

18th APEC Finance Ministers' TWG Meeting
June 23-25, 2004
Arica, Chile

PECC Finance Forum Report on
The 3rd Finance Forum Conference, June 20-21, 2004, Santiago, Chile

Greetings:

The PECC just completed its Third Annual Finance Forum Conference in Santiago this past Monday. 70 delegates representing 18 economies plus APEC Secretariat, IMF, World Bank and OECD participated.

The PECC would like to thank TWG as well as its chairman for their support of the Finance Forum Conference and for inviting the PECC to present the overall findings of this Conference. The PECC would also like to express its thanks to many of TWG members who participated in the Santiago Conference.

This year's conference theme was "Institution-Building in a World of Free and Volatile Capital Flows: PECC Perspectives." The selection of such a theme was to serve the APEC FMM Process as a think-tank since the PECC is a tripartite organization which is comprised of government, business and academia.

Under this year's theme, we have three focus areas:

- Strengthening International Financial Architecture: Global and Regional
- Strengthening Domestic Financial Systems
- Strengthening Capacity-Building in the Area of Domestic and Regional Bond Markets

PECC Finance Forum's Immediate Plans include:

- Filing a Consolidated Report entitled "*Institution Building in a World of Free and Volatile Capital Flows: An APEC Perspectives*" with the APEC FMM Process by the end of July for presentation at the Deputies Meeting and the Finance Ministers Meeting on August 30 through September 3 in Santiago.
- This Consolidated Report will be complemented by Three Sectoral Reports covering each of focus areas.
 1. *Issues and Challenges of the International Financial Architecture from the Asia-Pacific Perspective*
 2. *APEC Cooperation for the Strengthening of the Domestic Financial System*
 3. *Developing Bond Markets in the APEC Region: Need and Agenda for Public-Private Sector Partnership*

* The 3rd PECC Finance Forum Conference papers are available on PECC homepage at [<http://www.pecc.org/finance/forum2004.htm>].

- PECC Finance Forum also plans to publish a conference volume containing selected papers from this year's finance forum conference. The conference volume "Developing Asian Bond Markets: Challenges and Strategies" from last year's meeting in Hua Hin, Thailand, is forthcoming next month from the Australian National University Press.
- PECC Finance Forum will play a leading role in the upcoming 2005 PECC Biennial General Meeting in Korea. This Meeting will be scheduled to synchronize with the APEC Economic Leaders' Meeting in November.
- 2005 Work Programs will be formulated to assist the 12th APEC FMM Process. For this purpose, the PECC Finance Forum would be grateful for the opportunity of providing its input at the upcoming TWG meeting in December when the major theme of the 12th APEC FMM is discussed.

Now I would like to proceed with the presentation of preliminary findings from the Finance Forum Conference.

The world economy still faces potential sources of systemic risks

- Rising U.S. Interest Rates
- Higher Oil Prices
- Overheated China's Economy
- Adverse Impact of US Twin Deficits on the value of Dollar

The PECC Finance Forum participants agreed that the potential threat of this systemic risk has been substantially mitigated by a number of positive developments in strengthening International Financial Architecture since the 1997-1998 East Asian financial crisis.

- Greater Exchange Rate Flexibility
- Emerging Market Economies Became More Prudent in:
 - a. Short-term Borrowing from Abroad
 - b. Current account management with an export-oriented growth strategy
 - c. Fiscal policy implementation
- Greater Transparency in IMF's Operations
- Global Standards and Codes for Financial Disclosure and Governance Practices by International Financial Institutions
- Regional Initiatives for Financial Markets Integration

Nevertheless, Finance Forum Conference participants believed that further Improvement would be necessary because the strengthening of International Financial Architecture has been partial and/or tentative in some areas.

Specifically, the following areas were identified:

- Trans-Pacific Imbalance in Current Accounts
- Liberalization of Capital Account
- More Flexible Exchange Rate System
- Emerging Market Economies' Inability in Borrowing Abroad in Their Own Currencies

As a result, some emerging market economies and financial institutions remain vulnerable to external shocks.

This sense of insecurity has been leading Emerging Market Economies in cumulating a very large amount of foreign exchange reserves. At the end of March, total amount of foreign reserves cumulated by Asian Economies including Japan exceeded \$2.1 trillion.

Based on the lessons learned from the recent crisis, Emerging Asian Economies have been actively promoting Regional Financial Cooperation. Two major initiatives include:

Chiang Mai Initiative (CMI)
Asian Bond Market Initiatives

Finance Forum participants believed that an increasingly large amount of Foreign Reserves cumulated in the APEC region signifies the need for further flexibility in exchange rate policy and capital account opening. Large foreign exchange reserves may be an indication that some degree of complacency is present among Emerging Market Economies in macroeconomic policy adjustment

The CMI is an excellent vehicle for Effective Liquidity Support among participating economies given the fact that IMF's Credit Contingency Line has not been accepted because of signaling problems, high cost, and low flexibility.

Asian Bond Fund I and planned ABF II initiated by Executives' Meeting of East Asia and Pacific Central Banks or better known as EMEAP represent an important step for increasing the demand for the bonds denominated in US dollars and local currencies and issued by sovereign and quasi-sovereign borrowers in the Asian region.

The idea of the Asian Basket Currency Bond Corporation which has been considered by ASEAN + 3 may be an interesting first small step for exchange rate coordination among participating economies.

In pushing forward Asian Bond Market Initiatives, Emerging Market Economies should be aware of:

- Foreign investment in domestic bond markets in Asia remains insignificant and underlying reasons have yet to be identified
- Regional and global bond market activities are more integrated than normally perceived
- Asian borrowers still prefer global financial centers to Asian financial centers

- Creation of regional rating agencies, regional clearing and settlement systems, regional trading systems may increase the cost of borrowing in Asian financial centers
- Regional bond markets may not be sustainable if they are segmented and isolated from global bond markets
- A public-private sector partnership is critically important
- Promotion of regional market activities will need a careful evaluation of greater exchange rate flexibility and capital account opening in adequate sequence, as well as capacity building to upgrade and harmonize rating practices in domestic markets, accounting standards and insolvency regimes in domestic markets to encourage greater cross-border investment.

Finance Forum Conference participants felt that Emerging Market Economies should be realistic in their expectation on the Regional Initiatives:

- Regional financial architecture will take long time to implement
- Exchange rate coordination may take even longer
- Eliminating hurdles Impeding regional bond market activities and harmonization of legal and regulatory framework will be a time-consuming and prolonged process

Looking forward, Finance Forum participants recognized important steps in Institution Building for Regional Bond Market Activities

- Domestic Bond Market Development
- Continuation of Domestic Financial System Reform Programs
- Regional Initiatives should focus on credit guarantee and credit enhancement programs to help small-medium sized enterprises have access to capital market financing and facilitate financing activities for sovereign and quasi-sovereign borrowers by bridging the credit gap.

We welcome comments and suggestions on the work and plan of PECC Finance Forum.

Thank you for your kind attention.