"The Future of ASEAN-Japan Financial Relations," ASEAN-Japan Cooperation:
A Foundation for East Asian Community; (ed. Japan Center for International Exchange), Tokyo:
Japan Center for International Exchange, 2003, pp. 108-124.

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The Future of ASEAN-Japan Financial Relations

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There is no doubt that the Asian financial crisis of the late 1990s still exerts a powerful hold on anyone who seriously ponders the future architecture of Asian economies. One of the most pervasive preoccupations of policy makers is how to build a robust financial market that can withstand strains during a crunch. There is growing consensus that collective undertakings within the region are imperative if the goal is to be achieved. This seems to be a premise well founded.

Underlying this premise is the contagion that characterized the financial crisis that swept through Asia. No economy in the region was exempt from the merciless withdrawal of foreign capital, even as a few economies did manage to weather the shock relatively well. The region as a whole has a stake in preserving the confidence of the international investment community, which, when the panic struck, was rather indiscriminate in its actions taken toward countries in the region: It paid no attention to economic fundamentals of a country. This lesson seems to be engraved deeply in the minds of policy makers in the region.

The sense of community, born of this experience, has been further reinforced by a growing awareness of regional economic interdependence. The fate of one economy is closely intertwined with that of another, depending on where multinational corporations choose to locate their factories. This relationship among economies in the region has been largely complementary as the network of supply, which they provide, takes hold. This relationship, however, can also be one of rivalry, as exemplified by the situation with China, the rise of which, other countries fear, will result in the hollowing out of industries elsewhere.

For this and other reasons, the call for community building in the region has led to a series of bold proposals among leaders of the Association of Southeast Asian Nations (ASEAN) to strengthen the financial market environment in the region. The ideas fall into two categories. The first, the creation of an Asian currency unit, aims at eliminating or, at least in the initial stage, reducing foreign exchange volatility. The second is the establishment of an Asian bond market, which would more effectively channel savings into investment within the region.

Certainly, the proposals are ambitious, destined to be long-term projects, requiring assiduous effort over decades before tangible results are seen. In this respect, the European experience is instructive, as it has taken almost a half century, since the inception of the project, to achieve a single European currency, even as Europe is widely acknowledged to have less diversity and divergent interests than does Asia. There does, however, seem to be a great deal of virtue in the Asian process, if it is engineered carefully.

Concurrently, Japan stands to benefit greatly. Japan has resources, which constitute critical inputs in the implementation phase of the exercise. A leadership role of Japan, together with the active participation of ASEAN countries, would seem to be essential as well as desirable. Such leadership, however, should not be construed to mean domination. Japan acknowledges its constraints. Unlike two decades ago, Japan cannot be a role model for other Asian economies—not while its economy is stagnant and its financial house remains wrecked. Japan is acutely aware that the best contribution it can make to Asia is the resurrection of its own economy.

Japan's leadership in this Asian exercise, then, might be best seen as facilitation. In other words, Japan could make its financial resources available for the collective exercise, and Asian nations themselves would provide the impetus, through a kind of peer pressure, for reform.

The Initiative of an Asian Monetary Fund

In the wake of the 1997 Asian financial crisis, Japan and a few ASEAN countries launched the proposal for the creation of an Asian Monetary Fund (AMF). The proposal was met with staunch opposition by the U.S. government, and it was promptly withdrawn. Subsequently, after some negotiation, a compromise proposal was drafted at the Manila Framework Group meeting in 1998.

This episode illustrates at once the issues at stake, even if the proposal may have been made prematurely. The proposal continues to be given attention in the region, demonstrating the desire for a collective mechanism to protect the region's economies from violent and seemingly capricious changes of capital flows in the international financial market.

The basic role of such an AMF, which would have been funded by contributions from Japan and other countries, was to extend hard currency credit to economies in the region facing external liquidity difficulties. In other words, the notion was nothing more than the creation of an Asian International Monetary Fund. Not surprisingly, the United States denounced such a fund as an unnecessary and possibly harmful duplication: It would spoil the conditionality of the International Monetary Fund (IMF) and loosen the discipline exerted upon the economic policy of countries.

Japan's argument was that the IMF had proven ill-prepared and ill-equipped for the Asian financial crisis. The resources of the IMF were not large enough to cope with the capital account crises, which generated far greater liquidity gaps than had previous crises. Moreover, the imposition of conventional IMF conditionality, or the traditional recipe for corrective policy action, resulted in aggravating rather than mitigating the financial crisis, seemingly due to lack of consideration of factors unique to the region. An AMF, with its intimate knowledge of local circumstances, could be supplementary, as well as complementary, to the IMF in future crises.

The United States was adamant. Critics suggested that an underlying reason for the U.S. objection to the AMF proposal was the fear that an AMF could undermine the IMF, where the United States holds a privileged position, including veto power. With the lapse of the AMF proposal, many Asian countries grew disenchanted with the United States for its apparent reluctance to help or to alter its strait-jacket approach to debt crises.

Yet, the Manila Framework struck a compromise, which adopted a series of modifications to the modus operandi of the IMF that would address Asian concerns more properly. In this respect, the AMF initiative was not a total waste of effort. The IMF acknowledged the need for greater local input into the process of determining appropriate conditionality—which enhances the sense of a personal stake in the remedial policy and thus enhances its efficacy.

The New Miyazawa Initiative and the Japanese Proactive Approach

In any event, as it became clear that generous financial assistance was not readily available from the IMF and other international rescue mechanisms to countries suffering from the crisis, Japan acted swiftly with a series of measures. Major among them was, in 2000, the New Miyazawa Initiative, which made available bilateral lending guarantees worth US$30 billion. In so doing, Japan turned out to be the single largest provider of liquidity to the troubled economies in the region, helping to ease the pain of their subsequent macroeconomic adjustment.

During this process, Japan experienced a renewed awareness of its vital stake in preserving a stable, healthy economic environment in the region. It is true that Japanese multinationals, through trade and investment, had long been a principal vehicle of economic interdependence within the region; they were aware, obviously, that economic turmoil in the region would disrupt their logistical operations and business strategies. But at this moment, when the prolonged economic stagnation at home was beginning to erode these companies' international competitiveness, there was heightened pressure to develop their intra-company global distribution of labor more effectively. Naturally Asia was the place for them to do it, but if the investment environment in the region was subject to high uncertainty, their efforts would be seriously hindered.

In addition, the perception in Japan was that it was wrong just to sit and watch the Chinese economy thrive without interruption while ASEAN economies continued to suffer. Better would be to see both subregions prosper in healthy competition. That would also make it easier for Japanese multinationals to develop a harmonious and sustainable distribution of labor for their Asian supply networks. A proactive Japanese policy approach, which assisted ASEAN countries in their quest for a foundation of renewed growth, thus seemed necessary and desirable.

Another dimension to this calculus was that Japan realized that its initiatives are far more likely to be welcomed by their neighbors now than in the past. The burdens of history have made Japan extremely cautious about taking a leadership role in the region, but the past four decades of conciliatory diplomacy may finally have melted the skepticism in Asia over Japanese intentions.

More probably, however, the Asian financial crisis made ASEAN countries recognize that Japan's proactive diplomacy was a reliable source of assistance in time of need. It may not be too great an exaggeration to say that dialogue between Japan and ASEAN has taken on a tone urging Japan to take greater initiative, and this has encouraged further proactivism in Japan's policy toward the rest of Asia. The speech of Prime Minister Koizumi Jun'ichiro at the signing of the bilateral free trade agreement (FTA) with Singapore in December 2002, when he referred to the notion of a comprehensive economic partnership, was a manifestation of this new approach.

It is also true that this Asian initiative of the Koizumi cabinet is a response to the initiatives that the United States, as well as China, have taken toward ASEAN countries in the last few years. For instance, there is no denying that China's public commitment to conclude free trade agreements with ASEAN nations in the next decade has something to do with Japan's reconsidering its low-profile economic diplomacy. Nevertheless, any rivalry between Japan and China need not be antagonistic. Nor is it a forgone conclusion that Japan or China will dominate the economic future of the region. More likely, the rivalry will see entrepreneurial initiatives both from China and Japan that contribute toward converting the entire region into a credible common economic zone.

Apart from Japan and China, the Asian exercise seems to reflect a changing perception in ASEAN and other Asian countries toward community building. Certainly, there have been many mechanisms in the past that were instrumental in fostering development of community in the region. ASEAN itself was important in demonstrating the subregion's interest in participating in wider forums such as Asia-Pacific Economic Cooperation (APEC) in its endeavor to carve out a new international economic order.

While this may be true, it cannot be denied that individual countries deliberately avoided the guidance of a collective mechanism in their pursuit of industrial development. The need to address structural weaknesses collectively was often ignored, as individual nations enjoyed spectacular economic growth through fervent maneuvers to attract foreign investment. In this process, unsound macroeconomic management and lax regulations were allowed free rein.

In other words, countries chose not to listen to the voice of caution. The crisis altered this picture completely. The region's countries are now eager to be engaged in collective actions to rebuild their reputation in the international capital marketplace. Moreover, they have begun to regard the active participation of Japan in any collective mechanism as an essential ingredient for its success.

The Chiang Mai Initiative and a Surveillance and Consultation Mechanism

With this background, the Japanese government resumed its efforts to build an alternate collective arrangement, together with ASEAN and other Asian nations, to reduce the vulnerability of the region's economies against sudden sharp fluctuations in exchange rates. What emerged was the Chiang Mai Initiative, which was agreed to at the ASEAN + 3 (China, Japan, and South Korea) finance ministers meeting in Chiang Mai in May 2000.

In this initiative, Japan agreed to enter into a bilateral currency swap-borrowing arrangement with other Asian countries to supplement a similar arrangement set up earlier among ASEAN countries. The Japanese government succeeded in concluding this arrangement with South Korea, Malaysia, and Thailand, among others, and is still trying to widen this network with other countries in the region.

As a result, as much as US$36 billion has been committed to the collective pool of international liquidity available in the event of a foreign exchange crisis. The pessimistic view, particularly among Western observers, is that this arrangement is not likely to be of much help in the face of a huge capital flight.

Yet, there is little doubt that this arrangement is a right step forward. Clearly, the collective pool of readily available liquidity makes the crisis country less vulnerable to currency attacks. Furthermore, cultivated trust among central banks may be able to enlarge the amount of liquidity in time of need. To put it differently, the key for success in this exercise is how far the arrangement will be able to mobilize the collective facility when called upon. Such mobilization would need to be followed with corrective policy actions in the crisis country without undermining actions taken by participating countries. Otherwise, it would be easy to see how a collective defense could still be overwhelmed by skeptical capital outflows.

It is crucial here to stress that the proper mobilization of the facility cannot be done without an effective mutual surveillance mechanism as a basis of macroeconomic policy coordination. Currently, efforts are being made on several fronts. The meeting of the finance ministers of fourteen countries, monetary authorities, the IMF, the World Bank, and the Bank for International Settlements is one example.

The ASEAN + 3 surveillance process, which was set up in conjunction with the Chiang Mai Initiative, is another notable example. This mechanism is contemplating the development of an extensive monitoring system that could lead to a so-called early warning system with technical assistance from the Asian Development Bank. The Executives' Meeting of East Asia-Pacific Central Banks (EMEAP) emphasizes monitoring of foreign exchange markets and capital flows.

With these developments, the meeting of finance ministers, together with central governors, has been greatly reinforced by a series of subminister-level meetings, which convene regularly and deal with aspects of the surveillance process. In other words, the efforts of the Japanese government to strengthen the consultation mechanism have come to receive a wide endorsement from the countries in the region. This is indeed an encouraging development.

However, it would be premature to conclude that the mechanism to protect Asia against future crises in international financial markets is in place. The mechanism is in its early stage of evolution, requiring further specification and refinement before it can be counted on to function well in practice.

Furthermore, what is most crucial is, once again, mutual confidence and trust, which the mechanism is meant to promote. Without this, the mechanism is not likely to deliver in times of crisis. It should be remembered that the United Kingdom in 1992 did not help its cause by breaking away from the exchange rate mechanism when the Bundesbank refused to provide it with liquidity to defend the pound sterling. If Japan is asked to supply liquidity in an emergency, it should be fully convinced that the circumstance justifies the action and that the recipient country will follow with corrective policy actions and that other countries will not take advantage of the vulnerability of the economy in crisis.

This level of trust cannot be accomplished easily. It is highly questionable that further technical elaboration of the details of the mechanism would secure the necessary confidence, because any crisis situation leaves room for different policy responses. In addition, a government will not be quick to concede its mismanagement of its economy. It is worthwhile noting that even the G7's experience in macroeconomic policy coordination has not been entirely satisfactory. Given this, there may be truth to the alarmist view that the next crisis is the only real test of confidence.

Needless to say, it is fundamentally wrong to assume that the pooled liquidity together with an extensive surveillance and consultation mechanism is foolproof protection against future financial crises. Credible, sound macroeconomic management as well as effective financial market supervision are the only things that can avert economic crisis. This hearkens back to the determination each country must rouse to move toward necessary domestic reform. Any collective mechanism will be supplementary to an individual nation's efforts.

The merit of the exercise is in the dynamism of peer pressure that it fosters upon participating countries not to make easy, and ultimately damaging, policy choices. On that basis alone, the mechanism should be strengthened, but it must function first as a preventative against crisis, before it can function as a vehicle to deal with any crisis that might take place.

Should this surveillance and consultation mechanism have a permanent secretariat, as a kind of International Financial Institution (IFI), which is to some extent independent of participating governments? There is no reason to think otherwise if participating governments agree. But that is going several years down the road. There must be a sufficient degree of mutual confidence before individual nations relinquish even a part of their sovereign power over macroeconomic policy making. Undue haste should be avoided as it could wreck the whole exercise.

The Asian Currency Unit and a Currency Basket System

An enhanced sense of community has recently aroused increasing interest among the region's policy makers, especially in ASEAN countries, in a project that could eliminate foreign exchange risks altogether. Simply put, it is the creation of an Asian currency unit, which would eventually replace all regional currencies.

It is obvious that this interest has been bolstered by the success of the euro. The euro seems to have created a vast common economic zone in Europe, which could assert itself as a major player comparable to the United States in the global economy. The eagerness of east European nations for enlargement of the European Union suggests how the whole project has fostered a sense of economic community.

At the same time, however, the fact is that Europe has more solid foundations for economic integration than has Asia and that it has been nurturing such notions for quite a while. Differences of income level and diversity of economic structure in Europe are less great than in Asia. While a monetary union accelerates the process of integration and contributes to lessening the diversity in economic structure, dialectically, the process of economic transformation operates as a kind of feedback, in which an initial level of homogeneity rationalizes economic integration and, in turn, the integration reinforces homogeneity.

It is not certain that Asia has reached the stage in its economic integration where bold, top-down application of radical measures such as a monetary union can be justified. Even in Europe, significant stresses of transformation can yet be detected, as the United Kingdom stands apart from the monetary union and the German economy remains stagnant under the European Central Bank's tight monetary policy.

Asia has the potential to follow the same path as Europe, but unexpected developments could derail the entire enterprise. Moreover, on a theoretical level, few Japanese experts accept that Asia is an optimum currency area at this point in time. Nor does any country appear willing to yield sovereign control over monetary policy to an Asian central bank. Accordingly, most policy makers have proposed a transitional alternative that could nourish progress toward a stable currency region. This is the notion of a currency basket system.

There are a variety of conceivable currency basket systems. Each has been closely examined by the Kobe Research Project, a group of academicians commissioned by the finance ministers of the Asia-Europe Meeting (ASEM) in Kobe in January 2001; they reported back to the ASEM meeting in Copenhagen in July 2002. The analysis was that Asian nations should take steps to adopt an Asian currency basket system.

The merits of a currency basket system are persuasive. With the exception of Singapore, most Asian countries are pegged to the U.S. dollar. What this means is that each monetary authority intervenes in the foreign exchange market, trying to stabilize its currency value against the U.S. dollar; when stabilization appears impossible, the monetary authority alters the nation's monetary and fiscal policies in order to strike a new balance for its currency vis-à-vis the dollar. This makes individual economies subject to considerable external shock when the dollar rises or falls against Japanese yen, because the yen is also used extensively for trade and investment. Consequently, if an economy decided to peg its currency against a combination of the dollar, yen, and, possibly, the euro—that is to say, a currency basket—any external shock would be mitigated.

The report of the Kobe Research Project urges that ASEAN countries switch jointly to pegging to a common currency basket, due to the fact that coordination failure could occur if soothe pegging were done separately. For example, suppose that one country switched to basket pegging while other currencies remained pegged to the U.S. dollar. That currency would appreciate when the dollar depreciated against the yen, and the result could be a loss in international competitiveness for exports. Only by this country's returning to dollar pegging would this problem be resolved.

This common basket currency might be regarded as a prelude to an Asian currency unit if all the countries involved could agree upon the composition of currencies for the currency unit. For instance, the Institute of International Monetary Affairs, a think tank in Tokyo, has recommended that the composition of this currency unit be 60 percent dollar, 20 percent yen, and 20 percent euro. Whether fair or not, the greater problem is that, because countries have different patterns of international trade and investment, what might be an appropriate composition for an Asian currency unit differs from country to country.

On this account, experts anticipate that some countries will precede others in adopting a basket pegging of their choice and wait for others to follow. Progress in regional economic integration may lead to the conversion of various basket compositions into one accepted by all. Inevitably, this process of evolution will take years to complete and could be interrupted repeatedly by currency market turmoil. It is almost impossible to avoid coordination failures entirely.

It bears repeating that an occasional dollar-yen misalignment is not the sole cause of violent swings in the foreign exchange market. A big question is when China would liberalize, in wholesale fashion, capital account transactions with the rest of the world and switch from a fixed rate system to a variable rate system for the renminbi. American policy makers are likely to put this issue on the negotiation table at some point, as the U.S. trade deficit grows alarmingly large and China's foreign currency reserve continues to increase. All this means is that Asian countries could be forced to reconsider any composition of the currency basket once the renminbi begins to rise and fall against the dollar.

Perhaps more crucially, the success of basket pegging is still hinged to a country's ability to resist selling pressures during times of currency crisis. A country cannot so easily defend its currency against any basket of its choice when it cannot do so against the dollar. The fact is, a country needs to keep its economic house in order. Proper macroeconomic management and a healthy financial market environment are key for currency stabilization, regardless of a country's currency system. It would be a gross mistake to assume that a particular currency system could save a country from misery caused by mismanagement of its economy or financial markets. All this reinforces the potential benefits of strengthening the surveillance and consultation mechanism in the region.

It would seem, in any event, that dollar pegging is an unsatisfactory arrangement and should be replaced sooner or later by some sort of currency basket pegging. Governments might promote the shift in currency system by experimentation. An individual country might voluntarily make the switch, or another country might launch financial instruments denominated in a basket currency arrangement. As experiments go on, capital markets will be the guide.

The Asian Bond Market and Its Implications

The work of the Kobe Research Project also recommended development of an Asian bond market. This proposal, made in July 2002, was received very positively by political leaders in the region.

There has been seconding to this proposal. In December 2002, at an informal session of the ASEAN + 3 meeting in Chiang Mai, the Japanese government formally proposed an Asian bond market initiative, which was endorsed by several members. In June 2003, the Executives' Meeting of East Asia-Pacific Central Banks stated publicly that it would be establishing an Asian Bond Fund worth US$1 billion, which was expected to hold a portfolio of Asian bonds when they became available. Then, in July 2003, the ASEM finance ministers meeting ended with a joint communiqué that underscored the importance of an Asian bond market.

The allure of the Asian bond market initiative seems to be based on two potential benefits. First, it is expected to correct the imbalance between capital inflows and outflows in the region. The Asian financial crisis, as widely known, demonstrated the vulnerability of the region's economies, which were heavily dependent on foreign capital investment in stocks and bank loans. Less known is the fact that many countries in the region have also been exporting capital in amounts that are not insignificant. The level of savings in the region is generally high; hence, the net gap between savings and investment may not be as huge as imagined. Thus, the excessive dependence upon foreign capital and the accompanying currency mismatch would be reduced considerably if business could raise funds domestically, or regionally, in local currencies, by tapping the region's savings pool.

To date, however, domestic investors have opted not to finance domestic investment, choosing instead to acquire dollar-denominated securities issued in capital markets in New York and London. In this environment, then, the Asian bond market appears as an ideal venue to channel savings into investment more effectively within the region and with far less foreign exchange risk.

The second attraction of an Asian bond market is the hope that it will address the problem of high gearing. Another vulnerability that the Asian financial crisis exposed was the excessive reliance on short-term borrowing to finance long-term projects, which was another mismatch. The development of a bond market occurs here, too, as a natural remedy, providing capital projects with a source of long-term financing.

While the desirability of an Asian bond market is undeniable, there are several practical obstacles to overcome. For one, domestic bond markets remain underdeveloped in the region, even in comparison to other developing regions. A well-functioning bond market must fulfill a number of requirements, the most important of which is the assurance of liquidity, backed up by the efficiency and depth of the market. To put it differently, investors want to buy and sell bonds of their choice at any time in any quantity at the quoted price without hindrance. But before this can occur, the standing of bond issuers must be transparent. A lack of confidence in publicly available credit ratings makes investors hesitant.

The Kobe Research Project and analyses from other experts have made laundry lists of what must be done in order to promote development of an Asian bond market. The list normally includes the development of benchmark issues, reliable rating agencies, an efficient settlement system, establishment of a sound accounting system and its proper supervision mechanism, among others. There is no doubt that all should be encouraged collectively, because it takes the most advantage of peer pressure in the process.

However, there is another aspect, the crucial importance of which cannot be overstated. Close inspection of the laundry list reveals the items to be almost identical to what must be done to develop healthy, robust domestic bond and other capital markets. The inescapable conclusion is that an Asian bond market cannot substitute for effective domestic capital markets. And it is highly unlikely that an Asian bond market would come to full bloom without corresponding development of domestic capital markets.

This is not entirely surprising if one realizes that corporate governance is an indispensable ingredient of both domestic and international bond markets. Investors must have confidence in the publicly available assessments of corporate management and records that agencies and investment advisers make based upon accounting statements, prospectuses, and other documents.

Furthermore, the domestic bond market plays an essential role in imposing discipline on macroeconomic management as well as supervising the credit structure of a nation's financial activities. Long-term interest rates determined by the market yield of sovereign bonds enable active arbitrage transactions—for instance, among cash, bonds, and stocks—in the financial market; they serve as an indication of the market's verdict for or against the nation's monetary and fiscal policy. In addition, risk spreads between good and poor quality bonds are the best market signal of systemic risk, which the nation's financial market might incur as a whole.

In any event, a kind of chicken-and-egg cycle is at work here too. While a healthy domestic bond market is generally prerequisite for a robust regional bond market, successful experiments in the latter can stimulate the former considerably. Some experimentation is therefore recommended.

There are reasonable possibilities here when bond issuers in New York and London markets are persuaded to launch issues in the regional market, probably first in dollars and then in local currencies. Sovereign and IFI bonds are such examples, and it is possible that political initiatives can make them happen. It is hoped that these bonds would be followed by those of multinationals in the region.

Finally, it is important to note that the bond market is not a magic wand that can be waved to solve all the problems of the financial market. In any country, it is not easy for the countless small businesses to tap the stock and bond markets. For the foreseeable future, bank lending is likely to remain the principal source of finance for these small businesses. For this reason, the task of fixing the problem of bad loans in the banking sector and letting the system work well for indigenous firms will not diminish in importance.

Internationalization of the Yen

One potential advantage of an Asian bond market is the possibility that it might provide Japanese savers, including institutional and individual investors, with an entirely fresh investment opportunity. Japan is the world's largest capital exporter, and under current circumstances, it is highly likely that domestic savings will continue to exceed domestic investment opportunities and Japanese savers will be forced to seek investment opportunities abroad. Japanese institutional investors have long been holders, to a colossal degree, of U.S. Treasury bonds despite the inherent currency risk. The extremely low interest rates that prevail in the domestic financial market have only spurred investors, including individuals, to seek high-yielding bonds and bond funds abroad.

While it may be reasonable that the surplus savings of low-growth nations would be channeled into investment in high-growth nations, the pattern seems to be that the currency of the former depreciates over the years against the currency of the latter. That being the case, the risk associated with Japanese investment in Asian bonds could be much less than now perceived. All this suggests that Japan has much to benefit from the political initiative to establish an Asian bond market.

But there are reservations. The history of international asset allocation in the fund management industry indicates that the differential between the returns on the long-term investment in domestic bonds and in foreign bonds tends to be significantly less than the differential between the returns on domestic stock investment and on foreign stock investment. This may be the case because foreign exchange losses tend to offset the high yields in foreign bonds, as arbitrage transactions work to minimize currency hedging. It needs some caution, therefore, as for the overall merits of the regional bond market.

Japanese savers have historically been shy about taking risks in foreign exchange, and may well be drawn to Asian bonds denominated in Asian currencies, or even an Asian currency unit, as an alternative to dollar-yen risk. However, before this happens, it seems that issuance of Asian bonds denominated in Japanese yen should flourish first.

But why haven't foreign yen bonds, including Asian and non-Asian yen bonds, been issued on a large scale? The answer seems to be that the yen is not considered fully qualified as a reserve currency, especially in comparison to the dollar and euro. Of course, the prolonged economic stagnation, abnormally poor yields in the bond and stock markets, and fear of further market turmoil have not helped the yen's reputation among foreign investors. But there seems to be a more basic reason, which is that the internationalization of the yen is grossly inadequate.

The Japanese government did alter its restrictive posture on usage of the yen by non-Japanese, and it has taken encouraging steps such as reducing the withholding tax on bond income, diversifying the treasury bond issues in shorter maturity, and activating the bankers' acceptance market. Yet, as it is often pointed out, the yen remains an inconvenient and expensive transaction currency without satisfactory infrastructure, and it does not fully support direct exchange with other Asian currencies.

Without the yen being made into a more efficient transaction currency, the Asian bond market—especially with yen-denominated issues—and the currency basket pegging system are not likely to grow appreciably. The internationalization of the yen needs to be pursued vigorously, and it can be done only by the initiative of the Japanese government. If the Japanese government follows this course, it will be the single most crucial contribution to the entire exercise of building a common Asian financial market zone.

The Japanese government could demonstrate its political commitment by setting specific goals toward the internationalization of the yen, taking such measures as further modification on taxation, deregulation on derivatives transactions, and improvement of the infrastructure for settlement of securities transactions.

Conclusion

The Asian financial crisis exposed the fragile foundation of the growth in the region's economies as well as the powerlessness of individual countries in the face of external shocks in the globalizing financial market. At the same time, the success of the monetary union in Europe brought new awareness to the region of the merits of the collective exercise of building a community—in this case, a common financial market zone.

A monetary union, however, is a long-term project, requiring strong political will and decades of tireless effort. The wide diversity and divergence among Asian economies do not justify, at least at this point in time, the bold proposal of the creation of an Asian currency unit or an Asian bond market where regional institutions can readily raise funds in an Asian currency unit or local currencies.

Even so, there are virtues to this collective exercise, particularly between Japan and ASEAN, in building robust regional financial markets and common modus operandi. The peer pressure that is built into such arrangements could spur individual countries to develop necessary infrastructure that supports a healthy domestic financial market and prudent macroeconomic management. Moreover, there are areas in which experimentation with joint overtures could be feasible. Examples include some sort of currency basket pegging, a common pool of international liquidity as well as savings, and a regional bond market for IFIs and sovereign issuers. Success in this endeavor would reinforce the determination to launch further efforts. More basically, it would encourage participating nations to strengthen their domestic markets, because development of an Asian financial market zone must go hand in hand with development of domestic markets.

On Japan's part, if it is to carve out a desirable future for its own economy in the globalized marketplace, a deepening of an economic distribution of labor must be sought with ASEAN and Asia in general. Japan has critical resources to make community-building efforts move forward, and the region may now, after many years, be prepared to welcome a leadership role of Japan. It behooves Japan to demonstrate its political will and to embark upon community-building efforts in close consultation with ASEAN. Japan should at the same time strive for further internationalization of the yen, which is a prerequisite for collective efforts at creating an Asian financial market zone. Not doing so would make it difficult for Japanese savings to be channeled into Asian investment opportunities.

Lastly, the collective exercise between ASEAN and Japan may bring forth two rather unexpected benefits of the process. Currently at the multinational level, international institutions such as the IMF, the Bank for International Settlements, and the Organisation for Economic Co-operation and Development are establishing rules, principles, and best-practice standards for securing sound global financial activities. As the region goes about its collective exercise, these rules and standards will have to be taken in stride, and this could turn out to be a positive, constructive way of addressing Western domination in business. An effective, credible set of regional rules may well dissipate the anxiety of losing a regional identity.

The second benefit is associated with China, which may benefit immensely from the collective exercise between ASEAN and Japan. China is a rising economic power, but its economic system remains underdeveloped and closed on the whole. The renminbi is under a fixed rate system, and cross-border capital transactions are tightly controlled. The problem of bad loans in its banking sector is reportedly huge. Clearly, the tools of macroeconomic management are not yet fully in place. In other words, China is faced with the challenge of making its economic system compatible and fully integrated with the economic systems of the rest of the world.

Any achievement between ASEAN and Japan in their collective exercise will be an indispensable reference point for China. Needless to say, regional concerns make it desirable, even necessary, that the collective exercise between ASEAN and Japan proceed with close interface with China.