



**Policy Agenda for Institution Building
in a World of Free and Volatile Capital Flows**

Report to the 11th APEC Finance Ministers' Meeting

On the Work of the PECC Finance Forum 2004

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Kihwan Kim

PECC Chair, 2003-2005

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Your Excellencies, Distinguished Participants, Ladies and Gentlemen,

Let me first tell you how honored I am to take part in this 11th APEC Finance Ministers' Meeting in my capacity as International Chair for PECC. For this honor, I would like to thank all the Ministers, but particularly the Chairman of the meeting this year, H.E. Minister Nicolás Eyzaguirre.

My job this afternoon is to report on PECC's work in finance over the past twelve months. PECC created its Finance Forum three years ago to help APEC governments promote economic growth through financial stability in the Asia Pacific region. The Forum's work program this year focused on the theme of Institution Building in a World of Free and Volatile Capital Flows. The Forum examined three issues in particular:

- (1) How much progress has been made in strengthening the international financial architecture?
- (2) What steps have yet to be taken to strengthen domestic financial systems in the region?
- (3) What should be the approach to developing an Asian Bond Market?

The Forum has already submitted five summary reports on these issues for your consideration. Therefore, in my presentation this afternoon, I would like to highlight some of the key recommendations and findings.

The State of IFA

With regard to the progress in strengthening the international financial architecture, you all know that there have been two views. On the one hand, there are many who argue that the progress has been slow and far from complete. On the other, we have experts who argue to the contrary. In their view, one reason why there is no sign of crisis despite the existence of all the conditions for a classic emerging markets crisis, such as rising US interest rates, rising oil prices, worsening of US twin deficits and the lingering fear of a hard landing for the Chinese economy, is that the international financial architecture has already been greatly strengthened thanks to many reforms that have been implemented.

However, PECC as an organization cannot afford to be as sanguine as the optimistic view just cited. Indeed, the Forum's reports note that the financial reforms in many emerging market economies have slowed down considerably. In addition, the efforts addressing the supply side of the international capital markets still leave much to be desired. International capital flows continue to be so volatile that small open economies remain vulnerable to financial instability, even if they have a reasonably sound domestic financial system and good policies in place.

For this reason, PECC wishes to call the attention of APEC governments to the following set of problems:

- (1) There is still no serious policy coordination among the G-3 countries to prevent wide swings of the exchange rates among their currencies;
- (2) Highly leveraged institutions remain unregulated, and the proposal to require timely disclosure of their uncovered positions has been rejected;
- (3) Despite Basel II, there continues to be an institutional bias on the part of major banks in the G-10 countries toward short-term lending;
- (4) Collective action clauses (CACs) have become a standard feature of new bond contracts, but the framework for private sector involvement should be further strengthened with clarification of mechanisms for voluntary debt rollover and standstills;
- (5) The role of the IMF as a quasi-lender of last resort should be strengthened by providing the Fund with more resources.

Transpacific Imbalance: a Problem Requiring Renewed Attention

Let me also note in this connection that the serious problem called "the transpacific imbalance" is also a result of insufficient progress made in strengthening the international financial architecture. The transpacific imbalance refers to growing surpluses accumulated on current accounts by East Asia on the one hand, and the growing deficits on the current accounts being run by the US on the other. The basic problem with the transpacific imbalance is that it is neither sustainable nor desirable from the global point of view.

Viewed from the East Asian perspective, this imbalance represents a situation quite acceptable for the time being. The growing current account surpluses lead to

massive accumulation of foreign exchange reserves which amounts to a safeguard against financial instability. But when viewed from the US perspective, the same imbalance causes many problems. For one thing, the imbalance will result in growing US debt, much of which is held by East Asia. For another, with growing US debt, US interest rates will have to rise to the detriment of its economic recovery. Neither the US nor East Asia, for that matter, will want to tolerate such a situation very long. Unfortunately the only tool the US has at its disposal to contain this situation is a reduction of its budgetary deficits. However, this is politically difficult to achieve and even if achieved will likely set off a global recession.

As this scenario is unlikely to happen, there is a high probability for a default solution to take place with the consequences of a dollar crash and a subsequent global crisis. Viewed this way, the transpacific imbalance is truly a global problem. The fundamental way to address this problem is to strengthen both the international financial architecture and domestic financial institutions, particularly in East Asia.

The reasons are easy to see. First of all, the imbalance persists due to the “twin fears” on the part of national authorities in East Asia: the “fear of floating” and the “fear of another crisis.” It is these “twin fears” that compel management of the exchange rate as well as accumulation of reserves. We should note that these “twin fears” in turn stem from the concerns of the same national authorities with the volatility of the international capital markets and the resulting vulnerabilities for their respective economies.

There is of course another factor contributing to the persistence of this imbalance. It is East Asia’s adherence to an export-led growth strategy. This strategy has been made necessary by the fact that domestic demand for investment in plant and equipment in particular has remained weak in the wake of the financial crisis. This weakness in turn has been due to insufficient domestic corporate and financial restructuring.

Now that East Asian governments have amassed foreign reserves and should no longer fear another crisis, will they be willing to let their currencies rise and allow current-account adjustments? I am afraid the answer is no because the “collective action problem” comes into play. In other words, these governments would let the currency rise if there were a mechanism for exchange-rate policy coordination in the region. As there is no such mechanism, the transpacific imbalance is most likely to continue until

the default solution takes over, triggering a major international crisis.

The policy implications of the foregoing analysis are clear. To prevent the transpacific imbalance from creating a major international crisis, all APEC governments should work together to reduce the imbalance without delay. In doing so, they should recognize that structural factors are at the heart of the problem. Thus they should join forces and push financial reforms on both the domestic and the international fronts.

Recommendations on Domestic Financial Reform

In the balance of my time, I would like to state some of PECC's key recommendations for strengthening domestic financial institutions and developing an Asian Bond Market.

- Reinvigorating domestic financial reforms should be made a key priority. To this end, PECC recommends that APEC consider newly launching a peer review process over reform efforts by individual governments. PECC itself plans to launch its own peer review program over corporate governance reforms later this year. PECC would welcome working with APEC in this area.
- In view of the continuing weaknesses in the global financial architecture, APEC should appreciate the importance of supporting the efforts of its Asian members to build a regional financial architecture in their sub-region. This should include a short-term liquidity financing mechanism, an effective regional surveillance mechanism, an exchange-rate policy coordination mechanism, and development of an Asian Bond Market.

Asian Bond Market Initiative

Finally, I would like to invite your attention to some of PECC's findings on how to develop an Asian Bond Market. You will find in front of you PECC's published collection of its work last year on the Asian Bond Market. I am pleased to present it to you on behalf of PECC. I now come to specific recommendations on the subject:

- An Asian Bond Market must be part of the global markets rather than a segmented and isolated market;

- Asian economies must first develop domestic bond markets before the creation of an Asian Bond Market;
- The process of promoting the emergence of an Asian Bond Market is not only difficult and complex. It also involves risks that need to be managed. Foremost among these are risks arising from greater cross-border capital flows as a result of capital account opening, and the harmonization of tax and legal regimes, and market practices as well.

Closing Remarks

In closing, I would like to thank you for your kind attention, and let you know that it is the hope of PECC to further contribute to the APEC Finance Ministers' Process.

Thank you.