A NEW FRAMEWORK FOR ENHANCED ASIAN REGIONAL CO-OPERATION TO PROMOTE FINANCIAL STABILITY*

Currency turmoil is not unique to the Asian region. What Asia lacks, and Europe and the U.S. have is a deep, liquid and mature debt market. The recent Asian currency problem is one of a funding mismatch compound by ineffective intermediation. Thus, the remedy lies in creating an efficient and credible intermediation mechanism for debt instruments in the region.

In Vancouver last week the APEC Economic Leaders endorsed the Manila Framework to enhance financial stability in the Asian region. Our meeting today is very timely to take stock of what we have agreed in Manila and to explore how best we can provide a positive and coherent steer towards fleshing out the Framework as soon as possible.

This time last year, few of us would have been able to foresee that Asia, the fastest growing region in the world, would witness stock markets roughly 30-60% down from their peak and three large economies currently under IMF assistance programmes. The contagion has infected even economies with strong fundamentals, such as Hong Kong and Singapore.

However, I would echo our Economic Leaders in Vancouver that we must not lose sight of the fact that Asian fundamentals are strong. Despite all the short-term turmoil, Asia remains potentially the strongest growth region at the birth of the 21st century. What we are witnessing now in the last years of the 20th century is the financial crises identified by Michel Camdessus for the 21st century. As a region, Asia on this occasion is ahead of its time!

I believe it is useful to re-iterate the four main points that our colleagues have agreed in Manila:

- First, while the Asian problems are of imbalances, exacerbated by volatile capital flows, contagion is now a global problem requiring a global solution. This underlines the importance of international financial institutions (IFIs) such as International Monetary Fund (IMF), World Bank (WB) and Asian Development Bank (ADB) in the search of solutions.

- Second, a major Asian problem is the private sector sustaining excessive short-term debt in financing their current account deficits. East Asian governments have on the whole been very prudent, with a surplus of 0.1% of GDP in 1996, excluding Japan. Ironically, this makes the debt resolution problem much more complex. The experience of sovereign debt crises in Mexico during 1994 and earlier years is not entirely relevant.

- Third, Asia is suffering from three risk problems. First, a liquidity mismatch caused by borrowing short-term funds to meet recurrent, long-term commitments. Second, a currency mismatch arising from foreign exchange borrowing to finance real estate that does not generate the foreign exchange to repay the debt. And third, the credit risk, as asset price devalues, foreign exchange losses and higher interest rates erode both corporate and bank capital. All these are putting a tremendous strain on the banking system.

- Finally, in the event that IMF resources are not enough, the region would provide, on a case by case basis, supplemental financial resources for IMF supported programmes.

Issues at hand

While I believe that the Manila Meeting was spot-on in highlighting the direction for resolving regional financial problems, I think this Kuala Lumpur Meeting serves another important purpose. We should find concrete and practical mechanisms to deal with the turmoil at hand along the lines of what we have agreed.

* This is the text of the speech given by Donald Tsang, the Financial Secretary of Hong Kong, at the Meeting of Finance Ministers of ASEAN plus six at Kuala Lumpur, Malaysia on 2 Dec 1997.

The excellent work of the IMF to deal with the structural issues is in the good hands of Michel Camdessus as well as our fellow Ministers. I shall not dwell on it. I would like to put on the table an approach to address the question of liquidity in Asia as a result of the turmoil - an approach which will not create moral hazards or cause excessive strains on the politics and economics of those economies extending a helping hand. In Manila my colleagues floated some early ideas of invoking market mechanisms in dealing with monetary turmoil. We have since developed these ideas which I wish to share.

Intermediation in Asia

We would all agree that the fundamentals of Asia are strong. Our people make high savings and our governments are fiscally prudent. One of the interesting features in Asia is that we have saved away as much as 70% of the net capital inflows in foreign exchange reserves, so that East Asia has today over US$600 billion of foreign exchange reserves, and five out of the six largest foreign exchange reserve holders are in East Asia. However we tend to under-estimate the degree of pressure that volatile capital flows can bring to bear in our financial systems.

The Asian currency problem is essentially one of funding mismatch compounded by ineffective intermediation. We have invested our savings outside the region, mainly in OECD markets, while funds come back in the form of foreign direct investment and portfolio investment. More to the point, most of our official foreign exchange reserves are invested overseas in long-term bonds, while what is coming in is short-term bank loans, investment in equities and foreign direct investment. These inflows are footloose and can reverse quite easily, as we all have learnt from bitter experience.

Yesterday we agreed that hedging activities, rather than hedge funds, could exacerbate the volatility of fund inflows. I do not wish to repeat it here. But as an aside, Hong Kong shares the view that speculation can only drive market prices to levels that are supported by fundamentals, where speculation will cancel each other out. With Hong Kong's fixed exchange rate regime under a currency board system, the necessary corrections in response to speculative currency attacks do not take place in the exchange rate, but in the interest rate pressure on asset markets. We have experienced significant corrections in certain prices recently. In our view, such corrections to remove the undue exuberance in the equity and property markets, however painful in the process, were necessary. Indeed, these adjustments would make Hong Kong a more competitive service-based economy.

Need for market-based solution

The currency turmoil in Asia is not unique to Asia. Europe also suffered the ERM crisis and Scandinavian banks, as well as US Savings & Loans, also underwent major adjustment in the late 1980s and early 1990s. What Asia lacks (and Europe and the US have) is a deep, liquid and mature debt market where three things can occur:

- Governments and corporations can borrow long to invest long - thus eliminating the maturity mismatch that is currently inherent in Asia.

- Corporations can issue paper in US$, Yen or Euro currencies, with clearing and settlement in Asian time - thus eliminating the currency mismatches and developing a truly deep Asian debt market along the lines of the Euro-dollar, or Euro-yen markets in Asia.

- There is a good supply of high quality paper appearing in Asia, thus encouraging Asian economies to invest their official reserves in Asia. For risk management purposes, there will always be Asian investments in G-10 currencies and securities, but I see no reason why Asian reserves cannot be re-invested in Asia, as long as the investment risk, return and liquidity are comparable. As Finance Ministers, we can make the infrastructure and the environment to foster a vibrant debt market in Asia for this purpose.

In the light of these shortcomings, when we try to address the current short-term Asian liquidity problem caused by over-borrowing in short-term debt, we might consider creating an efficient and credible intermediation mechanism in the region. In other words, we must find some ways to transform the wealth created by Asian savings into powerful liquidity in our own markets without causing more disruptive fund flows on a global scale or costly liquidation of foreign assets.

Where do we find this intermediation capability? First, we have to recognise that public resources will never be enough to resolve the problems created by private over-borrowing. We must use market based solutions to solve market created problems. Second, we have to allocate our limited public funds to the best use, avoiding moral hazards, but creating the right environment of stability, transparency and rule-based incentives for private sector markets to adjust in an orderly manner. This will also kick-start private money for private solutions. Third, given that there is a confidence issue of credit risk, we should use the IFIs, such as the WB and the ADB, to issue their high-quality debt paper in Asian markets specifically to raise funds to be applied, under full IMF conditionality, to alleviate the liquidity needs of economies in trouble.

We believe such loans should carry market interest rates. Market interest rates and full IMF conditionality will take care of the moral hazard issues satisfactorily. Once the economy of the troubled territory recovers, we will see greater and greater direct issues to replace the IFI paper.

We also believe that the markets in Asia would welcome this intermediation role of the IFIs through the issue of such paper. Our private sector may even be willing to co-finance such loans. Furthermore, because such IFI paper are AAA-rated, with high liquidity, surplus economies both inside and outside the region can readily subscribe to them as investment in foreign exchange reserves.

In short, our approach has the following advantages:

- We put the solution to the currency problems created by private sector banks and corporations to where they started, i.e. the markets. Indeed, in some instances the liquidity shortages in the private sector of a troubled country may be so big that no friendly territories, including those with decent reserves, are in a position to help.

- The IFIs can build up resources for this purpose by issuing paper on a regular programme to which territories with a surplus can voluntarily subscribe, away from the limelight of an international crisis. This would obviate the need for raising huge rescue funds from less troubled economies on an ad hoc basis at very short notice in response to a national crisis as at present. As we know only too well, participation in such rescue operations often incur negative reactions in domestic politics. No economy can sustain repeated claims of this kind.

- This approach utilises the central role of the IFIs in the re-structuring of domestic financial systems at little cost to the IFIs. It encourage IFIs to provide a credit and liquidity intermediation role, where private markets on their own fail to be effective.

- Full IMF conditionality and market interest rates naturally overcome the moral hazard issues.

- It is fully consistent with the Manila Framework in mobilising the strengths of the IFIs, while the need for supplemental financial resources, implying open-ended commitments and residual uncertainties, may fall away.

These are our thoughts on a market-based approach to a market-induced problem. They involve technical issues, but not insurmountable ones. I propose that we should leave it to market experts to develop the approach in detail. In this regard, Hong Kong would welcome our neighbours and IFIs to tap our capital markets. The Manila Framework envisages a Working Party of experts to work on implementation. Hong Kong is happy to convene a meeting for these experts to pursue the ideas I have outlined.