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Deutsches Institut
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Monetary and Exchange Rate Policies in Cambodia, Laos and Vietnam: The Scope for Regional Cooperation

Incentives, Initiatives, and Obstacles to Monetary Integration

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DIW Berlin – Macro Analysis and Forecasting

Outline

- Introduction
- Financial Crisis, Crisis Management, and the Creation of Regional Self-Help Mechanisms
- Another Step Forward:
  Increasing Exchange Rate Cooperation
- Conclusions

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Goals of Economic Policy Making

- Goals
  - Macroeconomic stability
  - Sustainable economic growth
  - Convergence of living standards
- Regional monetary cooperation
  - Reduces exchange rate fluctuations ⇨ promoting intra-regional trade and investment
  - Prevents competitive exchange rate devaluations (beggar-thy-neighbor stategies) ⇨ avoiding resource misallocations and escalating trade-wars
  - Mitigates the effects of infectual currency crises and reduces the overall liklihood of such crises ⇨ reducing disfunctional exchange rate adjustments

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The East Asian Crisis 1

- Early until the mid-1990s: East Asian tiger states flooded with (predominantly!) short-term international capital
  - excellent macroeconomic performance (high returns)
  - currencies pegged to the dollar (low risks)
- Capital inflows higher than what was needed for current account financing
  - incoming funds showed up in increasing foreign reserves and surplus liquidity
  - unwarranted domestic credit expansion (excess productive capacities, real estate bubble)

The East Asian Crisis 2

- Double Mismatches
  - maturity mismatch (result of short-term borrowing)
  - currency mismatch (US-dollar denominated liabilities, outstanding loans in local currencies)
- Trigger: successful speculation against Thai baht followed by speculative attacks against other regional currencies
- Self-fulfilling crisis
  - devaluations and sudden outflow of capital
  - maturity mismatch hits financial industry
  - troubled business sector, increasing bad loans
  - infection of neighbor countries (herd behavior)

The Nature of the Crisis

- Boster of the crisis: Structural problems
  - non-credible exchange rate policies
  - insufficient banking sector and financial market regulation
  - implicit government guarantees for dubious investments
- Enabler of the crisis: Premature liberalization of capital accounts
  - countries without liberalized capital accont not hit
  - ⇨ **liquidity crisis, not a curency or current account crisis**
- Role of the IMF
  - active role in liberalizing capital accounts
  - bad management of the crisis itself

Regional Policy Initiatives after the Crisis

- Liquidity provision
- Regional surveillance
- Strengthening regional capital markets

Liquidity Provision

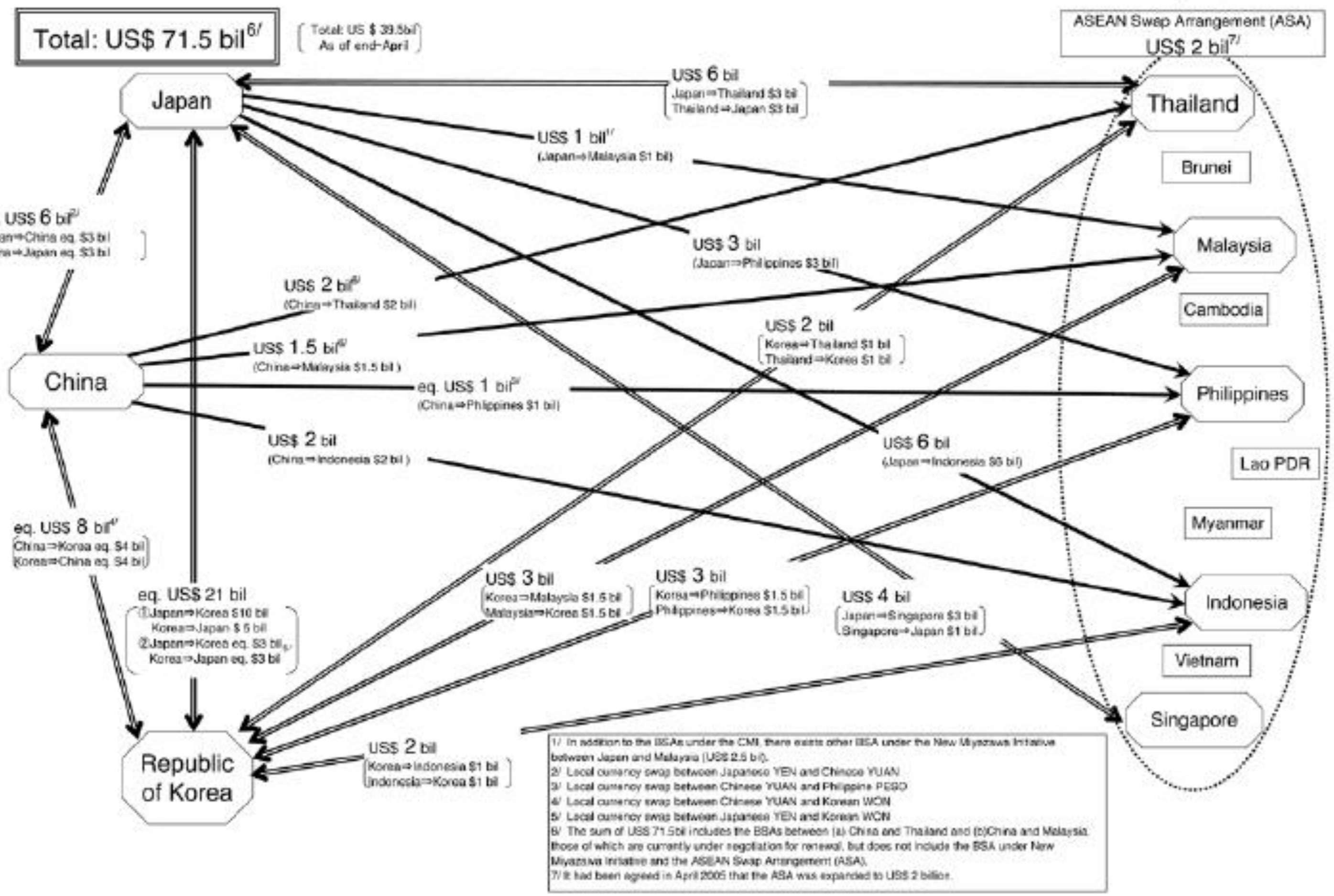
- Asian Monetary Fund (AMF) initiative by Japan (1997)
  - multilateral regional institution
  - liquidity provision for countries hit by abrupt reversal of international capital flows
  - liquidity endowment US$ 100 billion
  - opposed by US and IMF, unsufficient support by PRC
    - moral hazard problems
    - multilateralism not in line with IMF principles
  - finally rejected by APEC (“Manila Framework”)
  - Japan left with “New Miyazawa Initiative”
    - lower volume of liquidity (US$ 30 billion)
    - no multilateral approach
    - large bilateral swap agreements

Swap Agreements

- Chiang Mai Initiative (2000)
  - ASEAN+3
  - bilateral swap agreements: US$ 75 billion
  - ASEAN-wide swap agreement: US$ 2 billion
  - only 20 % available without IMF conditionality, therefore less autonomous than AMF
  - BUT:
    - bringing togehter Japan and PRC
    - solid ground for further monetary cooperation

Network of Bilateral Swap Arrangements (BSAs) under the Chiang Mai Initiative (CMI)

Ministry of Finance, Japan
As of February 24, 2006



Regional Surveillance

- Manila Framework Group (1997)
  - IMF, World Bank, ADB, BIS
  - increase the frequency and quality of high-level dialogue on risks to financial stability
  - peer pressure for “best practices” with respect to regulatory and supervisory frameworks of financial markets
- ASEAN Surveillance Process (1998), ASEAN+3 Economic Review and Policy Dialogue (2000)
  - similar to MFG but also including sectoral developments and implications for social policy (policy exchange in a broader sense)
- Early Warning System by ADB (2002), ASEAN+3 Technical Working Group on Economic and Financial Monitoring (2006)

⇨ Some room for consolidation to avoide redundencies and improve effectiveness

Strengthening Regional Capital Markets 1

- Underdeveloped domestic bond markets in ASEAN contries
  - small supply base (small number of firms with the necessary size and reputation to issue corporate bonds)
  - limited demand (households prefering safe and liquid bank deposits, also in foreign currency)
- Response to double mismatch problem
  - bonds with longer maturity ⇨ mitigating the problem of investors faced with sudden liquidity problems
  - bonds denominated in domestic currency ⇨ eliminating the danger of real liabilities increasing as a consequence of exchange rate fluctuations

Strengthening Regional Capital Markets 2

- Fruits from regional integration
  - supply and demand base become larger
  - possibility of risk diversifications expands (bond markets become more attractive as the market size increases)
  - infrastructure costs for bond markets lower compared to development of separated national bond markets
- Asian Bond Markets Initiative (2002/2003)
  - first proposed by Japan (2002)
  - endorsed by ASEAN+3 finance ministers (2003)
  - demand side: BIS-managed Asian Bond Fund for foreign reserves of regional central banks to be invested in US$-denominated regional bonds
  - supply side: public and quasi-public institutions (ADB, World Bank, German KfW, JBIC) issuing local currency denominated bonds in ASEAN countries (since 2004)

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Benefits from Exchange Rate Cooperation

- Stimulate intra-area trade and investment
- Strengthening of regional capital markets
- Higher resiliance to asymmetric corrections to global imbalances
- Political and economic integration goes hand in hand (but: political will and leadership needed)

Exchange Rate Cooperation and Fixed Exchange Rates

- Exchange rate cooperation ≠ fixed-exchange rates
- Fixed exchange rates without monetary cooperation are vulnerable to speculative attacks
- Challenge: increasing cooperation and lowering exchange rate volatility without increasing the probability of crises (like the 97/98 crisis)
- Historical lessons for fixed exchange rates
  - responsible monetary and fiscal policies of anchor country
  - acceptance of necessary realignments
  - ⇨ playing according to the rules of the game
- Monetary union ≠ fixed-exchange rates

Using the Asian Currency Unit

- Parallel Currency for the ABM
  - denominating public or quasi-public bonds in ACU
  - reducing capital flow restrictions on ACU-denominated assets prior to those on assets denominated in other currencies
- Currency Index as Peg for an Asian Monetary System
  - similar to EMS (without de-facto single anchor currency)
  - using CMI funds for stabilizing interventions
  - problems for countries with major extra-ASEAN trade
- Alernatively: Peg agaionst a weighted basket of myjor international currencies as an interim step

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Conclusions

- ASEAN+3 countries are on a good way
  - creation of various fora for policy dialogue (cooperation needs practice)
  - some redundencies could be consolidated
- Short/Medium run: Initiatives for increased monetary cooperation to improve intra-area trade and strengthening resilience to global shocks
- Economic and political integration is a simultaneous process; the same applies for various sub-fields of economic integration
- Political will and leadership is needed for the next big steps