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*Issues and Challenges for Regional Financial Cooperation in the Asia-Pacific*

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**Central bank cooperation in East Asia**

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# **Central bank cooperation in East Asia**

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## **Abstract**

This note seeks to inform discussion of the various proposals to provide institutional backing to financial and monetary cooperation in East Asia by reviewing the existing patterns of central bank cooperation in East Asia. This occurs at several levels, and engages several organisations. Cooperation focuses on monetary policy strategy and implementation and financial stability, including financial markets and capital flows, banking supervision and payment systems. The Bank for International Settlements, which established a Representative Office for Asia and the Pacific in 1998, seeks to promote central bank cooperation in the region, to provide research and organisational support for initiatives of regional central banks and to provide banking services to foreign exchange reserve managers.

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## 1. Introduction<sup>2</sup>

There has been substantial progress in concluding the network of swaps agreed to under the Chiang Mai initiative (CMI) linking ASEAN countries and China, Japan and Korea.<sup>3</sup> “The purpose of the CMI and mutual surveillance system is to prevent the occurrence of financial crises and contagion in the region” (Wang (2002)). This progress in signing bilateral swaps has run in parallel with efforts to deepen the policy dialogue. Because the swaps are not linked to IMF conditionality for the first 10% of the committed amount, and any extension of credit requires consent, many see the need for “an independent surveillance unit as a standing secretariat” (Ibid.). Indeed, many participants view the key question as what institutional development would leave signatories comfortable making more than 10% of swap lines available without IMF conditionality (Cheong (2002), p. 10).

At last year’s Pacific Economic Cooperation Council (PECC) Finance Forum, we learned of several possible models of institutional development. One proposal, by the Ministry of Finance of Japan and the Bank Negara Malaysia, was to increase the frequency of ASEAN Plus Three finance and central bank deputies meetings to twice a year, and thereby to review policy in greater depth (Cheong (2002), Sangsubhan and Nitithranprapas (2002), Wang (2002)). This proposal was accepted in spring 2002. The second proposal, not accepted “due to insufficient clarification”, was to improve the capability of the ASEAN Secretariat to perform a third-party policy assessment and to back this up with an eminent persons working group.<sup>4</sup> The Thai Ministry of Finance proposed a network of research institutes and top policy researchers in the region “to provide academic and non-binding policy alternatives for policy-makers ... [including] important changes in the ASEAN + 3, new regional financial architecture, and pre- and post-crisis conditionalities” (Sangsubhan and Nitithranprapas (2002)).

Quite different was the proposal of Barry Eichengreen (2002) that started off from the conviction that “monetary and exchange-rate cooperation is the wrong project for Asia”. Rather, he urged that policy-makers address the perceived underlying causes of exchange rate instability and thus calls for “cooperation to deepen and strengthen regional financial markets”. This cooperation would build on a shared understanding of the history of bank-centred financial systems, high corporate leverage and close business-government relationships. Moreover, regional cooperation could address the challenges posed by the importance of family firms and large cross-shareholdings between banks and industrial firms.

In particular, Eichengreen proposes an Asian Financial Institute, to be founded by the ASEAN Plus Three grouping, to undertake the following tasks:

- “Provide technical assistance to national agencies seeking to strengthen prudential supervision and regulation”.
- “Run training programs for bank inspectors, securities and exchange commissioners and accountants...”
- “Provide reserve management, clearing and settlement services not unlike the central bank services that the Bank for International Settlements provides to its members”.
- Provide a “venue for the negotiation of regional agreements on capital and liquidity standards and regulatory processes intended to promote the stability of banking systems, and of standards for information disclosure, securities listing and corporate governance designed to promote the development of regional financial markets” (pp. 19-20).

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<sup>3</sup> For an up-to-date account of the ASEAN Plus Three process, see “Chiang Mai and Beyond” by Park and Wang (2003).

<sup>4</sup> “Other options include the creation of a dedicated ASEAN+3 surveillance secretariat as well as the possibility of “out-sourcing” the secretariat function (technical support to the GEP [Group of Eminent persons] to a regional financial organisation such as the ADBI” (Cheong (2002), p. 12. Bergsten and Park (2002), section 9.2 with Yunjong Wang, describe as options “(i) developing the ASEAN secretariat; (ii) using an existing institution such as regional multilateral institutions, think-tanks or universities; and (iii) operation through a working group”.

Eichengreen's proposal was not embodied in the recommendations of the PECC to the APEC finance ministers at their meeting in Los Cobos, Mexico last September. There remains keen interest in his proposal, however, particularly on the part of the chair of this session, Wendy Dobson.

This note aims modestly to provide a broad overview of central bank cooperation in East Asia in order to inform the PECC's Finance Forum, building on the presentations of Latifah Merican Cheong and Gordon de Brouwer from last year's Forum. This note starts with a general description of the shape of central bank cooperation in East Asia, proceeds to take up monetary stability, followed by financial stability, including markets, institutions and payment systems, and then foreign exchange reserve management. It recalls the role played by the BIS in contributing to the project of European monetary union, some of it well recognised and other so characteristically low key as to have been generally unknown, before concluding.

This note commits sins of commission and omission that should be confessed at the outset. Inevitably, this note will give too much weight to the BIS efforts to serve central bank cooperation in the region. However, it does not seek to report all the activity of Asian central banks in Basel.<sup>5</sup> It does not discuss the progress in putting together the network of bilateral swaps as agreed in the Chiang Mai initiative, even though it is a very significant development, because this has been covered extensively elsewhere (Park and Wang (2003) and Rana (2002)). Moreover, this note will disappoint the PECC Finance Forum organisers in not providing a broad survey of existing programs to set financial standards or to build institutions involving ASEAN, ASEAN Plus Three, APEC, the Asian Cooperative Dialog, the Asian Development Bank, or the Bretton Woods institutions, including the IMF-Singapore Regional Training Institute.<sup>6</sup> Finally, this note does not attempt to draw any conclusion on whether a secretariat for ASEAN Plus Three or an Asian Financial Institute is advisable, and if so what form it should take.

## **2. The shape of central bank cooperation in East Asia**

Central bank cooperation in East Asia has a variable geometry. This is evident in meetings of governors of central banks. For instance, eleven governors gathered last month in Bangkok under the rubric of the Executives' Meeting of East Asia-Pacific (EMEAP), including those of China, Hong Kong SAR, Japan and Korea in northeast Asia, five ASEAN countries and Australia and New Zealand. So did the ASEAN governors. The SEACEN governors, comprising ASEAN and certain northeast Asian and south Asian economies, have been meeting annually since 1966, met last February in Manila. SEANZA governors meet annually and last gathered in Hong Kong in November 2002.<sup>7</sup>

EMEAP started in 1991 as a meeting of deputy governors and only added governors' meetings in 1996. That same year, EMEAP elaborated three working groups on financial markets, banking supervision and payment systems, judged "very effective" by Gordon de Brouwer (2002) last year. He reported, "The strength of EMEAP is that it allows officials to deal expertly with technical and broad policy issues but its distance from the political process means that it lacks political clout".

SEACEN pursues a somewhat different approach. While it has, as noted, governors meetings and meetings for heads of research and training as well, it puts a great deal of emphasis on training, as well as having a program of research pursued by secondees at its headquarters in Kuala Lumpur. As noted below, it runs courses and workshops in banking supervision, financial markets, monetary policy

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<sup>5</sup> Including participation in discussions of liquidity management and domestic bond markets; see BIS (2000, 2002).

<sup>6</sup> See [www.imf-sti.org](http://www.imf-sti.org).

<sup>7</sup> SEANZA, founded in 1957 to "conduct intensive, biennial central bank training courses" (Fraser (1995), p 22), originally included Australia, India, New Zealand, Pakistan and Sri Lanka. Since then, Bangladesh, China, Hong Kong SAR, Indonesia, Iran, Japan, Korea, Malaysia, Nepal, Papua New Guinea, the Philippines, Singapore and Thailand have joined. The South East Asian Central Banks (SEACEN) Research and Training Centre, founded informally in 1966 and incorporated in 1982, originally included Indonesia, Malaysia, Myanmar, Nepal, the Philippines, Singapore, Sri Lanka and Thailand, and now also includes Brunei, Korea, Mongolia and Taiwan, China. The EMEAP group, founded in 1991, originally included Australia, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore, and Thailand, and now also includes China and Hong Kong SAR.

and payment systems. Its long-standing ties to major bank supervision agencies outside the region have made its courses on banking supervision well attended.

The senior management of the BIS has on occasion addressed the various groups. The General Manager of the BIS made a presentation to the last SEACEN annual governors' meeting in Manila in February, just as he spoke to the annual EMEAP governors' meeting in Hong Kong several years ago. The General Manager was also invited to speak at the ASEAN Plus Three deputies meeting in Beijing last October on the subject of capital flows (Crockett (2002)). The Economic Advisor of the BIS made a presentation on asset prices to the biennial SEANZA governors last fall in Hong Kong.

The BIS opened its Representative Office for Asia and the Pacific in July 1998 to promote central bank cooperation in East Asia. The BIS therefore seeks to contribute to the work of the central banking groupings in the region through partnerships and participation in seminars (see below). The BIS also attempts to bring the key elements of the Basel process to the meetings that it organises in the region. In particular, BIS-organised meetings are usually "regional plus" meetings. That is, depending on the subject, selected BIS shareholding central banks from outside the region are included. In addition, the meetings aim for oval-table discussions that provide opportunity for practitioners from central banks to share their experience in a structured setting. The European experience suggests that both strictly regional and "regional-plus" meetings have their uses.

In early 2001 an Asian Consultative Council (ACC) was created, with secretariat services provided by the Asian Office. The ACC provides a vehicle for communication between shareholding central banks in Asia and the Pacific and the Board of Directors and Management of the BIS. It currently meets twice a year, once on the occasion of the just-concluded Annual General Meeting in Basel, and once on the occasion of a special governors' meeting in Asia, which is an annual "regional plus" meeting. Under the current chairmanship of Joseph Yam of the Hong Kong Monetary Authority, the ACC looks likely to provide ongoing guidance on BIS activities in the region, particularly those of the Asian Office.<sup>8</sup>

### **3. Monetary stability**

Central bankers in the region get together in many fora to discuss the strategy of monetary policy, including inflation targeting which has been adopted by four countries in the region since the crisis. Less generally appreciated is the potential benefit of comparing notes on the nuts and bolts of monetary policy.

#### **Monetary policy strategy**

The governors and deputy governors meetings described above often focus on aspects of monetary policy. In addition, individual central banks in the region often hold conferences on this subject with broad participation from within and outside of East Asia. Recent examples include conferences hosted by the Reserve Bank of Australia (Gruen and Simon (2001)), Bank Indonesia (Joseph and Gunawan (2000)), the Bank of Korea (2001), and the Bangko Sentral ng Pilipinas. "Setting monetary policy in East Asia: goals, developments and institutions", originally presented to the Reserve Bank of Australia conference in 2001 and now a SEACEN *Occasional Paper*, will serve for the third time as the lead-off presentation to SEACEN's annual course on monetary policy and strategies later this year. Similarly, Fung (2002) was presented to a SEACEN course last year on the monetary transmission process.

The BIS Working Party on Monetary Policy in Asia has met annually since 1997. It gathers representatives from Asia (basically the EMEAP central banks and the Reserve Bank of India) plus a couple of representatives from North America and a handful from Europe. Over the course of a day and a half, it discusses a wide range of questions under the chairmanship of Bill White, Economic

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<sup>8</sup> It might be noted that three governors in the region sit on the Central Bank Governance Steering Group of the BIS. It responds to requests by central banks for information on organisational and institutional aspects of central banking by conducting surveys of some 40 central banks on such issues as accountability, accounting, and division of operating responsibility with governments.

Advisor of the BIS. Hosts have included (or will include) central banks in China, Hong Kong, Korea, Malaysia, the Philippines and Singapore.<sup>9</sup>

### **Operating procedures**

There have been two meetings on monetary policy operating procedures chaired by a practitioner from the Bank of Japan at the BIS Asian Office. This meeting in some respects recalls similar meetings that took place in Basel between the late 1980s and 1999 (see Section 8, below). In the context of the European Monetary System tightening up in the latter 1980s, European central bankers realised that they did not fully understand the technical features each other's operating procedures (including reserve requirements, maintenance periods, open market operations, policy rates and so on). Thus sprang up a twice-a-year meeting in Basel, one with European Union members only and the other including both European Union members and their counterparts from the non-EU G10. These regular meetings ceased with the introduction of the euro, though practitioners from the Eurosystem, Bank of Japan and the Federal Reserve have met on occasion (Blenck, Hasko, Hilton and Masaki (2001), Borio (2001)). Comparisons of operating procedures in East Asia can be useful reference to central banks in the region as they periodically alter their own approaches, as well as furthering the understanding of each other's policy (Borio and McCauley (2002)).

## **4. Financial stability**

In their efforts to promote financial stability, central banks in the region concern themselves with the potential for instability affecting markets, institutions and the "plumbing". In particular, they cooperate in their focus on financial markets and capital flows, banking supervision and payment systems.

### **Financial markets and capital flows**

Much of the discussion of financial markets in the region has drawn on a widely shared analysis of the two balance sheet mismatches that contributed to the vulnerabilities of East Asian economies in 1997-98.<sup>10</sup> Borrowers in the region had financed long-term cash flow deficits with short-term obligations, exposing themselves to the risk that creditors might lower their assessments and refuse to roll over these obligations as they came due.<sup>11</sup> Firms also mismatched local currency cash flows with foreign currency debt, exposing their solvency to the risk of currency depreciation (Goldstein and Turner (forthcoming)). Central banks in East Asia have thus sought to cooperate, not only to understand better, but also to develop financial markets in the region.

In addition, the experience of speculative attacks during the Asian crisis and the increased flexibility of exchange rates in the region have put a premium on regular discussion of foreign exchange market developments. Similarly, in the aftermath of the Asian crisis, the sharing of perspectives on capital flows has been seen as particularly worthwhile.

### ***EMEAP and the Asian bond fund***

Even before the challenges of the Asian crisis, EMEAP had created three working groups: financial markets; banking supervision and payment systems.<sup>12</sup> The financial markets working group meets

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<sup>9</sup> There are parallel and similarly structured meetings in Latin America, Eastern Europe and Africa.

<sup>10</sup> See, for example, Tsung (1998).

<sup>11</sup> See Cho and McCauley (2003) on maturity mismatches in Korea.

<sup>12</sup> These working groups were created in the year following the call by the then Governor of the Reserve Bank of Australia (Fraser (1995), p. 24) for an "institution modelled on the BIS and serving EMEAP-based central banks". Whatever the role of this suggestion played in subsequent events, the speech bears reading today, with its references to the vulnerabilities created by financial liberalisation in the context of "sticky" exchange rates and the volatility of short-term capital flows. Eichengreen's proposal differs from Fraser's in its focus on the ASEAN + 3 grouping rather than the EMEAP grouping and

regularly to discuss financial market issues and occasionally spawns a task force to do a study of a particular issue. The product of one such effort is EMEAP (2001), a study by central bank analysts of practical issues of foreign exchange operations and of the role of the capital account and exchange rate in monetary policy.

Recent meetings of the Financial Markets Working Group have focused on the creation of the Asian Bond Fund (ABF) in order to promote the development of regional bond markets (EMEAP (2003)). This was described as a fund of about \$1 billion to be invested in the dollar bonds of issuers from the investing countries other than Australia, Japan and New Zealand.

Considering for the moment its policy aspect, the Asian bond fund addresses the first of the mismatches highlighted above. By investing in the long-term notes and bonds of issuers in the region, the Asian bond fund encourages longer-term funding and underscores the common interest in less fragile balance sheets. Investing in dollar instruments, it does not address the currency mismatch, despite reporting that places it in the context of a switch away from dollar holdings (Day and Sender (2003)). This fund is thus best thought of as a modest reallocation of foreign exchange reserves away from very low risk dollar instruments issued by major sovereign and agency borrowers to dollar instruments of slightly higher risk--and thus somewhat higher expected returns--issued by borrowers in the region.

The ABF attracted criticism in terms of its contribution to domestic currency bond markets (Fernandez and Klassen (2003)). At its launch, however, the EMEAP group set itself a new goal to study the practical requirements of a follow-on fund that would invest in the domestic currency bond markets. "After the launch of the US dollar ABF, the EMEAP Group will proceed to study the extension of the ABF concept to include bonds denominated in regional currencies, further strengthening the contribution of the initiative to the broadening and deepening of bond markets in the region".

Going forward, the BIS Asian Office expects to collaborate with the EMEAP central banks in research on the impediments standing in the way of central bank investment in local currency bond markets. This work will build on the investigations of market liquidity by the Committee on the Global Financial System under the chairmanship of former Deputy Governor Yamaguchi of the Bank of Japan and related work (CGFS (1999), the "Shirakawa report", Borio (2000), McCauley and Remolona (2000), CGFS (2001), BIS (2000, 2001a, 2001b, 2002). It will also build on work by APEC (1999), the Asia Policy Forum (2001), research institutes in the region (for instance, Park (2001)), the Asian Development Bank (Fabella, R and S Madhur (2003)), the Asian Development Bank Institute (Herring and Chatusripitak (2000), Shirai (2001), Yoshitomi and Shirai (2001)) and the IMF/World Bank (2001).

### ***The EMEAP Forum***

The potential for exchange rate issues to become thoroughly politicised is a fact of modern international financial life. Anyone with a policy memory that extends back to the late 1980s will remember the very public exchange rate diplomacy that accompanied the rebalancing of trans-Pacific trade flows. Thus a technical and discreet forum for those responsible for foreign exchange operations in East Asian exchange rates can serve a very useful purpose. Such discussions are usefully joined at the regional level, as with the EMEAP Working Group and the Four Markets Group.<sup>13</sup> In addition, they can also involve practitioners from outside the region.

The BIS Asian Office has joined hands with the EMEAP working group on financial markets to hold six meetings to date of the EMEAP Forum on foreign exchange and other financial markets. Chaired by the head of the EMEAP working group on financial markets, this biannual meeting is of the regional-plus variety. In particular those responsible for foreign exchange operations in the region meet with their counterparts at the ECB, Bank of England and the Federal Reserve Bank of New York, as well as the chair of the Basel-based Markets Committee (formerly the Gold and Foreign Exchange Committee), currently Deputy Governor Kennedy of the Bank of Canada.

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its stance towards what Fraser, page 25, called "emergency support mechanisms", including "coordinated foreign exchange operations and foreign exchange swap operations, to more highly structured temporary credit facilities".

<sup>13</sup> DeBrouwer (2002), p. 4, notes that this Group, comprising Australia, Hong Kong, Japan and Singapore, includes finance ministry officials as well as central bankers.

### ***Other work on capital flows***

In 2000, the SEACEN Expert Group on capital flows has coordinated data-sharing and regular discussion of the risks and vulnerabilities of capital flows based on analysis of the shared data.<sup>14</sup> This group has entered dialogues with the IMF regarding risk management approaches and with the BIS on using the BIS international financial statistics for monitoring external debts. It also seeks to raise the standards of data collection through its training and research, including next month's workshop on the international investment position and research projects on "External debt: concepts and monitoring for crisis prevention" (2002) and "Managing and monitoring direct and portfolio investment flows: a comparative review of central bank practices" (2003). (See Annex 1 for SEACEN events grouped in accordance with the outline of this note).

At the request of the State Administration for Foreign Exchange, the BIS helped to organise a seminar on capital account liberalisation (BIS (2003a)). The approach was to gather practitioners from central banks on four continents to offer the benefit of their experience regarding overall strategy, banking flows, corporate and institutional investor flows, equity flows and managing cross-border flows of cash.

### **Banking supervision**

With the new Basel Accord entering the final stages of refinement, it is not surprising that regional central banks have invested considerable time and effort in coming to terms with the new Accord, making their views heard and joining in the global study of its impact. This PECC Finance Forum has invited my colleague, the Asian Office's regulatory economist, Stefan Hohl, to speak, so what follows provides highlights of central bank activity in the region on this front.

### ***Comments on drafts of the new Basel Accord by supervisors in Asia***

The EMEAP Working Group on Banking Supervision, after meeting in Seoul in April 2001, addressed a letter of comment to the Basel Committee.<sup>15</sup> The letter pointed out, among other things, that

- For Asian banks the new capital charge for operational risk could more than offset the lower capital requirements under a revised standardised approach, potentially disadvantaging Asian banks still recovering from the Asian crisis.
- The proposed risk weight for loans that become past due of 150%, without regard to the value of the collateral and provisions, would be excessive; similarly, the value of real estate collateral, common in the region, should be recognised as mitigating credit risk.

Additional views were presented in comments from the Australian Prudential Regulatory Authority, the Asian Development Bank, the Macanese Monetary Authority, Bank Indonesia, Bank Negara Malaysia, the Bank of Korea, the Bank of Thailand, the Financial Supervisory Service of Korea, the Hong Kong Monetary Authority, the Monetary Authority of Singapore, the People's Bank of China, the Reserve Bank of India and the Reserve Bank of New Zealand.<sup>16</sup> On an occasion that the EMEAP Deputies discussed this matter, they received presentations on the arguments concerning whether the new Accord would work in an excessively pro-cyclic fashion (allowing banks to operate with less capital during good times and requiring more in bad times, possibly accentuating existing credit cycles) and whether it would discourage lending to small and medium-sized enterprises.

In the event many of the concerns addressed to the Basel Committee by supervisors in East Asia were addressed. The weights on household mortgages and on loans to small and medium-sized enterprises were lowered. These moves reduced concerns that the new Accord would ratchet up overall capital requirements, given the new operational risk charge, or lead to a withdrawal of credit to small and medium-sized enterprises. In addition, the capital charge for overdue loans secured by real

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<sup>14</sup> The Group is made up of senior officials from the 12 SEACEN member central banks plus representatives of the Reserve Bank of Australia and the Hong Kong Monetary Authority. See <http://www.seacen.org/segcapitalflows/index.aspx>.

<sup>15</sup> The Working Group's letter thanks Zahra El-Mekkawy of the Basel Committee on Banking Supervision secretariat for providing the meeting with an update of developments of the New Accord.

<sup>16</sup> See <http://www.bis.org/bcbs/cacomments.htm>.



estate was altered (in effect reduced) to reflect the value of appraised collateral and any provisions. Finally, two changes were made to the internal ratings approach that lessen the risk that it operate in a procyclical fashion. First there was a flattening of the risk weight curve, so that downgrades would require less incremental capital. In addition, stress testing was required, which should help increase ex ante capital allocation to risk and lessen the required increase in the event of adverse developments.

### ***Quantitative impact study of the new Basel Accord***

The Basel Committee on Banking Supervision (BCBS) recognises that market forces as well as the weight of supervisory practice work towards a broad application of its standards. Thus, in the formulation of the revised accord, an extensive effort was made to assess the impact of the proposed standards. In particular, would the proposed new capital standards result in significantly more or less capital to be held to back currently-held risk assets? The BIS Asian Office, in conjunction with the Australian Prudential Regulatory Agency, coordinated the participation in the third quantitative impact study of the BCBS of central bank and bank supervisors from economies outside of the G10 and the European Union. Globally, the so-called QIS3 involved 350 banks in 43 countries. Participation from the Asia-Pacific region was broad, with Australia, China, Hong Kong, India, Indonesia, Korea, Malaysia, the Philippines, Singapore and Thailand represented. As elsewhere, Asia-Pacific supervisors include bodies other than central banks (Australia and Korea), so the impact study transcended central bank cooperation.

### ***Implementation***

As noted, a particular strength of SEACEN is the range of seminars and courses that it runs on banking supervision. It ran its first course in banking supervision in 1972 and has conducted one or two per year since then, reaching its 40<sup>th</sup> course later this month. In addition, directors of supervision gather annually; the 16<sup>th</sup> such SEACEN meeting will take place next month in Mongolia. Lately, the new Accord has been the focus of a number of its offerings, both in general and in specific aspects (Annex 1).

The Financial Stability Institute runs workshops in the region on the New Basel Accord, both overview events and ones on such particular topics as credit ratings. These events, organised with SEACEN, SEANZA and in some years EMEAP, are aimed at high-level banking supervisors. See Annex 2 for the FSI's offerings in 2002-2003.

Issues raised by the implementation of the Accord in emerging markets are challenging (Neumann and Turner (2002), White (2002)). The BIS Asian Office stands ready to support collective efforts in the region to implement the new Accord.

### ***Regional standards?***

As noted in the introduction above, one of the tasks that Barry Eichengreen envisions for the proposed Asian Financial Institute is arriving at standards for, inter alia, banking supervision appropriate to the specific characteristics of the region's banks and financial markets. The first point to be made is that the Basel Accord sets minima, and national authorities, acting alone or in concert, can attach higher risk weights that they deem more risky than the consensus of supervisors. The Korean authorities have, in fact, recently responded in this manner to what they took to be signs of overheating in the extension of credit to households (Financial Supervisory Service (2002)). It may be easier, when banking systems are in close competition,<sup>17</sup> for such higher standards to be agreed among a region's supervisors.

Yoshikuni (2002), however, offers a cautionary tale about tailoring of capital standards to national peculiarities. In the late 1980s, the Japanese authorities succeeded in persuading their colleagues in Basel to count 45% of the unrealised profit on cross-held shares towards Tier 2 capital. This muted the restraining impact of the introduction of the Basel Accord in the midst of what is now recognised as a

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<sup>17</sup> See the evidence on regional participation in syndicated bank loans for regional borrowers in McCauley, Fung and Gadenec (2002).

bubble in land and equity prices in Japan.<sup>18</sup> Be careful what you wish for, would seem to be the lesson.

Eichengreen suggests, "Given the close connections between banks and industrial conglomerates, there may be a case for different regulatory standards for portfolio concentrations than those promulgated by the Basle Committee of Banking Supervisors". Looser limits on single borrower exposures than in BCBS' "Principles for the management of credit risk" (2000) would seem hard to square with the historical lessons ranging from Creditanstalt in the 1930s to Latin American *grupos* in the 1970-80s, not to mention the more recent experience of Korean banks' loans to *chaebol*. On equity holdings by banks, there is scope for national discretion in setting super-weights of 150% or more under the standardised approach (BCBS (2003b), and one can imagine a regional approach here.

### **Payment systems<sup>19</sup>**

Payment systems are critical but usually invisible features of financial markets. In this they resemble the plumbing of an apartment building, which comes to one's attention only when something goes wrong. The third EMEAP working group formed in 1996 has provided a regional forum for the discussion of payment systems. It has published two editions of the so-called Red Book describing payment systems in the eleven member economies (EMEAP (2002)). On the occasion of its second meeting in Hong Kong in October 1999, the working group invited the head of the secretariat of the Basel-based Committee on Payment and Settlements to speak on the subject of core principles for payment systems. The Basel-based Committee itself met in Hong Kong in the same year (CPSS (1999)) and co-sponsored a seminar with Bank Indonesia on the implementation of core principles in 2000. Last year, SEACEN and the Basel-based Committee held a course on payment systems issues in conjunction with a meeting of directors of payment systems. The course and meeting will take place again this coming September in Manila.

## **5. Foreign exchange reserve management**

Since the Asian crisis, foreign exchange reserves in the region have grown to more than half the global total. This has created a demand in the region both for a wider range of investment products and for opportunities to share experience in responding to the challenge of managing substantial reserve portfolios.

### **BIS banking services**

Spurred by the growth in reserves and the falling trend of interest rates in major markets, the long-standing process of diversification away from US Treasury, German government and Japanese government securities and from short-duration instruments to long-duration instruments has continued (McCauley and Fung (2003)). The BIS, offering returns generally between those available on G3 sovereign instruments and those on private instruments carrying greater credit risk, has attracted business from central banks in the region, both shareholders and non-shareholders. The opening of the Regional Treasury at the Asian Office in October 2000 has allowed regional central banks to deal with the BIS during convenient Asian morning hours. Partly as a result of overall reserve trends and partly as a result of the regional presence, placements with the BIS by Asian central banks now represent the largest single source of liabilities by region.

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<sup>18</sup> However, the demonstrated willingness of the Japanese banks at that time to trample on shareholder interests by realising gains and paying half them to the tax authorities leaves open the question of the importance of this effect.

<sup>19</sup> Payment systems are often the most intensive users of information technology at central banks. The EMEAP central banks set up a information technology directors' meeting last February. The intention is to meet annually and to stage more frequent e-meetings on the EMEAP confidential network.

The BIS has adapted its product line to the needs of central banks in the region. The introduction of the medium-term instrument responded to the expressed needs, as did the recent extension of the available term out to 10 years. With yields at very low levels, the BIS is exploring instruments that could provide yield enhancement.

The launching of the Asian Bond Fund is from one perspective another adaptation of the BIS product line to the expressed needs of central banks in the region. The BIS Asset Management group will be the manager of the fund, drawing on Banking Department resources in Basel and on the Regional Treasury team at the Asian Office.

### **Opportunities for sharing experience among reserve managers in the region**

The region also benefits from courses and seminars for reserve managers. SEACEN has run two courses on reserve management topics, to which the Regional Head of Treasury at the BIS Asian Office has contributed. The most recent course on foreign exchange and financial derivatives took place in Kuala Lumpur in January 2003. The BIS for its part, offers both seminars for senior reserve managers and course for staff. .

The BIS Asian Office has hosted three seminars in East Asia for foreign exchange reserve managers. The first in September 1998 focused on the euro; the second in 1999 focused on risk management. A seminar in late 2000 considered the implications of what seemed then to be shrinking sovereign debt markets, with Peter Fisher, now US Undersecretary of the Treasury as chair.<sup>20</sup> In early 2002, the BIS conferred with central banks in the region to find out whether central banks had enough foreign exchange business to justify a direct membership of the CLS Bank, designed to limit so-called Herstatt risk. In addition, reserve managers from Asia have been invited to Beatenberg in Switzerland for joint FSI-BIS Banking meetings (see Annex 2). A similar meeting is planned for Malaysia in the fall and another seminar for senior reserve managers, which was postponed owing to SARS in April, is in the process of being rescheduled.

In support of such meetings and more generally to inform reserve managers in the regions, the economists in the Asian Office conduct basic research on reserve management issues. A particular focus has been on the instrument choice in reserve management, on which relatively little research has been done to date (Fung and McCauley (2000), McCauley (2002) and McCauley and Fung (2003)).

With the IMF (2001) having offered guidelines for reserve management, certain central banks in the region have requested some help in upgrading the front-, middle- and back-office operations. These have led to ad-hoc visits by staff from the Asian Office and Basel. The fact that the BIS Asian Office has a credit risk officer has not only helped to expand the regional counterparties of the BIS among banks and securities issuers, but also puts the Office in a position to make suggestions regarding central bank risk management processes.

## **8. The future of East Asian monetary cooperation and the “Basel process”**

There is burgeoning body of work seeking to draw lessons from European monetary union for the prospects for Asian monetary union. This work compares and contrasts such features as the degree of economic integration, financial integration, political commitment, power polarity and so on.

Wyplosz (2001) draws on the European experience to emphasise the importance of collective institutions capable of drawing up bold blueprints that can be put to use when the opportunity unexpectedly arises. Taking the point of the critical importance of the bird's eye view, there is something to be said for the mole's eye view as well. The operational tasks and the technical exchanges undertaken by central banks build trust and understanding across institutions that are useful in and of themselves. They may also lay the ground for larger ambitions.

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<sup>20</sup> See McCauley (2002).

In this connection, it is worth recalling the services to European central bank cooperation that the BIS rendered in the long approach to the euro. This record shows how the BIS was willing to provide its offices and its organisational support to the initiatives of its shareholders. Some examples from the last half of the 20<sup>th</sup> Century, both operational and secretarial, are:

- Between 1950 and 1958, the European Payments Union used the BIS as an agent to permit bilateral surpluses and deficits in Europe to be cleared multilaterally in an era of dollar shortages and exchange controls.
- The European Monetary Cooperation Fund used the BIS as agent from 1973-1993. In particular, the BIS
  - Kept records for the short-term central bank swaps done by central banks in the European Monetary System;
  - Effected transfers to settle very short-term debts and claims arising from foreign exchange intervention in the context of the European Monetary System; and
  - Carried out payments associated with conditional medium term balance of payments financing extended by the European Community to member states including France, Italy and Greece.
- A group of experts on monetary policy operating procedures met at the BIS for a dozen years starting in the late 1980s, as mentioned above.
- Before the introduction of the euro, private ECUs were cleared by the BIS.
- The Delors Committee drew on the BIS for secretariat services.
- When the Exchange Rate Mechanism crises of 1992-93 highlighted the different room for manoeuvre of different central banks, the G10 central banks commissioned the Monetary and Economic Department of the BIS to coordinate a studies of the transmission mechanism in the G10 countries (BIS (1995)).
- The immediate predecessor organisation of the ECB, the European Monetary Institute, used the BIS as agent from January 1994 until May 1995. (The EMI was then housed at the BIS in Basel.) The EMI itself then took over this role.

None of this amounts to institution-building on a grand scale. It is easy to overstate the scale of the resources required to support, for example, the agency services for the European Monetary Cooperation Fund. Moreover, when the European System of Central Banks came into existence, the job of the BIS shrank. Ultimately more important than the particular tasks undertaken were the multilateral agreements among the European central banks that set these tasks.

## Conclusions

This note seeks to inform discussion of the various proposals to provide institutional backing to financial and monetary cooperation in East Asia by reviewing the existing patterns of central bank cooperation in East Asia. This occurs at several levels and engages several organisations. Cooperation focuses on monetary policy strategy and implementation, financial markets and capital flows, banking supervision and payment systems. The Bank for International Settlements through its Representative Office for Asia and the Pacific seeks to promote central bank cooperation in the region, to provide research and organisational support for initiatives of regional central banks and to provide banking services to foreign exchange reserve managers.

The endgame of central bank cooperation in East Asia is by no means obvious at this point. The experience in Europe in the last half of the last century suggests that a central bank service organisation with broader than regional shareholding can contribute to a regional project.

## Annex 1: SEACEN events 2003-2004

<http://www.seacen.org/training/2003-seminars.aspx#s2>

### **Monetary stability**

\*3rd SEACEN Course on Monetary Policies and Strategies, Colombo, 21 September - 3 October

SEACEN Course on Currency Management, Bali, 4-9 January 2004

### **Financial stability**

#### ***Financial markets and capital flows***

Workshop on International Investment Position (IIP) in SEACEN Countries, Manila, 12-15 August

\*SEACEN-BIS Workshop on Strengthening the Management of International Capital Flows, Bangkok, 20-23 August

#### ***Banking supervision and financial stability***

\*40th SEACEN-Fed Course on Banking Supervision (Intermediate Level): Market Risk Analysis, Kuala Lumpur, 9–18 July.

Seminar on Development of Micro-Finance Activities in SEACEN Countries, Jokjakarta, 29 July - 1 August

\*4th SEACEN/Fed/World Bank Seminar for Senior Bank Supervisors from Asia-Pacific Economies, Ulaanbaatar, 18-23 August 2003

SEACEN-Federal Reserve System Course on Electronic Banking and Technology Risk Supervision, Bangkok, 3-12 September.

3rd SEACEN-Toronto Centre Leadership Seminar for Senior Management of Central Banks on Financial System Oversight, Bangkok, 12-17 October

Seminar on WTO and Liberalisation of the Financial Services Sector in SEACEN Countries, Katmandu, 11-14 November

SEACEN/World Bank/IMF Seminar on Comparative Experiences in Confronting Banking Sector Problems in the Asia/Pacific Region, Kuala Lumpur, 2-3 December 2003

\*6th SEACEN-FSI Workshop for Bank Supervisors and Regulators: The New Capital Accord and Credit Ratings, Colombo, 7-12 December

\*SEACEN-BIS Seminar on Central Bank Governance, Langkawi, 17-20 February

Workshop on Financial Stability and Financial Soundness Indicators, Singapore, 1-3 March

\*7th SEACEN-FSI Workshop for Bank Supervisors and Regulators: The New Capital Accord and Financial Engineering from a Practical View, 14-19 March 2004

### **Payment systems**

\*2nd SEACEN-CPSS Course on Payment and Settlements Systems and 2nd Meeting of SEACEN Directors of Payment and Settlement Systems, Manila, 22-27 September

Note: \* denotes event with speaker or speakers from BIS.

## **Annex 2: Financial Stability Institute-selected events 2002-2003**

(<http://www.bis.org/fsi/fsi2003.pdf>)

### **2002**

"The New Capital Accord", FSI/SEANZA Forum of banking supervisors, Colombo, 23-24 January

"Risk and asset management for portfolio managers", special seminar with the BIS Banking Department, Beatenberg, 3-6 June

"Operational risk; corporate governance", FSI/SEACEN workshop, Bangkok, 2-5 July

"Advanced risk management for portfolio managers", special seminar with the BIS Banking Department, Beatenberg, 15-19 July

"Preparing for Quantitative Impact Study III of the Basel Committee", Singapore, 2-3 October

"Bank accounting and audit", Hong Kong, 21-24 October

"The New Capital Accord", FSI/SEACEN workshop, Manila, 4-8 November

"The New Capital Accord; risk-focused supervision", FSI/SEANZA Forum of banking supervisors, Hong Kong, 25-29 November

### **2003**

"The New Basel Accord", FSI/SEACEN workshop, Singapore, 3-7 March

"Risk management; consolidated supervision", FSI/SEANZA workshop, Kathmandu, 7-11 April

"Fundamentals of reserve management", special seminar with the BIS Banking Department, Beatenberg, 26-30 May

"Advanced risk topics for reserve managers", special seminar with the BIS Banking Department, Beatenberg, 1-5 September

"To be determined", workshop with SEANZA, Hong Kong, 6-10 October

"New Capital Accord", workshop with APEC, Taipei, 15-20 October

"Credit ratings and the New Capital Accord", workshop with SEACEN, Colombo, 8-12 December

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