

The Per Jacobsson Lecture

ASIAN MONETARY COOPERATION

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Sir Jeremy Morse
Mr Van Houtven,
Distinguished Guests,
Ladies and Gentlemen,

Introduction

1. Good afternoon. On behalf of the people of Hong Kong, particularly those of us at the Hong Kong Monetary Authority, let me extend my warmest welcome to all of you to Hong Kong. For those of you who have visited Hong Kong before, perhaps many times, I hope you are pleased to see that Hong Kong, as a Special Administrative Region of the People's Republic of China, remains as vibrant and dynamic as you have known in the past, retaining much of its free market characteristics, under the principle of "one country, two systems".

2. It is a great honour and privilege for me to be invited to give this year's Per Jacobsson Lecture. As a Managing Director of the International Monetary Fund (IMF), Mr Per Jacobsson led a life that was dedicated to the promotion of both European and later international monetary cooperation. It is only befitting that a lecture held in Asia in memory of this great man should address the topic of Asian monetary cooperation. This is also a subject that has been brought to sharp focus in the light of the recent turmoil in the currency markets of Asia.

3. What I intend to do this afternoon is first to define what international monetary cooperation is about, and in this connection, survey the attitudes of the parties that should have an interest in such cooperation and discuss the form of this cooperation. I wish to point out that these attitudes have, perhaps unintentionally, led to international monetary cooperation being regionalized. I shall then focus specifically on Asian monetary cooperation, covering the history, or the lack of it, and the monetary problems, current and potential ones, that Asian economies face. I shall then make a case for much greater monetary cooperation in Asia. I shall also suggest a way

forward for Asian monetary cooperation, with a strategy and a list of issues to be addressed in such cooperation.

Monetary Cooperation

4. Let me start now by attempting a **definition** on what monetary cooperation is about. The Oxford Dictionary defines “cooperation” as “working together to the same end”. So I suppose monetary cooperation can simply be defined as working together to the same monetary end. This then leads to the questions as to what that same monetary end should be, who should be working together and the form in which they should best work together, particularly when one is talking about monetary cooperation across monetary systems on a global or regional dimension.

5. The Articles of Agreement of the IMF provide some guidance on what that same monetary end should be. In defining the purposes of the IMF in Article I to be, among other things, “to promote international monetary cooperation”, the term “consultation and collaboration on international monetary problems” is used. So it would be appropriate to describe that same monetary end as the prevention and cure of monetary problems. Indeed, the rapid pace of financial liberalization and the associated globalization of financial markets have meant that monetary problems, when they arise, can be highly contagious on the global and particularly on a regional dimension. And if they are to be properly handled, by way of prevention or cure, there is a clear need for international monetary cooperation.

6. As to who should be working together, it is quite obvious that the **interested parties** would necessarily include the monetary authorities of economies facing or potentially exposed to monetary problems. The increasing realization of this need to work together has led to the formation of various, mostly regional, forums where monetary authorities gather to discuss issues of common interest.

7. Insofar as the Asian region is concerned, these forums are proving to be quite useful, but there is regrettably also some resistance in making further and the much needed progress because of, believe it or not, turf issues between ministries of finance and central banks, or perceived excessive rivalry on the part of individual economies in vying for the lead and influence in the cooperative effort. But these are facts of life that hopefully should not stand too much in the way of progress for the benefit of all in the longer term. It is also a fact of life regrettably that minds do not normally become adequately focused until they are jostled by damaging crises.

8. There are of course the multilateral institutions like the IMF and the Bank for International Settlements (BIS), and a number of international groupings of experts, who have a clear mandate or a keen interest in, among other things, promoting international monetary cooperation. They have been invaluable in providing the necessary support and guidance to monetary cooperation in Asia.

9. Nevertheless, some in this region have felt that such support and

guidance, particularly from the multilateral institutions, have been less forthcoming than they would have liked, comparing for example the support given to Thailand with Mexico. They also feel that the special circumstances and interests of economies in the region have not been adequately taken into account. Nor do their voices count for enough.

10. Whether or not this feeling is justified, one consequence is for regional initiatives to surface. This is no bad thing and perhaps the pragmatic way forward, given the need realistically to address regional disparities in financial markets, infrastructure and degrees of financial liberalization. But the down side risk which all of us should be aware of is the possibility that the global financial market may then become segmented into regional blocs which may result in more competition and friction, rather than cooperation.

11. On the **form of monetary cooperation**, there is a wide spectrum of experience on the basis of current practice. There is on the one extreme the simple exchange of information and expertise amongst monetary authorities helpful to the management of the domestic monetary system generally, covering the whole range of central banking functions in the management of the currency, the supervision of financial institutions, the development of the financial infrastructure, the management of foreign reserves, etc. On the other extreme, there is monetary cooperation to the extent of achieving monetary union or integration.

12. In between the two extremes there are arrangements for policy coordination at the macro level initiated on the realization of increasing international, particularly regional, economic interdependence. There are also the more focused schemes for mutual assistance in the provision of liquidity to facilitate effective monetary management, which may or may not involve the assumption of credit risks between governments. There have also been considerable efforts spent in supervisory cooperation towards the standardization of supervisory practices in order to promote international financial stability, again in recognition of the possibility of the damaging contagion effect of financial crises across financial systems. Then there are the more forward looking arrangements for the development and linkages of elements of the financial infrastructure to facilitate the efficient and safe financial intermediation across monetary systems.

13. Obviously no one point on this wide spectrum of international monetary cooperation can be considered as the ideal situation. Much depends on the needs arising from the circumstances, and the circumstances are changing all the time. But along with financial liberalization and the globalization of financial markets, the trend, to the extent that one can be ascertained, seems clearly to be one of increasing monetary cooperation. As is well known, European monetary cooperation is aiming for monetary integration by 1999, having moved in the past 50 years from information exchange to policy coordination. Whether this could be achieved on time or not, and whether monetary integration should necessarily then be considered as the final goal of monetary cooperation in other regions, we shall have to wait and see. But one has to

admire the vision of the pioneer thinkers. I understand that the French economist Jacques Rueff actually declared way back in the 1950s that “Europe will be created via a currency or not at all”.

14. By contrast, Asian monetary cooperation is considerably less well structured. There is traditionally some exchange of information, mostly on a bilateral basis, through meetings conducted annually, and largely prior to a game of golf or even on the golf course. There is little, if any, policy coordination amongst Asian economies, not to mention any interest in monetary integration. It is not clear whether this is a reflection of reluctance to subject domestic policy decisions to external influence. Indeed, until recently the majority of the economies in the region seemed happy to concede their sovereign right over monetary policy to the central banks of their major trading partners, notably the United States, through maintaining a stable exchange rate against the US dollar by varying degrees. But whatever the reason for the relative lack of monetary cooperation in the past, there have been significant changes recently, spurred by the events surrounding Mexico which affected the region and those of Thailand which is right in the middle of our region. There is serious and continuing discussion on the subject of Asian monetary cooperation. Hong Kong stands ready to contribute to this discussion and I very much hope that a long term strategy could come out of this.

History of Asian Monetary Cooperation

15. Let me now describe briefly to you the history of Asian monetary cooperation. In the post-war period, many Asian central banks evolved from colonial currency boards, which practised the virtue of stable money fixed to an international reserve currency. As a result of this monetary discipline, supported by sound fiscal discipline, Asia has enjoyed stable growth with low inflation. As Asian economies gradually opened their markets to international trade and competition, with Hong Kong setting a good example of how free markets work, the existence of stable exchange rates, largely linked to the US dollar, formed the anchor of Asian growth. The need for monetary cooperation amongst Asian economies, therefore, did not matter much as long as each traded mainly with Europe or America using the US dollar as the main currency of trade.

16. This was the reason why the work of the principal forum for central bank discussions in the late 1950s called **SEANZA** (South East Asia, New Zealand and Australia) focused mainly at providing training for central bankers. The 18 members of this group cover a geographical area that spans the whole of Asia-Pacific from India to New Zealand. Training and research was also the primary focus of another central bank forum founded in 1966. This is **SEACEN** (Southeast Asian Central Banks), comprising ten central bank members with a research and training centre in Kuala Lumpur.

17. In the 1990s, the number of Asia Pacific groupings increased, partly as

a result of accelerating intra-regional trade. The establishment of **APEC** (Asia Pacific Economic Cooperation) in 1989 promoted trade and investment amongst the 18 member economies, but there were only ancillary discussions on monetary cooperation. In February 1991, nevertheless, Asian monetary cooperation took a quiet but significant step forward with the creation of **EMEAP** (Executives' Meeting of East Asia Pacific Central Banks). This 11-member group of central banks was initiated by the Bank of Japan. At the beginning, EMEAP concentrated on the exchange of information on market developments in the economies of members and was the forum for the Bank of Japan to brief others on G-7 discussions. But it has since evolved into quite a productive and certainly the most active forum for central banking discussions in the region to-date through its biannual meetings of deputy governors and an annual meeting of governors.

18. The discussion in EMEAP now has a sharp focus on Asian monetary cooperation. This need was perhaps crystallized by the Mexican crisis, which rippled to Asian currencies in January 1995. In its wake, I convened an informal meeting of several EMEAP central banks that experienced speculative activity. There was immediate agreement that it would be useful to exchange market intelligence and to share knowledge and techniques on monetary operations helpful to the maintenance of monetary stability. Out of this meeting also evolved the package of **bilateral repurchase agreements** of US Treasuries signed by five central banks in Hong Kong on 20 November 1995 and aimed at the enhancement of the liquidity of the foreign reserves that they hold - a historic landmark in Asian monetary cooperation that eventually expanded to cover all the eleven EMEAP members.

19. In this connection, I should pay tribute to the foresight of Bernie Fraser, then Governor of the Reserve Bank of Australia, who called for the establishment of a new regional institution - for want of a better name, an **Asian BIS** - to promote Asian monetary cooperation. Bernie saw quite rightly that "globalisation is elevating the international dimension of monetary cooperation". In response to his call, EMEAP convened a working group to study the proposals and at its first Governors' Meeting in Tokyo in July 1996, further established two working groups and a study group to share knowledge and expertise on financial market development, central bank operations and banking supervision issues respectively. Although the question on the establishment of a regional institution to further Asian monetary cooperation has been put aside for the time being, the progress achieved by the various groups was commendable, with ambitious plans to produce the Asian equivalent of the Green Book on banking supervision, the Red Book on payment systems and a Gold Book on reserve management practices.

20. Meanwhile, greater international monetary cooperation involving the Asian economies was also advanced when the **BIS** admitted the People's Bank of China, the Reserve Bank of India, the Hong Kong Monetary Authority, the Monetary Authority of Singapore and the Bank of Korea, among others, to its membership in 1996, the first new Asian members after the Bank of Japan.

21. All these initiatives were unfortunately overshadowed by the advent of the Thai crisis, which erupted in May this year. But it was still to EMEAP's credit that in the second Governors' meeting in Shanghai in July, the group called for the creation of an **Asian facility** to supplement the IMF in providing assistance to member economies in Asia to make structural adjustments. That historic decision paved the way for the smooth meeting organized by the Fund in Tokyo two weeks later in August when more than US\$10 billion out of a total package of US\$17 billion facility to Thailand was amassed from EMEAP members with almost no fuss. Meanwhile, the call for an Asian facility is still being considered. Discussions are continuing amongst the interested parties, whenever opportunities present themselves.

Asian Monetary Problems

22. It is perhaps one of the ironies of the post-Bretton Woods era that the modern world is no longer generally short of liquidity, and indeed is arguably at present overflush with liquidity. Yet amidst all this liquidity and prosperity, liquidity crunches can even test the solvency of nations. The currency turbulence in Asia has prompted a realization of this irony and consequently much soul searching on the appropriateness of exchange rate and other monetary arrangements, macroeconomic and structural adjustment policies, the adequacy of financial market regulation and banking supervision, the pace of financial liberalization, etc. Many words of wisdom are being offered. While some are critical of the wisdom of fixed exchange rate systems, others blame volatile capital flows and currency speculators for the currency crises in rather strong and emotive terms. Still others fault inappropriate government policies and perhaps complacency in not taking early action. All in all a rather confusing picture. At the risk of causing even greater confusion, let me try to identify and articulate the monetary problems that Asian economies have been facing.

23. **Capital inflow** must be at the top of the list. At the beginning of the decade, net capital inflow to emerging markets was less than US\$50 billion a year. By 1996, however, this has increased to US\$245 billion. Asia has received roughly half of this capital inflow, thanks to the rather attractive basic economic fundamentals. These fundamentals, incidentally, have remained attractive today, notwithstanding the recent turmoil in Asian financial markets. The key factors that contributed to the surge in capital flows into the region include Japan's willingness to export capital as a result of sustained and large current account surpluses. The rising costs of production in Japan, associated with the appreciation of the yen have forced many Japanese firms to relocate their production to the rest of Asia. Also contributing was the low interest rate policy in the industrial economies, particularly in Japan in the post-bubble phase, which has flooded the global market with liquidity. Increasing amounts of mutual funds and pension funds of these economies looked for higher returns in the emerging markets. Clearly, Asian economies have benefited much from such capital inflows, but at the same time they have exposed themselves to the threat of a sudden loss of market confidence and hence large outflows of funds due to policy mistakes or shifts in the international economic environment. This is particularly true if a large proportion of

inflows are volatile portfolio investment or short-term borrowing.

24. The next monetary problem concerns **current account deficits**. A number of Asian economies were able to run larger than normal current account deficits in the balance of payments because they were easily funded by capital inflows. The bad news about large capital inflows is that they might allow investment and even consumption to expand without enduring the pain of overheating or loss of competitiveness. Higher levels of domestic credit, consumption, investment, growth and even budget revenues can be sustained at the cost of rapid accumulation of foreign debt. To make matters worse, over 80% of the current account deficits of selected Asian economies was funded from short-term bank debt (see Table 1). In hindsight, the ready availability of short term external financing might have delayed the necessary policy adjustments in face of cyclical and structural changes in the domestic and international economic environment. In short, we can all easily make the mistake of taking capital inflows for granted.

25. Then there is **asset price inflation** which is a rather common consequence of capital inflows. In an open economic environment, capital inflows may not lead to consumer price inflation, since imports would alleviate excess demand. However, if the domestic financial system is underdeveloped and financial institutions are not adequately supervised, as external hot money increases the deposit base of domestic banks they may be lured into fueling domestic asset price bubbles. These have two major consequences. First, asset price inflation eventually leads to domestic inflation and erode external competitiveness. Second, excessive lending concentration in real estate exposes financial institutions to large non-performing loans when oversupply of property emerges. Indeed, banks are absorbing credit risk on top of interest rate and exchange rate risks. In some Asian economies, weakness of the financial system has constrained the ability of the monetary authorities to raise interest rates to defend their currencies when the exchange rates are under pressure. Conversely, to allow the currency to depreciate exposes banks and other borrowers to exchange losses on their unhedged foreign currency liabilities.

26. At the same time, the **external environment** has been changing. Whilst Asia was enjoying an unprecedented boom, the global competitive environment was subtly but surely shifting, which led to portfolio rebalancing by global asset managers. The adjustments in the US economy, through fiscal and monetary tightening, and technology and corporate restructuring, had brought substantial benefits in the form of lower budget deficits, and the lowest levels of unemployment and inflation for decades. In case anyone forgets, the US equity market has in the last three years outperformed almost all Asian equity markets with the exception of that of China. Funds have been attracted back to the US markets which at the same time strengthened the US dollar, adding to the momentum of that flow. It was a pure case of risk versus return.

27. In addition, growing competition at the low-wage end of industries came from other Asian and non-Asian economies. In Europe, cheaper production

came from the restructuring economies of Eastern Europe. Competition came from the revival of Latin American economies with improved access to the US market through NAFTA. In Asia, India and China are emerging as major exporters. As a result, exports in Asia suffered a downturn, while imports continued to rise, leading to growing levels of current account deficits.

28. Then came problems on the **exchange rate** front. The volatility of key exchange rates, particularly that of the yen against the US dollar, has placed the balance of payments of some Asian economies under considerable stress. For instance, since most Asian currencies are explicitly or implicitly linked to the US dollar, the appreciation of the US dollar severely squeezed the exporters, who have to compete with their rivals in Japan and the emerging economies in other parts of the world. The weakness of the yen revived Japanese exports, placing Japan in direct competition with its major trading partners in Asia, as the cheaper yen stimulated exports of Japanese durable goods and capital goods to Asia, while reducing imports from the region. It did not make sense to export out of the subsidiaries in ASEAN when it was cheaper to buy directly from the plant in Japan. The weaker yen also has a tendency to slow foreign direct investment from Japan, as it is no longer so expensive to produce in Japan.

29. As we are all aware, this combination of Asian monetary problems has recently put tremendous pressure on the financial markets, in particular the foreign exchange markets, in the region. This was compounded by speculators who took advantage of these market developments to set up their attacks, resulting in the currency turmoil in Asian currencies that we have seen.

30. Here I cannot possibly resist the temptation to offer a few comments. There is a common perception that the adoption of more flexible exchange rate regimes by a number of Asian economies implied a failure of fixed exchange rate systems. This is in my view a mistaken perception. As all central bankers are aware, there is no one perfect exchange rate regime. One of the dilemmas of any exchange rate regime is how the exchange rate can reflect the underlying economic conditions, which are constantly changing, so that external balance can be achieved. A fixed exchange rate regime can function well if there is strict financial and fiscal discipline, and flexibility of domestic goods and services markets to adjust for any structural changes in the economy. On the other hand, a flexible exchange rate regime can also work, provided that the policy package is correct and there is a well functioning foreign exchange and financial market. But it would be a mistake to think devaluation can substitute for fundamental policy adjustments to correct a structural external imbalance. Competitive devaluations are “beggar-thy-neighbour” policies that are self defeating.

31. Indeed, the adoption of more flexible exchange rate systems by some Asian economies has not meant they can avoid the adjustments that are currently being undertaken. With a fixed exchange rate under a very strong and disciplined regime in the form of a currency board system, Hong Kong focused precisely on our underlying

productivity, maintaining strict financial and fiscal discipline, and also prudent banking supervision, in order to enhance the resilience of the linked exchange rate system, and minimize and manage the downside risks of overheating in the economy.

32. Let me also put the currency adjustments in their proper perspective. In the last few years, the currencies with the greatest adjustments and volatility have been the G-3 currencies, rather than the Asian currencies (see Table 2). The yen has depreciated by 50% against the US dollar from its peak in 1995. The deutschemark has likewise fallen by over 30%. In comparison, the Asian currencies have until recently remained relatively stable. The Hong Kong dollar has been the most stable of Asian currencies, moving less than 1% against the US dollar. It is the greater volatility of G-3 currencies that ultimately contributed to, if not caused, the volatility in smaller regional currencies.

33. There is yet another Asian monetary problem and this is one of a different nature. It concerns the effectiveness of **financial intermediation** in this region. Asia needs substantial investments in the economic infrastructure to prevent bottlenecks from hindering sustained growth. The World Bank has estimated that for East Asia alone, projected infrastructure investments amount to US\$1.5 trillion between 1995-2004. If other forms of capital investment are included, the figure rises to a staggering \$8 trillion. At the same time, Asian economies also have very high savings rates, some as high as 30% to 50% (see Table 3). The aging population in Northern Asia, for example, will be ploughing increasing savings into institutionalized retirement funds, which are risk averse and would need to be invested in markets generating, other things being equal, higher returns, lower risks and greater liquidity. Japan, for example, has an estimated ¥1200 trillion outstanding in private savings that must be invested. When the Hong Kong Mandatory Provident Fund comes into operation by the year 2000, about 4% of Hong Kong's GDP would be added annually to institutional investments. But the question is why Asian savings do not seem to have been adequately and effectively channeled into Asian investments in a manner more conducive to ensuring monetary and financial stability.

34. Much of Asian savings, in particular official sector savings and private sector savings that have been institutionalized, are still invested in assets of OECD countries, although the trend has been a gradually falling one. I cannot speak for other economies, but insofar as Hong Kong is concerned, in excess of 95% of our US\$85 billion of foreign reserves are invested outside Asia. Specifically, in the management of our foreign reserves, we work against a preferred neutral position of about 75% in US dollar assets, mostly in US Treasury securities. I understand also that more than 80% of total Asian foreign exchange reserves amounting to US\$600 billion are invested largely in North America and Europe. At the same time, there has been much foreign direct investment and foreign portfolio investment from OECD countries in Asia. It can be argued therefore that Asia is financing much of the budget deficits of developed economies, particularly the United States, but has to try hard to attract money back into the region through foreign investments. And the volatility of foreign portfolio investments has been a major cause of disruptions to the monetary and

financial systems of the Asian economies. Some have even gone as far as to say that the Asian economies are providing the funding to hedge funds in non-Asian centres to play havoc with their currencies and financial markets.

35. This comment is perhaps a little unkind, given the important role that is being played by the international financial community in the globalized financial environment. But there certainly is a problem with the effectiveness of financial intermediation in this region which is inhibiting the flow of long term savings into long term investments. I believe an important factor behind this is the perceived or actual risks inherent in dealing with the products, the intermediaries and the market that are part of the process of financial intermediation. I also believe that monetary authorities have a responsibility, through concerted efforts in prudential regulation and supervision, and the development of the financial infrastructure, to contain these risks to levels more acceptable to those concerned, including themselves as managers of official foreign reserves.

The Case for Asian Monetary Cooperation

36. These Asian monetary problems which I have described can seriously undermine the ability of Asian monetary authorities to deal with shocks, and so when shocks do come they will cause much agony in terms of economic disruptions and painful adjustments. The problems are also highly contagious, transmitted through sudden shifts in the same direction in the perception of risks by international investors, as they looked for worrisome similarities amongst Asian economies, as the recent turmoil in Asian currency markets has shown. The fall in one market may also lead them to look for liquidity in other markets, thus contributing further to the contagion.

37. We are living in an ever more interdependent region. Increasing trade and investment flows, made possible by trade and financial market liberalization, have bound our fates together. A decade ago, we relied heavily on markets outside Asia for our products, sending over three-quarters of exports to those markets. That reliance has been reduced sharply. In 1996, around 35% of trade in East Asia was conducted within the region, compared with the share of 28% with NAFTA countries and 20% with the European Union (see Table 4).

38. On investment and capital flows, the story is similar. As recently as in 1989, equity flows within the Asian region amounted to only US\$24 billion. In 1995, the flows had increased three-fold to almost US\$80 billion. According to the Asian Development Bank (ADB), the share of foreign direct investment from North America and the European Union in East Asia had fallen from 40% of the total fifteen years ago to 25% by 1993. Now over 50% of foreign direct investment comes from within the region. This trend can only grow, as the population giants of China and India increasingly become more engaged in trade and investment (see Table 5).

39. Much greater interdependence of course means that policies in one

economy can have important implications for others. A more liberalized financial environment also means that policy mistakes can be punished almost instantaneously by the market and that monetary problems in one economy can easily spread to others. So, referring again to one of the purposes of the IMF, as defined in its Articles of Agreement, there is a clear need “to promote international monetary cooperation” through “consultation and collaboration” on these “international monetary problems” that we now face in the Asian region.

The Way Forward

40. I would like now to spell out how I think monetary cooperation in this region should proceed. In order to have effective monetary cooperation, we must have clearly defined and realistic goals. Over ambitious goals may not be credible, and may even be counterproductive. In any case, they may not be politically acceptable to the individual economies. Monetary cooperation, and indeed any type of cooperation, is meaningless when you do not have common goals.

41. Notwithstanding increasing economic integration, one has to accept reality and this is that the economies in Asia are a very diverse group. There are dramatic differences with regard to political institutions, economic systems, basic infrastructure and any aspect you care to think of. In terms of economic structure, for example, they range from some of the largest, agricultural economies in the world to the most urban economies. In terms of economic philosophy, they range from some of the freest economies in the world to economies where there is considerable central planning. In terms of the stage of economic development, they range from economies with the highest per capita incomes to those still with a large part of their population living in poverty. In terms of financial sector development, they range from sophisticated international financial centres with deep financial markets and robust financial infrastructures to those which have just begun building their financial systems.

42. Reflecting such diversity, there are also dramatic differences in policies, in terms of the objectives pursued and the approaches to achieving those objectives. Focusing specifically on monetary policy, although there seems to be a clear consensus on the desirability of maintaining currency stability, there is great diversity on the degree of clarity with which this is defined. For some, currency stability is what the government thinks is politically expedient at the time. For others, currency stability is defined in the clearest of terms. Associated with this, there is also great diversity in the degree of independence of the monetary authorities and the degree of discretion available to them arising from the different monetary or exchange rate regimes practised. Nothing can be more polar than, for example, the currency board version of a fixed exchange regime in Hong Kong and the totally free float of New Zealand. Given differences in the economic and financial structure on the one hand, and differences in policy objectives and approaches on the other, the monetary transmission mechanism of Asian economies and their monetary reactions to internal and external shocks are also quite different.

43. How then should Asian economies pursue Asian monetary cooperation? The extent of the diversity of economies in Asia points quite clearly to one conclusion and this is that monetary integration is inappropriate, at least for the time being. One can perhaps get a better appreciation of this argument by attempting to apply the Maastricht criteria for European monetary union to Asia. Thus realistically Asian monetary cooperation will have to be pursued under a multi-currency environment. Asian monetary cooperation is not about monetary integration. The situation argues for monetary segregation, even to the extent, in the case of China, of maintaining two currencies in one country: the Renminbi for the Mainland of China and the Hong Kong dollar for the Hong Kong Special Administrative Region. Again apply the Maastricht criteria to the Mainland of China and Hong Kong and you will come quickly to the conclusion that the “one country, two currencies” arrangement is a sensible one. It is essential if Hong Kong is to continue to be stable and prosperous as an international financial centre, as provided for in the Basic Law of Hong Kong.

44. Moving along the spectrum for monetary cooperation from the extreme end of monetary integration, we could consider whether some form of monetary policy coordination in Asia is appropriate. So far, however, there seems to be a lack of interest amongst monetary authorities in Asia in promoting this. Perhaps there has been no such need identified. Monetary sovereignty has been carefully guarded in this region. There is also concern I suppose on the likelihood of dominance in such coordination by the more influential economies in terms of size and financial clout. There has therefore been no attempt to identify the pros and cons of monetary policy coordination in Asia. The subject has not even featured in any of the discussions amongst the regional central bank groups that I know of. But one must of course keep an open mind on the subject. The contagious turmoil in the currencies and financial markets of Asia will I am sure stimulate some interest in it. Without pre-judging the outcome, I expect some initiative in putting the matter on the agenda for future discussions amongst monetary authorities in the region.

45. By contrast, there is a great deal of enthusiasm amongst monetary authorities of the region to promote Asian monetary cooperation when this does not inhibit the freedom to determine domestic policies. I am sure for example that we would be keen to talk to each other about how to strengthen our monetary defensive mechanisms against attacks on our currencies, and how to enhance the pain tolerance level of our financial systems so that we can absorb financial shocks more effectively. There is also considerable interest in building more robust financial infrastructures on the one hand to facilitate effective financial intermediation and on the other hand to limit the contagion effect of financial crises domestically and on a regional basis. I believe that this is a sensible way forward, at least for the time being. At the EMEAP forum, monetary authorities have, as I mentioned earlier, examined the whole spectrum of central banking functions quite comprehensively and have identified issues where monetary cooperation would be beneficial.

46. Before going into these issues, let me just make two points about the

approach that should be adopted in Asian monetary cooperation. First is that Asian monetary cooperation must be considered within the context of global monetary cooperation. In other words, we should not, and I believe we are not trying to, build Fortress Asia. I do not believe that this is in the best interest of Asia. It is essential that we work within the international monetary and institutional framework as much as possible. Let us not forget that the international monetary order is still largely determined by the G-3 currencies. Asian economies cannot on their own, nor without the help of others, determine the fate of the G-3 currencies, even though we may have views about the future system.

47. Second is that, given the great diversity of the economies in the region, being at very different stages of financial development, Asian monetary cooperation should proceed with flexibility and at a pace comfortable to those wishing to take part in it. It would be pragmatic to build monetary cooperation and establish links, perhaps first at the bilateral level, between those who are ready and willing, and are operating compatible systems: for example, bilateral repurchase agreements of US Treasury securities to enhance each other's liquidity of foreign reserves, or bilateral linkages of real time payment systems and clearing systems for securities to facilitate effective financial intermediation across the cooperating economies. These bilateral linkages would serve to set targets and standards for others in the region who are not quite ready. And when eventually the majority of the bilateral linkages have been established, we would then have a network, an Asian monetary network, of considerable strength, which would hopefully enable Asian monetary problems to be tackled effectively. It should also be a network that is capable of being linked up with monetary systems outside the region, with a view to building the global monetary framework.

Issues for Asian Monetary Cooperation

48. Let me now turn to specific issues for Asian monetary cooperation. There are five areas. These are information exchange, resource provision, market infrastructure development, banking supervision and financial regulation, and policy consultations.

49. As the experience of EMEAP has shown, **information exchange** has been the easiest area of monetary cooperation. The use of the EMEAP Virtual Secretariat, using Internet technology, has greatly facilitated the exchange of information, helping the sharing of market intelligence, techniques and experience in all areas of central banking. The benefits are quite evident and I will not therefore dwell on this issue other than to mention the need perhaps to consider the removal of legal or other inhibitions to information exchange and sharing amongst central banks. Confidentiality provisions in domestic legislation may need to be suitably adapted in this context.

50. Let me quickly turn to **resource provision**. Here we can distinguish

between the provision of liquidity and the provision of credit. On the provision of liquidity, I have mentioned the network of bilateral repurchase agreements of US Treasury securities amongst EMEAP central banks. But as has been pointed out, the contagious nature of Asian monetary problems is such that when one of us is short of liquid foreign reserves, others may be in the same boat. It may be beneficial therefore if the network could be cast wider involving possibly non-Asian economies also holding substantial foreign reserves in US Treasuries. There is of course the New York Fed itself, as the custodian of the paper and the settlement agency of US dollar cash balances, which could play a supportive role in providing the service required. Yet another possibility is for the network of bilateral repurchase agreements to be multilateralized into a much more liquid pool, which could further be institutionalized so as also to facilitate, perhaps with leveraged arrangements, monetary cooperation through the provision of credit.

51. Asian monetary cooperation took quite a significant step forward when the financial package for Thailand organized by the IMF was met with ready willingness by a number of Asian economies, including ourselves. This I believe is the first significant arrangement involving Asian monetary cooperation through the provision of credit. As an international financial centre and an economy with significant interest in the Asian region, Hong Kong is willing to play its part in helping to maintain international and regional financial stability. This is ultimately in our own interest. This accounts for our willingness to join the New Arrangements to Borrow (NAB) to provide additional funding for the IMF. But the credit risks must be acceptable and manageable, and the case justifiable to the public in the overall public interest. Asian monetary cooperation through the provision of credit should therefore be on a multilateral basis and conditional upon the implementation of credible structural adjustment programmes.

52. At this point, we may well ask whether the present multilateral arrangements to handle international financial crises are totally satisfactory. It has been argued that economies in need should go earlier to the IMF for assistance. However, given the tough medicine that the Fund is well known to prescribe, there may have been a reluctance to approach the Fund, given also the limited resources available for a cure, thus delaying the whole process of crisis prevention and damage control. While the Thai package showed how neighbours are willing to help supplement Fund resources, this has the tendency to reinforce regional arrangements rather than dealing with the issue on a global basis.

53. We hope that a precedent has not been set that, if the Mexican crisis was an American problem, the Thai crisis an Asian one, the next case will be for whichever region to resolve. Such regionalism does not auger well for international monetary cooperation. We feel therefore that the resources of the Fund should be strengthened considerably and access level reviewed in the light of recent developments. This also applies to monitoring and enforcement efforts by the Fund. It would clearly not be efficient for regional groupings to duplicate the role of the existing international organizations such as the IMF and the BIS, with recognized

expertise and the machinery to deal with these issues. In any case, a regional crisis is quite often not limited geographically, but has global ramifications. In dealing with a crisis, the Fund should also have the mechanism and authority in place to negotiate with private sector lenders to ensure that equitable burden sharing remains, and that the burden of adjustment does not fall only on official creditors.

54. Another important area for Asian monetary cooperation is the building of the **market infrastructure**. In trying to draw attention to this area, I have often said that while billions of dollars are spent in building highways and airports as part of the physical infrastructure in order to move people around efficiently and safely, there is by comparison very little money spent in building the financial highways and airports to move money around efficiently and safely. As a result, the money does not move, at least not as much as one would like to see. Consequently, effective financial intermediation domestically and across economies in the region is inhibited, notwithstanding the rather attractive returns offered by the prosperity of this region. Financial markets remain fragmented along with geographical fragmentation of the region and there is a lack of liquidity because the regional critical mass has not yet been formed.

55. Another common complaint about Asian financial markets is the inefficiency of settlement and clearing processes for money and financial products. As a result the tendency is for many of the Asian economies to make use of established clearing and settlement systems in Europe and America. For example, Asian trading of Euro-yen paper has to be cleared and settled in European time. There is of course no logical answer to the question why trading of Asian paper by Asians cannot be settled and cleared in Asian time. I am often reminded that the Eurodollar and Eurobond market took off when Euroclear was established in the late 1960s. Furthermore, technology has now improved to the extent that we do not really need centralized clearing and settlement systems. I have long supported the concept of Asiaclear as a network of linkages of domestic clearing, settlement and depository systems.

56. Again, we in the Hong Kong Monetary Authority made a start in building this network through establishing bilateral linkages between our clearing system for debt securities called CMU and other systems. Our system is now linked up with Euroclear and Cedel, and we are working on linkages with corresponding systems in Australia, New Zealand and the Mainland of China. Once the matrix of bilateral linkages is filled up, the network of Asiaclear would be formed, like the Internet. There is no need for a centralized system or even a location. There is no centre for that network and so we do not need to get into the politically difficult question of where the network should be headquartered. We have also expressed our interest to other central banks in the region to establish similar linkages of payment systems. Our payment system in Hong Kong is already on the real time gross settlement (RTGS) mode. Others are proceeding with building their RTGS systems and as soon as they are ready we are happy again to work on establishing bilateral linkages to facilitate risk management of large value financial transactions across the two monetary systems. Once linked up, Herstatt risk of foreign exchange transactions involving the two

currencies concerned will immediately be eliminated. Payment versus payment (PvP) and delivery versus payment (DvP) within Asian time will become a reality.

57. The fourth area for Asian monetary cooperation is **banking supervision and financial regulation**. As financial markets are further liberalized and integrated, the growth of cross-border banking activities and other financial transactions is accelerating, increasing the risk of contagion. As ultimately monetary problems surface in the banking system, it is important for regulators in different economies to cooperate to safeguard the integrity of the banking and financial systems in the region. Part of the work will involve the harmonization of supervisory practices, including the adoption of the Core Principles for effective supervision advocated by the Basle Committee.

58. Through working closer together, such as the collaboration of the EMEAP Study Group on Banking Supervision, supervisory authorities in the region would be able to improve their understanding of each others' banking systems and supervision framework and approach. We will also review practices in the region against the existing Basle Committee benchmarks, identify reasons for any differences and thus help to raise the quality of supervision in the region. Over time, it may be possible to move on to the setting of standards.

59. Last, but not least, in Asian monetary cooperation concerns **policy consultation**. Clearly, there is scope to improve mutual understanding of each other's policy framework and priorities. This may or may not be a prelude to policy coordination, as the case has not yet been established. But a regular channel of communication on policy issues is still needed. The EMEAP forum is a good start, but needs to be strengthened. The IMF and the BIS have demonstrated how closer relations and deeper appreciation of the issues can only be fostered through a system of formal and informal channels of communications and regular discussions. Such discussions not only promote appreciation of the issues facing individual economies, but also regional and international matters. We look forward to their playing a more significant role in this region.

Conclusion

60. Ladies and gentlemen, the road to international monetary cooperation has never been straight and smooth. The European experience suggests that there are many bumps along the way. With much more diverse needs and perspectives in Asia, we must allow Asian monetary cooperation to take shape gradually and in a flexible way, starting with less ambitious goals and proceed at a pace and with arrangements comfortable to all. I believe the approach of building an Asian monetary network capable of further linkages to form a global monetary network is the correct one. It is based on voluntary participation and accommodates each participant's unique circumstances. We do not have the visionaries of Europe that saw the need for a single currency, nor do we believe that a single global institution would be adequate in providing solutions to all Asian monetary problems. In the Asian pragmatic and

patient way, and using the wise words of the late Deng Xiaoping, we cross the river by groping the stones. I am confident that in the end, we will be able to build a robust and efficient Asian monetary network that would contribute to monetary and financial stability, and economic prosperity in Asia, and in turn contribute to global financial stability and prosperity.

61. I cannot end this lecture without paying tribute to the tremendous support and cooperation that the Hong Kong Monetary Authority has received since its formation only four and a half years ago. I want specifically to acknowledge the unstinting support of the People's Bank of China and the Bank of England. Without their guidance the Hong Kong Monetary Authority would not have become a reality. The Bank of Japan, the Bundesbank and the Federal Reserve Bank of New York have also been generous in their support when we went around the international financial centres to explain the unique concept and practice of "one country, two systems". All our fellow central banks and monetary authorities in EMEAP, SEANZA, and BIS showed us great kindness and support during the sensitive transitional period to the resumption of sovereignty by China in 1997. Indeed, the Hong Kong Monetary Authority is itself the fruit of monetary cooperation.

62. When asked what comes after 1997, we used to give the very simple reply: what comes after 1997 must be 1998. As you can see for yourself, with goodwill and cooperation, the prosperity of Hong Kong has been ensured, both before and after the resumption of sovereignty to China. You have my assurance, and the assurance of China, that Hong Kong will continue to play its role as an international financial centre. We will work hand in hand with all central bankers around the world to build a safer and more robust international monetary system.

63. Thank you.

Table 1. Current Account Deficits and Financing of Selected Asian Economies

	1993	1994	1995	1996	Total
	Current account deficit (US\$bn)				
ASEAN 4					
Indonesia	-2.1	-2.8	-7.0	-7.4	-19.3
Malaysia	-3.0	-4.5	-7.4	-6.2	-21.1
Philippines	-3.0	-3.0	-2.0	-2.9	-10.9
Thailand	-6.4	-8.1	-13.6	-13.8	-41.9
Korea	1.0	-3.9	-8.3	-23.7	-34.9
Total	-13.5	-22.3	-38.3	-54.0	-128.1
	BIS reporting banks' net claims on financial sector (US\$bn)				
ASEAN 4					Change (93-96)
Indonesia	6.0	9.2	12.1	11.0	+5.0
Malaysia	-5.6	2.4	2.9	4.1	+9.7
Philippines	0.4	0.2	1.0	4.7	+4.3
Thailand	22.2	39.5	69.9	77.4	+55.2
Korea	20.9	29.3	42.9	58.3	+37.3
Total	43.9	80.6	128.8	155.5	+111.5

Source: Bank for International Settlements

Table 2. Currency Movements against US Dollar

	<u>1994 - 1995</u>		<u>1995 - 1996</u>		<u>1996 - August 1997</u>		
	Max	Min	Max	Min	Max	Min	8/29/97
G3							
Japanese yen	113.2	80.6	116.2	80.6	127.1	103.4	120.9
Deutschemark	1.77	1.35	1.56	1.35	1.88	1.44	1.81
NIEs							
Korean won	814	756	845	756	902	774	900
HK dollar	7.77	7.72	7.77	7.72	7.76	7.72	7.75
Singapore dollar	1.61	1.39	1.46	1.39	1.53	1.40	1.51
ASEAN 4							
Indonesian rupiah	2294	2098	2364	2195	3005	2280	2920
Malaysian ringgit	2.79	2.44	2.56	2.44	2.93	2.47	2.93
Philippine peso	27.8	23.6	26.3	24.4	30.5	26.1	30.1
Thai baht	25.6	24.5	25.7	24.5	34.1	23.2	34.1

Source: Datastream, Reuters.

Table 3. Savings in Asia (1996)

	Gross Domestic Product (US\$bn)	Gross Domestic Savings (% of GDP)
NIEs		
Hong Kong	155	30
Korea	485	37
Singapore	94	56
Taiwan	272	27
East Asia		
China	815	40
Indonesia	226	37
Malaysia	99	38
Philippines	84	16
Thailand	182	35
South Asia		
Bangladesh	31	6
India	326*	23
Pakistan	60	16
Sri Lanka	13	16
Memorandum item:		
United States	7,576	16
United Kingdom	1,159	16
Germany	2,352	23
France	1,537	20

Source: Asian Development Bank, International Financial Statistics (IMF).

* Figures for 1995

Table 4. Direction of trade of East Asia

	<u>1986</u>		<u>1990</u>		<u>1996</u>	
	US\$bn	% share	US\$bn	% share	US\$bn	% share
	Imports plus Exports					
European Union	110.3	17.1	231.2	20.5	401.6	19.5
NAFTA Countries	231.6	35.8	357.8	31.7	576.5	28.0
Intra-East Asia	156.0	24.1	326.9	28.9	708.3	34.5
Others	148.6	23.0	214.5	19.0	369.3	18.0
Total	646.4	100.0	1,130.3	100.0	2,055.7	100.0

Source: International Monetary Fund

Table 5. Foreign Direct Investment in East Asia by Source

	1982	1986	1990	1993
	(percent share of total stock outstanding)			
North America and European Union	39	40	30	25
Japan	25	25	25	20
NIE	10	15	25	35
Rest of World	26	20	20	20

Source: Asian Development Outlook 1996 and 1997

Chart 1A. Currency Movements against US Dollar

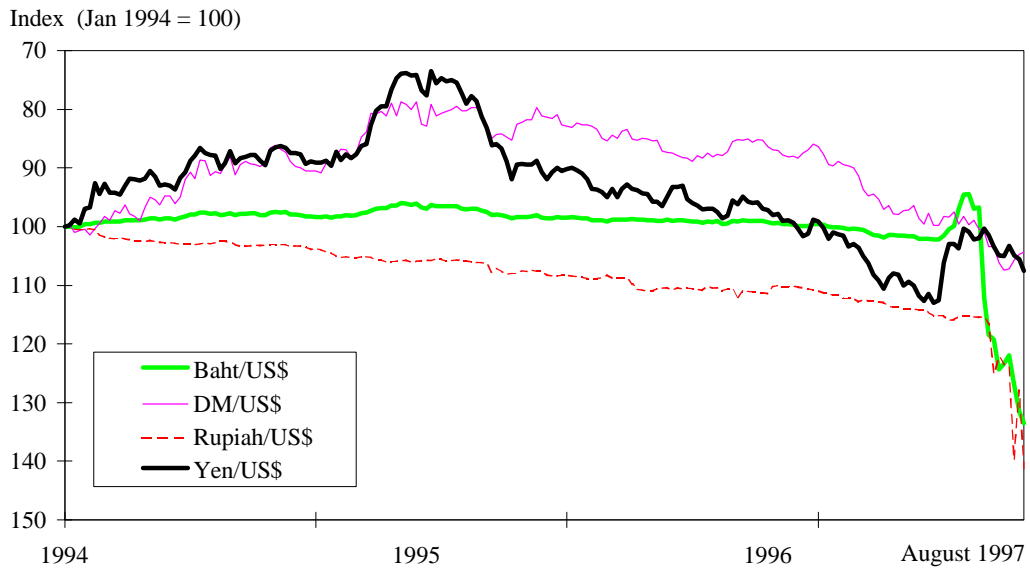
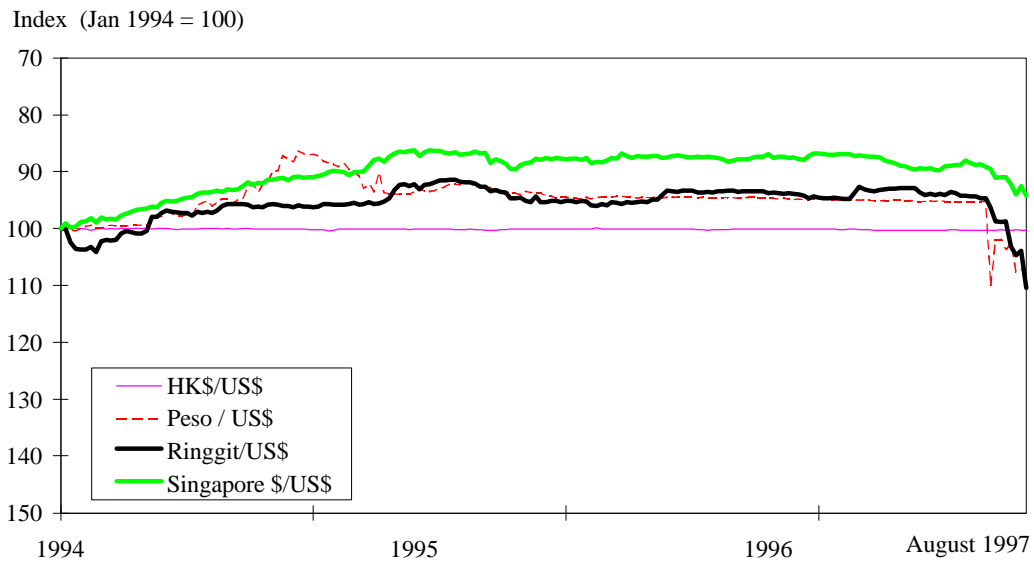
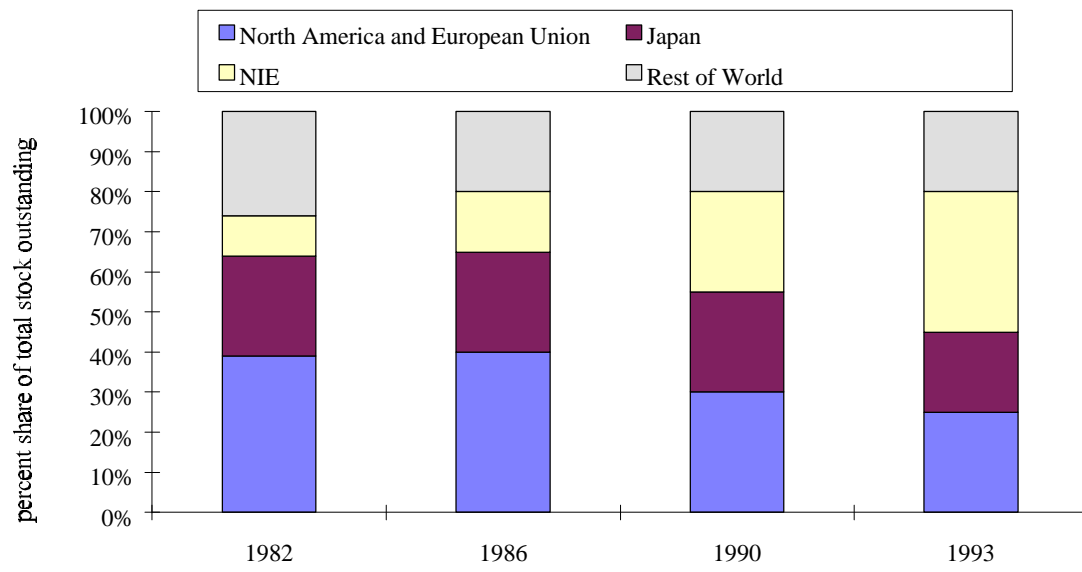


Chart 1B. Currency Movements against US Dollar



Source: Datastream

Chart 2. Foreign Direct Investment in East Asia by Source



Source: Asian Development Outlook 1996 & 1997