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External Aspects of East Asian Economies and Finance

-in light of growing interest in regional integration -

1. Introduction

The economies of East Asia have overcome the turmoil of the 1997-1998 currency crisis and gone on to achieve high growth. They have received large amounts of capital from the rest of the world, much of which in the form of foreign direct investment. This capital is the driving force behind the rise in export-oriented industries and one of the reasons that East Asia has continued to steadily develop as the "factory of the world." Under the GATT/WTO system, markets for goods and services in the region have become much more open, making their economies more interdependent. Consequently, regional economic integration has progressed. It has also been promoted by policy initiatives, e.g., a growing network of regional trade agreements (RTAs) and an acceleration of plans for establishing the ASEAN Economic Community.

On the monetary side, some researchers predict further progress in financial integration within the region along with visible efforts to introduce a common currency. They argue for this prediction by analogizing the current situation to the process leading up to the creation of the European Monetary Union (EMU) and the euro. In East Asia, however, individual economies preserve their specific characteristics in their financial systems and practices which operate the individual markets. In the business circles, the US dollar functions as the common settlement currency for international transactions within the region. Therefore, discussions for a new common currency is limited within the academic circles at present.

This paper is intended to provide an overview of the external aspects of East Asian economies and finance in response to the inquiries and requests from practitioners and researchers raised in the course of research activities at the Center for Monetary Cooperation in Asia (CeMCoA) of the Bank of Japan. This paper paints a general picture of developments in the region in light of growing interest in regional economic and financial integration. Considering the diversity in the region, however, individual items discussed in this paper need to be under further scrutiny and analysis.

Due to the constraints of data availability,[1] this paper's analysis focuses on the NIEs 3 (Hong Kong, Singapore, Korea),[2] the ASEAN 4 (Thailand, Malaysia, Indonesia, the Philippines)[3] and China,

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[1] The data in this paper comes in principle from the IMF International Financial Statistics (IFS).

[2] NIEs stands for "Newly Industrializing Economies."

[3] ASEAN stands for "Association of Southeast Asian Nations." The ten member countries are Indonesia, Malaysia, the Philippines, Singapore, Thailand, Brunei, Myanmar, Cambodia, Laos and Vietnam.

for a total of eight economies. Where possible, Taiwan has been included in the NIEs. All eight of these economies are members of EMEAP,[4] a cooperative organization for central banks and monetary authorities in East Asia and the Pacific regions.

2. High foreign demand-led growth and deepening interdependence

(1) High economic growth maintained within the region

Let us begin with a brief, somewhat long-term review of economic development in the East Asian region. The features most commonly noted in this region can be summarized as follows: 1) high growth of Japan's economy during the 1960s (average growth rate of 9.4% between 1960 and 1969), followed in the 1970s and thereafter by high growth in the NIEs and ASEAN and then China; 2) temporary difficulties due to the shock that has come to be known as the "Asian currency crisis" in the latter half of the 1990s; 3) overcoming this crisis and returning to high growth in the 2000s. Based on the national data that have been available since the 1970s, while Japan shifted to low growth in the 1990s, the NIEs 3 and the ASEAN 4 saw a slowing growth compared to the 1970s-1980s, but overcame the temporary negative growth after the crisis and have gone on to achieve around 5% growth in the 2000s. In China, the move to the reform and opening-up policy in the late 1970s set the stage for the rapid growth that has been taking place since the 1980s. The country continues to achieve high growth rates of around 9%.

Real economic growth rates in leading East Asian countries

(Unit: %)

	1970～79	1980～89	1990～99	2000～05
Hong Kong	+ 9.0	+ 7.4	+ 4.0	+ 5.3
Singapore	+ 9.5	+ 7.2	+ 7.7	+ 4.9
Korea	+ 8.3	+ 7.7	+ 6.3	+ 5.2
Thailand	+ 7.4	+ 7.3	+ 5.3	+ 5.0
Malaysia	+ 7.6	+ 5.9	+ 7.2	+ 5.2
Indonesia	+ 7.8	+ 5.8	+ 4.3	+ 4.7
the Philippines	+ 5.8	+ 2.0	+ 2.8	+ 4.6
China	n.a.	+ 9.7	+ 9.5	+ 8.9
Japan	+ 5.2	+ 3.8	+ 1.1	+ 1.9

Note: Figures represent arithmetical averages for each term. Data: IMF International Financial Statistics.

[4] EMEAP stands for "Executives' Meeting of East Asia-Pacific Central Banks." The members include the central banks and monetary authorities of the eight economies listed above together with Japan, Australia and New Zealand for a total of 11 countries and regions.

(2) Higher dependence on external demand, deepening interdependence

Another salient characteristic of East Asian economic development has been its high dependence on external demand. In terms of "aggregate exports and imports over nominal GDP," a proxy for countries' dependence on trade, rising trends can be observed for all economies with some differences among economies. Since the turn of the century, the figure has been extremely high for two of the NIEs 3, Hong Kong and Singapore, at roughly 300%. This reflects the fact that Hong Kong has China in its vicinity and Singapore has served as a commercial hub for the surrounding ASEAN countries. For Korea and the ASEAN 4, the figures range from 50% to 200%, which is a wide degree of variance, but nonetheless generally high, as can be seen by comparisons with Japan (19%), the United States (19%) and even Germany (55%), which has presumably benefited from the expansion of trade within Europe. Of particular note are the sharp changes over the period for Thailand (38% in the 1970s increasing to 106% in the 2000s) and Malaysia (99% in the 1970s increasing to 184% in the 2000s). China is also showing large increases since data became available in the 1980s. In recent years it has increased from 20% in the 1980s to 49% in the 2000s (58% for 2004 alone).

Dependence of leading East Asian countries on trade

(Aggregate exports and imports/Nominal GDP; %)

	1970～79	1980～89	1990～99	2000～05
Hong Kong	n.a.	n.a.	215.9 [a]	276.9 [b]
Singapore	248.4 [d]	293.9	282.4	305.4 [b]
Korea	54.7 [e]	60.7	55.3	62.6 [b]
Thailand	38.0 [h]	45.5	71.2	106.1
Malaysia	98.8 [f]	95.3	155.6	183.8 [b]
Indonesia	n.a.	40.7	49.9	53.8 [b]
the Philippines	34.7 [g]	39.8	64.5	96.6 [b]
China	n.a.	20.1 [c]	32.0	49.2 [b]
Japan	18.6 [g]	18.8	14.7	19.3
(Ref.) Germany	37.5 [i]	48.0	42.1	54.5
(Ref.) U.S.A	11.6	14.5	17.0	19.1

Note 1: Both exports and imports on an FOB base.

Note 2: Figures represent arithmetical averages for each period; a=1998~99, b=2000~04, c=1982~89, d=1972~79, e=1976~79, f=1974~79, g=1977~79, h=1975~79, i=1971~79.

The increasing dependence of East Asia on foreign demand has been accompanied by a deepening of economies' interdependence. This is illustrated by the ratio of regional exports to total exports for East Asian countries, which increased from around 30% in the late 1980s to nearly 50% in more recent years (45% in 2005, the most recent data available). While these levels are still low compared to the EU (67%) and NAFTA (56%), steady growth in East Asian regional trade is taking place. This increase in intra-regional trade is accounted for by active trading of raw materials and intermediate goods. Rather than trade being completed within the region, goods are given final processing in the region and then exported elsewhere in most cases. Indeed, this is why East Asia has come to be known as the "factory of the world".

Intra-regional trade ratios

(countries' exports within the region/countries' total exports: %)

	1980～85	1986～89	1990～94	1995～99	2000～04
East Asia	32.3	32.0	38.6	41.6	43.5
EU	58.9	63.1	66.6	66.3	67.1
NAFTA	36.7	44.2	49.9	49.8	56.0

Note 1: Figures represent arithmetical averages for each period.
Note 2: East Asia refers to the EMEAP countries excluding Australia and New Zealand.
Data: IMF International Financial Statistics.

(3) Expanding imbalances with the United States

This external demand-led growth has led to expanding imbalances with major extra-regional trading partners, especially the United States. The United States is a particularly important destination for the final goods manufactured and processed within East Asia, and over time, the US deficit against East Asia has steadily expanded.

The most obvious feature of the US trade deficit with East Asia is a dramatic increase in the deficit with China. In the late 1980s, the deficit with China accounted for only 3.2 billion dollars or just 2% of the total, but by 2005 it had grown to 218.0 billion dollars or 26%, making China the largest trade surplus country vis-à-vis the US. By contrast, Japan accounted for a 40% share of the US trade deficit in the late 1980s and early 1990s (a situation that resulted in increasingly strident economic friction between the two countries). The US deficit with Japan has continued to grow, reaching 86.5 billion dollars in 2005, but the overall US deficit has grown so quickly that the Japanese share has declined to roughly 10%. During the same period, the US deficit with the NIEs 3 declined from 15.2 billion dollars or 10% of the total in the late 1980s to 5.6 billion dollars or a mere 1% in 2005. By contrast, the deficit with the ASEAN 4 has consistently grown and reached 50.7 billion dollars in 2005, a share of 6-7% vis-à-vis the overall deficit. The deficit against oil-producing countries has also risen rapidly due to rising oil prices. In 2005, it was 99.2 billion dollars or 12% of the total, though still less than half of the deficit with China.

Country breakdown of US trade deficits

(Annual average, billion dollars)

	1985～89	1990～94	1995～99	2000～04	2005
World Total	− 151.8	− 126.1	− 243.1	− 543.0	− 828.3
NIEs-3	− 15.2	− 5.9	− 2.6	− 10.3	− 5.6
ASEAN-4	− 6.5	− 12.4	− 26.8	− 38.1	− 50.7
China	− 3.5	− 20.5	− 53.3	− 120.5	− 218.0
Japan	− 55.2	− 54.9	− 63.1	− 75.7	− 86.5
EMEAP-9	− 80.4	− 93.6	− 145.8	− 244.6	− 360.8
(Ref.) Oil producers	− 12.2	− 16.4	− 19.0	− 52.9	− 99.2

Note: (+) = surplus/ (−) = deficits. Data: IMF International Financial Statistics.

3. Sustained capital inflow

(1) Total public and private funds

Much of East Asia's external demand-led growth and deepening intra-regional interdependence seem to have benefited from a virtuous cycle consisting of: 1) initial-stage enhancements to economic infrastructure with a combination of funding from international institutions and official development assistance (ODA); 2) on top of those foundations, private sector investment generated by FDI and furthermore, the portfolio investments; and 3) expanding external trade for the industries in the region as a result of this private sector investment.

The statistics prove the existence of these changes in the flow of funds to East Asia. There was a significant shift away from public funding in favor of private, particularly from the 1990s through the 2000s. The flow of public funding (net basis) maintained its high levels with the ASEAN 4 during the 1990s and also expanded in the case of China. Against this backdrop, total annual averages were very high during the 1990s: 9.0 billion dollars in the first half and 10.0 billion dollars in the second half of the decade. However, after the year 2000, the situation changed. Total net inflows to the region declined to 800 million dollars per year due to repayments made by China and ASEAN countries against net capital inflows accumulated in the last decade. In addition, in 2003, the most recent year for which statistics are available, an outflow of 6.2 billion dollars was eventually recorded.

Official flows from all sources to East Asia

(Annual average, billion dollars)

	1990～94	1995～99	2000～03		
				2002	2003
NIEs-4	0.1	－0.0	－ 0.2	－ 0.1	－ 0.4
Thailand	0.6	2.4	－ 1.8	－ 3.9	－ 4.0
Malaysia	0.2	0.2	0.7	－ 0.1	－ 0.0
Indonesia	3.2	2.1	1.0	0.3	－ 0.1
the Philippines	1.5	0.3	0.3	0.3	0.4
ASEAN-4	5.6	4.9	0.2	－ 3.3	－ 3.7
China	3.5	5.3	0.8	－ 0.3	－ 2.0
Total	9.2	10.2	0.8	－ 3.7	－ 6.2

Note 1: Long-term flow of public funds from public creditors (including guarantees and grants). However, for the NIEs-4, only long-term public economic development assistance is posted.
Note 2: NIEs-4 includes Taiwan.
Note 3: Data: OECD (created from the World Bank's Global Finance Outline, etc.).

Meanwhile, the flow of private funding (net basis) in the form of foreign direct investment and portfolio investments has recorded a huge surplus, even with a certain degree of fluctuation. It averaged 50.0 billion dollars in the first half of the 1990s for East Asia as a whole, rising to 90.0 billion dollars in the second half before dropping to the 60.0 billion dollar level in the 2000s. The geographic breakdown shows significant differences among the following three groups: 1) a large volume of private capital inflow into China with an expanding trend; 2) maintenance of the inflow into the NIEs 4 inflow, albeit with some fluctuation; 3) large inflows into the ASEAN 4 during the 1990s, switching to outflows in the 2000s.

The 2002 and 2003 statistics show a doubling of the entire inflow from 50.0 billion dollars to 100.0 billion dollars. This is because, in addition to the high level of capital inflows into China and substantial increases observed in the NIEs, the ASEAN countries have turned from net outflows to inflows. Of particular note is Thailand's switch from outflows to inflows and Indonesia's cutting its outflows in half. Such a large shift in the flow of private sector funds is partly caused by the movement of portfolio investments, under such circumstances in which financial and capital markets globalization has accelerated. A large volume of shift in foreign capital makes economic management more difficult for individual economies in the region, but at the same time, this generates the effects of urging stronger discipline on them as well.

Net Private flows from all sources to East Asia

(Annual average, billion dollars)

	1990～94	1995～99	2000～03	2002	2003
NIEs-4	11.2	28.1	19.0	7.3	36.6
Thailand	5.1	7.8	－ 1.1	－ 1.6	1.2
Malaysia	8.2	6.5	2.9	5.3	2.2
Indonesia	3.5	2.0	－ 7.1	－ 6.9	－ 3.7
the Philippines	0.9	4.6	2.4	2.2	1.4
ASEAN-4	17.7	20.9	－ 2.9	－ 1.1	1.0
China	23.3	45.3	47.1	47.1	59.5
Total	52.2	94.3	63.2	53.2	97.1

Note: Total foreign direct investment, portfolio investment, non-public sector, long-term private debt (including debt guarantees) and private sector, non-guaranteed debt. However, for the NIEs 4, total direct investment, portfolio investment and private export credits to DAC countries.

Data: OECD (created from the World Bank's Global Finance Outline, etc.).

By focusing on foreign direct investment (FDI), a consistent and steady inflow of funds can be observed. FDI in the East Asian region increased from an average of 4.0 billion dollars per year in the early 1980s to an average of 10.0 billion dollars in the latter half of that decade, to 40.0 billion dollars in the early 1990s and to approximately 100.0 billion dollars in the 2000s. The geographic breakdown shows that while incoming investments peaked in ASEAN countries between the late 1990s and early 2000s, and particularly over the last 10 years or so, they have on the other hand expanded rapidly for China, Hong Kong and Singapore. It should be noted, however, that this also includes some amount of FDI ultimately destined for China flowing through Hong Kong and Singapore, so the actual volume of inflows should be discounted to some degree. With this reservation in mind, there has been a large and sustained inflow of FDI[5] for the region as a whole.

[5] It is likely that FDI figures in the table contain a certain amount of duplication due to the existence of FDI into China bypassed via Hong Kong. Therefore, it should be noted that the superficial numbers could not be sufficient for evaluating the status quo. Against this background, turning to the geographic breakdown of FDI into China by referring to the "China Statistical Abstract 2006" (published from National Bureau of Statistics of China), 17.8 billion dollars out of the total 55.0 billion dollars during the period of 2001 and 2005 (annual average) was incoming FDI from Hong Kong, which is equivalent to 76% of the total FDI received by Hong Kong during the same period (2.3 billion dollars).

FDI for East Asian countries

(Annual average, billion dollars)

	1981～85	1986～90	1991～95	1996～00	2001～05
Hong Kong	n.a	n.a	n.a	33.8 b	23.4
Singapore	1.4	3.3	6.4	12.7	11.3 c
Korea	0.1	0.8	1.0	5.8	4.4 c
NIEs-3	1.5 d	4.1 d	7.4 d	52.3	39.1 c
Thailand	0.3	1.2	1.9	4.6	2.4
Malaysia	1.1	1.1	4.5	4.0	2.7 c
Indonesia	0.2	0.6	2.3	0.8	－ 0.6 c
the Philippines	0.1	0.5	1.0	1.6	0.9 c
ASEAN-4	1.7	3.4	9.8	11.1	5.4 c
China	1.0 a	2.9	22.5	41.1	54.9
Total	3.9	10.4	39.7	104.4	93.4

Note 1: a=1982~85, b =1998 ～99, c =2001 ～04, d =2-country average of Korea and Singapore.
Note 2: Data: IMF International Financial Statistics.

(2) Role of Japanese ODA and FDI

In this section, we will examine the role played by the flow of funds from Japan, particularly Japanese ODA and FDI, for the achievement of regional high, external demand-led growth patterns.

Japan, which had received ODA and used it for enhancing its infrastructure[6] in the decade after the World War II, became an ODA donor after its own high-growth period, providing further impetus to the self-help efforts of East Asian countries towards economic development. In the 1970s, more than 90% of Japanese ODA went to Asia. While the share of Asia as a destination of Japanese ODA has declined as the overall size of the ODA budget has gradually expanded to its 1999 peak, it has consistently accounted for around 50% in recent years. The nature of Japanese ODA has also changed as economies in the region realized development. In the initial stages, it focused on roads, bridges, electric power plants, irrigation and other hardware infrastructure requiring large sums of money. Thereafter, it has increasingly focused on softer areas such as technical cooperation and support for policy planning and system designing in the economic, financial, monetary and accounting spheres and also for human resources development in these areas. As economic growth-oriented ODA enhanced both hard and soft infrastructure, it improved the investment environment, thus playing the role of a catalyst for FDI, and then FDI contributed to increases in trade of capital goods, intermediate goods and materials.

[6] In the case of Japan, it received 5.0 billion dollars from the United States in economic reconstruction funds between 1946 and 1951 (GARIOA and EROA), together with grants of goods and materials from Canada and other countries. In addition, in the 1950s and 1960s, the World Bank provided loans to Japan to build such infrastructures as the Tokaido Shinkansen line, Tomei Expressway and Kurobe Dam.

Regional distribution of Japanese bilateral ODA

(Net expenditure basis, billion dollars)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Total	10.6	8.4	6.6	8.6	10.5	9.6	7.5	6.7	6.0	6.0
Asia (share;%)	5.8 (55)	4.1 (50)	3.1 (47)	5.4 (62)	6.6 (63)	5.3 (55)	4.2 (57)	4.1 (61)	3.2 (54)	2.5 (43)
North East Asia	1.6	0.9	0.5	1.2	1.3	0.7	0.7	0.9	0.4	1.0
South West Asia	2.6	1.9	1.4	2.4	3.9	3.2	2.1	1.8	1.5	0.9

(Reference) ODA contributions to East Asia from DAC countries (billion dollars).

1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
6.7	4.7	4.0	5.6	7.5	6.2	4.8	5.0	4.5	n.a.

Note: Created from relevant data found in "Official Development Assistance (ODA) White Paper", Ministry of Foreign Affairs; (Reference statistics: "Geographical Distribution of Financial Flows 2005", OECD).

Turning to FDI, the sharp rise in the value of the yen against the dollar triggered by the Plaza Accord[7] of 1985 resulted in a rapid transfer of the production lines of Japanese companies to East Asian countries beginning in the late 1980s. These trends favorably impacted the enhancement of industrial basis in the region, energizing the trade in raw materials, parts, intermediate and finished goods with partners both inside and outside of the region, not only among Japanese companies but for local companies as well. The development of intra- and extra-regional trade prompted more direct investment, thus contributing to the high growth process supported by FDI and the trade nexus that continues until today.

This is illustrated by the balance of payments statistics. In the early 1980s, the annual average was 1.8 billion dollars, which tripled to 5.1 billion dollars in the latter half of the decade and then increased to 6.0-7.0 billion dollars in the 1990s and 9.0 billion dollars in the 2000s. On a geographic basis, Japanese FDI into the NIEs and ASEAN remained high in the 1990s, and investment in China has rapidly expanded after its accession to the WTO in 2001. As already discussed, beginning in the latter half of the 1990s, all countries rapidly expanded their FDI into China, resulting in a substantial decline in the relative weight of Japan. However, in the case of multinational enterprises, FDI into China and other countries is not necessarily from the country in which the head office is domiciled. Often, companies with global bases of operations invest through a foreign subsidiary instead. This holds true for Japanese companies as well. There are cases of investment coming from not only Hong Kong and Singapore but US and European subsidiaries rather than from Japan.

[7] The Plaza Accord addressed the twin deficits of the United States (fiscal and current account deficits) of the time together with the current account surpluses of Japan, Germany and other developed countries. The currency adjustments after the Plaza Accord accompanied policy coordination among the countries concerned. In this process, Japanese manufacturing companies spread out their production lines around East Asia, thus gathering momentum for economic development in the region beginning in the late 1980s.

Japanese FDI in East Asian

(Annual average, 100 million dollars)

	1981～85	1986～90	1991～95	1996～00	2001～05
Hong Kong	0.4	1.4	1.1	0.6	0.7
Singapore	0.3	0.9	0.9	0.6	0.7
Korea	0.1	0.5	0.3	0.5	0.9
NIEs-3	0.7	2.7	2.3	1.8	2.3
Indonesia	0.8	0.6	1.4	0.9	0.7
Malaysia	0.1	0.4	0.8	0.3	0.2
the Philippines	0.1	0.1	0.4	0.5	0.4
Thailand	0.1	0.7	0.8	1.2	0.9
ASEAN-4	1.0	1.9	3.4	2.9	2.1
China	0.1	0.5	2.1	1.4	4.5
Total	1.8	5.1	7.8	6.0	8.9

Note 1: Japanese fiscal year (April to March next year) basis.
Note 2: Created from balance of payments statistics. Figures prior to 1995 are based on notified statistics (one-way amounts); for 1996 and beyond, on Balance of Payments Statistics version 5 (net amounts).

4. Expansion of GATT/WTO, RTAs and other institutional frameworks

The establishment of the GATT/WTO's two overriding principles of most-favored-nation (MFN) status and national treatment (NT), which contributed to the establishment of a non-discriminatory, rule-based multilateral free-trade system[8] around the globe, helped to open East Asian economies and deepen their interdependence. In particular, since the establishment of the WTO, a large number of developing countries have received economic benefits from participation in a multilateral free-trade system and have switched their economic development strategies to the liberalization of trade and investment in order to strengthen their export competitiveness. For example, China acceded to the WTO in 2001, and as previously noted, experienced a significant increase in the degree of openness in its economy that led to an expansion of FDI and trade in goods and services, which enabled it to maintain its high economic growth rate.

Nonetheless, the increase in member countries/regions in the WTO has also led to conflicts of interest between developed and developing countries, and between importers and exporters of agricultural products, which have slowed the pace of multilateral trade and investment liberalization.[9]

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[8] After GATT was established (1947), there were several rounds of trade negotiations (Kennedy Round 1964-1967, Tokyo Round 1973-1979 and Uruguay Round 1986-1994) leading to the establishment of the WTO in 1995. These efforts have brought substantial reductions to tariffs, application of non-discrimination among member countries/regions, establishment of new rules (antidumping [AD], safeguards [SG], subsidies and trade related intellectual property rights [IPR], etc.), harmonization among member countries, liberalization of trade in services and application of the rule of law through the establishment of dispute settlement mechanisms.

[9] The current round (the Doha Development Agenda [DDA]) faltered at the onset (the Ministerial Conference in Seattle in 1999; the kickoff eventually took place at the Doha Ministerial Conference in 2001) and also failed to reach a framework agreement at the Ministerial Conference in Cancun in 2003. While only in July 2004 did the General Council arrive at a framework agreement so that negotiations in individual areas were expected to regain their momentum for the time being, negotiations once again slowed down due to the conflict of interests among member countries/regions as is typical in agricultural negotiations.

In reaction to such circumstances, neighboring countries and others sharing trade interests have accelerated efforts to sign regional trade agreements (RTAs). The number of RTAs had nearly tripled in 2005 from what it was at the time the WTO was established (from 62 to 174). All East Asian countries are members of at least one RTA and many countries within the region are currently very active in negotiating new RTAs.[10]

Regional trade agreements

1960	1970	1980	1990	1995	2000	2005
2	6	23	30	62	140	174

Note: WTO notifications base.

The expansion of the RTA network has negative aspects such as the increasing complexity of the rules applied (disparities in tariff concession systems, rules of origin, etc.), but even greater benefits in terms of the trade creation and improvements in investment rules for RTA member countries/regions. The development of the RTA network is therefore considered a means to complement the rule-based multilateral trading system.[11] Indeed, these changes in circumstances have prompted the Asia-Pacific Economic Cooperation (APEC) to begin collecting and disseminating RTA best practices and strengthening RTA frameworks as part of its efforts to liberalize trade and investment (the San Diego Initiative for Expanded Trade in APEC, November 2004).

In September 2006, the ASEAN countries announced that they had reached an agreement to accelerate achievement of the ASEAN Economic Community by 5 years, pushing it forward from 2020 to 2015. This project is widely viewed as an effort to integrate East Asia. Its goals are to strengthen existing initiatives like the ASEAN Free Trade Agreement, promote the creation of a single market and associated production networks within the ASEAN region and improve regional economic integration and international competitiveness.

5. Asian currency crisis and subsequent policy response

(1) Background and factors

Turning to the monetary and financial aspects, we first touch on the Asian currency crisis, which exerted a great degree of influence on the regional financial and capital markets. During the crisis, these economies experienced a temporary, sharp and widespread flight of capital which resulted in significant turmoil in the financial and foreign exchange markets in the region (the Asian currency crisis in 1997-1998). The regional economy cannot be discussed without examining the impact of this event.

Experts have attempted to identify the background and factors leading to the crisis. The orthodox view is that the East Asian economies (i) liberalized capital movements, (ii) retained *de facto* fixed foreign exchange (*de facto* dollar pegs) systems, and (iii) adopted independent

[10] Japan has reached RTA agreements with Singapore, Mexico, Malaysia, Thailand and the Philippines. Agreements for the Japan-Chile EPA as well as the Japan-Brunei EPA have also been reached in principle on major elements. Japan is engaging in bilateral negotiations with Korea, Indonesia and GCC countries, and also in negotiation on a comprehensive agreement with ASEAN. In addition, it has embarked on joint research into modalities for strengthening economic relations with India, Australia and Switzerland.

[11] The GATT/WTO does not allow the arbitrary application of exceptions to the MFN principle (for the purpose of preventing economic blocs from materializing), but does allow RTAs among member countries as exceptions to the GATT in case they facilitate full liberalization of trade within the region (Article 24-8 of the GATT 1994 defines full liberalization of trade within an RTA area as the elimination of tariffs and other restrictive rules for "substantially all the trade" among RTA member countries).

monetary policies. This policy framework was latently unsustainable and unstable. A brief review of the process that took place at the time is as follows;

1) Liberalizing capital movements with the *de facto* US dollar peg system generated large capital inflows into East Asian economies reflecting interest rate differentials with foreign markets.

2) These capital inflows initially served to drive high economic growth, just as anticipated, but the prolonged inflows eventually triggered sharp rises in real estate and equity prices. Concerns about the economy overheating began to surface as such distortions became omnipresent.

3) Monetary tightening was taken as countermeasures against such overheating with higher interest rates in the domestic financial markets, which on the other hand spurred more capital inflow, thus impeding expected policy objectives.

4) Against this background, confidence in economic management deteriorated and flight of capital started, reflecting concerns over the relevant authorities' competence in maintaining an ongoing policy framework. Not even repeated foreign exchange interventions could stem the accelerating capital outflows.

5) As foreign exchange reserves in the economies in question dried up, *de facto* fixed foreign exchange regimes had to be abandoned. Floating rate systems were adopted and capital restrictions were reintroduced. Parallel to these treatments to be adopted by relevant authorities, international financial institutions and leading developed countries began providing financial assistance to the economies suffering from market turmoil.

In addition to problems with policy selection, many experts also point to problems in fundraising and investment structures of the banking sector which was in effect the only channel intermediating domestic and foreign finance. More specifically, they point to the "double mismatch" between the short-term funds raised in foreign currencies and the long-term investments in home currencies, and this is what triggered the foreign currency liquidity crisis in the banking sector, as outlined below;

A) The huge amount of funds flowing into the region comprised those directly raised in the offshore markets by domestic financial institutions, as well as those passively remaining in the financial sector as portfolio investments.

B) This international fundraising focused on short-term foreign funds, specifically dollar-denominated interbank deposits. Banks used this "hot money" to fund expanding long-term lending denominated in local currencies.

C) This mechanism enabled financial institutions in the region to earn stable and large profits as long as confidence in the sustainability of the fixed-rate foreign exchange regime could be maintained among market participants. However, it exposed its own fragility as soon as flight of capital began occurring.[12]

D) In other words, overall cash flows for the banking sector was rapidly impaired under such circumstances in which it became difficult to roll over and/or procure new short-term foreign currency denominated funds and a lack of disposable liquid assets surfaced due to local banks' portfolio mismatches between long-term investment and short-term funding.

[12] Financial institutions in the East Asian economies were said to be excessively dependent on inefficient indirect finance because of underdeveloped capital markets in the region providing limited direct funding opportunities which meant facing a series of problems in their operation and administration (a lack of financial capability, sound governance, appraisal capacity, etc.).

The exposure of the frailties inherent in the double mismatch obligated regional financial institutions to strengthen their risk management capacity including interest rates, foreign exchange rates and liquidity risk management, and their capital base. For the regional monetary authorities, it also identified issues to be addressed within the sphere of financial supervision and underscored the need to enhance financial and foreign exchange markets with enough depth to absorb unexpected financial shocks.

(2) Policy response after the currency crisis

Given the nature and circumstances of the currency crisis, East Asian countries have devised a wide range of policies thus far. These policies can be categorized as: (i) the shift to a floating exchange rate system and the creation of a network for mutual accommodation of foreign exchange reserves, (ii) joint efforts to develop local capital markets, and (iii) efforts to reorganize and improve the soundness of the banking sector. Among these, the creation of a bilateral swap arrangements network translates into initiatives to strengthen the region's ability to handle crises. As will be described later, the creation of funds to invest in local currency bonds will contribute to overcominge mismatches between currencies and maturities that create problems in the banking sector's intermediation function. What follows is an overview of these policy responses.

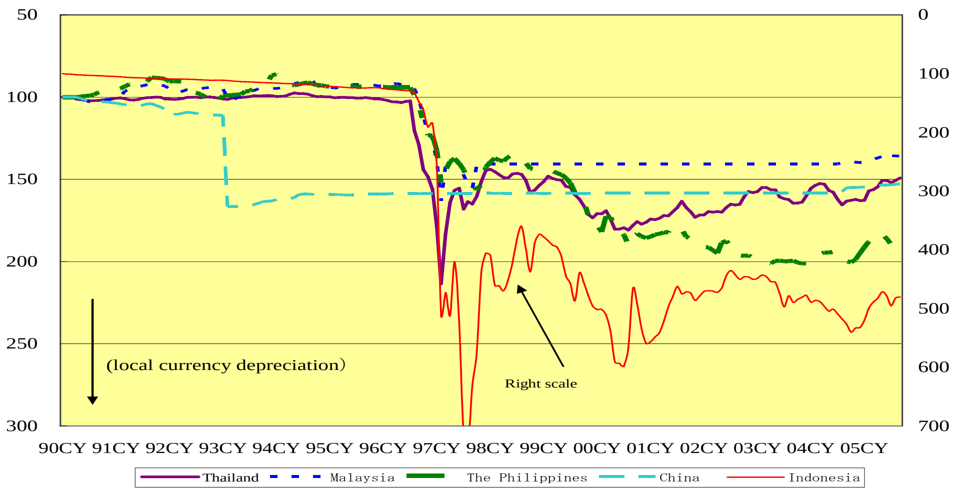
1) Transition to floating exchange rates and the creation of a network of bilateral swap arrangements

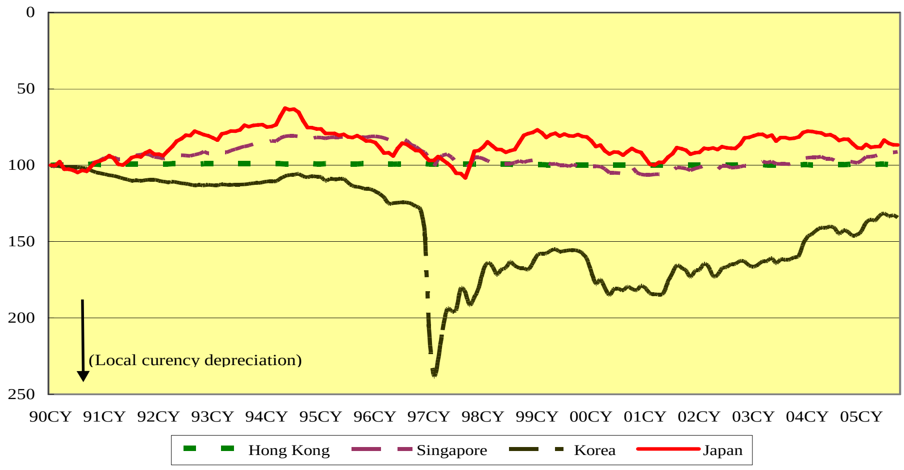
Faced with the crisis, many countries in the region reexamined the feasibility of the *de facto* dollar peg system and shifted to more flexible foreign exchange regimes including managed floats. Other than Hong Kong (which has adopted a currency board system that linked domestic interest rates to US interest rates), China (which was cautious about relaxation of capital regulations), Singapore and Taiwan, the remaining ASEAN countries such as Thailand, Indonesia and the Philippines, together with Korea, moved to floating rates at more or less the same time. Even Malaysia, which temporarily adopted a dollar peg, has returned to a float system. All of these countries initially adopted regulations attempting to restrict speculative capital flows. Some of the primary regulations were restrictions on offshore foreign currency lending, restrictions on capital inflows, requirements that foreign exchange be based on real demand, requirements of license/advance permission for capital transactions, and stricter reporting obligations for foreign exchange transactions to central banks. However, most of these regulations have been considerably loosened or abandoned altogether.[13]

Long-term time series data on foreign exchange markets for East Asian currencies versus the dollar (see the following graph; indexed at the December 1990 average = 100) shows that the Thai baht, Indonesian rupiah, Philippine peso and Korean won had moved in a more or less constant range until mid-1997, but after the outbreak of the crisis were forced to drastically devalue and move to floating rates. During this period, China moved to unify the market for the yuan by converging the official rate to the market rate in 1994, resulting in a significant devaluation and subsequent stability. More recently, the Chinese yuan has been strengthened in a gradual manner.

[13] Malaysia adopted capital restrictions in September 1998, but began to phase them out in February 1999.

Local East Asian currencies versus the dollar
(December 1990 average = 100)





When the crisis broke out, there was an unexpectedly large and rapid increase in the demand for foreign-currency liquidity that exceeded the ability of individual countries to respond. This experience brought renewed recognition of the importance of ensuring liquidity. The result was the Chiang Mai Initiative (CMI) to create a framework for mutual support among the ASEAN + 3 (Japan, China, Korea) that began in 2000. Under this framework, a network of bilateral swap agreements (BSA) has been entered into as a mechanism for mutual lending of foreign-currency reserves. The agreements have gradually been enhanced and are currently able to provide total liquidity of approximately 75.0 billion dollars.

Statistics of the foreign-currency reserves held by East Asian monetary authorities illustrates that a rapid rise in balances since the 1990s, with the growth particularly prominent in the last few years. In 1990, the nine countries had a total of 200.0 billion dollars, but in 2005 they had 2.5 trillion dollars, an increase of more than 2 trillion dollars. In terms of individual countries, China and Japan increased to a level of 800.0 billion dollars, the NIEs 4 to a total of 700.0 billion dollars and the ASEAN 4 to a total of 170.0 billion dollars. There are many different views on the substantial accumulation in foreign exchange reserves in recent years, but, for the region's monetary authorities, who have experienced the risk of evaporating reserves entailed by the flight of capital in the crisis, it admittedly means a provision of an ample cushion in foreign exchange liquidity, as the case might be for the network of bilateral swap arrangements under the CMI.

Foreign exchange reserves in leading East Asian countries

(billion dollars)

	1970	1980	1990	2000	2005
Hong Kong	n.a.	n.a.	24.5	107.5	124.2
Singapore	1.0	6.5	27.7	80.1	115.7
Korea	0.6	2.9	14.7	96.1	210.3
Taiwan	0.5	2.2	72.4	106.7	257.9
Thailand	0.8	1.5	13.3	32.0	50.6
Malaysia	0.6	4.3	9.7	29.5	70.1
Indonesia	0.1	5.3	7.4	28.5	32.9
the Philippines	0.2	2.8	0.9	13.0	15.9
China	n.a.	2.5	29.5	168.2	821.5
Japan	4.3	24.6	78.5	354.9	834.2
Total	7.7	50.8	206.6	910.1	2,536.9

Note: Excludes gold reserves. Data: IMF International Financial Statistics, etc.

2) Development of local capital markets

The region has also moved to develop markets for local currency bonds as a means of providing multiple channels of financial intermediation. There are two specific projects: (A) the Asian Bond Market Initiative (ABMI) and the (B) Asian Bond Fund (ABF). The former focuses on the "supply" side and the latter on the "demand" side of bond market development. These projects are implemented within the intergovernmental cooperation framework of ASEAN + 3 (ABMI) and the central bank cooperation framework of EMEAP (ABF).

(A) Asian Bond Market Initiative (ABMI)

ASEAN + 3 is using the ABMI to improve the regulatory environment and infrastructure for securitization, credit guarantees, ratings agencies, foreign exchange and capital regulations and securities settlement, etc. Since its startup, the ABMI has achieved local currency-denominated bond issues by the Asian Development Bank (ADB) and International Finance Corp. (IFC) as well as local currency-denominated bond issues from collaborations between private enterprises and government institutions. In addition, it has been dealing with bonds denominated in a basket of regional currencies, credit guarantee mechanisms within the region and enhanced local ratings agencies.

(B) Asian Bond Fund (ABF) project

As part of the cooperation among regional central banks aiming to foster local capital markets in Asia, EMEAP proposed the "Asian bond fund" (ABF) project for joint investment in Asian bonds (sovereign and quasi-sovereign bonds issued by 8 countries and regions, excluding Japan, Australia and New Zealand). ABF-1 (launched in 2003) is an investment fund for EMEAP central banks that invests in dollar-denominated bonds; ABF-2 (launched in 2005) is a fund that invests in domestic currency bonds managed by private financial institutions and open to investment not only from EMEAP central banks but also from private sector investors as well.

This project serves as a model case for the creation of funds in East Asia; among its chief functions are to formulate benchmark indices and improve the overall transparency of mechanisms. It also serves as a project for the development of innovative, low-cost and efficient bond-related instruments. Its goals are to increase the interest of ordinary investors in the East Asian bond markets and to catalyze market enhancements by relevant regulators.

6. Currency trading in the region

(1) The US dollar's dominance in the regional foreign exchange markets

Turning to currency trading in the region, even after Asian countries overcame the currency crisis to go on to achieve high, external demand-led growth and deeper interdependence, the US dollar continues to be a dominant vehicle for payments and settlements in the region's international markets for goods, services and capital. In addition to the large, sustained inflows of capital already described, the balance of payment imbalances between East Asia and the United States have created a strong preference for payment in dollars not only for transactions in which the United States is the ultimate destination but also for transactions with final destinations inside the region. It should be noted that while local subsidiaries/branches of multinationals that are highly dependent on trade have developed dollar-based transaction structures on both the revenue and expenditure payments, they tend to experience smaller impact by dollar/local currency foreign exchange fluctuations than local exporters.

Reflecting the US dollar's predominant position as the common currency of payment within the region, foreign exchange markets have little if any direct trading between local regional currencies. Trading is conducted primarily on a "cross currency" basis mediated by the US dollar, and trading against the dollar is the standard for all market transactions. According to the Bank for International Settlements (BIS) data on trading between local currencies and other currencies in the East Asian markets in 2004, more than 90% of transactions were for those against US dollars with only a very small amount of trading against the euro, yen, etc. in every market including the ASEAN 4 countries, China, as well as the NIEs 4 whose markets are relatively large.

Trading between local currencies and other currencies in East Asia

(Daily average dealer trading in April 2004; billion dollars)

	Total	*vs dollar*	*vs euro*	*vs yen*	*vs sterling*	*others*
Hong Kong	*27.2*	*26.1*	-	-	-	*1.1*
Singapore	*10.8*	*10.4*	*0.1*	*0.1*	*0.1*	*0.2*
Korea	*17.1*	*16.7*	*0.1*	*0.3*	*0.0*	*0.0*
Taiwan	*4.1*	*4.0*	*0.0*	*0.1*	*0.0*	*0.1*
Thailand	*2.3*	*2.1*	*0.1*	*0.1*	*0.0*	*0.0*
Malaysia	*1.0*	*1.0*	*0.0*	*0.0*	*0.0*	*0.0*
Indonesia	*1.8*	*1.8*	*0.0*	*0.0*	*0.0*	*0.0*
the Philippines	*0.6*	*0.6*	*0.0*	-	*0.0*	-
China	*0.6*	*0.6*	*0.0*	*0.0*	-	-
(Ref.) Japan	*139.6*	*120.5*	*13.6*	-	*1.8*	*3.8*

Note 1: "Others" include Swiss francs, Canadian dollars, Australian dollars and other major and minor currencies.

Note 2: Data: BIS Triennial Central Bank Survey March 2005 ("Foreign exchange and derivative market activity in 2004").

(2) *Active NDF transactions in offshore markets*

Another characteristic feature of the region's currency transactions is the active trading of NDFs (Non-Deliverable Forwards) on offshore markets. NDFs are a kind of forward foreign exchange trading instrument that requires only margin calls with US dollars as a means of settlement – it does not require delivery of principal and settlement with local currencies. A lack of statistics makes the exact size of NDF trading uncertain, but the market participants' perceptions suggest that NDF trading volume would be an equivalent to 1/4 of onshore forward and swap transaction volume. In terms of individual currencies, the largest is the Korean won (1.0-2.5 billion dollars traded per business day), followed by the Taiwanese dollar (0.5-1.0 billion dollars), Chinese yuan (0.2-0.5 billion dollars), Indian rupee (0.2-0.4 billion dollars), Indonesian rupiah (0.1-0.25 billion dollars) and Philippine peso (0.1-0.15 billion dollars). It appears that similar offshore trading takes place for such instruments as swaps and options.

Offshore-market NDF trading in Asian currencies is said to be more speculative than onshore trading and generally considered much more volatile. As monetary authorities in the region shifted their currency policy to tolerate a certain degree of floating after the crisis, market participants have come to have greater needs for hedges against foreign exchange fluctuation. On the other hand, local foreign exchange markets in East Asia are not liquid enough to absorb the variety of transactions to be carried out by participants with different motivations including hedging needs, because such regulations as the "real demand" principle for currency trading remain in place. This has led to the emergence of offshore markets specializing in transactions not based on "real demand."

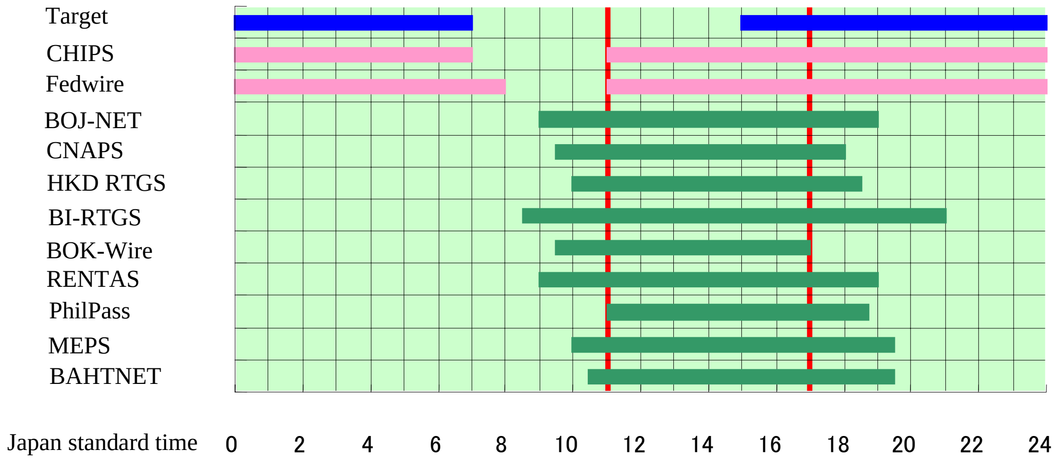
This problem is not limited to the foreign exchange markets, but covers the money and capital markets as well. In the regional financial markets, trading volume with individual maturities is not sufficient enough to form an appropriate yield curb structure – both a short-term zone and a long-term one – so that interest rate arbitrage between domestic and foreign markets also fails to function, and this would be a factor destabilizing NDF rates. The solution to this polarization of foreign exchange rate formation between onshore and offshore markets is to be found in the elimination of financial and foreign exchange market regulations and enhancement of regional financial markets. For example, there is no NDF trading for the Japanese yen in the Asian time zone; forward trading is centralized in Tokyo. Therefore, offshore NDF markets in other Asian national currencies should also eventually converge on domestic markets in the future.

(3) *Improvements in foreign exchange settlement functions*

In the meantime, the stability of currency transaction settlements comes from an improved settlement system for US dollars and other currencies. For US dollars, core settlement systems such as Fedwire and CHIPS have extended their operating hours to enable real-time gross settlement (RTGS) of US dollar funds, even during East Asian daytime trading hours. This has significantly improved the safety and convenience of the US dollar payment services provided by financial institutions participating in the US settlement system. It has also alleviated settlement risk arising from time differences between East Asia and the United States, and it has reinforced the region's preference for US dollars.

The same applies to funds settlement in local currencies because the settlement hours for US dollars and East Asian currencies now overlap to a great extent. As further progress is made in the enhancement of payment systems provided by monetary authorities and private financial institutions in East Asia, there will be greater safety and convenience for funds settlement not only between US dollars and East Asian currencies, but also among East Asian currencies within the same time zone. CLS is a mechanism for private, cross-border multi-currency settlement that was introduced as a means of reducing the "Herstatt Risk". While the Japanese yen was originally the only participating East Asian currency, the number has now expanded to four with the addition of the Singapore dollar, Hong Kong dollar and Korean won.

Operation hours for principle settlement systems



7. Conclusions

From an international perspective, economic development in East Asia is characterized by sustainable and ample inflows from overseas. This capital inflow has taken several forms, and typically in the case of portfolio investment has been accompanied by wide fluctuations. On the other hand, FDI has generally recorded stable net inflows among others, which prompted industrial development in the region, particularly in export and import sectors. In a nutshell, a virtuous cycle generated by an FDI-trade nexus is an important mechanism to support high economic growth in the region.

This FDI-trade nexus has also encouraged growth in the number of industries in individual economies in such a manner that heightened the region's interdependence through the active intra-regional trade of goods and services. Against this background, East Asia has come to be known as the "factory of the world" with a complex cross-border transaction of raw materials, parts, intermediate and finished goods in the region. Thus, external demand-led industrialization has been a driving force toward regional integration of the real economy.

On the financial and monetary front, there continues to be a strong preference for the US dollar as the common settlement currency in the region not only for extra-regional transactions but also for intra-regional transactions. This had once led relevant monetary authorities in the region to adopt policy selection of a *de facto* dollar peg foreign exchange system on the one hand, which set a basis for securing stable capital inflows into the region, and together with capital controls, an independent monetary policy on the other. However, this policy mix became unsustainable with a rapid globalization of financial markets, resulting in the Asian currency crisis of 1997-1998 which forced many economies in the region to float their currencies. Subsequently, progress has been made in strengthening the ability to deal with crises and diversify financial intermediation functions in the region. As long as foreign capital inflows continue to be an important driving force for the economic development in the region, it is of vital importance for the region to develop financial and foreign exchange markets that are liquid and resilient enough to absorb shocks caused by large-scale capital flows.

In this regard, interest rate arbitrage mechanisms must be structured between domestic and foreign markets in order to improve market functions for the East Asian region as a whole. Such market mechanisms will be preconditioned on the formation of interest rates in a variety of maturities in domestic financial markets through active trading by a wide range of market participants. This will set a basis for securing an appropriate swap spread in the foreign exchange markets. In addition, increased stability in settlement among local currencies is another important factor contributing to improvement of market mechanisms. If regional foreign exchange and fina-ncial markets were equipped with full fledged market mechanisms and constantly were to be adjusted in accordance with the change of expectations of market participants, the risk of turbulent movement in capital flow would significantly be reduced. It should be added that enhanced functioning of short-term money markets is crucial for effective central bank operations in safeguarding the economy against disruptive external shocks.

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