

## New Cooperation in East Asia: Peer Assistance and Review

### Executive Summary

Since the financial crisis that started in Thailand in early July 1997, there have been innumerable analyses of the crisis and policy prescriptions for those economies in East Asia most directly hit by the crisis.

Since the analyses highlighted different causes of the crisis, inevitably the policy prescriptions have also varied considerably. In fact, the finger pointing has not stopped.

We are far from any firm consensus, but it has also become increasingly clear that the financial crisis in many East Asian economies cannot be blamed on any single cause. Causes vary in relative importance from one economy to another, although in many instances they tend to reinforce each other. Since we are dealing with economic systems that have become more interdependent with each other, weaknesses and strengths tend to be systemic. And contagion becomes a fact of economic life within each economy as well as within the East Asian region: it also spreads fast and wide.

Faced with contagion, East Asian economies are pragmatic enough to focus their efforts on strengthening their domestic corporate and industrial structures as well as their local financial systems. But they can not stop with domestic reforms. They also are being called upon to undertake initiatives on an East Asian regional basis: **since the problem has a regional dimension, part of the solution must also be region-wide.**

It is in this regard that the Financial Markets Development Project Group of PECC (PECC FMD) is attempting to bring representatives of the three sectors -- government, business, and academe -- generally represented in PECC undertakings, to look at the financial challenge facing East Asian economies. In particular, it is looking at a mechanism by which economies in the region can work more closely with each other in coping with the present crisis and in minimizing future financial crises. PECC FMD will be working to encourage peer assistance, support and review on the three major reform agendas of:

- corporate and industrial restructuring
- financial sector reform and strengthening
- macro-economic risk management

## **Peer Assistance, Support and Review**

The East Asian financial crisis of recent years has highlighted the increasing reality of East Asia as a region in the economic and financial sense. The fact is that global financial markets have begun to treat the increasingly interdependent economies of East Asia as one “Asian” market.

Many, who are still operating with old paradigms, were caught by surprise that a financial crisis in Thailand can spread quickly to the rest of the original ASEAN 5 economies. Their surprise was greater still when told that these ASEAN economies were already put under competitive challenge after the earlier devaluation of the Chinese yuan and the Japanese yen. When the wake of the ASEAN financial crisis also reached and lapped up on South Korea, Hong Kong, and Chinese Taipei, initial surprise turned into deep dismay.

But there should have been little surprise, since there have been rather strenuous efforts at liberalizing trade and investments in East Asia. ASEAN has been aggressively cutting tariffs and other trade barriers within the ASEAN Free Trade Area. Cross-investments have been flowing into the more open ASEAN economies, and more generally into all the other East Asian economies from Japan and even from global financial markets. As a result, these economies have become so much more interdependent. In the process, global financial markets started to deal with them and think of them as one region, and referred to the East Asian region somewhat grandiosely as “Asia”.

An Asia that trades and cross-invests intensely within itself inevitably builds financial links that become much stronger between the individual economies within the region. These economies, more closely bound to each other, are increasingly expected to move more in sync with each other. Indeed, any significant movement or lack of movement in one or a few of the major economies in the region can have substantial impact in the entire immediate economic neighborhood.

If this has become an economic fact of life, and it is expected to become even more so in the future, then the call is for them to act together as neighbors. The field for action can be a very broad one. As a set of economies that place a premium on pragmatism and realism, they can start at the low end of the spectrum, where they feel more comfortable and the prospect for building success upon success, bit by bit, can be higher.

This is the level where they can swap information, exchange notes of experience, look at each other’s successes, particularly in the reform programs they are now undertaking. This can be gradually expanded to sharing of human resource development programs in specific technical areas of common interest to most, if not all, of them. One or two

economies may even put forward specific initiatives around which regional consultation and decision-making mechanisms can be built. The possibilities and opportunities expand with time, as initial joint efforts build trust and confidence that regionalism, of the functional sort, is the effective way forward.

**For as long as economies in the region treat each other as peers, they soon discover that they have many more areas which bring them together rather than those which pull them apart.** Thus, the stress on peer assistance and support, from where mechanisms for peer consultation, exchange, and review can be made to evolve.

### **Corporate and Industrial Restructuring**

A common reform area that many East Asian economies have to focus their efforts on, in the wake of the financial crisis, is corporate and industrial restructuring.

Many corporations and industries have been so weakened by the crisis that they need to be restructured and strengthened.

Corporate and industrial governance issues come to the fore. The application and adoption of key principles of competition policy, in line with open market competition need to be considered and made. Creating or realigning legal and administrative frameworks that are conducive to the workings of market discipline becomes a priority.

This is a complex and difficult field, especially taking into account where many East Asian economies are coming from. It calls for greater transparency, fuller disclosure, more professional, arms-length relationship between government and business, a more even and level playing field, open to all potential players, irrespective of origin, nationality, ethnicity, political or social class and position. The listing of requirements behind the call can go on and on.

What is definite is the need for economies in East Asia to work in support of each other, for that call to be answered decisively and soon. Alone, each one left to itself, any economy will find it difficult, even impossible, to put in the required reforms with the determination and speed that the crisis demands. But together, with support from neighbors and peers who may be undertaking similar reforms, the task can become easier and the possibility of success brighter.

The level of financial and human resources required by corporate and industrial restructuring cannot be underestimated. It is very high. Since new conceptual systems, new operating mechanisms, new attitudes and skills are involved, the time required may also be long. Thus neighbors need to act as peers, in support of each other, at least

through mutual encouragement, sharing of experiences and lessons, and pooling of training and other human development resources.

## **Financial Sector Reform**

For any economy, it is important that the reform effort starts at ground level. Thus, the first steps out of the crisis should be in corporate and industrial restructuring.

**Corporations and industries are at the base of any economy. Strengthen them, and we strengthen the economy in the end.**

But an essential complement to these first steps in corporate and industrial restructuring is the set of crucial steps related to financial sector reform and the strengthening of financial sector supervision. The financial sector is the soft underbelly of any economy. **As recent experience in the wake of the East Asian financial crisis has shown, weaken the financial sector, and the entire economy gets weakened.**

In many East Asian economies, the financial sector must clean up the process by which it reckons itself. It must own up to the dirt it has accumulated in its accounts. It must have a clear and short program for disposing of such dirt and taking the losses for doing so. It must then have a program for rebuilding its capital base. As important and essential, it must take out guarantees, and therefore put new systems and practices in place, to ensure that similar, grievous mistakes are much less likely to be repeated in the future.

For such guarantees to be taken out, an independent financial supervisory authority should be given the effective powers it can exercise in proportion to the serious responsibility invested upon it. There is no gainsaying that financial markets and the discipline of market competition in the financial sector require that such supervisory authority be strong, independent, effective, competent and professional. In fact, for domestic financial markets to operate in an open, competitive, and efficient manner, clear rules and prudential standards must be put in place, and a public authority must strictly monitor their observance. Among the rules of the game within the financial sector are the real prospects of sanctions, with varying severity, as well as of losses and even of closures on the part of financial institutions that go beyond the pale of prudential norms.

All these require enormous effort, resources, and time. Given the diversity of East Asian economies, they can find immediate advantage in close cooperation in this field. For instance, they can work towards coherence and eventual convergence of banking supervision practices. Rules, standards, norms need not be reinvented. In fact, they can simply be put in line with those already adopted internationally. Moreover, the process of transition towards international practices can be facilitated if neighbors and peers in

the financial supervisory authorities of East Asia can freely compare notes of experience in bank restructuring and in financial sector strengthening. Research and training also offer some room, no matter how limited, for sharing. A bigger room will eventually emerge for cooperation in financial sector monitoring and surveillance.

### **Promoting Macro-Economic Stability**

Monitoring and surveillance of macro-economic performance have become the vogue in the wake of the East Asian financial crisis. There have been many calls for a more comprehensive, more detailed reading of economic trends as well as a more forthright reporting of clearly agreed economic accounts. These calls have been issued in the hope and expectation that if they are answered properly and continuously, future crises can be avoided, or their severity can be minimized.

But there has been no clear agreement as to what needs to be monitored, or what items should be subjected to close and continuous surveillance.

In fact, many East Asian economies have expressed “surprise” that their currencies were subjected to attacks by speculators in financial markets despite the underlying “strength” of their macro-economic fundamentals. They have insisted, with general justification, that they have been abiding by the standard macro-economic criteria of high savings ratios, high real economic growth, low inflation, prudent fiscal balances. Conventional macro-economic wisdom should have held those speculators at bay, and should have kept them away, far from East Asian economies religiously observing proper Asian “values”.

The surprise and the self-justified posture only highlight the need to bring officials, academics, and market players together. These need to form a consensus on the items that constitute the full range of macro-economic fundamentals. **It is clear market players and other analysts, who have gone way beyond the old framework of conventional macro-economic wisdom, have introduced new paradigms.** What they think should be included in any monitoring and surveillance mechanism could be subjected to critical study and deep analysis. Eventually some consensus must be forged so officials become realistic and open-eyed in the way they judge their economic performance. Academics and market players in turn can help steer consensus judgments in financial markets, at any time, towards greater stability and earlier warnings.

This is a big wide-open field for cooperation between East Asian economies. Since financial markets increasingly view them as constituting one closely interdependent region, East Asian economies should put in place a mechanism for monitoring of macro-economic performance in the broad and more inclusive sense in which the financial markets make judgments. Such a mechanism will call for their officials to be in close

and frequent touch with each other. These officials may have to come to informal consultation meetings with each other, in ways and frequencies similar to the G-7 process. East Asian Ministers and Central Bank Governors may also have to come together formally a few times a year to review the economies of their region, to read the prospects ahead, and to agree on guidelines for future action.

This will not be easy. This will be new, at least for East Asia. But it is not altogether new in the financial world. Europe has been doing this for many years now. The G-7 has a similar mechanism that has been in place for several years. East Asia, should it decide to initiate such a mechanism, will only be adapting practices already done elsewhere into its new circumstances as an emerging economic region with a weight all its own.

### **Moving Forward -- the APEC Mode**

All these considerations have to be brought into the APEC process to see what consensus can be forged around them. APEC, after all, prides itself for its ability to bring broad ideals, to which there is universal commitment, into specific actions, for which individual economies take full responsibility.

There is need to start with broad ideals then. What might these be in the field of financial and monetary issues?

The answer is not difficult to find, since it stems from the very close inter-relation between trade and finance. Liberalize trade, and sooner rather than later, financial flows would need to be liberalized too. In other words, a commitment to free and open trade and investments carries with it the inextricably connected seed for commitment to free and open financial flows.

This sounds overly simplistic and general. But principles generally do. That is why much of the discussion centers on the phasing and sequencing of steps towards the full application of simple and general principles. For instance, there is a raging debate on what to include in financial liberalization. In some APEC economies, there is also a very strong insistence that conditions do differ between economies, so the timing and pacing of steps in the direction of free and open financial flows must be prudent and deft.

In fact, APEC's experience in trade liberalization should serve it well in the field of financial liberalization.

In Seattle, APEC Leaders committed to free and open trade and investments in the community of economies in the Asia Pacific region. In Bogor, they set a differentiated time frame, one for developed economies (2010) and the other for developing economies (2020), within which the shared commitment is to be actualized. In Osaka

and Manila, they agreed on flexibility by which individual action plans are to be formulated and implemented.

The same approach can be considered for financial liberalization as well. **The principle of free and open financial flows within the APEC community can be held up as an ideal towards which individual economies progress at their own discretion and pace.** But time frames can be set far enough into the future, and with some differentiation between developed and developing economies, to allow for prudent flexibility and time for appropriate institution building. Nonetheless, there should also be individual action plans, submitted to peers, and reviewed periodically to assess real, substantive progress.

In principle, this has been messy and maddening, mainly for those accustomed to more structured and orderly progression towards agreed goals and timetables. But in a region where economies are very diverse, with significant gaps between them in terms of economic and institutional development, there is no realistic alternative.

But in practice, despite the frustration and the multiple irritation over failure to move in lock step, the APEC process has served the Asia Pacific region well in the field of trade liberalization. Economies have been forthcoming in unilaterally bringing down barriers to trade and investments. Sub-groups of economies have also banded together to set a faster pace and reach a higher bar together with their more immediate neighbors. In the seeming disarray, there has been significant advance towards free and open trade within the region. The advances have been made possible because of the process itself.

### **Building Blocks for Regional Engagement**

APEC is a multi-faceted process, which is open to differentiated levels of engagement at any given time.

At the lowest level lie informal conversation and open dialogue. The importance of these cannot be underestimated. Between economies that had not been in frequent and meaningful contact with each other, the opportunity to meet, talk with, listen to, and observe others from the same general geographic and economic neighborhood is invaluable. Familiarity in most instances leads to friendship, which can be sustained over many years to become deeper and more genuine as a base for greater understanding.

Greater understanding brings neighbors to a higher level, that of cooperation and mutual support. Once economies know each other much better, soon areas of common interest become clear. More than a few present themselves almost naturally, especially if the conversation has been focused on a specific field such as trade, or possibly finance. Over

time, the possibilities expand and multiply to a point where meetings become all too frequent and occasions for exchange and contact almost unlimited.

From all these exchanges and contacts arise specific possibilities for coordination and joint action. When neighbors reach this very high level, they are on to putting in place substantive building blocks by which a genuine community can be established. Their interaction strikes deeper roots, which eventually allow neighborhood or regional institutions to grow and become strong. Through those institutions and other oft-used and well-oiled regional mechanisms, many initiatives can be coordinated and jointly undertaken. These initiatives sustain and substantiate the community spirit that can then move more freely and go where it wills.

In real interaction between economies, there is free and uninhibited movement up and down the different levels of interrelationship. Conversation and open dialogue continues even as many areas for cooperation and mutual support are already explored and worked on. They continue to be even more important as coordination and joint actions are undertaken. In such a complex web, one level intrudes into the other, and all levels are mutually supportive of each other.

### **Priorities in Conversation, Cooperation, & Coordination**

At the level of conversation and dialogue, general principles and broad ideals predominate. These are not unimportant. They are essential. Indeed, the commitment made in Seattle by APEC Leaders to free and open trade and investments came as a result of their conversation. That commitment rang out loud and clear. It was soon heard by Ministers and Officials, by academics and strategic business managers who went to work, trying to give substance to it.

In the attempt to substantiate broad commitments to a principle or ideal, practices need to be closely examined. They have to be sifted for their consistency with the principle. For instance, in trade, practices have to be tested against the principle of free and open trade and investments. Tests provide norms and set standards. Thus, in trade again, tariff and non-tariff barriers need to come down. A long-term program has to be formulated and implemented accordingly, over a given time horizon. In this regard, there is need for close cooperation between economies. Many economies also find themselves in need of support from others. And it is for this reason that trade and investment facilitation as well as economic and technical cooperation take on enormous importance, especially for developing economies.

As several economies undertake broadly similar programs towards the same ideal, they soon find areas for close coordination and joint action. This is where the rubber hits the road. This is where focused outcomes and concrete steps take precedence before all else.



This is where common practices become vital and the regional institutions to promote them and secure their observance become essential. But this point is reached after many years of conversation and open dialogue, and after many successful experiences through cooperation and mutual support within the region.

An example of this in the field of finance can be taken out of many decades of community building work in the European community. In the Asia Pacific region, and particularly in crisis Asia, where conversation and open dialogue are of recent vintage, and where cooperation and mutual support are a new experience, it is premature to suggest coordination and joint action. It is only after many more years of closely interacting with each other on financial and monetary issues that they can begin to consider in what specific areas they can cooperate, where they can mutually support each other. In time, they should be able to move on and coordinate a few of their actions under specific circumstances.

**In crisis Asia, the recurring reference to anchors, baskets, and bands may be a case of putting the cart before the horse.** In a period of instability, one sympathizes with the desire of having more stable anchors for the currencies in crisis Asia. The US dollar, the European euro, and the Japanese yen can provide these anchors, for as long as they remain relatively stable towards each other through the Financial Stability Forum and other mechanisms of the G-7. But even anchors move, and within the current international financial architecture, the three anchor currencies do move relative to each other. Thus, in many economies within crisis Asia, there has been an attempt to keep all three anchor currencies in their basket of reserves. The weight of each anchor currency should be broadly reflective of the weight of economic and financial transactions each economy has with the United States, Europe, and Japan. The weight changes flexibly and often so as to obviate the need for big revaluation. The same flexibility, perhaps within somewhat broader bands, should be kept by the currencies of other economies in crisis Asia in relation to each other.

It is easy to see that this is pie in the sky today. Even if desirable, the arrangements would require tight and close coordination as well as occasional, hopefully not too frequent, joint action. Crisis Asia is far from ready for all these. The economies are relatively new as dialogue partners. They are even newer as peers who normally would cooperate with and give mutual support to each other. They are a far distance away from being able to coordinate closely and take action jointly especially in such a sensitive area as finance.

But this does not mean that no initiative should be undertaken. In fact, the first steps need to be taken now at a time of crisis so crisis Asia can seize the opportunity of taking together a journey of a thousand miles. It is in this spirit that PECC FMD is taking

initiatives to promote a process of conversation, cooperation, and eventually of coordination within crisis Asia, and eventually also within APEC.

### **PECC FMD Work Program**

FMD has taken all these considerations, and has decided to undertake a few immediate initiatives.

On a functional basis, we have followed the financial markets in their judgment that in East Asia -- as the financial and economic crisis has shown -- ten economies have to consult more freely with each other. Indonesia, Malaysia, the Philippines, Singapore and Thailand are the original ASEAN 5. Japan, China, Hong Kong, Chinese Taipei and South Korea are APEC economies in North East Asia. These economies are the East Asian 10. They are at the very core of crisis Asia. They need to dialogue and converse as well as cooperate with each other more productively, with a view towards initiating and eventually strengthening mechanisms for mutual exchange and support in the region.

The principle of subsidiarity suggests that the crisis economies should be at the forefront of reforms. Most of those reforms are to be undertaken domestically. The weight of the work that needs to be done has to be shifted largely to domestic policies impinging upon the strength and competitiveness of corporations, enterprises, and industries as well as upon the stability and strength of the banking and financial sector. A strong micro-economic base provides the foundation for a strong macro-economic structure, which also has to be properly tended by policies consistent with market discipline.

Even as homework has to be given the critical importance, economies in crisis Asia should be given every opportunity to consult with and learn from each other. After all, many of the basic elements of the homework they need to undertake are similar. All of the reforms, precisely because they have to be market-consistent and in broad conformity with the paradigms of the APEC principle of free and open trade and investment, follow the same general orientation. There can be benefit from the economies of crisis Asia dialoguing with and supporting each other on their respective reform agendas towards financial market stability and development.

The recent financial crisis has highlighted three major reform agendas where the East Asian 10 can cooperate with and support each other as peers.

The first is **corporate and industrial restructuring**. Most East Asian economies are already engaged in this critical and huge initiative. From adoption of principles of competition policy to application of techniques for corporate workouts and proper corporate governance, the field is wide for regional dialogue and exchange.

The second is **financial sector reform and strengthening**. Many East Asian economies have established independent financial supervisory authorities. Their initial experience is well worthwhile documenting, so others can learn from it. The broader challenge of strengthening financial sector supervision has been hurled to all these economies. They can look for concrete and practical possibilities by which they can meet the common challenge together.

The third is **macro-economic risk management**. Both ASEAN and APEC have called for a mechanism, which should include peer assistance and support so it leads to a productive and effective peer review. The East Asian 10 can take the initiative to set up such a mechanism for the region. For as long as they operate such a mechanism in a manner consistent with the open regionalism principle of APEC, they can make it work for themselves. In time, after it has been strengthened, it may even become its contribution to a more global initiative under a new financial architecture.

These reform agenda items are already being addressed at different levels, in different fora, and by different bodies. Within the official process of both ASEAN and APEC, there are already several ongoing initiatives on these items.

PECC FMD Project has created a separate, supportive track to the official process. Our track is continuous, since it is led by academic institutions and is backed up by ongoing research. Its main purpose is to add value, to continue something of substance and meaning to the official process.

Moreover, we preserve a distinctive, definite tripartite character, a hallmark of PECC. We count upon contribution of Ministers and Officials, acting under their unofficial capacity. We seek out the active and deep involvement of business players and representatives from other relevant sectors. We put great value on the ideas and research results of academics. We get together in occasional workshops and seminars, mainly to gain insight into each other's views, and eventually to formulate reports, intended for leaders of all types (including the APEC Leaders) with whom we communicate in a free and open manner.

A small Secretariat<sup>1</sup> is taking a responsibility for promoting and integrating the results of our three umbrella programs, which relate to the major reform agendas in the field of finance.

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<sup>1</sup> The Secretariat is with the FMD Chair, currently in Manila, the Philippines.

We organize working parties after our occasional Workshops so continuing work is undertaken, and so networks are forged and strengthened. In fact, we take pains to ensure that our network is active, alive, and well wired.

The results of our work are to be presented in the General Meeting of PECC (Manila, October 1999). They are also to be reported to APEC officials, Ministers, and Leaders (1999).

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<p>This paper is prepared by Dr Jesus Estanislao, in his role as Chairman of the PECC Financial Markets Development Project Group (PECC FMD)</p>
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