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Bank of Japan

Future of Central Bank Cooperation in Asia, Latin America, and Caribbean States

Remarks at the BOJ-CEMLA Seminar on Regional Financial Cooperation

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I. Introduction: Central Bank Cooperation in Asia

Good morning, honorable speakers and distinguished guests. Welcome to the Annual Meetings of the IMF/World Bank Group, and in particular, to this BOJ/CEMLA seminar on regional financial cooperation, which is one of the most relevant and pressing issues in our increasingly inter-connected world. Today, in my remarks, I would first like to touch upon the history of cooperation among central banks in Asia, followed by an assessment of what has been achieved since the Asian Currency Crisis of the late 1990s, and how this helped Asia weather the shocks of the current global financial crisis. Then I will discuss the issues we face today in this post-crisis world.

The Bank for International Settlement, the BIS, is the first name that comes to mind when considering cooperation among central banks. The BIS provides opportunities for major central banks to discuss various issues, including international banking standards and global financial stability.[1] However, most Asian central banks had to wait until the latter half of the 1990s to become directly involved in BIS activities.

It was this circumstance that led the Bank of Japan to propose the establishment of the Executives' Meetings of East Asia and Pacific Central Banks, or the EMEAP, which was officially established in 1991 with the members of eleven economies of East Asia and Oceania.[2] The EMEAP

1 The BIS provides secretariat services to various committees and high-level meetings of central banks and supervisory authorities such as the Financial Services Board, the Basel Committee on Banking Supervision, the Committee on Payment and Settlement Systems, and the Committee on the Global Financial System. The BIS also functions as the study and research center for global finance and economics.

2 The primary objective of the EMEAP resembles that of the BIS. It is to strengthen the

plays a particularly important role in promoting the exchange of opinions among practitioners and the maintenance of a surveillance network. Member central banks share information at the working group meetings which cover financial markets, banking supervision, payment and settlement systems, and information technology. To take a prominent example, the Working Group on Payment and Settlement Systems (WG/PSS) regularly updates its "Red Book", using methods similar to those adopted by the BIS, to explain details of the payment and settlement systems of the member economies. Currently, the Working Group on Financial Markets (WG/FM) is closely monitoring the impact of the European sovereign debt crisis upon financial markets in Asia and Oceania.

II. Two Financial Crises and Asian Financial Markets

In the past two decades, member economies of the EMEAP have experienced two financial crises: the Asian Currency Crisis of the late 1990s, and the current global financial crisis. However, the impact of these crises was very different: severe in the former, and relatively mild in the latter. I believe the difference is partly due to the enhanced cooperation among the central banks of the EMEAP member economies.

The Asian currency crisis highlighted the structural vulnerabilities in the region's economies: first, there was the double-mismatch of currency and maturity in the region's financial sector, and second, corporate finance remained highly dependent on banks. As a result, Asian countries were

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cooperative relationship among its members. The EMEAP started as the regular meetings for the Deputy Governors. Since 1996, it has developed into a triple layered system similar to that of the BIS, with the Governors' Meetings, Deputy Governors' Meetings and Working Group Meetings.

vulnerable to sudden changes in global financial markets and their abundant savings were not being mobilized effectively within the region.

To rectify the problem of overdependence on banks, the EMEAP started the Asian Bond Fund (ABF) initiative to promote local-currency bond markets, a project giving members the opportunity to invest in bonds in Asia. In parallel, the governments of ASEAN+3 member countries are now implementing the Asian Bond Market Initiative (ABMI) to foster deregulation and to create an environment conducive to investment. The results have been impressive: the local-currency bond markets in Asia have developed significantly, as shown in Figure 1, in terms of amount outstanding for both government and corporate bonds. The share of Asian-currency bonds in global bond markets increased from 2.1% at the end of 1996 to 8.4% at the end of 2011. What is remarkable here is that the presence of foreign investors in a number of local-currency bond markets in Asia is rapidly increasing, as shown in Figure 2. This can be attributed to the enhancement of the market infrastructure of these economies, not just because of improvements in the risk/return profile of these bonds in terms of the creditworthiness of the issuers and the relatively higher yields of the papers.

Moreover, there has also been a significant improvement in the problem of currency mismatch. The share of foreign lenders' loans denominated in local currencies has increased remarkably, as shown in Figure 3, although the maturities of such loans are still one year or shorter. It is worth mentioning here that some countries have implemented measures explicitly to reduce the mismatch. A case in point is the Republic of Korea which obliges local banks to hold a certain proportion of short-term foreign currency assets against short-term foreign currency debt.

The Asian economies have weathered a series of shocks starting from the bankruptcy of Lehman Brothers to the European debt crisis of today. I believe the improved market structure described above has contributed to this performance, together with good economic fundamentals and the relatively plain business models of banks in Asia.

III. Challenges for the Future──Beyond the Boundary of Asia──

The financial market developments described so far pose new challenges for central bankers in Asia. I believe these challenges are also relevant for our colleagues in Latin America and Caribbean states.

The first challenge is how to cope with cross-border capital flows. Given that the bond markets have developed and that the proportion of non-resident holders has increased, there have been calls for categorical restrictions on cross-border capital flows to prevent the sudden reversal of portfolio flows that could cause a financial crisis. This problem may be particularly keen when the growth of the bond markets is so rapid that the market infrastructure fails to keep pace. In fact, there is some evidence suggesting a positive correlation between the ratio of non-residential holders and the volatility of bond yields.[3] However, we need careful benefit-cost analysis here since such restrictions may impose substantial efficiency loss on the country in the long run. What is essential is to

[3] For example, see Jochen R. Andritzky, "*Government Bonds and Their Investors: What Are the Facts and Do They Matter*?", IMF Working Paper, June 2012.

strengthen market infrastructure: for the bond issuer to maintain sound creditworthiness, and for the market to increase its transparency. In fact, in Germany, the share of non-resident holders of government bonds reaches almost sixty percent, yet this is not seen as any cause for concern.

The second challenge is to improve the resilience of financial markets against financial stress, and here collateralized markets are the key. While the bond markets show remarkable growth in Asia, the collateralized money markets, including the repo markets, are underdeveloped, except in Japan. In most of the emerging market economies, repo transactions are largely used for the monetary policy operations of the central bank, while they are rather rarely used between private market participants. Legal uncertainty regarding the effectiveness of collateral has often been pointed to as the main reason for this scarcity of private repo transactions. However, in order to maintain the functioning of the money market, especially under very stressful conditions, it is essential to have well-functioning markets for collateralized transactions, including repos.

The third challenge is cross-border financial regulations. In particular, this is the issue of how Asia, Latin America, and Caribbean states should respond to the latest regulatory developments in the United States and Europe. There have been moves to extend U.S. and European regulations beyond their domestic borders to be applied in other jurisdictions, based on the argument of guaranteeing a "level playing field". A level playing field is undoubtedly important for fairness. Nonetheless, what we really need is a playing field that leads to fair competition among financial institutions of different types and backgrounds. The regional and functional heterogeneity of Asia, Latin America, and Caribbean states should be honored in the appropriate way. However, I am also aware of the danger of "spaghetti regulations" once each and every country starts insisting on its own unique regulations, where we end up with extremely complicated and entangled regulations with unintended cross-border consequences. As such, we need to formulate a "regional voice" to make sure that the global regulatory framework is clear and consistent.

Last but not least, given the mutual linkages among the regions of Asia, Latin America and Caribbean countries, it is all the more important to monitor whether there are any financial imbalances in any countries. To achieve this goal, we need to improve not only the credibility and the accuracy of our economic data, but also their timeliness. Central banks should play a major role in such regional surveillance work and economic data improvement.

To conclude, I believe candid discussion and collaboration on nuts and bolts issues among central bank experts are truly important in the context of central bank cooperation. I hope the rewards of our endeavors will be the formulation of fruitful new ideas and the expansion of rewarding human networks.

Thank you for your attention.

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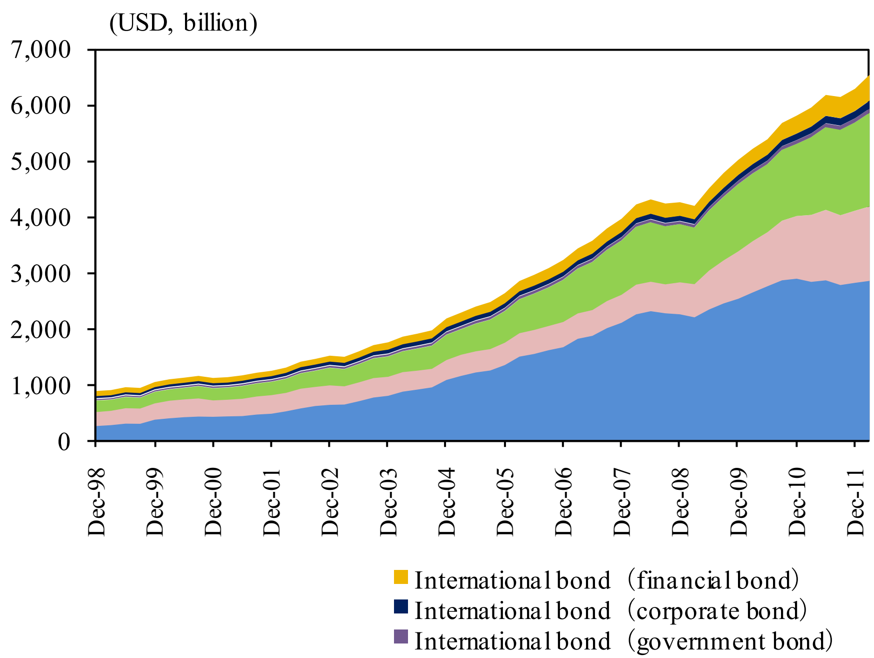
(Figure 1) Development of Asian Bond Markets

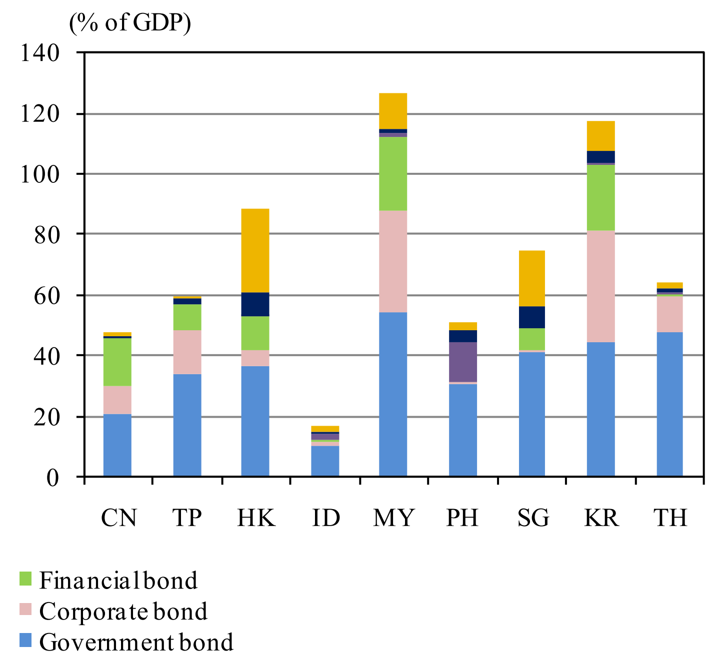
- The size of bond markets has grown, driven by the government bond market.
- Corporate bond /financial bond markets growth has accelerated since 2008.

Size of Bond Markets

Asia (ex. Japan)



Jurisdiction Comparison (2011)



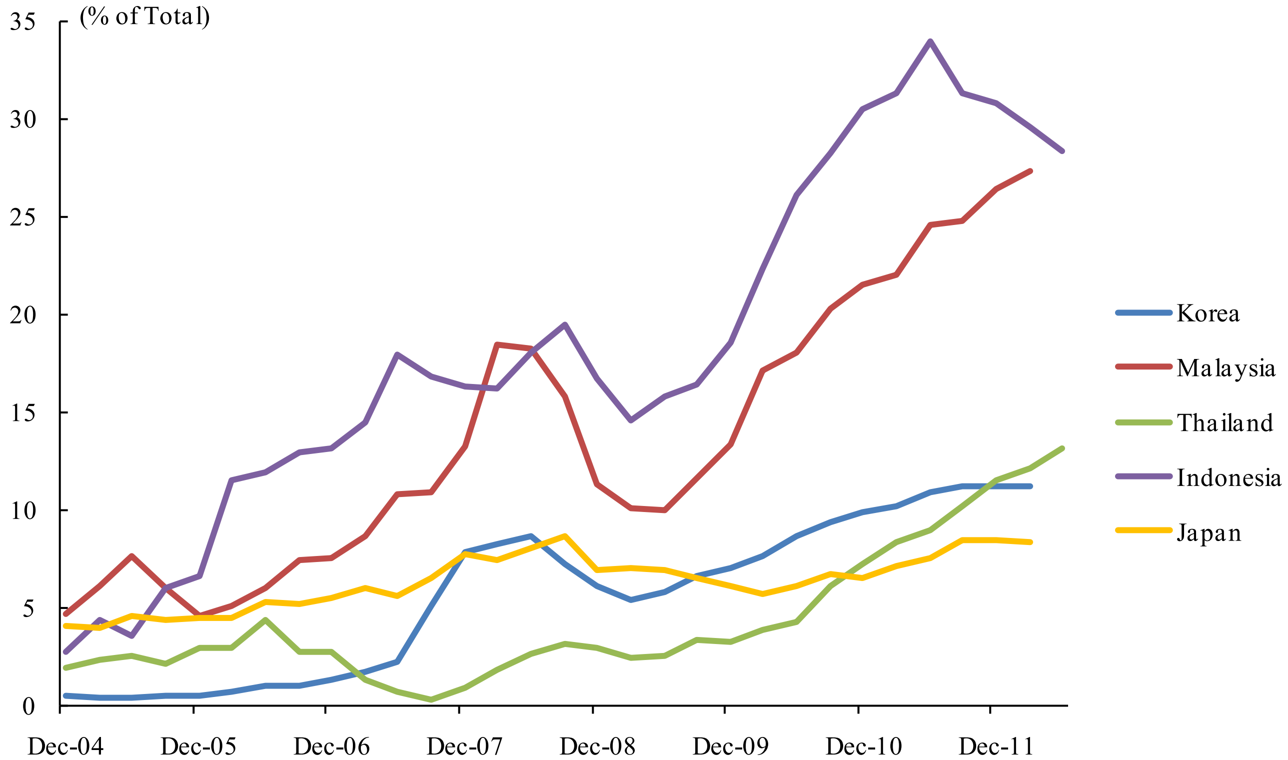
Note 1: Asia is the aggregate of China (CN), Taiwan (TP), Hong Kong, (HK), Indonesia (ID), Malaysia (MY), Philippines (PH), Singapore (SG), Korea (KR), and Thailand (TH).

Note 2: Government bond, corporate bond and financial bond are local currency bonds issued by local residents. International bonds (offshore) are the aggregate of the foreign currency bonds issued by local residents and the bonds (both local/foreign currency) issued by non-residents.

Sources: IMF, BIS.

(Figure 2) Foreign Holding in Local-Currency Government Bonds

- The ratio of foreign holding in local-currency government bonds has surged in a number of economies.



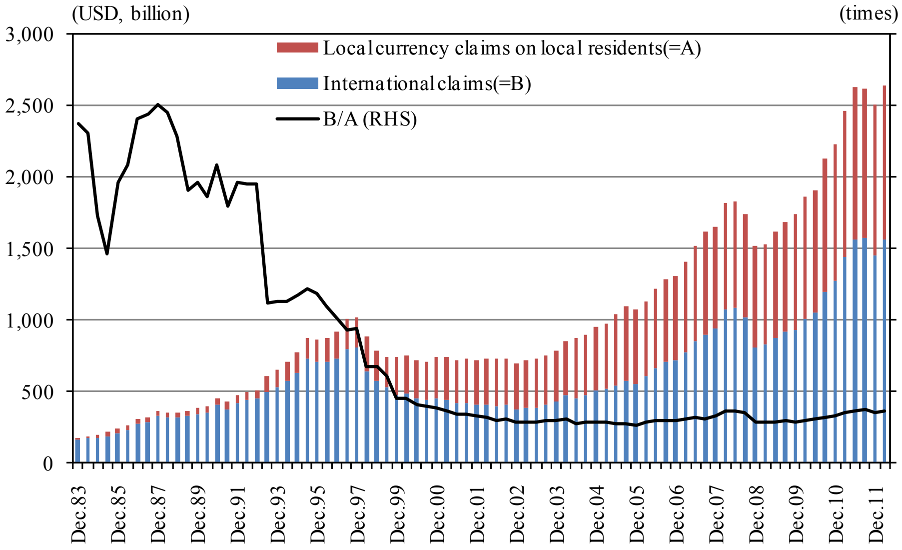
Note: The percentage in local currency government bonds held by foreign investors relative to the amount of local-currency government bonds outstanding in a specific market.

Source : ADB.

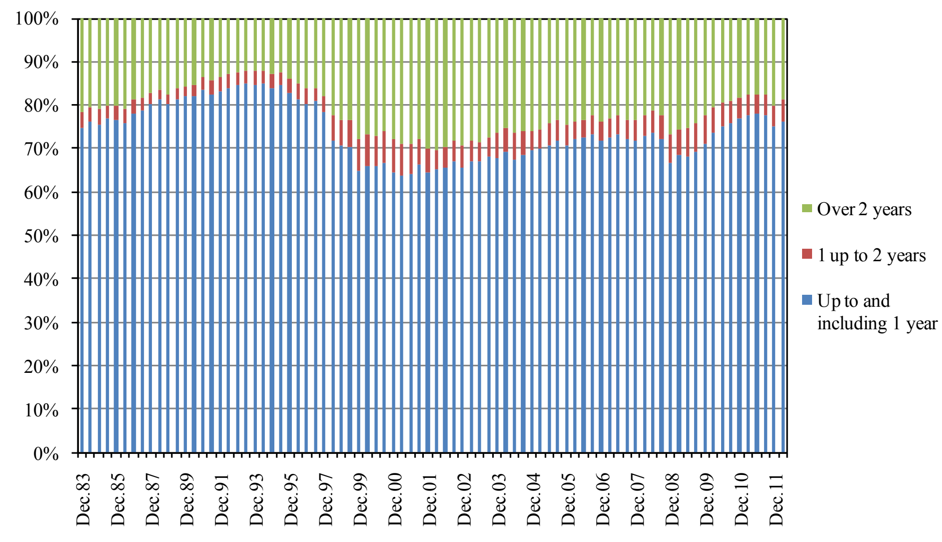
(Figure 3) Double Mismatch (Currency and Maturity)

- Currency mismatch seems to have lessened gradually (left).
- Maturity mismatch still lingers (right).
  Ratio of short-term maturity bond remains high.

International Claims and
Local Currency Claims on Local Residents



International Claims by Maturity



Note 1: Local Currency Claims are the local currency denominated claims held by local branches/subsidiaries of foreign banks on residents.

Note 2: International Claims are the claims (denominated mainly in foreign currencies) held by foreign banks on residents and the foreign currency denominated claims held by local branches/subsidiaries of foreign banks on residents.

Note 3: All figures are the aggregate of China, Hong Kong, Taiwan, Korea, Singapore, Malaysia, Indonesia, Thailand, and Philippines. Data from 1983 to 1999 is semi-annual, quarterly thereafter.

Source: BIS Consolidated Banking Statistics.