The 3rd Annual PECC Finance Conference

Institution-Building in a World of Free and Volatile Capital Flows: PECC Perspectives

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Discussant Comments on Session I & II

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Discussant comments on session I papers:

(A) Paper by Professor Sougil Young:

Professor Young aptly reflected and accurately described the East Asian critique or the widely recognized frustration we felt towards the International Monetary Fund (IMF) in responding to crisis-hit economies during the 1977-1978 Asian financial crisis, and how her policy prescriptions actually deepen the crisis in the initial stage due to lack of understanding of the environment and institutions in which the East Asian economies operate. Four broad areas of dissatisfaction were mentioned in the paper, which I shall not repeat them here but I am sure we all would agree these are to be regarded as water under the bridge.

In the keynote speech delivered this morning by Professor Eichengreen, I took note of the ten areas of reform progress made either in emerging markets or international system "which have helped to make the world a safer financial place", though we may differ significantly on the extend of the progress made in most if not all cases. Now that most of the East Asian economies have recovered strongly, the current debate and challenge are no longer on how to regain the respective pre-crisis growth levels, but rather on identifying the new competitive landscape and be part of the new growth path following the strong emergence of China and India as economic growth locomotive in Asia. It is against this new backdrop of robust economic rebound and intensified competition from these two large emerging economies in Asia that the slow pace or lack of substantial progress in reforming the international financial architecture (IFA) becomes more worrisome, disappointing and inadequate as formally registered by Professor Young in his paper.

Professor Young rightly pointed out the continue lack of fair and real representation and hence voiced struggling to be heard from emerging economies in international groupings or forum and international institutions. Questions are also raised about the various codes and standards by the Financial Sector Assessment Program (FSAP) launched by the IMF, in terms of their local applicability and legitimacy as these are developed by those who mostly represent the creditors side of the market. **Most of all,** and we cannot agree with Professor Park more, that why there is this continued under representation of East Asian countries in comparison with European states in the IMF governing bodies, in terms of quota allocation, voting rights and participation in executive board, most unthinkable of all on reserving the post of Managing Director for an European or supposedly to be rotated amongst Western individuals. By the way, the same lack of fair and real representation of East Asians in many international agencies include none other than the Bank for International Settlements (BIS), which sets the Basle Capital Accord that affects the livelihood of many significantly in our part of the world.

Confronting with such helplessness, Professor Young looks towards prospect and dilemma of establishing the regional financial architecture (RFA). In response to the frustration at the multilateral negotiation table by the World Trade Organization (WTO), East Asian countries have shown leadership and impetus in concluding and initiating bilateral and regional free trade agreements (FTAs) amongst major trading nations. In the area of finance, in response to discontent with effort of international agencies, such similar strategy has long been embarked on, which triggered East Asian policy makers to self-help at the national and regional levels rather than "waiting for the IFA cow to come home".

We do know that such efforts are never easy but some preliminary progress have been made as in the failed Asian Monetary Fund (AMF) which emerged as the New Miyasawa Initiative (NMI) to be executed under the Japanese Overseas Development Assistance (ODA), setting up of the Manila Framework Group (MFG) which resulted the Ching Mai Initiative (CMI) which is a network of bilateral swap arrangements (BSAs) and the recently conceived Asian Bond Fund (ABF) both launched and endorse under the ASEAN 10+3, We hold the view that, like multilateral FTAs, reforming of IFA and multilateral level is much more complicated and would take a longer time to accomplish globally. However, sequencing strategy is necessary in the area of finance in that domestic financial reform (DFR) should take top priority and followed by regional financial arrangements (RFA). However, in the face of free and volatile international capital flows, unlike FTAs, in terms of financial services, there must be a great degree of consistency and coordination in terms of reform and liberalization work program. The lack of coordination in financial reform, inconsistent financial systems and institutions may no longer result in the case of "spaghetti bowl", it can lead to severe price signal distortion and resource misallocation. We do have some humble views on this and no doubt would like to discuss it in the work program for Finance forum 2005.

In terms of RFA, Professor Young shared with Professor Henning (2002) who identified AMF, exchanger rate coordination as the twin-pillar to step out of CMI-BSAs and not optimistic on the prospect within the ASEAN 10+3 governments in terms of pace, extend and direction of regional financial cooperation, which Professor Eichengreen (2003) offered four reasons, that is heterogeneous economies, less economically self-contained especially in finance than trade, reluctant political integration and preference for weak formal institutions. **Particularly in Asia, we are of the view** that traditions and cultural habits die hard, and drastic and imposed changes tend to be counter-productive. Changes, both in terms of corporate governance and institutional reforms, can be expedited through peer pressure which if conducted sensitively, ASEAN 10 + 3 could be an useful platform to motivate other relevant PECC economies. By way of quantifying and ranking reform progress and effort made by member economies through "soft sell" and market discipline could hold the key as our recent experience suggests, which would be touch upon in session II today.

(B) Paper by Professor Yung Chul Park:

Essentially Professor Park views the transpacific imbalances as a serious concern, i.e. a large portion of the East Asian current account surpluses resulted largely from export to the US through exchange rate-trade competitive interventions, the huge foreign exchange reserves accumulated since the 1997-1998 Asian financial crisis are in turn being converted into holding of the short-term US treasury securities in order to fund the large US current account deficits.

Professor Park pointed out that it is incorrect to argue that East Asian current account surpluses is the principle cause of the imbalances, rather he argued that much of the present current account surpluses since the Asian financial crisis are due to a sharp reduction in domestic investment while domestic savings as a proportion of GDP has remained largely unchanged.

He further argued three possible scenarios of real appreciation of East Asian currencies that would eventually take place. First, East Asian economies may start importing more from one another or from non-US region thus may not necessarily lead to a corresponding reduction in the US current account deficits. Second, East Asian policymakers may also be searching for alternative ways to invest the vast accumulated foreign exchange reserves such as to finance investment within East Asia with Asian currencies without disrupting regional and global financial markets. Such move, if significant in amount, would mean strengthening of East Asian currencies too over times. Third, East Asian current account surpluses would attract more capital inflows as fundamentals of the economies are deemed improved and generate further expectations of currency appreciation. So long as not all US dollar reserves that flooded the local foreign exchange markets are fully sterilized, increase in money supply will spark off real estate boom and build up inflationary pressure.

We tend to think that all three cases mentioned by Professor Park is at best medium term concerns that may take place but not necessarily in a significant way, assuming the Chinese locomotive continue to pump away with near double-digit growth rate. In fact professor Park has provided a plausible answer to the serious concern he made of the transpacific imbalances when he said that “China is likely to replace the US as the final destination of exports for many East Asian countries. Assuming China is able to sustain rapid growth as it has, East Asian’s dependence on US market will decline and with this development the transpacific imbalances will gradually decline”. In fact as of 2003, China has indeed replaced the US as the biggest export destination for East Asian economies taken as a whole, although their combined exports to the US are still significant.

Professor Park also expressed concern over the endorsement of the East Asian export-led growth model by the G-7 nations and IMF in exchange for the strict Washington Consensus regimen of financial, corporate and public sector reform under a flexible exchange rate regime, yet not fully realize the potential conflict between the export-led growth model and financial market opening. Firstly, he argued that a greater exchange rate flexibility with capital account deregulation increased volatility of nominal exchange rate that is counter-productive to maintaining trade competitiveness required under the export-led growth model. Secondly he argued that export-led growth model is very cyclical in nature and subjected to upswings and downswings and monetary and fiscal policies are not reliable to enough to moderate these swings, hence capital controls may be required to reduce volatility of capital flows which is going against the principle of free floating exchange rate regime.

We believe that exchange rate volatility can be "smooth" under the managed-float trade-weighted exchange rate regime, and volatility of exchange rate caused by undue speculative forces can be effectively curtailed under the policy of non-internationalization of local currency (or restrictive usage of local currency by residential status and by geographical boundary which we would talk about later in session II discussion). In any case, we think the best way to avoid cyclical swings in export performances is and hence volatile capital flows are not by imposing capital controls but rather by diversifying export activities and sustainable macroeconomics growth strategy. As regard to how such accumulated foreign exchange reserves can be appropriately managed, we would certainly like to raise those issues involved in the work program for Finance Forum 2005.

More than six years since the Asian financial crisis, most East Asian economies a still face with weak financial system for effective risk management, non-transparency and poor disclosure rules, weak corporate governance, rudimentary legal and regulatory systems, obsolete or outdated financial institutions and infant capital markets with over-dependence on bank-based financing. Under these circumstances, policy makers in East Asia tend to continue to accumulate massive foreign exchange reserves through the export-led growth model as the surest way of pulling out from recession or slow growth. Exchange rate-export competitiveness targeting will likely to continue to prevail without much restraint. Eventually, as Professor Park argues, that "it will triggered a painful adjustment process, which in due cause would result in real appreciation of East Asian currencies, possibly igniting a real estate and construction investment boom. Widespread expectation of weakening of the US dollar will lead to more foreign portfolio inflows into East Asian economies and perhaps even provoke a financial crisis".

We take the view that in order to avoid unrestrained export-led trade-competitiveness exchange rate targeting, under the name of "smoothing" at times, by East Asian policy makers, collective exchange rate realignments for the East Asian region seem logical, presumably with leadership from China and Japan. While Japan and all other East Asian economies have been recording trade surpluses with China since 2000, in contrast all East Asian economies have been running large trade deficits with Japan. Unlike the western economists, we tend to argue that Chinese Reminbi is currently not undervalued. The fact that Reminbi held it ground during the Asian financial crisis in 1997, the weak Chinese banking sector, serious and structural non-performing loans difficulties, potential rising unemployment from privatizing the state-owned enterprises, urban-rural income disparity and other host of problems are yet to be effectively resolved. However, we assess that if such robust and steady GDP growth of 10% were to persist for another decade at least, there would be room for Reminbi to appreciation in the longer-term.

On the other hand, we think it is important that the Japanese authorities should take measure to correct the trade imbalances with the rest of the East Asian economies. While we think G-7 nations rightly persuaded the Chinese authorities to increase the flexibility of the their exchange rate band and in the longer-run move towards a freer market-determined exchange rate regime as China gradually integrate with the global financial system (and like-wise for other East Asian economies), rather than demanding discrete exchange rate upwards adjustments which tend to be arbitrary. We therefore agree with Professor Park that the best way to move towards further global financial integration is for G-7 nations to assist East Asian economies to enhance their capacity building capability and to take leadership by helping to restructure their financial institutions and markets.

Discussant comments on session II papers:

(C) Paper by Professor William Witherell

Professor Witherell shared with us his extensive experience in work he has done on peer review, defined for us the exact peer review process and pointed out some useful understanding and implications on peer review in the area of financial sector development, much needed by emerging economies. We certainly shared his observations on the six urgent issues for domestic financial reform in the APEC / PECC economies which include strengthening the soundness of the banking system, developing and improving the capital markets, enhancing corporate governance, establishing / strengthening pension system, effective fostering financial intermediation of domestic savings into the domestic financial system and capacity building. In any case we shall offer some observations pertaining to the unfinished business on domestic financial reforms during the panel presentation tomorrow.

He aptly put it that if the objective of any exercise is the encouragement of reforms, the process can and should be one that is friendly and constructive, based on exchanging positive and negative experiences". He also highlighted that the peer review process should not be of a confrontational or even of negotiating nature, and should be differentiated from one in which "the objective is to see certain international obligations or commitments are being met, or to determine if international standards designed to combat illegal or harmful activities are being applied". Indeed in the aftermath of the Asian financial crisis, there still exists suspicion by top leaderships between targeted troubled countries and the compliance-imposing international agencies, which explains why calls for reforms are being resisted and good intentions even doubted, there is lack of good faith so to speak.

Professor Witherell further made a interesting distinction between "peer review" and "peer pressure", the latter he defined as "the influence and persuasion influenced by the peers during the process", which can give rise to through a mix formal recommendations and informal dialogue, public scrutiny, comparison and ranking among countries and their associating impact to domestic and international public opinion, civil servants and national policymaker, with public scrutinized often arises from media involvement. Peer pressure that does not take the form of legally binding acts, sanctions or other enforcement mechanisms or to put it simply, it is "soft persuasion". It is no secret that the peer review process undertaken by the Asian Development Bank and the ASEAN Secretariat soon after the Asian financial crisis under the name of regional surveillance scheme or early warning signals did not go as well as expected, our recent experience at the Singaporean thin-tank, the Institute of Policy Studies (IPS) on IPS-NTU ASEAN 9 + 1 Economy Competitiveness Ranking Indices in fact confirmed the observations of Professor Witherell on peer pressure which we do not have time to elaborate here except to say that the initial response to the proposed project before embarking was half-warm at best, but it was overwhelmingly supported and positively solicited after the official launch on 3 April 2004 by senior officials of economies involved, we believe due largely to the international media publicity, interests expressed by CEOs of multinational corporations, policy think-tanks. Not forgetting of course the non-aggressive manner but credible and independent launching agencies with good regional familiarity, namely IPS and Nanyang Technological University (NTU), Singapore. We have since moved on to utilize such technique in different context and modalities, that include the Financial Sector Reform and Liberalization Ranking Indices for ASEAN 10 + 3.

(D) Paper by Professor Wendy Dobson

In this similar vein as mentioned above, the APEC/PECC Finance Forum research initiative headed by Professor Wendy Dobson on financial system reforms is timely and is to be welcome and encouraged. In the paper she proposed to examine the possibilities for systematic and objective evaluation of progress on financial strengthening and reforms using the conventional scorecards methodology by heavily relying on survey data being put to regulatory authorities undertaken by The World Bank consultant Barth, Caprio & Levine (2001).

After discussing the empirical results (from table 2 to table 5), Professor Dobson raised a crucial point by asking some very pertinent questions such as “Do these indicators tell us anything we do not already know? Does it provoke us to find out what lies behind the variances? Is it too simplistic or at worst misleading?” Indeed we tend to confirm Professor Dobson’s own suspicion that we were provoked by the empirical findings that are seriously at variance with facts that we are aware of and refused to be misled by it. For example we are surprised by the Bank oversight on capital soundness in Singapore which ranked as good as that of Indonesia and Thailand and fare worse than that of Mexico and India! In terms of supervisory stringency, Indonesia, Philippines and Japan along with the US are amongst the top league, never mind the finding’s apparent inconsistency between supervisory stringency and capital soundness for India! (See table 2). Singapore was found to have scored incredibly lowest amongst APEC economies on supervisory powers, which I would have thought should exceed total points possible for being almighty! (See table 4).

My final suggestion is that unless sufficient and necessarily sizable resource funding can be made available to undertake with appropriate methodological and individual country studies to cover all economies concerned in terms of secondary data computation, raw collection and field trip visits which are expected to take at least two years to accomplish, it would be difficult to do a credible piece of work that can withstand public scrutiny and defense put up from members economies concerned.