

Asian Regional Integration Initiatives: A Critical Review¹

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Abstract

Efforts at Asian regional integration have proceeded at three fronts – trade, monetary and financial integration. This paper will concentrate on monetary and financial integration.

There are two broad objectives of monetary and financial integration. The first objective is defensive and the second developmental, both arising from the Asian Financial Crisis. The aim of the Chiang Mai Initiative was defensive – to provide a regional fund to Asian countries experiencing international liquidity problems and to discourage speculative currency attacks.

The developmental objective was to address three issues: diversification of a financial system that is over reliant on bank lending; resolving the problem of currency and maturity mismatch that contributed to the Asian Financial Crisis; and mobilization and recycling of Asian surpluses for regional development. The standard solution proposed has been the development of capital markets, particularly the deepening of local currency bond markets.

While the advantages of local currency bond markets are well known, this paper will examine the risks of capital markets, namely the financial and economic volatility and instability they generate particularly for small economies. It then proposes that attention should also be given to the development of regional long-term credit/developmental banks that can reduce financial and economic volatility associated with capital markets while at the same time address the double mismatch problem.

Introduction

We could be in the cusp of another financial crisis. This time the epicenter is Europe, with banks, particularly European banks, over-exposed to both sovereign and private loans given to peripheral and semi-peripheral countries of the European Union. The failure of any meaningful reform of the international financial architecture and the present European crisis make it more urgent for Asia to learn lessons from the European experience and take critical stock of the Asian initiatives at monetary and finance cooperation and integration.

This paper has five sections. The first section provides a brief history of Asian initiatives at regional cooperation and integration. The second section examines the objectives of and efforts at monetary cooperation and integration. The third deals with similar issues at financial integration, taking a critical look at the push for development of Asian bond markets. The fourth section discusses the alternatives between capital markets and long-term development banking methods of financing. The final section offers the conclusions.

¹ This is an abridged version of papers commissioned by and submitted to UNCTAD, South Centre and ESCAP on Asian integration.

Brief History of Asian Initiatives at Integration

ASEAN (Association of Southeast Asian Nations) was established in 1967 as a political alliance during the Cold War period, but it was only in 1992 that leaders started to work on economic integration and the creation of AFTA (ASEAN Free Trade Area) to reduce tariffs on intra-ASEAN trade to between 0 and 5% within 15 years. While trade integration proceeded well, nothing much was done on monetary and financial integration.²

The Asian Financial Crisis of 1997 (AFC) was the catalyst that ignited the call for greater Asian economic cooperation and integration. There are two broad objectives of monetary and financial integration. The first is defensive and the second developmental.

Most ASEAN economies experienced severe currency depreciation, massive loan defaults, banking crisis, and international liquidity shortage. Some were on the verge of collapse. The first proposal for regional financial cooperation came from Japan at the G-7/IMG meeting in September of 1997 where Japan proposed an Asian Monetary Fund to rescue ailing economies and offered US\$30 million contribution. The idea was strongly opposed by the U.S. and IMF who was providing rescue packages to Thailand and Indonesia. However, dissatisfaction over IMF's management of the crisis prompted Asian leaders to look for their own regional solutions. Hence, the first ASEAN+3 meeting was held in December 1997 to explore further regional economic and financial cooperation.

Thereafter many meetings, forums, groups and agencies were held and established to deal with the issues of greater regional cooperation and integration. For example, the ASEAN Surveillance Process (ASP) was created in February of 1998 during the 2nd ASEAN Finance Ministers' Meeting to carry out peer review and exchange of information. Although the Executives' Meeting of East Asia Pacific Central Banks (EMEAP) was set up in 1991, its first central banks' governors' meeting was only held in 1996 to study financial markets development and the primary functions of central banks (EMEAP Website). Its first important policy was the establishment of the Asian Bond Market Initiative. The ASEAN+3 Economic Review and Policy Dialogue (ERPD) was formed in 2001. The first meeting of the ERPD involved: assessing global, regional and national economic conditions; monitoring regional capital flows; analyzing macro-economic and financial risks; strengthening banking and financial systems; and providing an Asian voice in international financial forums (Yap, 2007: 13). In 2008, the Asian Financial Stability Dialogue (AFSD) was proposed by the President of the ADB as an early warning and surveillance system for the region's financial markets (Plummer, 2010:17). In 2010, the ASEAN+3 Macroeconomic Research Organization (AMRO) was officially set up with a secretariat in Singapore; its roles are to conduct and analyze basic economic and financial conditions of member countries, focusing on risks and vulnerability and to be the secretariat for the Chiang Mai Initiative Arrangement.

² One exception was in 1977, the 5 original ASEAN countries established an ASEAN Swap Arrangement (ASA) of US\$100 million to provide international liquidity support to member countries experiencing balance of payment difficulties. It was raised to US\$200 million in 1978.

Section II -Monetary Cooperation and Integration

Chiang Mai Initiative – International Liquidity Management

In 1999, the ASEAN+3 Finance Ministers met to pursue regional financial cooperation in three areas: regional economic surveillance; regional reserve pooling; and regional bond market development. The most important effort at regional monetary cooperation came in 2000 with the strengthening of the regional reserve pooling mechanism. Although the ASEAN Swap Arrangement existed, it was never used. On the sideline of the ADB Annual General Meeting in Chiang Mai in 2000, the finance ministers agreed to expand the ASA facility to all the remaining 5 new members of ASEAN and also introduced a new Bilateral Swap Arrangement (BSA). This was known as the Chiang Mai Initiative (CMI). In November of the same year, the facility was increased from US\$200 million to US\$1 billion and raised again to US\$2 billion in May 2005.

This bilateral swap arrangement provided countries with balance of payment difficulties in the form of swap of US dollars with domestic currencies of the borrowing countries in the form of repurchase agreement. Despite dissatisfaction with IMF, the swap facilities are linked to IMF conditionalities except for the first 10% of the draw down that can be used without any linkage to an IMF program for 180 days.

In March 2010, the CMI was taken a step further when the bilateral swap arrangements were converted into a multi-lateralized self-managed reserve pool governed by a single contractual agreement, known as the Chiang Mai Multi-lateralization (CMIM) Agreement. The size of the fund took a quantum leap from US\$2 billion to US\$120 billion.

The CMIM is easily the most important part of Asia's efforts at monetary cooperation. It arose out of the failure of international financial institutions to produce a mechanism to assist Asian countries that face international liquidity problems. Thus the CMIM primarily served a defensive objective.

The CMIM arrangement suffers from several weaknesses. First, even though it is a multi-lateralized swap arrangement, what has been multi-lateralized is only the process and not the facility. In other words, because it is a self-managed pool of reserves, each lending country reserves the right not to contribute to the specific request of the requesting countries. Second, despite the increase in the fund size, the amounts that countries can borrow are still too small. Third, the usage of part of the facility is still tied to IMF conditionalities, though it has been reduced to 80% from 90%. Thus despite the existence of CMIM, it has not been used by any member country even during the latest global financial crisis. Two member countries, Korea and Indonesia, faced temporary international financial difficulties in 2009 but did not or could not access the CMIM facilities. Instead, Korea received a US\$30 billion bilateral swap facility from the U.S. and Indonesia received support directly from Japan.

Beyond the CMIM, there have not been any substantial efforts at monetary cooperation, let alone integration. Several ideas have been advanced by economists (Ogawa and Shimuzu, 2011; Kawai 2005), on some form of foreign exchange coordination including the introduction of an Asian currency or monetary unit made up of a weighted average

of currencies of the ASEAN+3 region. The uses of an Asian currency unit are: providing a benchmark for monitoring the strength or weaknesses of individual currencies; providing a signaling device on the impact of capital inflows; and determining the central parity for a managed float system.

The difficulties in coming up with regional exchange rate cooperation are: (1) the exchange rate regimes of Asian economies are heterogeneous – ranging from peg currency (Hong Kong), to free float (Korea, Japan, Indonesia), to managed float (Malaysia, Singapore); (2) it is hard to tame exchange rates if capital accounts are relatively open; (3) an effective surveillance and monitoring system and international liquidity fund are necessary.

One of the major challenges facing Asian countries is volatile capital flows and the attendant exchange rate volatility and financial instability. The huge capital inflows, particularly portfolio and other investment flows of a short-term nature, prior to the Asian Financial Crisis, followed by a sudden and massive outflow during the crisis, devastated many Asian economies. Some countries have individually coped with these volatile movements by enacting different measures of capital controls, with varying degree of success. Malaysia, in the midst of the AFC, pegged the Ringgit, imposed a temporary moratorium on repatriation of short-term profits, abolished the offshore Ringgit markets, and controlled Ringgit borrowing by non-residents in 1998 and thereafter gradually relaxed these measures. These capital control measures, together with other counter-cyclical fiscal and monetary policies and banking reforms, were effective in stabilizing the economy. Although at that time, the IMF roundly criticized these measures, even the IMF has now recognized them as acceptable policy instruments in times of crisis. Thailand in December 2006 introduced unremunerated reserve requirements for 30% of inflow of foreign funds to discourage the surge in capital inflows but soon had to reverse it when the Thai stock market plunged.³

Without an effective regional cooperation on capital controls, exchange rate coordination, and the provision of international liquidity without stringent pro-cyclical conditionalities, individual Asian countries have little recourse but to build up large international reserves, over and beyond their normal needs. The total international reserves of major East Asian countries amounted to US\$ 5.5 trillion as of 2010 (ADB Key Indicators, Table 4.15, 2011). The accumulation of these vast reserves comes at a great cost, as the returns on reserves invested abroad are lower than the costs of domestic sterilization of these reserves and/or the interest and dividend paid on the borrowed reserves. Akuyz (2010) estimates the costs to be US\$50 billion per year.

In summary efforts at monetary cooperation in Asia is still at a primitive stage. Ideas regarding a regional currency in the form of Asian Currency or Monetary Unit, spearheaded by ADB, remain at a conceptual level. But the direction of moving from a dollar peg to a basket peg in exchange rate coordination is a proper one. The Chiang Mai Initiative and the setting up of AMRO are the most advanced and important parts of monetary cooperation. However, even in this area, it has not been very effective and

³ A financial economist commented that what Thailand did was probably what other countries might have contemplated but in their own cost-benefit analysis did not have the guts to do (Fuller and Arnold, 2006).

AMRO is only at an incipient stage. There appears to be a tug of war between China and Japan over leadership of regional monetary cooperation initiatives particularly with the renminbi as a rising regional currency. The appointment of a Chinese as the first managing director of AMRO for the first year, to be succeeded by a Japanese for the following two years is an indication of this competition. The drawback is the initiatives might be dominated by the two superpowers unless ASEAN countries have a stronger voice. Another challenge is member countries have different views on important issues like exchange rate regimes and management of capital flows.

Section III - Financial Integration: Developmental Objectives

If the objective of the Chiang Mai Initiative is defensive, the objectives of financial integration are more developmental. They are: (a) to diversify the financial markets from dependence on the banking sector; (b) minimize or avoid the problems of currency and maturity mismatch arising from short-term loans in the banking sector; (c) mobilize and utilize the huge amount of savings that Asian countries have accumulated in the form of foreign reserves.

Among the causes of the AFC were the problems of currency and maturity mismatch arising from short-term loans denominated in foreign currencies. Compared to the banking sector, bond markets were under-developed. Ten years after the AFC, Asian countries have accumulated huge international reserves that were invested outside the region. It was argued that the development of capital markets (particularly the bond markets) would enable these surplus funds to be recycled within the region.

The ASEAN+3 Finance Ministers meeting in 2003 endorsed the Asian Bond Markets Initiative (ABMI). The ADB has taken the primary role in providing technical studies and in supporting the establishment of regional credit guarantee mechanism, regional clearing and settlement system, introducing new securitized debt instruments, and improving local and possibly regional credit rating systems (Yap, 2007:15). An Asian Bonds Online website was launched in May 2004.

The Executives' Meeting of East Asian and Pacific Central Banks (EMEAP) is also actively promoting regional bond markets. It launched the first Asian Bond Fund (ABF I) in June 2003. EMEAP countries bought 1 billion of US dollar bonds issued by sovereign and quasi-sovereign institutions in 8 EMEAP countries. This led to the second ABF; this time local currency bonds equivalent to US\$ 2 billion again issued by similar institutions (Yap, 2007:15-16; Jang, 2011"14-15).

In May 2008, the 11th ASEAN+3 Finance Ministers agreed on a new ABMI roadmap. Four key areas were addressed: (i) promoting the issuance of local currency-denominated bonds (supply side); (ii) facilitating the demand for such bonds (demand side); (iii) improving the regulatory framework; and (iv) improving infrastructure for bond markets (ADB Bond Website). A steering group and four task forces were established to implement these objectives. In June 2010, the ASEAN+3 Bond Market Forum (ABMF) met in Tokyo to discuss how best to harmonize regulations and market practices in Asian local currency bond transactions. A regional bond market would entail the

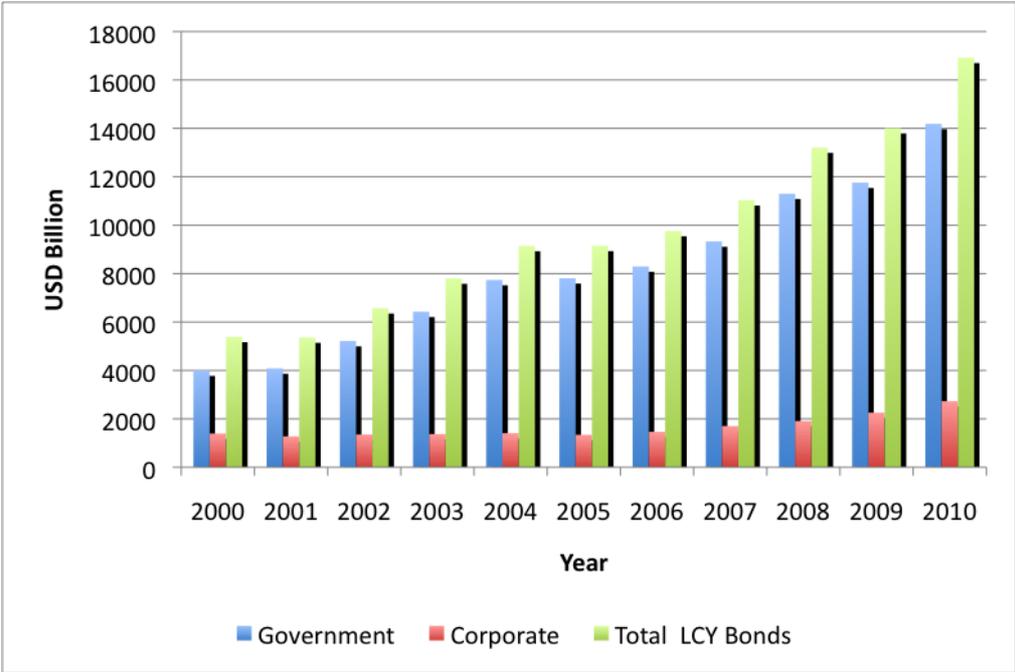
development of institutional infrastructures such as harmonization of tax rules, setting common standards for bond issuance, development of cross-border clearing, settlement, payment and depository systems, and regional credit rating agencies. A developed bond markets also requires free convertibility and free capital flows.

In November 2010, the Credit Guarantee and Investment Facility (CGIF) was set up as a trust fund of the ADB. CGIF will provide guarantee for local currency denominated bonds issued by investment grade companies in the ASEAN+3 countries. These companies are rated by either domestic rating agencies of each country, like RAM in Malaysia, or international rating agencies likely Standard and Poors. There is as of now no regional rating agency for Asia. CGIF has received capital contributions of US\$ 700 million from ADB (\$130 million), China and Japan (\$200 million each), South Korea (\$100 million) and ASEAN (\$70 million). By providing guarantee, CGIF will assist companies to tap the local bond markets for longer term funding. Initially the business will not be leveraged, i.e., the guarantee will be supported solely by its own capital.

Performance of Asian Local Currency Bond Markets

The East Asian local currency (LCY) bond markets have grown substantially over the past decade. Figure 1 shows the market for 8 East Asian countries tripled from US\$5.4 trillion to US\$16.0 trillion (2000-2010). However, 84% of these are government bonds, only 16% are corporate bonds

Figure 1: East Asian Local Currency Bonds, 2000-2010



Source: ADB, AsianBondsOnline Website

Table 1 shows the distribution of LCY bond markets in 2010 by country and by type. Japan has the largest bond market (69% of total in East Asia), followed by China (18%), South Korea (7%), the rest are each at about 1% of the total.

But in terms of percentage of GDP in their own country, the bond markets are not insignificant. In Japan and Korea the bond markets are 198% and 110% of their GDP, Malaysia (99%), Singapore (76%) etc.

It is the government bond markets that dominate in all these countries. In Japan, government bond markets are 180% of GDP while corporate bond markets are only 19% of GDP. China, Korea, Malaysia, Singapore all have substantial government bond markets, a large part due to the need to sterilize their foreign reserves. In addition, Malaysia and Singapore have compulsory savings schemes that are invested in government bonds. Thailand government bonds are a legacy from its bank-restructuring program following the AFC and its populist fiscal policies.

Korea has the highest percentage of corporate bond markets at 63% of GDP, followed by Malaysia 49%, Hong Kong 34%, and Singapore 32%. Korea has a well-developed corporate bond market due to the presence of chaebols, Malaysia's corporate bond markets are given a lift by Islamic bond financing, while Singapore and Hong Kong are regional financial centers.

Table 1: East Asian Local Currency Bond Markets, 2010.

2010	Government	Corporate	Total	Government	Corporate	Total	
	% GDP	% GDP	% GDP	US\$ billion	US\$ billion	US\$ billion	%
China	40	11	51	2408	644	3052	18.0%
Hong Kong	39	34	73	87	77	164	1.0%
Indonesia	13	2	15	94	13	107	0.6%
Japan	180	19	198	10609	1113	11723	69.3%
Korea	47	63	110	492	657	1149	6.8%
Malaysia	58	40	99	145	101	247	1.5%
Philippines	31	4	35	64	8	73	0.4%
Singapore	44	32	76	103	76	179	1.1%
Thailand	54	12	67	183	42	225	1.3%
TOTAL				14186	2731	16917	100.0%

Source: ADB, AsianBondsOnline Website

A Critical Assessment of Bond Markets Development

Mainstream and conventional literature on financial development in Asia takes the view that Asian financial markets are too dependent on banks and the development of capital markets as the best solution for growth and recycling of the vast Asian savings. They extol the virtues of bond markets (direct financing) that include the efficient allocation of capital, effective evaluation and monitoring of investment activities, maximization of economic welfare, decreased volatility of capital flows, and reduced vulnerability to financial crises (Hakkanson,1999; Herring and Chatusriptak,2000; MAS,2007; Park and Park,2003; Bhattacharyay, 2011).

This paper raises two critical issues associated with development of capital markets (i.e. bond and stock markets) that are normally glossed over; they are: liquidity-stability trade off and efficient allocators of resources.

Liquidity-Stability Trade-Off

The sine qua non of capital markets is liquidity – the ability to buy and sell at an instant, the ability to dip in and out of markets. An ADB article on bond markets emphasized this aspect, “Common trading standards would make it faster and cheaper for investors from across the region to **dip in an out of their neighboring markets**” (ADB, 2010. Emphasis added).

But as Keynes pointed out, the concept of liquidity applies only to individual investors and not to the investment community as a whole. He wrote:

“Of the maxims of orthodox finance none, (sic) surely, is more anti-social than the fetish of liquidity, the doctrine that it is a positive virtue on the part of investment institutions to concentrate their resources upon the holding of “liquid” securities. It forgets that there is no such thing as liquidity of investment for the community as a whole. The social object of skilled investment should be to defeat the dark forces of time and ignorance, which envelop our future. The actual, private object of the most skilled investment to-day is to “beat the gun”... to outwit the crowd, and to pass the bad, or depreciating, half-crown to the other fellow.” (Keynes, 1936:155).

This is amply demonstrated in the recent Great Financial Crisis, where not only toxic subprime assets became illiquid when every investor rushing to exit the door got stuck, but even money market funds that are supposedly as liquid as cash became illiquid (Lim and Lim, 2010:Chapter 2).

In the case of investments from foreign sources, there is the divergence between benefits of liquidity to individual investors and the macro-economic costs to recipient economies in terms of vulnerability to volatile short-term capital flows.

This is particularly true in times of widespread financial crisis, as was the case with the collapse of Lehman Brothers in the Great Financial Crisis of 2007-09. Despite strong macro-economic fundamentals and healthy corporate balance sheet in Asian economies, foreign capital (stock and bond markets) withdrew massive amount of funds to meet redemption and liquidity problems in their home countries, causing declines in the equity and bond markets of host countries that were greater than the drop in their countries of origin. Many Asian countries could not sustain such massive capital flight without serious negative effects on their real economy. This one of the dark sides of capital markets that Keynes talked about and is absent in the literature on bond market development in Asia. To quote him, “...with the development of organized investment markets, a new factor of great importance has entered in, which sometimes facilitates investment but **sometimes add greatly to the instability of the system.**” (Keynes, 1936:150-151. Emphasis added.)

Capital Markets As Efficient Allocators of Resources

The report by Monetary Authority of Singapore (2007) claims that “Financial integration – including the development of a regional bond market – promotes a more efficient allocation of resources, contributes to the efficient price discovery process for financial products, improves access to financial services, and lowers the cost for such services.”

(MAS, 2007:46). The experience of the Great Financial Crisis should call into question such strong statements.

Spiegel (2009) is one of the few authors who raised doubts about conventional wisdom on capital markets. He questions the validity of Greenspan's idea of bond markets as safe spare tire in a financial system; whether dependence on banks for intermediation is such a bad idea; and to what extent recent growth in bond markets is due to increase in risk appetite etc.

Do capital markets allocate resources efficiently? What is the meaning of market efficiency?

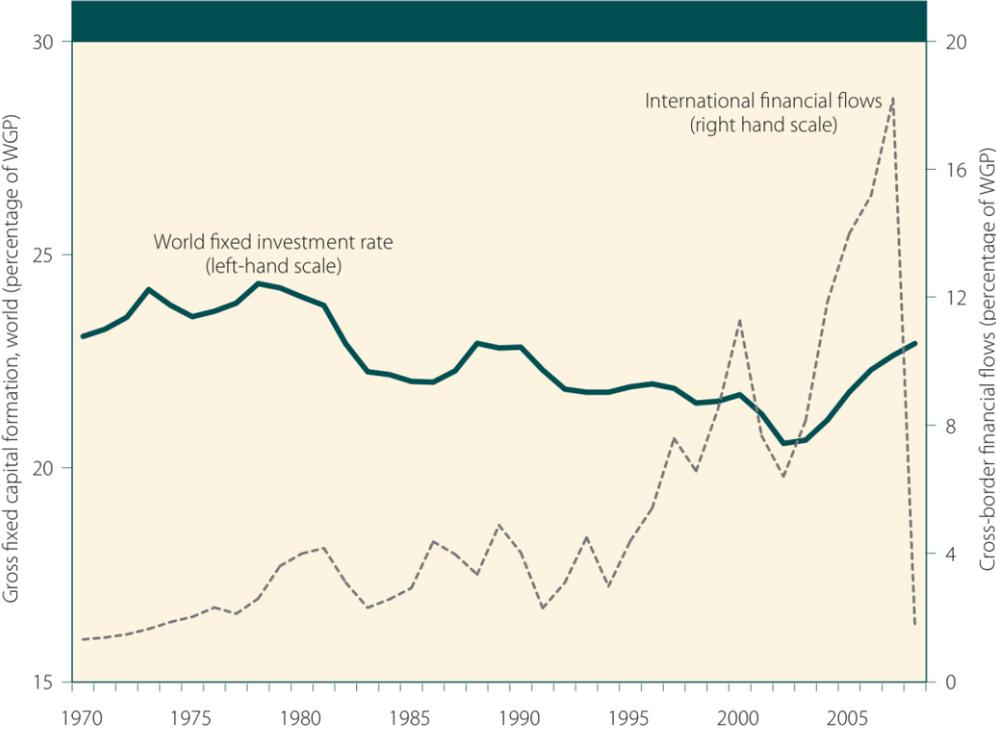
Tobin (1984) examined critically this concept. He enumerated four meanings of market efficiency – information-arbitrage efficiency, fundamental-valuation efficiency, full insurance efficiency in the Arrow-Dubreu sense, and functional efficiency, sometimes known as social efficiency as defined in the UNCTAD Trade and Development Reports of 2008 and 2009. On all these counts, Tobin concluded that market is efficient only in the first sense, i.e., on average it is not possible to gain from trading on the basis of generally available public information. It fails in the second and third sense, and most miserably in the fourth sense. He laments that the U.S. is throwing their best resources into financial services remote from production of goods and services and generate rewards disproportionate to their social productivity (Ibid:20).

UNCTAD (2009:12) restates the issue more categorically. It says financial markets do a decent job at evaluating all information, and in processing transactions (transactional efficiency); but if they do not contribute to long-run economic growth, they do not provide any social return, and from a regulator's perspective the most relevant criterion to judge efficiency is in terms of social or functional efficiency, i.e. its contribution to stable and long-run economic growth.⁴

The Asian Financial Crisis and the recent Global Financial Crisis call into question the claims of market efficiency particularly in terms of contribution to financial stability and long-term investment and growth. The fundamental thesis of Minsky (1986) is that the U.S. financial system has become intrinsically more unstable and fragile, moving away from hedge financing to speculative and Ponzi financing. Figure 2, shows that despite rapid financial growth, world fixed investments stayed relatively constant.

⁴ Studart (1995-6:284-5) makes a similar argument that the macro-aspect of market efficiency should evaluate how well a financial system expands the use of resources of an economy at minimum costs with minimum possible increase in financial fragility.

Figure 2: International Financial Flows and World Fixed Investments, 1970-2009
 Rapid financial growth but stagnant fixed investment, 1970-2009



Source: United Nations, 2010

Section IV - Alternatives in Financing Structure

Broadly speaking there are two types of financial structure – direct and indirect financing. The former refers to capital markets and the latter to bank financing. In capital markets, borrowers access the investors directly either through equity or the bond markets. Here the ability to buy and sell the instruments (liquidity) is paramount and hence price and market volatility. This method of financing is transaction oriented and there is no customer relationship. It is represented by the Anglo-American model of financial development where capital markets predominate over bank lending.

In indirect financing, banks and other financial institutions, stand as intermediaries between savers and borrowers and they engage in maturity transformation taking liquidity risks that can end up as solvency risk. Here the creation of a durable relationship between borrower and lender is important. The German, Japanese and Korean financial systems in the early stages reflect this financing model.

Many economists argued that currency and maturity mismatch in bank lending contributed to the AFC. Consequently, they proposed the development of local currency bond markets to solve this problem. There was little or no debate on what type or mix of financial structure can best promote stable, long-term economic growth. The experience of Japan and Korea where a subset of banks, known as development banks or long-term credit banks, played a vital role in the industrial development of these economies does not seem to be explored or discussed.

While bond markets represent a financing method that can mobilize large amount of funds directly from the financial markets, they are prone to price volatility and can generate foreign exchange and macro-economic instability particularly if a significant percentage of investments are foreign owned and the host economies are small. Funding through long-term credit banks on the other hand can also achieve the objective of solving the problem of double mismatch with less risks of macro-economic instability.

We shall briefly look at the Japanese experience in long-term credit banks, the Canadian banking system, and other examples of national and regional development banks such as the Brazilian National Development Bank (BNDES), European Investment Bank, and the Bank of North Dakota to see what relevance they hold for Asia's financing structure.

Japanese Experience in Long-Term Lending

Briefly, Japanese banks, particularly the long-term credit banks, played a vital role in the rapid industrial development of Japan between 1950s and 1970s. The corporate sector, the largest deficit unit, depended on private banks, and public financial institutions, like postal savings, rather than capital markets for funding its capital investments. The Japanese banking system is segmented with different types of banks catering to different market segments. The major classes of banks are city banks, long-term credit banks, trust banks, regional or local banks, foreign banks and specialized financial institutions providing services to agriculture and small businesses. The long-term credit banks specialized in providing long term loans to businesses in government targeted industries as well as important manufacturing industries. They enjoyed the privilege to issue long-term debentures. To mitigate long-term credit risks, they built up in-depth credit analysis capacity, project evaluation, took collateral, monitored the performance of the borrowers and maintained special relationship by sending staff to work in the clients' companies for certain period. Through these practices they were able to reduce the problem of informational asymmetry and focused their energies on long-term prospects of their clients (Packer, 1994; Sunamura, 1994). The system was designed to achieve stable, long-term relationship rather than short-term transactional relationship aimed at maximizing profit (Cargill and Royama, 1988: 43-48).

The overall conclusion of the study of the Japanese main bank system edited by Aoki and Patrick (1994) is that despite an undeveloped capital market structure, this system, in conjunction with the government's industrial policy, played a pivotal and effective role in the rapid growth of the Japanese economy after the Second World War. Patrick (1994) wrote, "In the economic and financial environment of the high growth era the main bank system matured and flourished. It represented a successful solution to a key developmental problem: how to finance large industrial enterprises efficiently and effectively" (388). However, with financial liberalization, Japanese long-term credit banks ran into trouble; all were restructured or taken over by new entities, and they no longer exist. Patrick concluded that despite this, "The problems and difficulties the Japanese financial system and its banks faced in the 1990s, ... do not undermine the fundamental lessons of the Japanese case" (Ibid:406).

Brazilian Development Bank (BNDES)

The Brazilian Development Bank is a state-owned bank started in 1952 to provide long term financing for the country's economic development. Initially it focused on infrastructure but soon also financed agriculture and dairy, education, health, sanitation, and mass transport. In the 1990s it supported the state's effort in regional decentralization into the less developed regions of the countries and also branched into financing SMEs and micro-enterprises.

The BNDES has grown to become the largest national development bank in the world with total assets of R\$549 billion as of December 2010, shareholders equity of R\$ 66 billion and CAR of 20.5% in September 2011. In 2010 it disbursed R\$ 168 billion of loans, more than the World Bank. In the first nine months of 2011, R\$ 92 billion of loans were disbursed with 41% and 40% going to infrastructure projects and micro and small medium sized enterprises respectively. During the period of global financial crisis (2007 to 2010), the bank's lending rose steadily from R\$ 65 billion to R\$168 billion and its profits from R\$ 7.3 billion to R\$ 9.9 billion; its default rate is 0.12% of total portfolio.

European Investment Bank (EIB)

It started as a multi-lateral development bank in 1958 with the Treaty of Rome signed by 6 European countries to work towards the integration of the European community. Its main function was to provide long-term loans for infrastructure development and to compensate for the laggards of the inter-European Union. Though started by the governments of the 6 countries, it operates independently of them and has its own lending objectives and policies. By 1988, it branched into lending to small and medium enterprises and in 2000s it moved into lending to foster innovation and competitiveness. In 1994 it also started a subsidiary, the European Investment Fund to provide indirect equity and debt financing through financial institutions that then invest in or lend to economic enterprises including micro-finance.

Today, EIB is the largest and highly successful multi-lateral development bank in the world with total assets of Euro 420 billion in 2010, twice the size of the World Bank.

The Bank of North Dakota (BND)

The BND is a state bank owned by the state of North Dakota. It started in 1919 with US\$2 million capital to provide loans to agriculture, industry and commerce. Today, its capital is US\$270 million with total assets of US\$ 4billion.

The bank partners with, rather than compete, private local banks and provide loan guarantees and federal fund lines to them. The state of North Dakota deposits its revenue with the BND and a part of the profits is transferred to the state. One study shows that over a 15-year period, the contribution of BND to state coffers was more than the state's oil tax revenue. The role of BND in contributing to North Dakota's enviable economic performance cannot be dismissed. North Dakota has the lowest unemployment rate (3%) in the country, enjoys budget surplus, and has the lowest foreclosure and default rates.

Significantly, BND not only did not experience any financial difficulty during the recent financial crisis; in fact, between 2006 and 2010, its total assets rose from US\$ 2.3 billion to \$4 billion and made profits every year.

Section V - Conclusion

The above few examples show that in contrast to the Anglo-American model of universal/investment banking that focus on capital markets that imploded and plunged the entire world into a great financial crisis, prudently and well managed banking institutions that focus on long term lending and stable relationship, not engaged in speculative instruments, and not obsessed with maximizing rates of return, have managed well over this recent crisis.

The recent and on-going global financial crisis has brought to the fore once again the contrast between two types of financial system, namely the Anglo-American financial system that is more inclined to capital markets as the major source of financing, and the other model that is more dependent on bank financing as historically was and still is the case in Germany, Japan and Canada.

A recent study by Bordo et al (2011) comparing the Canadian and American banking systems over 200 years explains why the Canadian banking system did not suffer a banking crisis not only in 2007/08 but also for the last two centuries, whereas the U.S. suffered many banking panics and crises since 1830s.⁵ Using the perspective of economic history, the authors explain the historical and political forces that shape the present banking systems in both these countries.

In Canada, the federal government was able to charter nation-wide banks and allowed a few large banks to operate under an oligopolistic manner. In return they were well regulated. While this may have the disadvantage of being slow on innovation, it has the advantage of preserving financial stability. ⁶ There were many instances of bank failures but few that led to bank panics and crisis.

In the U.S., the political struggles between the federal and state governments over the right to charter banks, ended up with the state chartering state banks and the federal unable to charter any bank to operate nation wide. Since inter-state banking was not allowed, there was a plethora of banks operating at state level. The inability of this fragmented and weak banking system to finance large scale industrial development throughout the country and to move capital across state line created the condition for the development of capital markets where financial instruments (stock and bond markets) can be traded and capital moved freely. Therefore, capital markets and investment banking became equally, if not more, prominent than commercial banking in

⁵ Canada, of course, experience bank failures, but these are limited and did not bring down the whole financial system and the economy as happened in the U.S. in the Great Depression and the recent Great Recession.

⁶ The claim that regulated banking is costlier is not supported in the Canadian case. In an earlier study Bordo et al (1994) found Canadian banking costs were not higher than those in the U.S.

the U.S. financial system. Despite the greater risks and volatility of this sector, it was not regulated until after the 1930s, even then with a lighter touch. In short, a fragmented and weak banking system co-existing with a largely unregulated investment and shadow banking system created the conditions for financial instability.

It is clear that there are costs and benefits associated with each type of financing and they are not mutually exclusive. But the type or mix of financing chosen is dependent on historical and current conditions and also on the objectives of development. We should however, at all time, keep in mind that the primary role of finance is to serve the real productive sector and not the other way around; and the objectives of development should be to create stable, long-term economic growth that is balanced, employment-creating, equitable and welfare maximizing. Too often means, such as creating a deep and liquid financial market or even the idea of financial integration, are confused for ends. While capital markets instruments are efficient in mobilizing capital to move freely and quickly across borders (assuming free capital flows and minimum regulation), they come with greater social economic costs, i.e., volatility of exchange rates and macro-economic instability.

The major challenge is how to recycle regional savings from surplus to deficit countries within Asia in the most socially efficient way that will not create the same problem that is confronting the core (surplus) and periphery (deficit) countries of the Eurozone today.

We have suggested that another way of meeting this objective, as a complement to, not a total substitute for LCY bond markets, is to develop regional or national long-term developmental or credit banks, borrowing elements that are applicable from countries that have successfully used such institutions to promote economic growth. It is beyond the scope of this paper to provide a blue print of such institutions.

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