestic financial institutions. The first and most obvious is the risk of currency mismatches when crossborder transactions involve different currencies, as they are likely to do in Asia. Although monetary integration is a topic often mentioned in the region, realizing monetary integration, if this occurs, is almost certainly going to take considerably more time than it will take for financial markets to become more closely linked. Meanwhile, financial systems will have to be robust with respect to fluctuations in exchange rates that may impact the assets and liabilities of financial institutions differentially. Of course, the financial turbulence in 1997 and 1998 has already alerted regulators and the private sector to these risks, but, if financial integration leads to increased crossborder financial commitments for domestic financial institutions, the size of the risks may become larger.

If integration has the desired effect of increasing cross-jurisdictional intermediation between savers and investors or if it leads to the establishment of cross-jurisdictional subsidiaries and branches, the nature of the credit risks faced by financial institutions may also change. Exposures to different business cycles will increase, as will exposures to different sources of idiosyncratic risk. Supervisory agencies need to make sure that appropriate risk control measures are implemented in individual institutions and that the available institutional capital adequately reflects the market, credit, and operational risks faced by institutions as they become exposed to foreign markets.

In Hong Kong, China, we are well on our way to implementing the latest international standards in this respect, that is, the Basel II standards. As the bank supervisor, the Hong Kong Monetary Authority has been working with banks and legislators to ensure that we are able to implement the new standards by January 1, 2007. We have also been working with other regulators in the region through the Working Group on Banking Supervision of the Executives' Meeting of East Asia–Pacific Central Banks to share our experiences on the implementation process. As financial flows increase within the region and as financial institutions increasingly operate in several jurisdictions, it is essential that this process proceed across the region.

The implications of financial integration for regional monetary arrangements

The successful introduction of the euro and the success of the European Central Bank in delivering monetary stability have naturally raised the question whether it would be appropriate for East Asia to contemplate monetary union. Studies have been undertaken with the goal of

determining whether such a development would be desirable based on optimum currency area considerations. Not surprisingly, there is no clear-cut answer, but a number of authors suggest that East Asian economies are no less an optimum currency area than Europe when Europe started the process toward union.²

But, in discussing monetary union, one must bear in mind that a monetary union among a set of economies implies a single common currency, which, in turn, requires a single, common central bank. The decision to establish a monetary union therefore becomes intensely political because it involves ceding sovereignty over an institution that is a symbol of economic independence. In Europe, monetary integration was a political process, as well as an economic one. Indeed, without strong support by the political leadership in France and Germany, monetary integration might not have come about at all.

While I do not want to offer predictions about the political relationships among candidates for monetary union in East Asia, it seems safe to assume that any such union is many years away. After all, the process in Europe took more than 20 years between the first proposals and the launch of the euro. The implication is that East Asia is likely to find itself with substantially liberalized and integrated financial markets, together with different currencies in each jurisdiction, for a considerable time. This raises an important question. What is the nature of the monetary and exchange rate arrangements in a region characterized by highly integrated financial markets side by side with numerous independent currencies and central banks? It is well known that free capital mobility, independence in monetary policy, and a fixed exchange rate are not compatible. An economy must choose only two of the three as a basis for its monetary system. For example, Japan has opted for monetary independence and a floating exchange rate, whereas Hong Kong has chosen a strict, nondiscretionary version of a fixed exchange rate, thus foregoing monetary autonomy. In both economies, international capital mobility is complete. Currently, some economies maintain significant controls on capital movements and are therefore able to conduct an independent monetary policy, while pursuing a policy of exchange rate stability. China is a particularly revealing example. To varying degrees, other countries in the region, such as the Republic of Korea, Malaysia, and Thailand, are also relying on restrictions on international capital movements in order to maintain a degree of control over domestic monetary conditions and exchange rate movements.

As financial integration in the region proceeds along the lines suggested in the previous section, policy makers will increasingly have to choose between monetary independence and exchange rate stability. The Hong Kong Monetary Authority has already made this choice by opting to forego monetary independence altogether. This has been a highly successful strategy. It has delivered substantial benefits. The financial system is fully integrated with world capital markets, but there is a degree of monetary and financial stability that arguably would not have been achievable under other likely monetary strategies.

It has been suggested that economies in the region should tie their currencies together by pegging them to a common currency basket as a transition arrangement similar to the European Exchange Rate Mechanism. I would caution against such an approach; it may well increase the risk of a recurrence of currency crisis in the region. As Issing (2006) points out, the speculative attacks in the European Monetary System during the 1992 crisis arose in part because central banks were setting interest rates that were not consistent with the goal of maintaining fixed exchange rate parities. It would be a sad irony if the desire for monetary integration and exchange rate stability in East Asia led to agreements on a common exchange rate policy that would precipitate another currency crisis in the region.

To avoid such an outcome, it may be necessary to pursue coordination among monetary policies without relying on a common exchange rate policy.³ One possibility would be for like-minded central banks to coordinate the setting of goals for independent domestic monetary policies, which would lead to similar levels of policy interest rates when the economies are at similar cyclical positions. If policy makers so desired, such coordination might naturally evolve into closer monetary cooperation through the creation of a common institutional framework for monetary policy decisions. By avoiding explicit exchange rate commitments, central banks would not set themselves up for the kind of foreign exchange speculation that featured in the financial crisis of 1997–98. At the same time, they could start building the institutional infrastructure necessary for the establishment of closer monetary cooperation.

I see at least three advantages to such an arrangement. First, the risk of exchange rate crisis in the region will be minimized because central banks that pursue independent monetary policies are not committed to defend any particular exchange rate levels. Second, the cooperation between central banks in the definition of policy objectives and the building of institutions will bring benefits whether or not the final outcome is full monetary union. Third, the arrangement is flexible in that central banks can take part in particular aspects of the arrangement without committing to full monetary integration.

Growth and investment of official reserves

The rapid growth of official reserves in East Asia since the financial crisis is now well known. For the region as a whole, the U.S. dollar value of reserves increased from US\$660 billion at the end of 1998 to US\$2.3 trillion at the end of 2005.⁴ Japan alone held US\$831 billion at the end of 2005, while China had US\$819 billion. Hong Kong had a more modest US\$117 billion, but, as we shall see, this may still be quite large relative to some measures of reserve adequacy. The rapid growth and the large size of these reserves suggest three interrelated questions. What are the motives and reasons for the accumulation, and will the accumulation continue? What constitutes an adequate level of international reserves? In what financial instruments should reserves be invested?

In coming years, we are likely to find answers to these questions by observing the actions of central banks. These actions will undoubtedly differ because institutions face different circumstances and constraints. Nevertheless, there will be trends.

There is, of course, no single motive or reason for the persistence in accumulating reserves. Supply and demand factors are at work. The supply factors leading to reserve accumulation are the capital flows that have entered the region, as well as current account surpluses. In the absence of official interventions, these factors tend to appreciate local currencies, and authorities have judged it prudent to resist at least part of this appreciation by intervening in the foreign exchange market and accumulating reserves. The major demand factor during the past six to eight years is, without doubt, the desire on the part of regional central banks to build up a stock of reserves as a buffer against possible swings in capital flows in the future. There is a view in the region that holding a substantial stock of international reserve assets may prove advantageous if international borrowing possibilities dry up suddenly or if capital flows precipitously change direction. There is a sentiment that, in such circumstances, one is better served by one's own guaranteed resources rather than by the uncertain prospects of credits from multilateral institutions, even if there is an opportunity cost associated with holding accumulated reserves.

The supply and demand factors are bound to have finite duration because countries with current account imbalances will eventually find that corrective action is in their interest and because central banks that are accumulating reserves will, at some stage, realize that the insurance value of an additional dollar in foreign exchange reserves is not worth the opportunity cost entailed. A major reason for the postcrisis current account surpluses in East Asia (except China) was the fall in investment rates. As economic growth resumes, investment will follow sooner or later, thus narrowing or eliminating the savings-investment gap. In China, the high savings rate is likely to fall as the economic policy strategy of the authorities begins to emphasize domestic consumption and as improvements in the social security system reduce the precautionary savings of households.

I would like to offer some thoughts on how to measure reserve adequacy and what might be done with “excess” reserves.

If we view international reserves as a kind of insurance against unforeseen events, what events are we insuring against? The traditional answer is that we need to keep international reserves equal to some multiple of monthly import payments in the event that export receipts suddenly dry up. In today’s world of large and volatile capital flows, the traditional answer is, of course, not adequate. As central bankers, we need to pay attention to the possibility of sudden stops or reversals in capital flows. The so-called Guidotti rule for assessing reserve adequacy is one response to such concerns. This rule suggests that central banks should hold reserves that are no smaller than the scheduled interest payments and amortization of foreign debt in the coming 12 months. While this is a useful point of departure for thoughts about reserve adequacy, it does not fully address the vulnerability of an economy to potential capital flows. For example, in circumstances such as those facing Hong Kong, the rule is not particularly helpful because we do not have any external debt, at least as regards the official sector.

More generally, therefore, it must be recognized that owners of domestic liquid assets may, on some occasions, collectively decide to convert some portion of these assets into foreign exchange, potentially leading to strains on the domestic financial system and pressures on the exchange rate. The monetary authority, which is required to maintain financial stability, must then be able to supply a corresponding amount of foreign exchange to the market. Hence, one element that enters the assessment of reserve adequacy will be the size of short-term liquid assets in the domestic financial system. But what proportion of liquid assets may be said to be “at risk”? This depends in part on the volatility of the demand for these assets, a quantity that may be estimated based on past behavior.

According to this line of reasoning, the authority responsible for determining the appropriate amount of international reserves needed for self-insurance will have to determine what types of domestic assets risk being withdrawn from the financial system and converted into foreign currencies. The authority will then have to assess the volatility in the private sector’s demand for these assets. Using these data, together with an estimate of the opportunity costs of holding highly liquid international reserves, the authority might obtain a rough estimate of reserve adequacy. I believe that authorities are already reasoning along these lines and will do so even more in the years to come. My guess is that, as time passes, many will come to the conclusion that the reserves already accumulated have surpassed the needs of self-insurance.

Insurance principles also suggest that the pooling of resources will reduce the amount of resources required by each of the members of the pool. This idea lies behind the Chiang Mai initiative. If, one day, this becomes a blueprint for a multilateral agreement, as I hope and believe it will, then the need for international reserves from each of the participants will be reduced. It is

therefore useful to start contemplating the mandate that should be given to reserve managers with respect to dealing with any excess of actual holdings relative to the amounts considered required.

There are essentially two approaches to this problem; one is for the authorities to divest themselves of the excess reserves, and the other is to manage the excess according to objectives that are different from those applied to the reserves required for insurance purposes. Because international reserves, by definition, are denominated in foreign currencies, divesting may not be a feasible option if it would lead to undesirable pressures on the exchange rate.⁵ Converting foreign exchange proceeds from the sale of external assets into domestic currency would tend to appreciate the domestic currency, which may be contrary to the objectives of the central bank. The only case in which such pressure would not materialize is if the domestic private sector is willing to add to their foreign assets as the central bank reduces its holdings. Prasad and Rajan (2005) of the International Monetary Fund have proposed an interesting method of divesting official international reserves under conditions where the domestic private sector has a latent demand for foreign currency denominated assets. They believe such a situation exists in China at the moment due to restrictions on holdings of external assets by the private sector. The essence of their proposal is that the domestic authorities should authorize the creation of mutual funds that would sell shares denominated in domestic currency to the public. The proceeds would be used to obtain foreign exchange from the central bank for the acquisition of external assets. While their proposal might be a solution for some jurisdictions that have strict controls on the purchase of the foreign assets of the private sector, it is not applicable to countries without such controls, a fact explicitly recognized by the authors.

Excess reserves could also be used to buy back external government debt. Of course, this assumes that there is some official external debt to buy back, which, as already noted, is not necessarily the case for all jurisdictions. In any event, such a buy-back should be evaluated in the context of an optimal portfolio allocation strategy. Such a strategy would involve consideration of a number of assets beyond the traditional, highly liquid securities of a small number of sovereign issuers, and it would include agency bonds, highly rated corporate bonds, equities of top-rated corporations, commodities, and maybe private equity. As with the liquid reserves used for self-insurance, the management of the portfolio could be carried out by the central bank according to a specific mandate specifying the risk-return trade that it should be aiming for. Alternatively, a special government agency could be established for this purpose, like the Korean Investment Corporation, the Government Petroleum Fund in Norway, or the Government of Singapore Investment Corporation. I believe that, in the coming years, an increasing number of central banks will take steps to distinguish explicitly between different portions of their international reserve holdings and determine investment strategies involving specific risk-return profiles for each portfolio. This will lead to reserve management strategies that emphasize liquidity for the traditional insurance portion of international reserves and national wealth management for the excess reserve portion. The principles that should determine the optimal size and composition of an official national wealth management portfolio will have to be elaborated, and the conflicting interests of current and future generations of citizens will have to be addressed.

Concluding remarks

This essay has focused on three challenges that I believe will frame discussions among central banks in Asia in the coming years: the development and integration of financial markets,

the evolution and nature of monetary cooperation, and the management of international reserves. Properly managed, the challenges can lead to the emergence of a stronger, more resilient, and more efficient financial and monetary system in the region. I hope that the ideas spelled out in this essay will aid the discussions in regional forums such as the Executives' Meeting of East Asia–Pacific Central Banks and various working groups in the context of the Association of Southeast Asian Nations or of Asia-Pacific Economic Cooperation, as well as in international financial organizations more generally.

Notes

¹ Empirical evidence consistent with this line of reasoning can be found in Kaminsky, Lyons, and Schmukler (2000).

² Ito and Park (2004) review the empirical literature.

³ I rule out the possibility of adopting Hong Kong–style currency board arrangements in other jurisdictions on the grounds that central banks have shown a preference for monetary policy autonomy.

⁴ These figures are based on data from *International Financial Statistics* (International Monetary Fund) and refer to the reserves of the countries in the Association of Southeast Asian Nations (except Brunei Darussalam because of data unavailability), plus China, the Republic of Korea, and Japan.

⁵ In the case of Hong Kong, divesting is not even an option given our linked exchange rate system.

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