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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

- Why monetary cooperation?
- Looking back: Financial Crisis, Crisis Management, and the Creation of Regional Self-Help Mechanisms
- Another Step Forward:
Fostering monetary cooperation in Asia
- Conclusions

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Goals of Economic Policy Making

- **Goals**
 - macroeconomic stability
 - sustainable economic growth
 - convergence of living standards
- **Regional monetary cooperation**
 - reduces erratic exchange rate fluctuations
 - ⇒ promoting intra-regional trade and investment
 - prevents competitive exchange rate devaluations
 - ⇒ avoiding misallocations and escalating trade-wars
 - mitigates the effects of infectious currency crises and reduces the overall likelihood of such crises
 - ⇒ reducing disfunctional exchange rate adjustments

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- Why monetary cooperation?
 - Looking back: Financial Crisis, Crisis Management, and the Creation of Regional Self-Help Mechanisms
 - the Asian Crisis
 - liquidity provision
 - surveillance and dialogue
 - Asian bond market
 - CLV participation
 - Another Step Forward:
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- The diagram illustrates a flow from 'the Asian Crisis' to 'scope/potential?'. A horizontal line connects 'the Asian Crisis' to a vertical line that drops down to 'scope/potential?'. A bracket on the left side of this vertical line encompasses 'liquidity provision', 'surveillance and dialogue', and 'Asian bond market', with the label 'lessons/actions' to its right. A horizontal line then connects 'scope/potential?' back to 'CLV participation'.

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

- **Booster 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 account not hit
 - ⇒ **liquidity crisis, not a currency 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

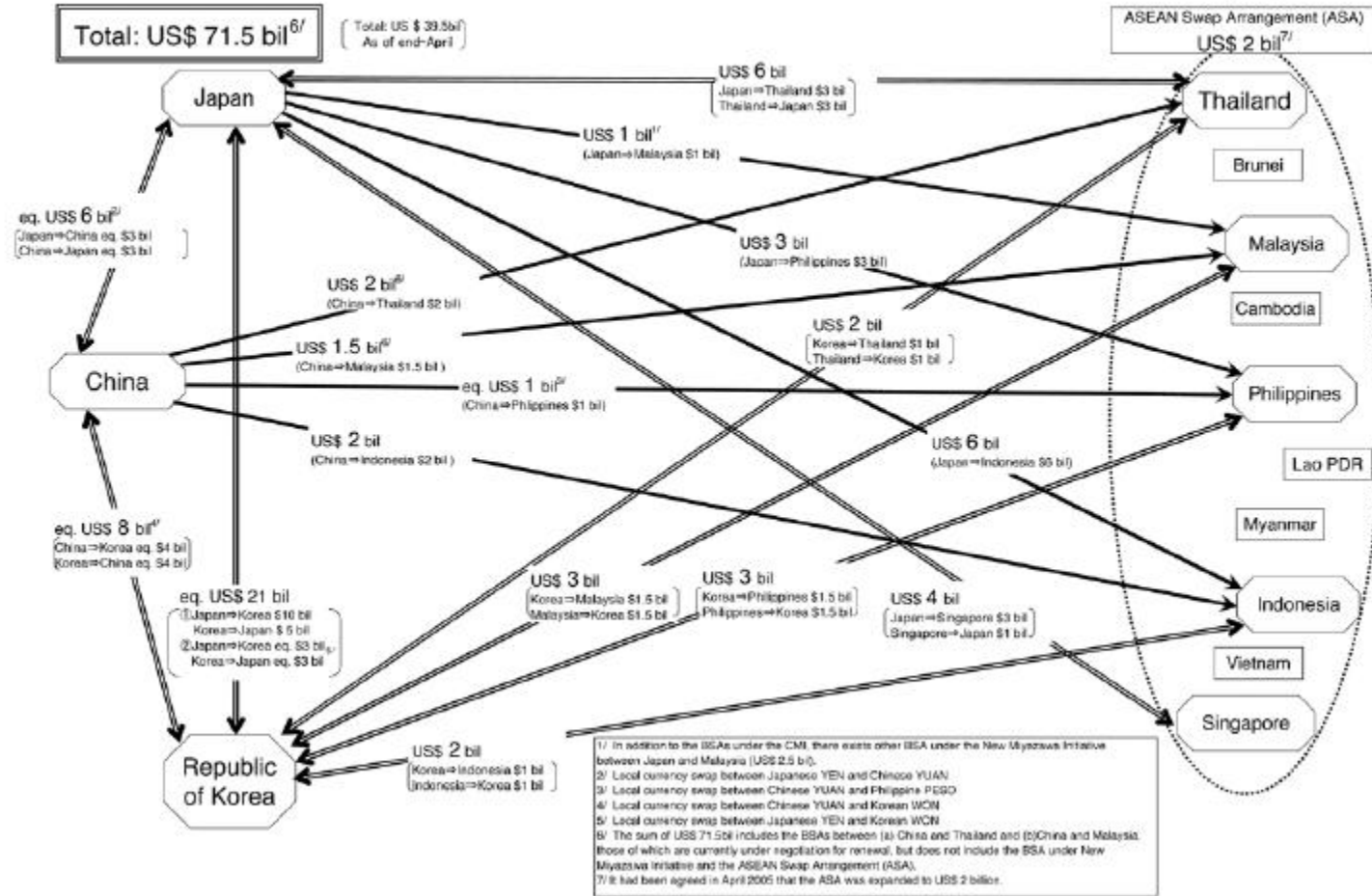
- Asian Monetary Fund (AMF) initiative by Japan (1997)
 - multilateral regional institution
 - liquidity provision for countries hit by abrupt reversal of international capital flows
 - liquidity endowment US\$ 100 billion
 - opposed by US and IMF, insufficient support by PRC
 - moral hazard problems
 - 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 together 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 avoid redundancies and improve effectiveness

Strengthening Regional Capital Markets 1

- Underdeveloped domestic bond markets in ASEAN countries
 - small supply base (small number of firms with the necessary size and reputation to issue corporate bonds)
 - limited demand (households preferring 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)

CLV Participation

- Limited integration in ASEAN initiatives
- Within CMI involved through ASA, but no bilateral agreements on their own
 - limited foreign reserves
 - minor importance of their domestic currencies
 - MCP (Lao PDR, Cambodia)
- Limited involvement in deepening and integration of regional capital markets
 - no domestic bond markets
 - stock market only in Viet Nam
 - emerging financial systems
- Presence at multi-national surveillance and working groups

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- **Another Step Forward:
Fostering monetary cooperation in Asia**
 - incentives for exchange rate cooperation
 - possible form of exchange rate cooperation: advantages and obstacles
- Conclusions

Benefits from Exchange Rate Cooperation

- **Stimulate intra-area trade and investment**
- **Strengthening of regional capital markets**
- **Higher resilience 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 Rate Regimes

- Exchange rate cooperation \neq 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 \neq 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
- **Alternatively: Peg against a weighted basket of major international currencies as an interim step**

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Conclusions

- ASEAN+3 countries are on a good way
 - creation of various platforms for policy dialogue (cooperation needs practice)
 - some redundancies 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