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1. Painful experiences of Asian economies in the past two years are largely outcomes of policy errors on the external account front. That is, capital flows across border were liberalized but values of home currencies were pegged to the U.S. dollar, which unfortunately moved in the direction that was inconsistent with the macroeconomic status and policy of home countries.

2. One repercussion of financial crisis is regional fragmentation, because after each developing country floated its own currency, the exchange rate of each country moved rather wildly depending upon pertinent factors at each moment and market sentiment.

3. Amid such scenario, several parties wonder whether there is any possible way to unify East Asian (EA) economies by adopting a common currency. Detailed investigation of each EA country's economic profile reveals that chances of common currency in EA are slim because macroeconomic temperament of each EA country differs from one another's drastically. For example, in 1997 per capita GDP went from US\$ 1,074 in Indonesia to US\$ 9,623 in South Korea and US\$ 31,071 in Singapore. Such vast gaps of per capita income mean huge differences in cost of living, and make currency union rather impractical because integrating currencies is equivalent to unifying commodity prices across border. Similar divergences occur on the inflation and interest rate fronts. Inflation in 1998 went from -0.2% in Singapore to 8.0% in Thailand and 61.1% in Indonesia, while deposit interest rate went from 3.5% in Singapore to 7.8% in Malaysia and 20% in Indonesia. Besides, monetary and fiscal policies differ markedly from one country to another with respect to direction, timing, and extent, depending on prevailing problems, predominant pressures, and groundwork or economic fundamentals. Differences in implemented economic policies make currency unification an even more difficult task, if possible at all.

4. In Western Europe, currency union is possible because economic background of each member country is close to one another's, e.g. inflation, interest rate, fiscal deficit, and government debt, making the abidance by common rules doable.

5. Even though the earlier mentioned argument may sound discouraging that EA members are left without many choices for regional integration, but indexation of EA currencies still remains as one alternative route for market mechanism to help the EA region.

6. Before dealing with East Asian Currency Index (EACI) in detail, it is worth reminding ourselves of a few crucial features of EA, as follows.

- a) EA is the region that is trading more within itself. That is evident from the volume of intra-EA trade which climbed from 35% of total EA external trade in 1980 to 47% in 1990 and 53% in 1997. This implies that EA currencies need not be pegged with U.S. dollar or other non-EA currencies, since doing so will generate unnecessary currency exposure.
- b) EA as a whole commands continual current account surplus or its total savings exceed investment.

7. From the EA's status as described above, it immediately suggests that to make EA self-sufficient fundwise is not, a priori, an impossible target for fund recycling efforts. And if achieved, such recycling will help reduce EA's vulnerability or exposure to volatility of funds from outside the region.

8. Everybody is well aware that current crises are largely attributed to retrieval of short-term capital flows from EA to the West because of slackening confidence in debt servicing capacities of EA economies. This clearly demonstrates the importance of capital flows relative to that of current account transactions. Therefore, if surplus funds of EA are successfully recycled within EA, that should help avert financial crisis in the future.

9. To achieve successful fund recycling needs 3 channels:

- a) Regional capital market is to be developed to facilitate long-term capital flows.
- b) New financial instruments and currency mix are to be devised so as to persuade both EA lenders and borrowers to agree upon risk sharing and/or terms of lending.
- c) Special-purpose vehicle called East Asian Fund Recycling Agency (EAFRA) probably needs to be established so as to assist in recycling private-to-private funds within the region. This EAFRA, functioning as if was a private ADB, could become essential in the first five years after the crises emerged (1997-2002) because the financial crises markedly weaken creditors' confidence to lend directly to borrowers within EA. Besides, EAFRA will help allocate surplus funds to proper utilization as well. In other words, EAFRA will help EA avoid bubbling up their economies again.

10. It is useful to analyze what the situation will be without the three aforementioned channels.

- a) Without a regional capital market, the surplus funds of EA could easily move

to financial institutions or centers in the West and may not return or be available to borrowers in EA. Or even so, the extent is likely to shrink and maturity to shorten, which may lead to a recurrence of another financial crisis.

- b) Without attractive financial instruments and currency mix, EA lenders and borrowers are likely to resort to typical credit instruments in U.S. dollar again, which will generate unnecessary credit exposure since fundamentally lenders and borrowers in EA rarely have financial bases in U.S. dollar.
- c) Without EA Fund Recycling Agency, it will be formidable, at least in the first stage, to persuade surplus units to offer credits directly to deficit units in EA, since the former's confidence in the latter deteriorates considerably due to the crises.

11. Given the significance of fund recycling and currency exposure in EA economies, we now turn to the question of why we should formulate a new currency-mix financial instrument or East Asian Currency Index (EACI). The underlying rationale will be evident once we examine a small subset of EACI such as a bilateral credit agreement between Thailand and Japan. The Japanese parties want to lend in yen while the Thai want to borrow in baht in order to avoid exchange risks. However, different units have different characteristics of risk aversion or preference. For example, while lender A may demand 100% in yen as loan denomination and 3% as interest rate, lender B may comply with 80% in yen and 20% in baht but interest rate must be higher or $0.8(3\%) + 0.2(9\%) = 4.2\%$. The same situation could easily occur on the borrowers' side. Some may look for all credit denomination in yen due to low interest rate as they are willing to accept all exchange risks or the possibility that yen may appreciate against baht in the future. Meanwhile, other borrowers choose to bear higher interest burden instead of exchange risks, so the baht portion is higher in the mixture of currency denomination.

12. As different creditors and debtors have different risk preferences, market mechanism must be resorted to so as to create and match deals between the two. The governments' roles in the two countries are to encourage the two to negotiate and reach a compromise because the governments' underlying objective is to maximize the volume of intra-EA borrowing or recycling of funds.

13. Once a simple case between Thailand and Japan is understood, everybody can generalize the conceptual framework to EACI. For instance, in the Thailand-Japan case if 80:20 is an agreeable proportion of yen to baht, this currency mix represents a proper combination of currency deal between Thailand and Japan. As for the generalized case of EACI, if there are a large volume of intra-EA transactions, market sentiments or expectations will help formulate widely accepted combinations of currencies or EACI.

Such EACI will serve in

- a) distributing risks to creditors and debtors in accordance with their preferences.
- b) Facilitating flows of funds within EA
- c) Reducing currency exposure of EA to extra-EA exchange rate disturbances such as the surging U.S. dollar in 1995-97.

14. Risk preferences of lenders and borrowers are influenced by both intra-EA economic fundamentals and extra-EA factors (e.g. U.S.-Japan relations). But if the volume of intra-EA transactions grow large, extra-EA factors should generate declining impact.