

ISSUES

PACIFIC ECONOMIC COOPERATION COUNCIL



Prospects and Challenges for Regional Financial and Monetary Cooperation among PECC Economies

Governmental Perspectives on
Regional Financial Cooperation

Report of Country Surveys by the PECC Finance Forum

Background and Key Findings

The Asian financial crisis of 1997-98 has triggered a proliferation of serious efforts among the PECC economies, especially among those in East Asia, to promote closer regional cooperation to prevent the recurrence of such crises and to prepare to manage them better when they occur. Regional financial cooperation has become a new main focus at a number of existing regional economic forums such as SEANZA (1956), ASEAN (1967), SEACEN (1981), and EMEAP (1991). A few regional forums such as the Manila Framework Group (1997), ASEAN Surveillance Process (1998), and the ASEAN+3 Chiang Mai Initiative (2000), have been newly created with the promotion of closer financial cooperation as the main goal. It is highly significant in this regard that the APEC Economic Leaders Declaration issued in Shanghai on October 21, 2001 states:

“[R]ecognizing the importance of promoting financial stability and crisis prevention, we stress the need to strengthen the international financial system... While the IMF and other international financial institutions play a pivotal role, regional cooperation can also be very useful in complementing efforts by these institutions to promote financial stability. In this connection, we welcome the substantial progress in implementing the Chiang Mai Initiative to

strengthen cooperative financing arrangements among the Association of Southeast Asian Nations (ASEAN) countries and China, Japan and the Republic of Korea. We also note the ongoing work in the Manila Framework Group. We support all these efforts and urge them to be strengthened.”

These are all important developments strongly indicating the possibility of the emergence of regional systems of policy cooperation for financial and monetary stability in East Asia. To be realistic as well as constructive, however, this possibility has to be carefully viewed against those various conditions---developmental, structural, institutional, and political---of the East Asian economies taken as a group which, on the whole, seem to present difficulties.

One of the first initiatives of the PECC Finance Forum that was created in late 2001 was to examine the prospects for the evolution of closer regional financial and monetary cooperation in the region with a focus on East Asia. A task force¹ was created for this purpose and it carried out a survey of the PECC economies during June-July 2002. This report summarizes the main findings of the survey.²

1 Called the Financial and Monetary Cooperation Task Force (FMC), this Task Force was coordinated by Dr. Soogil Young, Coordinator of the Finance Forum. The research was designed, and the main text of this report written, by Prof. Wendy Dobson, University of Toronto.

2 The full report on the results of the survey, along with the questionnaire on which the survey was based and a background paper that was circulated with the questionnaire, may be found on the website: <http://www.pecc.net/finance/fmc/survey-report.htm>.

The purpose of the survey was to assess the status of intergovernmental arrangements for closer regional financial cooperation by inquiring about the governmental views on the desirability, reality, potentiality, and future directions of those arrangements. Thirteen economies from East Asia, Western Pacific Asia, and the Americas responded.³ Most respondents were officials and advisers in the finance ministries and central banks. The results are therefore presented in a way that preserves respondents' anonymity.

Major conclusions of the survey are:

- There is a unanimous desire for closer regional economic cooperation.
- East Asian economies are very determined to develop a self help capability to reduce their vulnerability to volatile international capital flows.
- There is also widespread expectation that the G 10 economies will follow through on reforms to increase transparency in financial markets and enhance supervisory efforts to reduce the volatility of capital flows on the “supply side” of these flows.

Concerning what, if any, should be done to improve and strengthen regional processes and institutions in East Asia:

1. Sequencing reforms. While there was a consensus on the value of consultative and cooperative forums, it was noted that the ASEAN + 3 Vision Group has recommended a sequenced two-track approach to financial integration, beginning with self-help financing arrangements, followed by the coordination of a suitable exchange rate mechanism. It was also emphasized that more effort is needed to reduce intraregional trade barriers as a precursor to deeper monetary integration.

2. More robust surveillance. It was also emphasized that a more robust surveillance mechanism is required. Such a mechanism will depend on agreed future financial agreements. Indeed, some respondents suggested that the regional mechanism should aim to be more ambitious than IMF Article IV surveillance (IMF+); that it should deepen the substantive preview beyond what is carried out by the IMF, for example through the examination of financial systems and corporate governance.

³ The thirteen economies are Australia, Canada, Chile, China, Chinese Taipei, Japan, Korea, Malaysia, New Zealand, Peru, Singapore, Thailand and United States.

3. **Institutional support.** Another reform theme was secretariat and institutional support for regional cooperation. One suggestion was to develop an independent surveillance unit as a standing secretariat to support the dialogue process (three possible candidates exist: ASEAN Surveillance Unit, the Regional Economic Monitoring Unit of ADB, and the Asian Development Bank Institute – or even collaboration among these three). It was also noted that Malaysia and Japan have suggested a possible modality whereby finance deputies in ASEAN+3 might meet to focus on economic reviews and policy dialogue in greater depth; the Secretariat function might rotate from one government to another. A second phase was also suggested – involving an independent third-party assessment -- but this suggestion was rejected.

4. **Membership.** A fourth reform theme focused on membership in regional financing mechanisms. One sub-theme was criteria for “widening” membership in Chiang Mai Initiative (CMI). For example, it was suggested that ASEAN + 3 should consider an accession clause to the BSA (Bilateral Swap Arrangements)

mechanism to allow anyone who wants to join CMI to provide a swap line with at least two - thirds of the existing membership. Another criterion proposed was to accept as members those countries that have "financial capacity", measured by reserves or capacity to borrow. Another sub-theme explored the possibility of a ‘two-speed’ Asia: accelerate deeper cooperation among the most market-oriented members of APEC and deepen technical support for the other members.

Analysis of Responses in Detail

A Common Vocabulary

Before reporting the results in detail, a common vocabulary will be established, since certain terms were used repeatedly in the country reports, but sometimes with different meanings. The term "cooperation" refers to a spectrum of activities ranging from information exchange and consultation, to mutual encouragement, joint problem identification, and the pursuit of mutually beneficial ways to tackle objectives. The term "regional cooperation mechanisms" refers to a range of forums; some focus on trade policy. In the context of this report "regional cooperation mechanisms" refer to forums for macroeconomic policy consultation among finance ministries and central banks and to forums with a microeconomic focus on financial institutions, financial markets and products, and regulatory and supervisory issues. "Regional financing mechanisms" is another term that was frequently used; it refers to a group of economies that enter into an agreement to provide financial resources to members to facilitate an effective response to a financial crisis. "Monetary cooperation" refers to monetary and exchange rate arrangements among member central banks to stabilize exchange rates or even create a common currency to be used in member countries. Finally, "surveillance" refers to efforts among national authorities to monitor regional and

national economic performance and policies and to engage in peer pressure for preventive and/or corrective actions.

Regional Financial Cooperation

Respondents were asked about the desirability and necessity of regional cooperation. They were also asked to indicate which regional institutions best serve the goals of regional financial cooperation and the practices of these institutions in monitoring economic performance and preventing future financial crises. Experience has shown that the effectiveness of cooperative institutions often depends on which countries provide leadership; it also depends on the degree of cooperation within the bureaucracies of countries themselves. Thus questions were posed about leadership provided by member countries in these institutions and the roles played by central bank and finance ministry officials.

East Asian and Latin American countries have different objectives. Hence the discussion that follows is divided along geographical lines beginning with East Asia.

East Asia

There was consensus on the desirability of closer regional cooperation in East Asia. Various views emerged, however, as to whether and how

to strengthen such cooperation. Some suggested regional cooperation should aim to improve the understanding of each other's policies and performance, but that action itself should be taken only by the global financial institutions. Others believed that regional cooperation mechanisms could be strengthened sufficiently for members to take joint action. One respondent pointed out that recent financial crises in Latin America suggest that IMF surveillance, while necessary, is no guarantee for financial stability.

Respondents evaluated various regional institutions. Some have been around for many years; SEANZA, for example, was created in 1956; ASEAN in 1967. (See Table 1.) Some respondents commented that there are too many institutions, but others reflected that some overlap may be a good thing and that competition for leadership might hasten the integration process. They identified different countries providing leadership in different areas. Japan provides leadership on regional financing mechanisms, the United States in the Manila Framework Group, and China on regional free-trade areas.

All respondents commented on the potential value of ASEAN + 3 and the Chiang Mai Initiative (CMI).⁴ Some noted, however, that CMI has not

yet been tested by a crisis. Many respondents noted the value of EMEAP. Some of its strengths derive from its homogeneous membership, its clear technical focus, and its potential as a foundation stone for deeper monetary cooperation.

Suggestions for institutional reform tended to begin with the observation that "there are too many meetings" and that it might be sensible to merge APEC and the MFG, with the MFG becoming a deputies' process on the margins of APEC meetings. This suggestion was countered by some who observed that since there are unresolved membership issues in the Asia-Pacific region, specifically the involvement of Taiwan, Hong Kong, Australia, New Zealand and the United States, a plethora of mechanisms for the time being allows for the involvement of all of these players. Some emphasized that the time is not yet right to rationalize the existing structure; rather certain institutions require deepening before they widen their memberships.

Latin America

Respondents commented that the themes of regional financial cooperation in Latin America differ from those in East Asia. Monetary and financial cooperation depends on open capital

⁴ This is a financing mechanism based on bilateral swap arrangements (BSAs) created in 2000 at a meeting in Chiang Mai, Thailand by the members of ASEAN + 3. It is envisaged to be complementary and supplementary to the IMF's financing facilities. Joint work is underway to develop an appropriate surveillance mechanism that is necessary to facilitate the conditions under which members could obtain liquidity support in a crisis.

markets and current accounts and on full integration with international markets in trade and finance. In the Latin American economies, domestic reforms are necessary to liberalize exchange rate regimes as well as to support domestic financial service providers so that they can compete with foreign financial service providers. These reforms need to involve the creation of solid banking systems and the development of financial innovation such as hedging instruments, both of which need to be built on a base of sound macroeconomic conditions, and on solid, prudent fiscal positions in particular. They emphasized the importance of inflation targeting as an anchor for floating exchange rates and the importance of free-trade agreements to increase the economic integration of Latin American economies with the rest of the world.

Latin American respondents also noted certain other topics:

- A regional financial fund: they noted the importance of a regional fund to reduce contagion and suggested two criteria for its activities: (1) it should supplement IMF resources and (2) it should be able to act more quickly than the IMF.
- Curbs on international capital flows might be required, although the first line of defense should be domestic supervisory systems that meet global standards.
- Regional financial cooperation through dollarization: respondents raised the question of whether Andean financial cooperation might be deepened by dollarizing.

They reported on 3 initiatives to promote Latin-American financial cooperation: the Agreement of Reciprocal Payments and Credits of the Latin American Integration Association (ALADI); the Latin American Fund of Reservations that supports macroeconomic adjustment; and Andean Development Cooperation, a multilateral financial institution to promote sustainable development and regional integration.

Examples of Cooperation

Respondents were requested to provide some examples of successful cooperation and some negative examples. The following examples (which overlap somewhat) were cited as positive examples:

- Swap arrangements among central banks (success attributed to EMEAP);
- First line of defense arrangements in the Asian financial crisis;
- CMI swap agreements;
- APEC Finance Minister dialogue on corporate governance in financial markets;
- Regional Training Center in Singapore;
- EMEAP activities.

Examples of unsuccessful attempts at cooperation included the following:

- The second line of defense in the Asian crisis;
- " Emotional" elements in ASEAN + 3;
- APEC finance ministers and MFG “barriers to provision of effective levels of technical assistance”.

Regional financing arrangements in Asia

Respondents noted that the main rationale for regional financing arrangements is to reduce the risks of contagion in future financial crises; to facilitate effective crisis response efforts; to bolster investor confidence and to supplement the IMF resources.

Some emphasized the design risks of such arrangements. Moral hazard heads this list. Providing financing without appropriate criteria for eligibility and without transparent terms to be met by the borrower can create expectations of bailouts; borrowers take greater risks if they think they will be bailed out than they would if they knew they would be at the mercy of market forces. Thus, respondents emphasized the importance of basic principles to guide regional financing arrangements. Such financing should complement IMF funding; it should reinforce IMF conditionality; it should require effective surveillance mechanisms and ensure that sources

of moral hazard are removed from the design of such arrangements. It was also emphasized that a platform for crisis management has yet to emerge. While there was widespread recognition of the Chiang Mai Initiative as a "good start", most noted that its effectiveness as a crisis prevention and the management mechanism has yet to be tested by a crisis.

Respondents noted that a number of global mechanisms provide surveillance in the East Asian economies. These include IMF Article surveillance and the IMF/World Bank Financial Stability Action Plans as well as the Reports on Observance of Standards and Codes (ROSCs). ASEAN created its surveillance process in 1998, assisted by the Asian Development Bank Regional Economic Monitoring Unit (REMU). APEC voluntary action plans were also identified as regional surveillance mechanisms.

Evaluations of the effectiveness of these forums varied. Some noted that regional forums are not suited to the surveillance function due to the restricted mandates that prevent peer review and rigorous assessment of the performance of member economies. One observer also suggested that in fact there is no independent institution to carry out regional surveillance. Others made a similar observation, noting that "ASEAN + 3 and MFG are the only institutions focusing on a crisis prevention" but that ASEAN+3 needs an

independent surveillance mechanism to encourage sound policies.

The longer term: regional monetary cooperation in East Asia

The other topic receiving extensive attention was the prospects for monetary cooperation. Respondents noted that the purpose of such cooperation would be to reduce exchange-rate volatility by creating an Asian Currency Unit and eventually a common currency area. However, a number expressed skepticism that such a development would be possible any time soon. First, sound foundations must be laid by strengthening and modernizing domestic financial systems. Prudent domestic fiscal and monetary policies must be part of the foundation.

A number of principles for successful monetary cooperation were noted. First, unwavering political and institutional commitment is required to make the system work. Central banks should be independent. Systematic opportunities are required for dialogue and communication among member economies. Deeper economic integration through trade and capital flows is a necessary precondition (indeed, one example put forward for this linkage was the trade integration underway in Greater China as a basis for closer monetary cooperation in future). Common standards need to be created for banking,

accounting, etc., to provide benchmarks for sound domestic financial systems. These standards should be global. Finally, effective surveillance mechanisms are essential.

It was noted that the ASEM/Kobe project (in which ASEAN + 3 researchers cooperate with European researchers) begun in 2001, provides a welcome mechanism to allow East Asian economies to draw lessons from the EU experience.

Views on the role of the international financial institutions

Several views were expressed. One observation was that the more effective and reliable is global financial cooperation, the smaller is the need for regional cooperative mechanisms. A contrasting view was that credible regional financial arrangements may be better suited to preventing contagion than the IMF. Despite these differing views, there was general agreement that robust links are needed between regional and global financial institutions. It was also observed that efforts to develop alternative regional financial institutions provide leverage for East Asian countries to increase their clout and their profile in the global financial institutions.

Table 1. Forums for regional financial cooperation: East Asia, 2002.

Forum	Membership	Founded (year)	Focuses	Mandate
SEANZA (South East Asia, New Zealand, Australia)	Central bank governors from British Commonwealth countries in Asia	1956	Providing training course for central Bank staffs and forum of Banking Supervisors in order to exchange information on issues and problems of common interest	The objective of The SEANZA Forum of Banking Supervisors established as an offshoot to provide a means for banking supervisors from the region to establish contact with each other
ASEAN (Association of South East Asian Nations)	10 member countries: Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam	1967	The objective range from free trade to environmental protection, social, cultural and scientific development	
SEACEN (South East Asian Central Banks)	Central banks of 11 economies: Indonesia, Korea, Malaysia, Myanmar, Mongolia, Nepal, Philippines, Singapore, Sri Lanka, Thailand, Taiwan	1982	Facilitating co-operation in research studies and training program relating to the policy and operational aspects of central banking	The objectives of The SEACEN Research and Training Centre established as a legal entity to promote a better understanding of the financial, monetary, banking and economic development matters...
APEC (Asia Pacific Economic Cooperation)	21 member economies	1989	Macroeconomic issues and exchange rate issues, freer and stable flows of capital, private sector participation in infrastructure development, and the development of financial and capital markets	Leaders' Declaration in Vancouver in Nov 1997 (This is the first time to touch upon the regional surveillance) ...strongly endorse the framework agreed to in Manila as a constructive step to enhance cooperation to promote financial stability; enhanced regional surveillance; intensified economic and technical cooperation to improve domestic financial systems and regulatory capacities...

Forum	Membership	Founded (year)	Focuses	Mandate
APEC Cont'd				<p>Memorandum to APEC Leaders in Sep 1999 Ministers reaffirmed the value of peer surveillance within APEC economies and the benefits to be derived from greater co-operative efforts at the micro level, particularly in financial and capital markets</p>
EMEAP (Executives' Meeting of East Asia and Pacific central banks)	Central banks and monetary authorities of 11 economies: Australia, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore, and Thailand	1991	Exchanging the information in the areas of banking supervision and monetary policy, foreign exchange policy and operational issues (3WG on Payment and Settlement Systems, Financial Markets, Banking Supervision) Reporting on the Regional Foreign Exchange Markets Monitoring and Exchange Rate Regimes	Governors' unanimous agreements at the meeting in July 1997 that a closer cooperation and coordination among EMEAP members is necessary and important to enhance financial stability and market development in Asia Pacific region
Manila Framework Group (MFG)	Finance and central bank officials from 14 member countries (Australia, Brunei, Canada, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore, Thailand, and the United States of America) and representatives of IMF, World Bank, ADB and BIS	1997	macro-economic policies of crisis-affected economies in the region, exchange rate developments and their implications for monetary policies in the region (6th Meeting in March 2000) strengthening of IMF facilities, strengthening the international financial system, including the work of IMF, G-20, FSF (8th Meeting in March 2001)	Finance and Central Bank Deputies Agreement at the meeting in Manila In Nov 1997 as follows This framework includes the following initiatives: (a) a mechanism for regional surveillance to complement global surveillance by IMF, (b) enhanced economic and technical cooperation particularly in strengthening domestic financial systems and regulatory capacities, (c) measures to strengthen the IMF's capacity to respond to financial crisis (d) a cooperative financing arrangement that would supplement IMF resources.

Forum	Membership	Founded (year)	Focuses	Mandate
ASEAN Surveillance Process	Same as ASEAN	1998	Monitoring and analyzing macroeconomic situation and developments, and any other specific areas including structural and sectoral issues Enhancing surveillance work, relevant sector and international organizations within and outside ASEAN may be consulted	Terms of Understanding in 1998 1. exchanging information and discussing economic and financial development... 2. providing an early warning system and peer review process to enhance macroeconomic stability and financial system 3. highlighting possible policy options and encouraging early unilateral or collective actions to prevent a crisis... 4. monitoring and discussing global economic and financial developments...
ASEAN+3	13 countries (ASEAN economies plus China, Japan and Korea)	2000	Enhancing policy dialogues and regional cooperation activities, particularly in the areas of regional self-help and support mechanism, international financial reform and short-term capital flows monitoring, Exchanging data on capital flows bilaterally among member countries on a voluntary basis	The Joint Ministerial Statement of the ASEAN+3 Finance Ministers Meeting in Chiang Mai in May 2000 ...we agreed to strengthen our policy cooperation activities in, among others, the area of capital flows monitoring, self-help and support mechanism and international financial reforms... The joint Ministerial Statement of the ASEAN+3 Finance Ministers Meeting in Honolulu in May 2001 ...we agreed to update the capital flows situation in each member country and to exchange data on capital flows bilaterally among member countries on a voluntary basis...

Forum	Membership	Founded (year)	Focuses	Mandate
BIS Asian Consultative Council	Governors of BIS member central banks in the region	2001	Providing a vehicle for communication between the Asian and Pacific members of the BIS and the Board and Management on matters of interest and concern to the Asian central banking community	
IOSCO Asia Pacific Regional Committee	A regional committee of securities regulators: Australia, Bangladesh, China, Hong Kong, India, Indonesia, Japan, Korea, Kyrgyz Republic, New Zealand, Pakistan, Papua New Guinea, the Philippines, Singapore, Sri Lanka, Taiwan, Thailand, Viet Nam and Malaysia	2002	Regional co-operation in the regulation of the capital markets, particularly focusing on the enhancement of co-operation, mutual assistance and information-sharing in the enforcement of illegal securities activities. Formulating a regional approach in combating these illegal operations, which have affected investors in the region	APRC will consider its regional multilateral Memorandum of Understanding, aimed at enhancing information sharing as well as cross-border co-operation and multiple jurisdiction surveillance and enforcement functions. (2002) (IOSCO established a Special Project Team on co-operation, which is developing an IOSCO-wide multilateral MOU.)

Source: Ito, Takatoshi. 2002. "Regional Surveillance Mechanisms in East Asia". Unpublished.

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