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Local Currency Contribution to the CMIM

Chapter 3. Promoting Local Currency Usage in the Region

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Chapter 3. Promoting Local Currency Usage in the Region

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Abstract

This chapter focuses on policies to promote the greater use of regional currencies in intra-regional trade and investment. This will reduce the dominance of the U.S. dollar and lessen the region's exposure to U.S. monetary conditions and monetary policy. A key focus in this chapter is on policies to help set up efficient currency exchange markets to reduce currency exchange transaction costs. This is fundamental, as high currency exchange spreads between local currencies discourages local currency (LCY) usage for trade and investment. China's policy to internationalize the RMB and set up offshore direct exchange markets between the RMB and other currencies is also highlighted. Other important issues include the Local Currency Settlement Framework (LCSF), the Asian Bond Market Initiative (ABMI), Asian Bond Funds (ABF) and Bilateral Swap Arrangements (BSA).

JEL classification: G01, G10, G15

Keywords: Local currency, Currency markets, Transaction costs, Local Currency Settlement Framework, Asian Bond Market Initiative, Asian Bond Funds, Bilateral Swap Arrangements.

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Executive Summary

This chapter focuses on policies to promote greater usage of local currency (LCY) for trade and investment in the region. The dominance of the U.S. dollar as the major currency for denominating intra-regional trade and investment means the region will continue to be exposed to U.S. policies and problems. The negative outcomes of such exposure have been evident in the past, such as from U.S. dollar shortages after the closure of Lehman Brothers, the volatile capital flows from excess liquidity created by quantitative easing policies, and the Federal Reserve's current upward interest rate path. Greater use of LCY in intra-regional trade and investment will better shield the region from these shocks emanating outside the region.

The adoption of LCY for trade and investment is unlikely to happen automatically as it is market determined. This section looks at some key policy areas that could promote the usage of LCY in the region. The key focus is on policies to set up efficient currency exchange markets to reduce transaction costs for currency exchange. This is fundamental, as high currency exchange spreads between LCYs discourage the use of LCY for trade and investment. China's policy to internationalize the RMB and set up offshore RMB clearing banks and direct exchange markets between the RMB and other currencies is also highlighted. The section also looks at the Local Currency Settlement Framework (LCSF), a sub-regional initiative among Indonesia, Malaysia and Thailand to promote greater use of these countries' currencies. Developments in local currency bond markets to create more demand and supply of LCY bonds through the Asian Bond Market Initiative (ABMI) and Asian Bond Funds (ABF) are also covered. These initiatives are aimed at attracting more of the region's savings to invest within the region and to avoid the double mismatches such as those that led to the Asian Financial Crisis. Finally, Bilateral Swap Arrangements (BSA) are discussed as one way to promote the use of regional currencies for bilateral trade and investment.

3. Promoting Local Currency Usage in the Region

3.1 Introduction

1. Under the Bretton Woods system, even though John Maynard Keynes proposed the creation of the Bancor as a supranational currency, the U.S. dollar was made the global reserve currency convertible into gold, underlining post-war U.S. dominance. While not as good as gold under the gold standard, there was a commitment of the U.S. government to convert U.S. dollars into gold (at USD35 an ounce) under the Bretton Woods system (for central banks). This led to the dominance of the U.S. dollar for international transactions and as a reserve currency. Even after the Nixon shock that ended U.S. dollar-gold convertibility and triggered the collapse of the Bretton Woods system, the previous chapter showed that the U.S. dollar remained the dominant currency to denominate trade and investment in East Asia (as well as globally). The dominance of the U.S. dollar is not just limited to trade and investment between the U.S. and other trading and investment partners; it extends to third parties preferring the U.S. dollar over their own currencies in their transactions. For example, in 2017, 66.3 percent of Thai exports to the E.U. were denominated in the U.S. dollar, a currency that was neither a local currency for both the E.U. and Thailand. Similarly, 58.5 percent of Thai exports to Japan were denominated in the U.S. dollar.

2. As East Asia undergoes deeper integration economically and financially (see Chapter 2), greater LCY usage in the region is expected in intra-regional trade and investment. To some extent, this is already happening, as shown in Chapter 2, although there is still a long way to go. Reliance on the U.S. dollar as the major currency for denominating intra-regional trade and investment means the region will continue to be exposed to U.S. policy and problems. We have already seen how acute U.S. dollar shortages after the closure of Lehman Brothers led to large capital outflows from some parts of East Asia and the need to depend on the Federal Reserve to supply U.S. dollar liquidity. These shortages also led to the drying up of the U.S. dollar for trade financing, leading to sharp declines in world trade and recessions for most of the world including East Asia. U.S. quantitative easing (QE) policies in the aftermath of the Global Financial Crisis (GFC) also created several problems for emerging market economies as recipients of volatile capital flows from excess liquidity created by QE policies. Finally, as the Federal Reserve is now on an upward interest rate path, East Asia is now facing the challenge of managing another phase of capital outflows, interest rate hikes and a strengthening U.S. dollar. Looking at the longer term, greater LCY use for intra-regional trade and investment would better shield the region from these shocks coming from outside the region.

3. The adoption of LCY in trade and investment is unlikely to happen automatically as it is market determined. If there are appropriate incentives for people to use LCY for trade and

investment, then there will be greater LCY usage. In the absence of incentives, U.S. dollar usage (and the usage of other major currencies from outside the region) will continue to dominate transactions. This section looks at some key policy areas in promoting LCY usage in the region. The focus is on policies to set up efficient currency exchange markets to reduce transaction costs for currency exchange. This is fundamental, as high currency exchange spreads between LCYs discourage their use in trade and investment. China's policy to internationalize the RMB and set up offshore RMB clearing banks and direct exchange markets between the RMB and other currencies, is highlighted. The section also looks at the Local Currency Settlement Framework (LCSF, a sub-regional initiative between Indonesia, Malaysia and Thailand to promote greater use of these countries' LCY. Developments of local currency bond markets to create more demand and supply of LCY bonds through the Asian Bond Market Initiative (ABMI) and Asian Bond Funds (ABF) are covered. These seek to attract more of the region's savings to invest within the region and avoid the double mismatches like those that led to the Asian Financial Crisis (AFC). Finally, supportive policies to provide LCY liquidity through bilateral swaps in case of high LCY usage and possible LCY shortages occurring in bilateral trade and investment are looked at. This last policy area concerns the provision of LCY liquidity, which is closely related to the question of LCY contribution to the CMIM.

3.2 Currency Markets and Currency Exchange Transaction Costs

4. The dominance of U.S. dollar usage in trade and investment is not because people are forced to denominate their transactions in the U.S. dollar, but because, in most cases, it is the best currency to use, both in terms of minimizing risks, low transaction costs and potential investment benefits. Table 3.2.1 shows foreign exchange buy and sell rates for bank transfers in various currencies for major banks in Thailand, Indonesia and Malaysia. For Bangkok Bank, the gap for the U.S. dollar was 0.91 percent, which is less than half the gap of any other currency. The gaps for most other currencies (EUR, GBP, SGD and RMB) were around 2 percent with the gap for the yen being the largest among currencies shown in the Table at 2.67 percent.

Table 3. 2.1 Currency Exchange Transaction Costs (Bank Transfer Rate, 17/8/2018)

| | Bangkok Bank (Thailand) | | | Maybank (Malaysia) | | | Bank Mandiri (Indonesia) | | |
|-----|-------------------------|--------|-------|--------------------|-------|-------|--------------------------|--------|-------|
| | Sell | Buy | Gap | Sell | Buy | Gap | Sell | Buy | Gap |
| USD | 33.37 | 33.07 | 0.91% | 4.162 | 4.048 | 2.82% | 14.69 | 14.465 | 1.56% |
| EUR | 38.21 | 37.483 | 1.94% | 4.745 | 4.614 | 2.84% | 16.78 | 16.374 | 2.48% |
| GBP | 42.765 | 41.915 | 2.03% | 5.288 | 5.165 | 2.38% | 18.747 | 18.313 | 2.37% |
| SGD | 24.413 | 23.91 | 2.10% | 3.023 | 2.941 | 2.79% | 10.729 | 10.44 | 2.77% |
| JPY | 30.408 | 29.618 | 2.67% | 3.756 | 3.646 | 3.02% | 133.83 | 129.35 | 3.46% |
| RMB | 4.865 | 4.7675 | 2.05% | 60.5 | 58.2 | 3.95% | 2.158 | 2.061 | 4.71% |

Source: Respective bank's foreign exchange quotations

5. The pattern for Bank Mandiri (Indonesia) also shows the gap for the U.S. dollar being lowest, at 1.56 percent. This next lowest gap was for the pound at 2.37 percent, which was about 1.5 times that for the U.S. dollar. The gap for the yen was 3.46 percent, while that for the RMB was the largest among these currencies at 4.71 percent, more than three times larger than that of the U.S. dollar. In the case of Malaysia, the gap is lowest for GBP. This reflects the deep economic relationship between Malaysia and the U.K. However, it should be noted that the gap for Malaysia is larger than the corresponding gap for Thailand for every currency in Table 3.2.1. This may reflect differences in the degree of openness of the financial system and the extent of competition in the financial sector between the two countries.

6. The reason why the gaps for many currencies in some countries are large is because there is no direct currency exchange market between that currency and the local currency. For example, trading baht for yen in Thailand and vice versa has to go through the U.S. dollar. This implies that changing baht for yen involves the bank implicitly changing from baht to U.S. dollar and then changing from U.S. dollar to yen. The outcome is that the gap between buying and selling rates for the baht and yen was about 2.94 times than that of between the baht and the U.S. dollar (Table 3.2.1).

7. Information from Japanese banks in Thailand as to why they don't operate a direct exchange market between the baht and the yen indicates they want to be able to square their exchange rate risk position daily, but this is not possible because there are no forward markets between the yen and the baht. Clearly, if there is no spot market, then there will not be a forward market. Therefore, this is clearly a case of market failure and government interventions will be needed to establish these markets. The lack of direct currency markets also makes hedging costs through forward contracts much more expensive as these also need to go through the U.S. dollar. Therefore, denominating trade contracts in U.S. dollar is a good way to share exchange rate risks among the trading parties. There are extensive direct foreign exchange markets between the U.S. dollar and almost every currency in the world. There are also numerous hedging instruments for the U.S. dollar to deal with exchange rate risks. In addition, there are numerous opportunities for investing in U.S. dollar-denominated assets to earn income from U.S. dollar holdings.

3.3 Policies to Promote RMB Usage

8. The most important development affecting the usage and holding of global currencies in the future is likely to be the increasing role of the RMB in the global financial system. Since 2013, China has become the world's largest trading nation (in terms of export and import value). Over the next one to two decades, China's GDP size in current market value is also likely to surpass that of the U.S. Given this, and given China's policy to promote RMB internationalization and its use in China's transactions globally, the RMB is likely to become an increasingly important international currency. The IMF's Executive Board approved the

inclusion of the RMB into the basket of currencies making up the SDR, joining the USD, EUR, JPY and GBP, effective on 1 October 2016.

Apart from increasing RMB use in China's transactions globally, which will lead to a greater role for the RMB as a reserve currency, the next major step in the medium- to long-term is to develop the RMB into a currency that more and more third parties will want to denominate their transactions in, like the U.S. dollar currently. For this to happen, China needs to set up direct exchange markets and clearing banks between the RMB and other currencies throughout the world. This will reduce the currency exchange transaction costs between the RMB and other currencies, and will make RMB usage for international transactions more attractive and pave the way for the development of many types of derivative markets involving the RMB to make available hedging instruments to reduce exchange rate risks when using the RMB.

9. China has actively pursued setting up offshore RMB clearing banks and direct exchange markets between the RMB and other currencies as part of its RMB internationalization policy. By end-2016, China had established 23 RMB offshore clearing banks worldwide. Obviously, many more will be established in the future. This will help to make RMB use for international transactions more attractive. China has also been very active in agreeing BSAs with many central banks in order to support the liquidity of the RMB as it is being used increasingly. These BSAs have amounted to more than RMB3.3 trillion (close to about USD0.5 trillion).

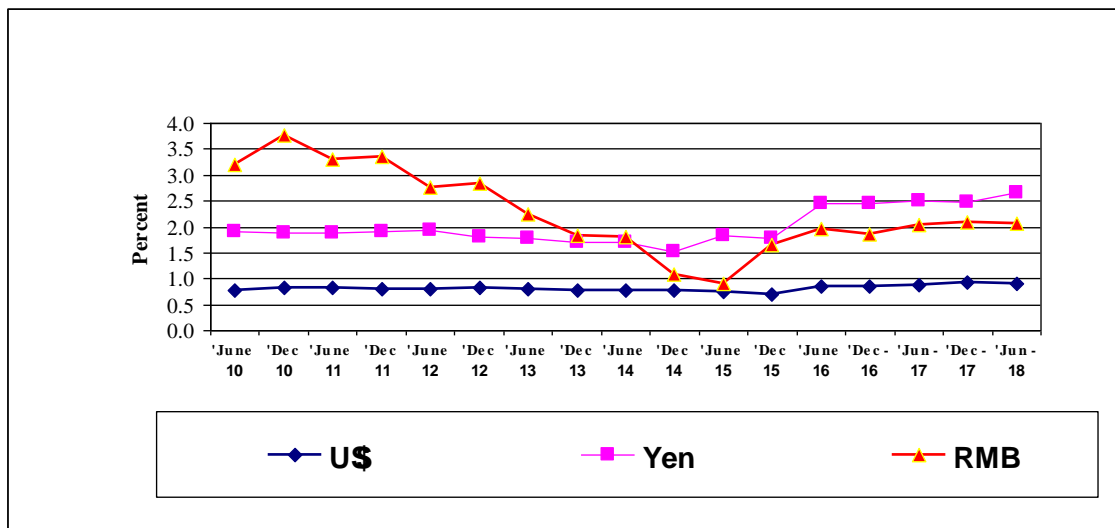
10. In Thailand for example, the Industrial and Commercial Bank of China (Thai) Public Company Limited (ICBC Thai) was officially appointed as an RMB offshore clearing bank in January 2015. Historically, the ACL Bank Public Company Limited was established on 23 December 2005, transforming from Asia Credit Finance and Securities Company Limited, which had been operating finance and securities businesses since 1973. The Industrial and Commercial Bank of China (ICBC) became the largest shareholder in ACL Bank in 2010 and its name was changed to ICBC (Thai).

11. The impact of setting up an RMB clearing bank and the direct RMB/ baht currency exchange market can be clearly seen from the trend of currency exchange transaction costs for the U.S. dollar, JPY and the RMB in Figure 3.3.1.

12. Until June 2014, the gap for the RMB was higher than that for the yen, and much higher prior to 2013. As the policy to internationalize the RMB and promote its use internationally took effect, the gap for the RMB became lower than that for the JPY since the second half of 2014 and has remained lower ever since. The gap for the RMB declined rapidly, reaching almost the level of the gap for the U.S. dollar in mid-2015. The RMB internationalization process may have proceeded too rapidly and there were clear negative symptoms, particularly in the form of huge capital outflows from China, resulting in a rapid

drain of China’s foreign reserves (see below). After June 2015, the buy-sell gap for the RMB began to increase to around 2 percent since mid-2016. However, this was still lower than the buy-sell gap for the JPY.

Figure 3.3.1: Buy Sell Gap Versus the Baht



Note: Data is from the last business day of the month.
Source: Bangkok Bank.

13. In the longer term, for the RMB to really challenge the U.S. dollar as the key international currency, it has to be used increasingly among third parties, i.e. parties whose currencies are not RMB, as the currency to denominate their trade and investment transactions. This is starting to happen, but only for specific cases and at rather low amounts as is the case in South Africa. Quoting from SWIFT RMB Tracker (August 2016):

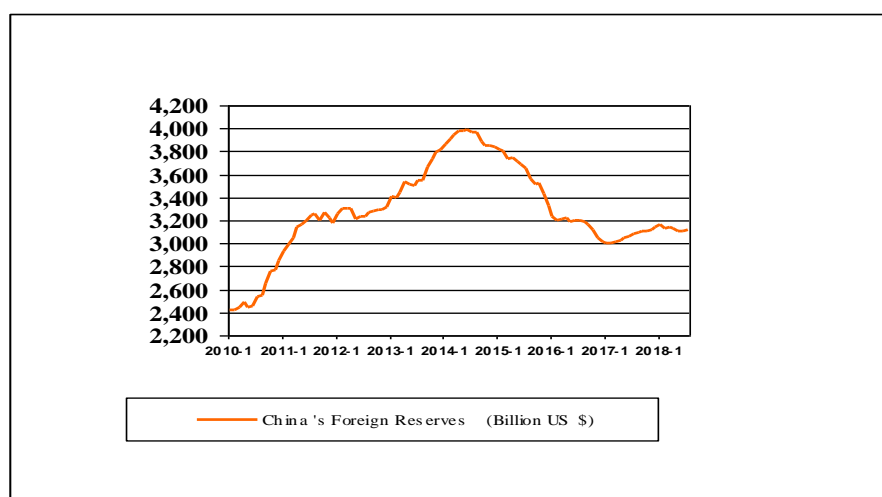
“Excluding domestic traffic, RMB payment messages increased in volume by 70% in the last 12 months. In addition, nearly 40% of RMB payments by South African institutions have been offshore payments exchanged with countries other than China and Hong Kong, compared to 16% in July 2015. South Africa has experienced a major shift in RMB growth over the last two years, strengthening the country’s trade relations with China and Hong Kong...The establishment of an RMB clearing centre in South Africa in July 2015, as well as Singapore’s increased use of the RMB for payments with South Africa, have been a catalyst for RMB growth in the region.”

14. With policies pushing for continued RMB internationalization, its use for international transactions is likely to grow significantly. The RMB will also become more prominent in official foreign reserves although it is starting from a very low base (about 1.2 percent at the end of 2017). Of significant importance is the ability of RMB holders to have access to deep

markets for RMB financial assets. This will increase the potential benefits of holding RMB reserves. However, there is a long way to go in this regard.

15. Appropriate sequencing of RMB internationalization will be very important. Past experiences, including those from Thailand before the AFC, have shown that rapid currency internationalization without appropriate sequencing can lead to major crises. It is likely that China will carefully sequence the process of RMB internationalization. Rapid internationalization could lead to a situation similar to that in 2014-16 when large capital outflows led to a decline in China's foreign reserves of almost USD1 trillion between June 2014 and December 2016 (Figure 3.3.2).

Figure 3.3.2: China's Foreign Reserves



Source: State Administration of Foreign Exchange

16. A repeat of such a situation could destabilize China's financial system with serious implications for the global economic system. So while the RMB will undoubtedly become increasingly prominent as a global international currency, it may be some time yet before it can come close to challenging the dominance of the U.S. dollar.

17. In the context of East Asia, apart from developing currency markets between RMB and other regional currencies, markets between other major regional currencies also need to be developed. This will facilitate the development of the region's capital markets. Since the AFC, there have been multiple discussions about the need to develop East Asian capital markets in order to keep the region's saving surplus within the region, rather than recycle the surplus to finance the U.S. deficit and then have hot money flowing back to East Asia with all the problems it can cause. The development of deep and well-functioning currency markets in the region will reduce the transaction costs of investing and earning in the regions' local currencies and help promote the region's local currency capital markets.

18. Finally, it is worth mentioning that Japan is also now promoting the development of offshore direct exchange markets between the JPY and other currencies. The Japanese Ministry of Finance announced in mid-2017 a comprehensive plan to launch direct currency trading with other regional players. The ministry will first enter into talks with Thailand, where about 48 percent of bilateral trade is settled in the JPY or THB, compared to 51 percent for the U.S. dollar. Japan sees significant demand for direct JPY to THB exchanges (Nikkei Asian Review, 2017).

19. In March 2018, a Memorandum of Cooperation was signed between the Ministry of Finance of Japan and the Bank of Thailand to promote the local currency usage. The brief joint press statement stated that (MOF Thailand and BOJ Japan, 2018):

“The authorities of both countries reached mutual agreement on initiatives relating to the promotion of the use of local currencies for trade and investment settlement, which includes, among others, promotion of the direct exchange rate quotation and interbank trading between the Japanese Yen and the Thai Baht. This cooperation will be enhanced through information sharing and periodical discussions between Japanese and Thai authorities.

This collaboration marks a key milestone in strengthening bilateral financial cooperation between Japan and Thailand. The authorities believe that it will positively contribute to closer trade and investment ties between the two countries.”

3.4 Local Currency Settlement Framework (LCSF)

20. The LCSF is an initiative between Indonesia, Malaysia and Thailand to promote wider use of local currencies to facilitate and boost trade and investment in these countries. The LCSF between Malaysia and Thailand came into operation in March 2016, covering bilateral trade between the two countries. With the framework, Malaysian and Thai businesses will be able to effectively source ringgit and baht from the banks in their home countries to settle trade transactions. This was expanded to cover direct investment at the beginning of 2018 when Indonesia also joined the framework. The aim is to promote greater usage of the countries’ local currencies in their mutual trade and investment to move away from depending mainly on the U.S. dollar for trade and direct investment among the countries.

21. Table 3.4.1 shows the shares of various currencies used in Thailand’s trade with Malaysia, both in terms of Thailand’s exports to Malaysia and Thailand’s import from Malaysia. A row showing the usage of the countries’ local currencies, “Baht+Ringgit”, is included as well as separate data for baht and ringgit. The data is quarterly, starting in Q1 2015.

22. The LCSF between Malaysia and Thailand effectively started in the second quarter of 2016. Looking at the baht+ringgit denominations for Thai export to Malaysia in Table 4, one

can see a slight increase in the ratio of the countries' local currency usage after Q2 2016, but then after a year or so the ratio declined but remained slightly larger than prior to the operation of the LCSF. Between Q2 2015 and Q1 2016, the average ratio of denominations in baht+ringgit was 15.2 percent, and between Q2 2016 and Q1 2017, it was 16.7 percent. Furthermore, the same ratio between Q2 2017 and Q2 2018 was 15.7 percent. So after the initial jump in the ratio, it declined again. In terms of baht and ringgit usage, ringgit usage was very low at around 2 percent and usage of the baht was quite high (around 13-15 percent). The changed pattern in the ratios of both baht and ringgit usage was similar to the changes for the baht+ringgit. The ratio therefore increased after the LCSF for about a year and then declined again.

23. For payment of Thailand's imports from Malaysia, the pattern was slightly different. The ratio of baht usage declined after the LCSF was introduced and then increased again after about a year, but still to a level less than before the LCSF on average. For the ringgit, the denomination ratio was again much less than the ratio for the baht, at about 2.5 percent, with a pattern of changes similar to usage of ringgit in Thailand's exports to Malaysia. After the LCSF, the usage ratio for the ringgit increased slightly and then declined after about a year.

24. In both Thailand's export and import cases, the dominance of the U.S. dollar can be clearly seen. The ratio of U.S. dollar denomination averaged about 81.6 percent from 2015 to mid-2018 for Thailand's export to Malaysia, while that for Thailand's import from Malaysia was about 86.7 percent for the same period. Moreover, there is no clear trend of a decline in the dominance of the U.S. dollar for either exports or imports.

Table 3.4.1: Denomination of Thai Trade with Malaysia

| | Q1/2015 | Q2/2015 | Q3/2015 | Q4/2015 | Q1/2016 | Q2/2016 | Q3/2016 | Q4/2016 | Q1/2017 | Q2/2017 | Q3/2017 | Q4/2017 | Q1/2018 | Q2/2018 |
|---|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|
| Denomination of Thai Export to Malaysia (Shares %) | | | | | | | | | | | | | | |
| USD | 79.2 | 79.8 | 81.4 | 84.0 | 83.1 | 82.4 | 79.6 | 80.5 | 81.0 | 82.7 | 82.2 | 82.7 | 81.8 | 82.2 |
| Yen | 3.4 | 1.4 | 1.6 | 0.7 | 1.2 | 0.7 | 1.8 | 1.0 | 1.3 | 1.0 | 1.1 | 1.0 | 0.8 | 0.6 |
| SGD | 0.6 | 0.8 | 0.9 | 0.8 | 0.6 | 0.6 | 0.6 | 0.5 | 0.6 | 0.5 | 0.4 | 0.4 | 0.4 | 0.4 |
| Baht+Ringgit | 15.8 | 17.3 | 15.3 | 13.9 | 14.4 | 15.6 | 17.3 | 17.4 | 16.4 | 15.1 | 15.7 | 15.3 | 16.3 | 16.3 |
| Baht | 13.7 | 15.2 | 13.5 | 12.0 | 12.6 | 13.2 | 15.3 | 14.9 | 14.0 | 12.9 | 13.3 | 13.4 | 14.2 | 14.2 |
| Ringgit | 2.1 | 2.1 | 1.8 | 1.9 | 1.8 | 2.4 | 2.0 | 2.5 | 2.4 | 2.2 | 2.4 | 1.9 | 2.1 | 2.1 |
| Others | 1.0 | 0.7 | 0.8 | 0.6 | 0.7 | 0.7 | 0.7 | 0.6 | 0.7 | 0.7 | 0.6 | 0.6 | 0.7 | 0.5 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| Denomination of Thai Import from Malaysia (Shares %) | | | | | | | | | | | | | | |
| USD | 86.6 | 86.3 | 86.5 | 86.7 | 84.5 | 86.2 | 88.2 | 86.7 | 88.4 | 87.0 | 87.0 | 86.0 | 87.0 | 87.1 |
| Yen | 0.7 | 0.6 | 0.6 | 0.6 | 0.8 | 0.8 | 1.0 | 0.9 | 0.7 | 0.8 | 0.8 | 0.9 | 0.7 | 1.0 |
| SGD | 0.7 | 0.5 | 0.7 | 0.7 | 0.7 | 0.6 | 0.7 | 0.7 | 0.5 | 0.6 | 0.6 | 0.6 | 0.5 | 0.5 |
| Baht+Ringgit | 11.4 | 12.1 | 11.6 | 11.1 | 12.8 | 11.5 | 9.5 | 10.6 | 9.5 | 10.8 | 10.3 | 11.3 | 11.0 | 10.6 |
| Baht | 9.7 | 10.0 | 8.9 | 8.7 | 10.0 | 8.0 | 6.7 | 8.3 | 7.5 | 8.4 | 7.9 | 8.8 | 8.9 | 8.5 |
| Ringgit | 1.7 | 2.1 | 2.7 | 2.4 | 2.8 | 3.5 | 2.8 | 2.3 | 2.0 | 2.4 | 2.4 | 2.5 | 2.1 | 2.1 |
| Others | 0.6 | 0.5 | 0.6 | 0.9 | 1.2 | 0.9 | 0.6 | 1.1 | 0.9 | 0.8 | 1.3 | 1.2 | 0.8 | 0.8 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

Source: Bank of Thailand

25. Table 3.4.2 shows the denomination of Thailand's trade with Indonesia, both for export to and import from Indonesia. As the LCSF between Thailand and Indonesia only started at the beginning of 2018, it would not be appropriate to infer anything concrete from the table about the effect of the LCSF on the use of local currencies in Thailand's trade with Indonesia. However, the impact of the LCSF on local currency usage will have to be seen in the medium to long term. Therefore even in the case of Thailand's trade with Malaysia, the observed patterns of changes in local currency usage before and after the operation of the LCSF are only tentative.

Table 3.4.2: Denomination of Thai Trade with Indonesia

| | Q1/2015 | Q2/2015 | Q3/2015 | Q4/2015 | Q1/2016 | Q2/2016 | Q3/2016 | Q4/2016 | Q1/2017 | Q2/2017 | Q3/2017 | Q4/2017 | Q1/2018 | Q2/2018 |
|--|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|
| Denomination of Thai Export to Indonesia (Shares %) | | | | | | | | | | | | | | |
| US\$ | 78.2 | 80.8 | 78.7 | 81.1 | 78.1 | 77.5 | 73.9 | 75.0 | 76.6 | 79.7 | 77.4 | 75.8 | 77.9 | 78.4 |
| Yen | 5.2 | 3.6 | 4.3 | 3.5 | 8.0 | 6.7 | 8.6 | 6.8 | 6.9 | 5.5 | 2.5 | 2.2 | 1.1 | 1.0 |
| Sing\$ | 0.1 | 0.1 | 0.2 | 0.2 | 0.1 | 0.1 | 0.1 | 0.2 | 0.1 | 0.1 | 0.1 | 0.3 | 0.1 | 0.2 |
| Ringgit | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Baht+Rupiah | 15.5 | 14.5 | 15.8 | 14.1 | 13.2 | 15.0 | 16.8 | 17.4 | 15.9 | 14.1 | 19.0 | 21.0 | 20.1 | 19.2 |
| Baht | 13.6 | 12.6 | 14.2 | 11.9 | 11.5 | 13.1 | 15.1 | 15.5 | 14.5 | 13.1 | 17.8 | 19.8 | 18.9 | 18.1 |
| Rupiah | 1.9 | 1.9 | 1.6 | 2.2 | 1.7 | 1.9 | 1.7 | 1.9 | 1.4 | 1.0 | 1.2 | 1.2 | 1.2 | 1.1 |
| Others | 1.0 | 1.0 | 1.0 | 1.1 | 0.6 | 0.7 | 0.6 | 0.6 | 0.5 | 0.6 | 1.0 | 0.7 | 0.8 | 1.2 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| Denomination of Thai Import from Indonesia (Shares %) | | | | | | | | | | | | | | |
| US\$ | 88.0 | 90.3 | 89.9 | 84.8 | 87.3 | 87.8 | 87.7 | 84.7 | 90.8 | 87.8 | 86.5 | 85.4 | 88.3 | 88.4 |
| Yen | 2.4 | 1.7 | 1.5 | 2.2 | 1.5 | 1.4 | 2.2 | 2.0 | 1.0 | 1.5 | 1.7 | 2.1 | 1.8 | 1.9 |
| Sing\$ | 1.0 | 1.3 | 1.0 | 1.2 | 0.9 | 1.2 | 1.2 | 1.2 | 0.3 | 0.8 | 1.7 | 1.4 | 1.0 | 0.9 |
| Ringgit | 0.1 | 0.0 | 0.0 | 0.1 | 0.1 | 0.1 | 0.0 | 0.1 | 0.1 | 0.0 | 0.0 | 0.0 | 0.1 | 0.1 |
| Baht+Rupiah | 7.6 | 6.1 | 6.9 | 10.8 | 9.2 | 8.8 | 8.2 | 11.3 | 7.2 | 9.3 | 9.5 | 10.5 | 8.3 | 8.2 |
| Baht | 7.3 | 5.9 | 6.6 | 10.4 | 8.8 | 8.4 | 7.8 | 10.9 | 6.9 | 9.0 | 9.3 | 10.3 | 8.0 | 7.9 |
| Rupiah | 0.3 | 0.2 | 0.3 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 | 0.3 | 0.3 | 0.2 | 0.2 | 0.3 | 0.3 |
| Others | 0.9 | 0.6 | 0.7 | 0.9 | 1.0 | 0.7 | 0.7 | 0.7 | 0.6 | 0.6 | 0.6 | 0.6 | 0.5 | 0.5 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

Source: Bank of Thailand

Acknowledgment: The author would like to thank the Bank of Thailand for kindly providing the data for Indonesia with the data for rupiah separated out, which is not available in the online version of this table.

26. Promoting the use of local currencies will only work if the transaction costs in changing one local currency to another become low enough to be worthwhile. This involves setting up direct exchange markets between various major currencies, as well as ensuring there is sufficient liquidity and turnover. This still needs to be developed further. For example, at Bangkok Bank (17 August 2018) the buy-sell gap between the baht and the ringgit was about 3.1 percent (compared to the U.S. dollar gap of only 0.9 percent), while that between the baht and rupiah was very large, at about 8.1 percent. Clearly, these need to be brought down to make it worthwhile for businesses to denominate their trade and direct investment in the local currencies. Therefore, the LCSF needs to be developed together with the development of efficient currency exchange markets among the three countries' currencies.

3.5 Asian Bond Market Initiative (ABMI) and Asian Bond Funds (ABF)

27. Prior to the AFC, the East Asian region (ASEAN+3) was in fact a region with a net saving surplus (of around USD100 billion per year). However, most of the surpluses were channeled to invest in the advanced economies in the West. Those with deficits had limited access to long-term financing to fill their saving gaps and had to rely mainly on bank lending from abroad to finance their investment. These borrowings (mainly from OECD countries) were mostly of a short-term nature. This was because of the Basel Capital Accord provisioning requirements for risk assets; for lending to non-OECD financial institutions, if the lending had a maturity of over one year, a 100 percent risk weighting for assets should be applied, but if the lending had a maturity of up to one year, only a 20 percent risk weighting was necessary (see BIS, 1988). This led to a double mismatch for many of the borrowers as these borrowings were used to finance medium- to long-term projects and many projects only earned revenues in local currencies. There was a rapid buildup of short-term foreign debt in many countries, to the extent that short-term foreign debt became bigger than foreign reserves in some countries, particularly Thailand, Indonesia and South Korea. This eventually led to the AFC, starting in Thailand in 1997.

28. Therefore, a major lesson that was learned from the crisis was that effective regional long-term capital markets needed to be developed to recycle some of the surplus saving in the region for long-term financing within the region, especially in local currencies, so that countries, and particularly companies, can have easier access to long-term investment financing that addresses the twin mismatches referred to earlier. If this can be developed, then there would be much less need to rely on short-term foreign borrowing and it would contribute to future financial stability in the region.

29. An important point is that the main need is to recycle long-term financing to the private sector. This is because the public sector can easily tap long-term financing when required, whether through bilateral channels, multilateral channels or in the domestic and foreign capital markets. In Thailand, before the crisis, almost all the short-term foreign debt arose from bank borrowing from abroad by the private sector. Therefore, the success of the development of the regional bond market in reducing the risk of a future financial crisis of a similar nature to the previous crisis will have to be judged on whether the resulting bond market can effectively meet the long-term financing needs of the private sector.

30. ASEAN+3 launched the Asian Bond Market Initiative (ABMI) in December 2002. At the ASEAN+3 Finance Minister Meeting in Manila in 2003, there was a Chairman's Press Release on the ABMI, stating that:

"The Asian Bond Markets Initiative (ABMI) aims to develop efficient and liquid bond markets in Asia, which would enable better utilization of Asian savings for Asian investments. The

ABMI would also contribute to the mitigation of currency and maturity mismatches in financing. It is a key step forward in ASEAN+3 finance cooperation.” (AFMM+3, 2003a).

31. The Joint Ministerial Statement of the ASEAN+3 Finance Ministers Meeting also stated that:

“We agreed to intensify our efforts to develop regional bond markets. This will further strengthen our financial systems by better utilizing the aggregate savings in the region and minimizing the risk of maturity and currency mismatches. Voluntary working groups have been established to further discuss a range of key issues crucial to further development of the domestic and regional bond markets, such as, securitization, credit guarantee, promotion of local currency-denominated bonds, credit rating, and foreign exchange transactions and settlement issues.” (AFMM+3, 2003b).

32. Since its inception, the ABMI has been a major area of financial cooperation for ASEAN+3.[†] Its progress has been reviewed and discussed in every annual meeting of the ASEAN+3 Finance Ministers’ Meeting (now the ASEAN+3 Finance Ministers and Central Bank Governors’ Meeting) since and been reported in the Joint Ministerial Statement of the AFMM+3 of all these meetings.

33. An ABMI road map was developed in 2008. The implementation of the road map was through four task forces. The first was on promoting the issuance of local currency-denominated bonds, covering issues such as credit guarantee and investment mechanisms, debt instruments for infrastructure financing and the development of derivatives and swap markets. The second was on promoting the demand for local currency-denominated bonds, covering issues such as developing a good investment environment for institutional investors, development of repo markets and enhancing cross border transactions. The third was on improving the regulatory framework, covering issues such as strengthening the regulatory and supervisory framework and promoting the application of best practices in accounting and auditing standards. The fourth was on improving infrastructure for the bond market, covering issues such as developing a benchmark yield curve to help increasing liquidity of bond markets and the development of a credit risk database.

34. The roadmap was revised in 2012, although with the same four objectives and implemented under the same four task forces. Some new specific areas were stressed, such as launching guarantee operations under the Credit Guarantee and Investment Facility (CGIF), developing infrastructure financing schemes including green local currency bonds for infrastructure investment, and strengthening the foundation of a regional credit rating system. The activities under these four task forces are ongoing.

[†] For discussions of various areas of ASEAN+3 regional financial cooperation, see, for example, Sussangkarn and Vichyanond (2006) and Sussangkarn (2011).

35. Prior to the AFC, the domestic bond markets in most of the developing East Asian countries were very thin or almost non-existent. As most governments were running budget surpluses for many years before the crisis, the supply of government bonds was minimal. There were therefore no clear benchmarks for private sector bonds, and bond trading in general was very limited. In that environment, it was not surprising that the private sector was unable to tap the bond market for investment financing.

36. The situation now is very different. The local currency bond markets in emerging East Asia have grown substantially (see Table 3.5.1). For example, in 1997, the ASEAN local currency bond markets totaled only about USD37.2 billion. By 2017, the size has increased to about USD1.28 trillion, or an increase of about 34.3 times. Private sector local currency bonds have also grown, although not as fast as the government bonds. In 1997, private sector local currency bonds totaled about USD16.6 billion. By 2017, this has increased to about USD403.9 billion, or an increase by about 24.4 times.

37. The larger private corporations have been able to take advantage of the situation by issuing long-term debt instruments to the general public and by using the rates on government bonds as benchmarks. Bond trading is now much more active than before in line with the size of the market. However, access to the bond markets (and the capital market in general) for SME's is still problematic.

Table 3.5.1: Size of Local Currency Bond Markets in Emerging East Asia (USD, billions)

| | 1997 | 2000 | 2005 | 2010 | 2015 | 2017 |
|--------------------|-------|-------|--------|---------|---------|---------|
| ASEAN Total | 37.2 | 218.4 | 368.0 | 836.3 | 1,035.8 | 1,277.1 |
| Government | 20.7 | 158.3 | 265.2 | 602.0 | 711.5 | 873.2 |
| Private | 16.6 | 60.2 | 102.8 | 234.3 | 324.3 | 403.9 |
| Share Private | 44.4% | 27.5% | 27.9% | 28.0% | 31.3% | 31.6% |
| China Total | n.a. | 202.3 | 899.6 | 3,054.0 | 6,248.5 | 8,739.5 |
| Government | n.a. | 198.8 | 835.2 | 2,407.8 | 4,066.7 | 6,326.7 |
| Private | n.a. | 3.49 | 64.46 | 646.26 | 2181.73 | 2412.81 |
| Share Private | n.a. | 1.7% | 7.2% | 21.2% | 34.9% | 27.6% |
| Korea Total | n.a. | 355.0 | 753.7 | 1,149.1 | 1,719.5 | 2,019.8 |
| Government | n.a. | 122.4 | 392.9 | 492.2 | 699.5 | 827.0 |
| Private | n.a. | 232.6 | 360.75 | 656.94 | 1019.97 | 1192.73 |
| Share Private | n.a. | 65.5% | 47.9% | 57.2% | 59.3% | 59.1% |

Source: AsianBondsOnline, at <https://asianbondsonline.adb.org/data-portal>

38. In the early days of the ABMI and in parallel with it, the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP[‡]) – a group of 11 central banks (comprising Australia, China, Hong Kong SAR, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore and Thailand) – launched the Asian Bond Fund 1 (ABF1) in June 2003.

[‡] EMEAP stands for Executives' Meeting of East Asia-Pacific Central Banks, which was launched in 1991 as a forum for central banks in the East Asia and Pacific region to strengthen the cooperative relationship among its members.

Approximately USD1 billion was gathered from the reserves of EMEAP central banks and invested in a basket of liquid U.S. dollar bonds issued by sovereign and quasi-sovereign issuers in eight emerging EMEAP member economies (excluding Australia, Japan, and New Zealand). The Bank for International Settlements (BIS) was given the mandate to manage the fund. The ABF1 should facilitate the re-investment of some of Asia's reserves back into the region and aide the development of regional capital markets.

39. As the ABF1 was invested exclusively in public sector bonds, it did not directly address the need to provide long-term financing to the private sector. That notwithstanding, the ABF1 was a tiny first step in developing an effective saving recycling mechanism for the private sector in the region. The ABF1 was also restricted to U.S. dollar-denominated bonds, so it was related to dealing with the maturity mismatch problem and could not deal with the currency mismatch problem.

40. In December 2004, EMEAP launched the Asian Bond Fund 2 (ABF2). The size of this fund was about USD2 billion. ABF2 comprised two components – a Pan-Asian Bond Index Fund (PAIF) and a Fund of Bond Funds (FoBF). The PAIF is a single bond fund investing in sovereign and quasi-sovereign domestic currency-denominated bonds issued in the eight EMEAP emerging markets. The FoBF is a two-layered structure with a parent fund investing in eight sub-funds, each of which will invest in sovereign and quasi-sovereign domestic currency-denominated bonds issued in the respective markets of the eight emerging EMEAP economies (See EMEAP, 2004). Investment in PAIF and FoBF were about USD1 billion each. In 2016, the ABF1 was discontinued and the funds reinvested in ABF2.

41. ABF2 took ABF1 another step by investing in local currency bonds in the eight emerging EMEAP economies. However, the PAIF was U.S. dollar-denominated and was designed as a regional Exchange Traded Fund (ETF). It was, and still is, listed on the Hong Kong Stock Exchange and can be traded by investors. All sub-funds of the Fund of Bond Funds were also designed to be an ETF. These ETFs have been listed on the stock markets of all eight emerging economies of EMEAP.

42. As with the ABF1, investment of the ABF2 funds was limited to sovereign and quasi-sovereign bonds (although denominated in local currency). This too does not directly serve to channel long-term funds to the private sector, which is really what the region needs in order to avoid a situation of dependence on short-term foreign borrowing such as prior to the AFC.

43. However, if development of the Asian bond funds helps improve the bond market infrastructure of the region, then this will help develop the domestic bond markets with easier access for the private sector. Apart from helping to improve bond market infrastructure, funds such as the PAIF will benefit the development of the local currency bond market in an

indirect way. As there are exchange rate risks inherent in funds such as the PAIF, investors should become more familiar with how to manage such risks and the market may also develop new derivative products that investors in these bonds can use to reduce the impacts of currency risks. The availability of better risk management instruments will also help to make local currency private sector bonds more attractive, as investors can more easily hedge against exchange rate losses.

44. As was indicated in Table 3.5.1, local currency bond markets in emerging East Asia have grown substantially. Thus, the impacts of funds such as the Asian Bond Fund are now rather small. However, there are still a lot of constraints for corporations, particularly SMEs, to access the bond markets for long-term financing. As a result, in more recent years, the ABMI has been focusing on operations of the Credit Guarantee and Investment Facility (CGIF), which was set up by ASEAN+3 and the ADB in November 2010. CGIF provides guarantees on local currency-denominated bonds issued by investment grade corporations in the region. The guarantees issued by CGIF are irrevocable and unconditional commitments to pay bondholders upon non-payment by the issuers throughout the tenor of the bonds. This commitment is backed by CGIF's equity capital, which started at USD700 million and has now been approved to increase to USD1.2 billion. CGIF should make it easier for corporations to issue local currency bonds with longer maturities and directly help to reduce the double mismatches that were responsible for the AFC.

45. Finally, as with the case of promoting the use of local currencies, promoting cross-border investment of local currency-denominated bonds will only be fully effective if there are efficient currency exchange markets, with low exchange transaction costs and extensive hedging instruments, between the currency of the investor and the currency denominating the bonds. As such, setting up efficient currency exchange markets between major currencies in the region is an important area of cooperation for ASEAN+3 to focus on.

3.6 Bilateral Swap Arrangements to Support Local Currency Usage

46. Since the global financial crisis (GFC), the proliferation of bilateral swap arrangements (BSAs) has facilitated a more multi-layered Global Financial Safety Net (GFSN). These BSAs have played an important role in maintaining global and regional financial stability, which was also stressed in the joint statement of ASEAN+3 Ministers' and Governors' Meeting in 2017.

47. In this region, the total amount of BSAs has increased to over USD300 billion so far (table 3.6.1). Most BSAs are between Plus 3 and ASEAN members. There are basically two types of BSAs in the region.

- One is between JMOF and some ASEAN central banks. These BSAs are developed from original bilateral swaps under the Chiang Mai Initiative (CMI) denominated in U.S. dollar. After the establishment of the CMIM, members could continue or cancel

these BSAs on a bilateral and voluntary basis. These BSAs keep the feature of linking with IMF program, which means they have close relationship with CMIM and the IMF in terms of financial conditions. Since 2017, JMOF completed a new round of negotiations (so called “new-type BSA”) with BSP, BOT, MAS and BI, which allows the JPY to be another choice in addition to the U.S. dollar.

- There are also other local currency BSAs between central banks in the region. These BSAs, denominated in local currency, are mainly focused on promoting bilateral trade and investment, maintaining financial stability, or providing liquidity support to financial institutions. After the GFC, PBOC has signed BSAs with BOK, HKMA, BNM, BI, MAS, BOT and BOJ, which account for about one half of the total amount signed by PBOC. In 2013, the BOJ and MAS signed a BSA to provide local currency liquidity to the counterparty financial institutions in their jurisdiction. In 2014, the BOK signed BSAs with BI and BNM, aimed at promoting bilateral trade and financial cooperation. In November 2018, MAS and BI signed a BSA with a size of about USD7 billion.

Table 3.6.1 BSAs in the Region

| | Other members | Size in local currency (bn) | Currency | Size in USD (bn) | Note |
|--------------|---------------|-----------------------------|----------|------------------|---------|
| PBOC | BOK | 360.0 | RMB | 52.5 | |
| | HKMA | 400.0 | RMB | 58.3 | |
| | BNM | 180.0 | RMB | 26.2 | |
| | BI | 200.0 | RMB | 29.2 | |
| | MAS | 300.0 | RMB | 43.7 | |
| | BOT | 70.0 | RMB | 10.2 | |
| | BOJ | 200.0 | RMB | 29.2 | |
| JMOF | BI | JP→ID:22.76 | USD/JPY | 22.8 | One way |
| | BSP | JP→PH: 12 PH→JP: 0.5 | USD/JPY | 12.0 | Two way |
| | BOT | JP→TH: 3 TH→JP: 3 | USD/JPY | 3.0 | Two way |
| | MAS | JP→SG: 3 SG→JP: 1 | USD/JPY | 3.0 | Two way |
| BOJ | MAS | 1100.0 | JPY | 9.7 | |
| BOK | BI | 10700.0 | KRW | 9.6 | |
| | BNM | 5000.0 | KRW | 4.5 | |
| MAS | BI | 9.5 | SGD | 6.9 | |
| Total | | | | 320.8 | |

Note: 1. In addition to the above, a JMOF-BNM USD currency swap was agreed in principle in May 2017.

2. Exchange rate (as of 5 December 2018): 1USD=RMB6.860, 1USD=JPY112.93, 1USD=KRW1112.0, 1USD=SGD1.3677.

Source: ASEAN+3 Central Banks/ Ministry of Finance websites.

Impacts on the Use of Local Currency

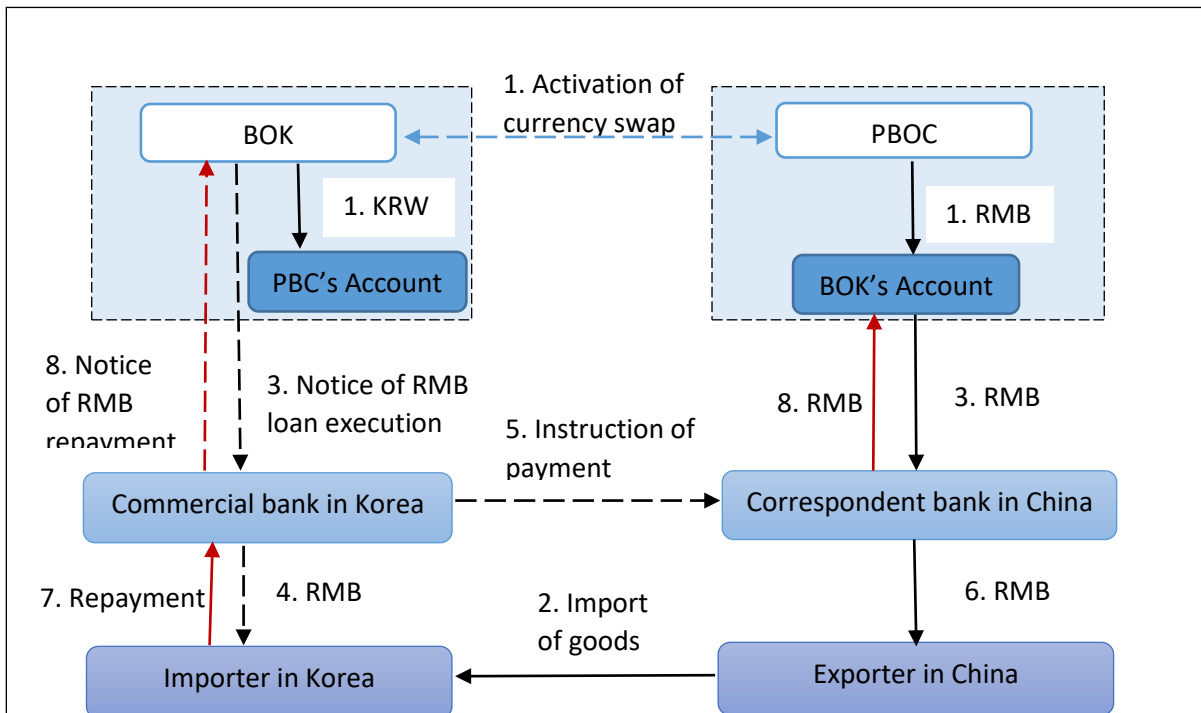
48. Since the GFC, the region has realized the importance of reducing its reliance on the U.S. dollar. However, the U.S. dollar has long been a dominant currency in the regional market, and it's not easy for the market itself to change the trend. In this context, cooperation among authorities becomes very essential for market developments. As mentioned above, some BSAs are signed to provide the first necessary funds to the market to promote local currency settlement in bilateral trade or investment. In other words, BSAs can play a catalyst role in local currency usage. Whether to use local currency or otherwise is for individual companies to decide, but the authorities should make sure that the mechanism is ready when the private sector has the willingness to do it.

Since most ASEAN+3 currencies are not internationalized, the implementation of BSAs also results in some degree of deregulation of its currency. Korea introduced a currency swap-financed trade settlement facility in 2012 to promote local currency usage with China (Figure 3.6.1). Later, Korea introduced the same facility to be used in bilateral local currency swaps with Malaysia in 2014. With the help of such a facility, the share of local currency is increasing gradually both in trade and investment.

49. For the BSAs between JMOF and ASEAN central banks, their initial purpose is to address short-term liquidity difficulties just like the CMIM, by adding JPY as an additional choice besides the U.S. dollar. The authorities, however, believe this will also promote the use of local currencies (including JPY) in Asia in the medium-term, in addition to its contribution to the stability of financial markets. Given the similarity with the CMIM, these BSAs provide good references for local currency contribution to the CMIM.

50. In sum, the BSAs, together with other policy support like the establishment of direct trading between local currencies, have facilitated the increased use of local currency in the region. Even the BSAs that aim to maintain financial stability or provide liquidity support to financial institutions also indirectly send a positive signal to the market or secure local currency liquidity and eventually support local currency usage.

Figure 3.6.1. Illustration From the Perspective of an Importer in Korea



1. The BOK and the PBOC activate the currency swap and deposit the respective currencies in the counterparty's account held with themselves (the BOK places KRW and the PBOC, RMB).
2. An importer in Korea imports goods from an exporter in China on the condition of settlement in RMB and applies for an RMB loan at a bank in Korea.
3. The bank in Korea submits an application for an RMB currency swap-financed loan to the BOK. The BOK reviews the application and transfers the RMB funds to the Korean bank's account with its agent bank (correspondent bank) in China.
4. The bank in Korea signs an RMB loan contract with the importer.
5. The bank in Korea instructs its correspondent bank in China to transfer the RMB funds to the account of the exporter in China.
6. The correspondent bank in China makes RMB payment to the exporter.
7. The importer in Korea repays the RMB loan at maturity.
8. The bank in Korea collects the importer's RMB loan and transfers the RMB funds to the BOK's account with the PBOC through its correspondent bank in China.

Source: "Introduction of Korea-China Currency Swap-Financed Trade Settlement Facility," Press Release, 4 December 2012. Bank of Korea website.

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