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Issues and Prospects for Regional Cooperation for Financial Stability and Development

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Day One: Scope for Regional Financial Cooperation among PECC Economies

Session I: An Overview – ***What are the issues?***

Whither Monetary and Financial Cooperation in Asia?[1]

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1. Introduction

For many, the Chiang Mai Initiative is indicative of an historic shift in Asia's approach to regional integration. The event responsible for this change was, of course, the 1997-8 financial crisis. That crisis fostered the belief that Asian countries need to band together in order to create a framework for economic, financial, and political stability in which the contagious spread of crises is minimized and they are insulated from destabilizing impulses emanating from outside. As three Korean authors have put it, "...when East Asian countries were attacked by vagrant international capital and were temporarily short of liquidity, they could not depend on the IMF or other international organizations as lenders of last resort. Thus, in order to avoid the detrimental effects of exchange rate crises due to unstable capital flows, East Asian countries must protect themselves."[2] Charles Oman has written that regionalism should be understood not just as an attempt to achieve specific economic objectives but as a broader effort to regain political control over the process of economic globalization that has curtailed the effectiveness of national policy instruments.[3] Nowhere does this observation, penned in 1994, have more salience than in post-crisis Asia.

Moreover, in Asia today there exists not just the desire but also the basis for economic, monetary, and financial cooperation. Efforts to cultivate closer ties can build on existing

[2] Moon, Rhee and Yoon (2000).

[3] Oman (1994), pp.11, 35.

regional institutions such as ASEAN, ASEAN+3, PECC, APEC, and the ADB, which bring together officials and technocrats to discuss issues of common interest.

The beginning of the new century may be an especially propitious time for advancing the process of regional integration. Japan, seeing its currency weaken and becalmed in macroeconomic doldrums, fears losing its place in the region and the world. Its market-led approach to regionalism, which relies on exports and foreign investment to bind Asia closer together -- and closer to Japan -- has grown less effective as the Japanese economy has grown less dynamic. Tokyo has consequently sought to supplement market-led regionalism with policy-led regionalism. It seems less deterred from proposing regional initiatives by the fear of reawakening historical antagonisms. It thus tabled the Miyazawa Plan, advanced its proposal for an Asian monetary fund, and launched the Chiang Mai Initiative.

The crisis seems to have had much the same effect in China, which is now more willing to engage its Asian partners. Beijing's early opposition to Tokyo's proposal for an Asian monetary fund, reflecting wariness that this would increase Japan's influence in the region, has given way to active participation in ASEAN+3 and support for its policy dialogue and credit lines, as Chinese leaders increasingly see their country playing a leadership role internationally. Indonesia, Malaysia, Singapore, and Thailand, for their part, see ASEAN+3, which takes their Association of South East Asian Nations as the platform for wider initiatives, as elevating the stature of a troubled grouping that has failed to deliver on the promise of deep integration.

Those unconvinced by this discussion of factors and trends need only consider concrete economic and political achievements in the last 12 months. Tokyo and Beijing successfully

used consultation to resolve their dispute over Japan's safeguards on agricultural imports, averting the threat of Chinese retaliation. In November 2001 China and ASEAN committed to negotiating a free trade agreement (FTA), and Japanese Prime Minister Koizumi responded not with warnings but by proposing a parallel Japan-ASEAN FTA. Koizumi emphasized that cooperation between ASEAN and Japan in developing deeper links should extend to both other issues (besides trade) and other countries (notably China, Korea, Australia, and New Zealand). Meanwhile, the prospective depreciation of the yen, which is widely seen as a necessary part of Japan's economic recovery strategy, has intensified the pressure on other East Asian countries that fear that their competitiveness will be eroded, providing a further motivation for cooperation and intensifying the dialogue among regional monetary authorities. If this was not enough, Korea and Japan served as joint hosts of the World Cup.

For all these reasons, East Asia is changing. As Fred Bergsten (2000a) has put it, the region may be on the threshold of a revolution in integrationist thought and policy not unlike that of Western Europe 50 years ago.

The Chiang Mai Initiative, or CMI, is a case in point. Gauged by the number and economic weight of the participating countries, it is more encompassing than any previous East Asian initiative. The financial commitments exceed anything that has been attempted before. And, by addressing problems of money and finance, the CMI speaks to issues brought to the fore by the Asian crisis. It illustrates that more serious efforts are being made to advance the process of regional integration than at anytime in living memory.

Yet key questions regarding the structure and operation of the CMI remain to be

answered. In part, this reflects the stance of "constructive ambiguity" adopted by Asian officials to deflect the objections directed at their earlier proposal for Asian monetary fund. But this stance has costs; in particular, governments are unlikely to invest significant resources in a new regional arrangement unless its objectives are made explicit and hence the returns on their investment are clear.

The central question from this point of view is on what concrete objectives the CMI should focus – the stabilization of intra-regional exchange rates, or something else? And how should this regional initiative be structured to conform to the constraints and opportunities posed by the distinctive histories and circumstances of the participating countries? What, moreover, is the relationship between these two questions – in particular, what are the implications of institutional form for the kind of cooperation that can be successfully sustained?

My answer is that Asia's history and current circumstances make the kind of strong institutions and close cooperation needed for successful exchange rate stabilization and monetary integration unlikely anytime soon. The existence of historically-rooted sources of resistance casts doubt on the advisability of forcing the pace -- of first negotiating an exchange-rate stabilization agreement and hoping that this then encourages closer monetary and exchange-rate cooperation. It suggests that moving ahead with a system of collective basket pegs as a first step toward monetary integration would be a costly mistake whose failure could discredit the wider process of cooperation.

The gist of the argument is as follows. Exchange rate stabilization is an expensive proposition in a world of liquid financial markets. A successful exchange-rate stabilization

agreement must therefore be rooted in deep political commitments on the part of the participating countries. Beating back market forces requires pooling reserves, and pooling reserves presupposes a willingness to pool political control over financial resources. The ability to anchor market expectations requires the participating countries to continuously move down the road toward deeper monetary integration. In turn, this requires a political commitment to deeper integration and the creation of supranational institutions with agenda-setting power. These are demanding preconditions; not even Western Europe could satisfy them continuously in the final quarter of the 20th century.

The kind of cooperation that is feasible under these circumstances is not cooperation to hit a quantitative target -- not an effort to stabilize a set of exchange rates against which financial markets can take aim -- but cooperation in promoting a process. I have in mind the process of developing the financial markets and institutions needed to repair the defects in the Asian development model that set the stage for the 1997-8 crisis. Asia requires deeper and more liquid securities markets in order to reduce its dependence on bank finance. It needs to strengthen market discipline on banks and to distance them from governments. Building deeper and more liquid financial markets is integral to enhancing financial stability and limiting vulnerability to future crises. That process can be pushed forward by sharing expertise, applying peer pressure, and collectively mobilizing financial resources, things that regional cooperation can promote.

At the same time, this kind of cooperation does not require the same compromises of sovereignty that are essential to a successful exchange-rate stabilization agreement. It does not

require governments to make incentive incompatible financial commitments. It can be fostered without invoking the unrealistic goal of a single Asian currency within ten years. And it will have the corollary benefit of delivering a greater degree of exchange rate stability, the concrete objective that many of the advocates of regional integration so passionately wish to achieve.

2. What is Different About the Context for Integration in Asia?

Any attempt to promote economic and financial cooperation in Asia must confront a number of respects in which the regional context is distinctive.

Asian countries are heterogeneous. Asian countries differ widely in terms of their economic structures and stages of development. Per capita incomes vary more dramatically than in Europe and North America, other places where there is considerable momentum for regional integration. Market structures vary from the concentrated to the atomistic. Some national economies and financial systems remain heavily regulated, while others are extensively deregulated. Asian economies differ greatly in terms of transparency and shareholder rights.

The implication that I am inclined to draw is that regional initiatives based on the assumption that the same monetary and financial arrangements are appropriate for all Asian countries make little sense. Since their economic circumstances differ, so too should their monetary and financial arrangements. To put the point another way, an initiative whose goal is to place all countries in the same monetary and financial straitjacket is unlikely to succeed.

Asia is less economically self-contained than other regions. Many Asian countries

rely as heavily on the United States and Europe for export markets as they do on other Asian countries, including Japan. Hence, the complementarities between regional commercial and monetary initiatives are likely to be less pronounced in ASEAN and ASEAN+3 than in Europe. Minimizing intra-European exchange-rate volatility promised to sustain precisely those trade and factor flows on which the members of the European Union depended most heavily. Because the economic stakes were high, leaders were prepared to commit considerable political and institutional capital to their regional exchange-rate stabilization agreement. Its lower level of intra-regional trade suggests that this is less likely to be true of Asia.

Compared to other regions, Asia has less appetite for political integration. Any institutional arrangement for promoting monetary and financial cooperation must recognize the value that Asian countries attach to their sovereignty. In a year when the European Union is embarking on a constitutional convention and discussing political federalism, it is important to acknowledge that Asia is different in this regard.

3. Can Asia Live with Floating Rates?

The case for using the Chiang Mai Initiative as the basis for a regional currency arrangement is predicated on two assumptions, one positive, one negative. The negative assumption is that Asian countries cannot live with floating rates. The positive one is that currencies can be stabilized by a properly designed regional exchange rate mechanism -- if expert advice is only taken on the composition of pegs, the surveillance of policies, and the provision of

credit lines. This section challenges the first presumption; the next one critically scrutinizes the second.

The conventional arguments against floating are two: floating rates encourage competitive depreciations that are a mechanism for the contagious spread of crises, and floating rates are incompatible with Asia's export- and investment-led growth and development model. Ogawa and Ito (2000) epitomize the argument, generalizing from the Asian crisis, that contagion spreads more quickly and virulently when currencies are unpegged. The devaluation of the baht, Indonesia's abandonment of its band in response to instability spreading from Thailand, and Taiwan's decision to devalue its dollar in October 1997 in response to mounting competitive pressure from its neighbors are portrayed as the key events transforming a country crisis into a regional disaster. Once currencies began to move, countries lost control of their economic destinies. This sequence of events, whether causal or not, created an understandable reluctance to contemplate further exchange rate flexibility.

With the passage of time it has become more common to argue that the pegs rather than their abandonment were at the root of the problem. What caused the devaluations of 1997 to be so destabilizing was not that exchange rates were allowed to move but that their movement discredited prior policy commitments. Governments' entire economic policy strategies had been organized around their currency pegs. To abandon those pegs called into question the coherence of those strategies and planted doubts about official promises. This is the familiar "exit problem," in which exiting from a peg around which the authorities had previously organized their economic policy strategy -- and to which they had repeatedly reiterated their

commitment -- damages their credibility and therefore undermines consumer and investor confidence. Eichengreen and Masson et al. (1998) show that exits from pegs have typically been associated with significant output losses. Those losses are greater when banks and firms, taking the authorities' commitments at face value, accumulate unhedged foreign exposures that are a source of balance-sheet distress when the exchange rate moves. They are greater when the authorities are slow to substitute an alternative operating strategy for monetary policy and to install a new anchor for expectations, thereby failing to reassure households and firms.

It is too simple to simply assert that these problems will disappear once countries embrace greater flexibility. Large exchange rate movements and/or reserve losses -- the constituents of currency crises -- can occur with a floating rate. Historically, they have been at least as common under floating as fixed exchange rates. But the reason, to repeat, is that countries historically have failed to put in place an alternative anchor and new monetary-policy operating strategy. It can be argued that subsequent experience with inflation targeting has largely solved this problem. And, with the crisis-induced abandonment of pegs, exit has already occurred. Its costs have been sunk. Agents have begun to adapt to the reality of greater exchange rate flexibility, hedging previously unhedged exposures and more carefully managing their balance sheets. There is no reason to go back.

The experience of countries like South Korea with inflation targeting provides evidence for this view. Following the crisis, Korea revised its central banking law to enhance the institution's independence. Price stability was singled out as the primary goal of policy, relieving the central bank of its previous responsibility for the soundness of the banking system.

Each year the Bank of Korea now sets a price stability target in consultation with the government and elaborates a plan for achieving it. It publishes its target, its plan, its monetary policy board minutes, and its annual report to the National Assembly. Thus, the country has installed all of the essential elements of an inflation targeting regime. And now that it has adopted inflation targeting, Korea's flexible exchange rate has become part of the solution rather than part of the problem. The won depreciated in 2000-1, on a nominal and real effective basis, just as the textbooks suggest it should have, in response to the slowdown in the global electronics industry. It then recovered in 2001-2 along with the electronics sector, again as predicted by textbook models. All the while, the recovery of Korean economy, partially insulated from this external disturbance, proceeded apace.

The implication is that a more flexible exchange rate, backed by inflation targeting, can be part of the solution as opposed to part of the problem. It can help to buffer economies against external disturbances. And it is entirely compatible with domestic monetary and financial stability.

Are floating rates incompatible with Asia's export- and investment-led model of growth? There is no question that stable exchange rates were integral to that model once upon a time. They encouraged firms to move into the export sector, facilitating efforts to move down the learning curve and providing the hard currency needed for imported capital goods. By minimizing exchange risk, they made it easier for Asian banks and corporations to borrow abroad. They served as a focus for wage negotiations, facilitating the wage moderation that made possible export-market penetration and high levels of investment.

It is clear, I think, that for the region's middle- and high-income countries, this model has now outlived its usefulness. Policy makers in middle-income countries acknowledge the need to shift away from export-oriented industrial policy toward a more decentralized model centered on domestic demand. In the less-developed, lower-income countries of the region, in contrast, the traditional model may have some way to run. This in turn suggests that the argument for exchange rate stability to facilitate export-led growth and associated learning is stronger for some Asian countries than others. It is stronger for China and the four new members of ASEAN, for example, than for Korea, Thailand and Singapore. Again, the implication is that a single exchange rate arrangement is not suitable for the entire region.

This observation is distinct but complementary to the familiar argument that low-income countries with shallower financial markets, weaker policy-making institutions, and less developed supervisory capacities should wait before moving to a more flexible exchange rate and opening the capital account. A monetary policy operating strategy like inflation targeting that can be substituted for the now abandoned exchange rate peg relies on stable links between asset prices and quantities on the one hand and the level of activity on the other. It is unlikely to operate reliably where financial markets are underdeveloped and undergoing rapid change -- where inflation cannot be accurately forecast or reliably controlled. Since the argument for continuing to organize monetary policy around an exchange rate peg is correspondingly stronger for such countries, so too is the case for retaining capital controls to limit the pressure on the peg.

Thus, inflation targeting is likely to be feasible and attractive for more developed Asian countries like Korea, Singapore and Taiwan. Inflation is not noticeably harder to forecast than

in Europe or the United States. Financial markets are sufficiently well developed that there exists a stable relationship between the central bank's instruments and its targets. The adverse balance-sheet effects of exchange rate movements, while present, do not dominate all other effects of policy.

In the less developed countries of the region, like Cambodia, Laos, Myanmar and Vietnam, these conditions are unlikely to prevail for some years yet. Foreign borrowing means foreign currency borrowing, amplifying balance-sheet effects. Financial systems are fragile and underdeveloped. Since inflation targeting is not feasible, these countries will want to continue pegging and to support their pegs with capital controls.

There is no reason to doubt that inflation targeting is compatible with the Asian approach to growth and development. It is simply not true, as sometimes alleged, that export-oriented economies are adverse to inflation targeting. Moreover, the recent record indicates that inflation targeting is more widely feasible than predicted by early certain analyses. It is not obvious either theoretically or empirically that inflation targeting has more demanding fiscal prerequisites than other monetary regimes. Latin American experience does not suggest that it is necessary to bring inflation down to very low levels before starting the transition to inflation targeting. Chile was able to embark on inflation targeting despite an inherited inflation rate of more than 20 per cent. Peru succeeded in putting in place elements of an inflation targeting regime well before reducing inflation to target levels. As Goldstein (2002) observes, inflation targeting can deliver presumptive benefits even before the central bank has full independence and even if it does not adopt the full formal apparatus, including announcing an inflation forecast and

publishing an inflation report.

4. On the Viability of a Common Basket Peg

Notwithstanding these arguments, some remain convinced of the desirability of a regional system of currency pegs. A viable system of collective currency pegs must satisfy four conditions.

! **It must have credibility.** It must be supported by credible commitments on the part of participating governments and central banks to defend their exchange rate regime. Otherwise, there will be no bias in the band -- no stabilizing speculation. If market participants instead suspect that a currency will exit the system when it reaches the limit of its fluctuation band, that limit will become a focal point for speculation. If the collective commitment to stabilize rates is abandoned when it is tested, moreover, it will discourage future efforts at cooperation.

! **A viable exchange rate arrangement must be flexible.** Either there has to be scope for periodic exchange rate adjustments, or there has to be adequate flexibility on other margins (wage and price flexibility or labor mobility, for example). Otherwise a currency peg will become a straitjacket, as Argentina s recent experience has illustrated.

! **There must be a mechanism for coordinating adjustments**. This is what makes a unilateral peg different -- and in principle less robust -- than a system. Beggar-thy-neighbor adjustments that relieve the pressure on one currency by transferring

it to another will do little to support a collective exchange rate arrangement. They will only cast doubt on its rationale.

! **There must be financial supports.** Raising interest rates to defend a weak currency is costly. Consumption and investment will be crunched; corporations and banks with maturity mismatches on their balance sheets will suffer serious financial distress. Hence, currency stabilization arrangements from the Bretton Woods System to the European Monetary System have included swap and credit lines to provide additional financing for countries of having to defend weak currencies.

I now suggest that a system of East Asian basket pegs is unlikely to satisfy these requirements.

Credibility. Historically, Asian governments have regarded exchange rate stabilization as a priority. But three factors are likely to temper that commitment in the future: capital mobility, democratization, and the diversification of social goals. The tradeoff between capital mobility and exchange rate stability, assuming that governments attach some value to policy autonomy, is a corollary of the "impossible trinity" of international economics. To put it another way, increased capital mobility makes it necessary to sacrifice other policy goals in order to stabilize exchange rates.

This is where the second consideration enters, namely, that as Asian economies mature and regional relations normalize, governments come under pressure to pursue a wider range of social goals. Following World War II, when the Korean and Taiwanese economies were dominated by subsistence agriculture, raising per capital GNP was a national priority. So long

as South Korea was threatened from north of the 39th Parallel and Taiwan was threatened from across the Straits, industrial growth was synonymous with national security, which in turn was regarded as indispensible. A stable exchange rate was integral to the growth model employed to achieve these ends.

In today's richer societies, in contrast, citizens attach greater weight to other social goals, employment security for example. Governments that deliver stable exchange rates by raising interest rates and thereby sacrificing employment are less likely to retain public support. This is where the third factor, political democratization, another corollary of economic development, comes into play. This perspective suggest that Asian governments have more limited scope than in the past for subordinating other goals of policy to the pursuit of exchange rate stability.

Flexibility. In Williamson's (1999) proposal for a common basket peg, flexibility is lent by the willingness of the authorities to shift the band when conditions change. The problem is the observed reluctance of governments to adjust the exchange rate when its equilibrium level is altered. To induce stabilizing market behavior, the authorities must reassure the markets that they attach priority to preservation of the peg. This in turn means that their credibility is tarnished when they renege on that promise and change the rate, which deters them from adjusting the latter before market pressures build up. Moreover, if the authorities reassure the markets that they are prepared to effectively minimize exchange risk, they will encourage capital to flow in beyond the point where its social return equals its social cost and set the stage for financial difficulties when the peg collapses.

The proponents of currency bands assume that these problems can be solved if

governments only recognize the merits of early exchange rate adjustments (thereby solving the "exit problem") and if they commit to restoring depreciated rates to their previous level following each episode of financial pressures (which would limit the financial distress due to unexpected depreciations). But this assumes convenient answers to difficult questions. Official have to reassure the markets that they have no intention of shifting the band; otherwise, they have no hope of stabilizing speculation. But to then shift the band damages their reputation. This is why virtually every system of pegged exchange rates that has existed through history has been more rigid than envisaged by its architects.

Cooperation in Providing Financial Support. A network of credit lines and swaps that pools the reserves of the participating countries is an obvious response to this problem. The Chiang Mai Initiative is just such a network.. But whether these limited resources will ensure the maintenance of a network of common basket pegs is another question. While the combined reserves of the participating countries are large, the liquidity that will be available to individual countries is small. The $1 billion of dedicated funds is so small relative to the liquidity of financial markets that it can be regarded as token. While there are also bilateral swap lines, the credits available to each country are only a fraction of the total.

Countries could conceivably commit more finance. They could supplement pre-negotiated swap lines with extraordinary finance like that which was extended to Mexico by the United States in 1995 through the U.S. Treasury's Exchange Stabilization Fund. They could expand their system of swaps when the CMI comes up for review in 2004. They could formally pool a portion of their reserves (as contemplated by Kuroda and Kawai 2002). But they will do

so only if they are confident that their resources will not be squandered -- only if they are assured that the CMI is accompanied by surveillance capable of anticipating and heading off crises, and only if it is accompanied by conditionality that leads to strong adjustment in the crisis country which will reassure the markets and maximize the likelihood of prompt repayment of any swaps. Otherwise, strong-currency countries will be unlikely to commit significant resources to the support of weak regional currencies.

Efforts to marry the financial resources of the CMI to strong surveillance and conditionality thus must confront the tradition in Asia of nonintervention in national affairs, which translates into a low-key approach to surveillance and conditionality. The ASEAN+3 countries are of course developing a CMI surveillance procedure. But that process has no secretariat or formal organization. It is burdened by unanswered questions. Will findings be released? Will it be possible to publicly reprimand governments and central banks running policies of questionable sustainability that threaten to create financial liabilities for their CMI partners? Will there be other mechanisms capable of forcing weak currency countries to take early policy adjustments?

Gordon de Brouwer (2002b) has written that "exchange rate cooperation must be backed by unequivocal financial cooperation if it is to work." The state of play regarding surveillance and policy conditionality in Asia suggests that the region remains very far away from making cooperation unequivocal. In turn, this suggests that any system of common basket pegs would be fragile. It would be unlikely to last. And its collapse would discredit the wider project of monetary and financial cooperation.

5. Financial Cooperation

Having argued that monetary and exchange rate cooperation is the wrong project for Asia, I want to now suggest that there is a case for cooperation to deepen and strengthen regional financial markets. Not only does this address the root problem -- weak banking systems and underdeveloped securities markets -- as opposed to one of its symptoms (the volatility of exchange rates), but it is better attuned to historical and political conditions in the region

The arguments for cooperation in this area are three. First, Asian countries share financial problems as a result of shared historical experience. National histories differ in their particulars, but bank-centered financial systems, high levels of corporate leverage, and close bank-government connections are widespread. Pooling information, analysis, and expertise on these problems has obvious efficiency advantages. Insofar as Asian policy makers and bureaucrats understand these problems better than the employees of multilaterals located in Washington, D.C., information sharing at the regional level is likely to be more efficient.

Second, insofar as the Asian model is distinct (something that needs to be established rather than asserted), there is a case for cooperation in the design of financial regulations that differ from those developed in other regions. Given the close connections between banks and industrial conglomerates, there may be a case for different regulatory standards for portfolio concentrations than those promulgated by the Basle Committee of Banking Supervisors. Given

Asia's continued reliance on family control, there may be a case for different standards for corporate governance, which rely less on outside directors but give minority creditors other (legal) means of protecting their rights. In principle, there is a case for regional cooperation in the design and implementation of such standards.

Third, there is a case for regional cooperation insofar as Asian banks and nonbank financial firms increasingly compete with one another. With the intensification of competition between Malaysian and Singapore banks and Hong Kong and Chinese banks, for example, there will be more pressure on regulators to race to the bottom -- or at least it will become more difficult to race to the top. It will be harder for the regulatory authorities in one country to increase capital requirements for fear that doing so will cause domestic institutions to lose business to the foreign counterparts, since capital is a cost of doing business. The same argument that motivated the negotiation of the Basle Capital Accord in 1988 thus provides a motivation for regional cooperation on capital and other financial standards in Asia. Insofar as proximity matters for the intensity of international financial competition and the structure of efficient regulatory standards differs in Asia, the Basle Committee's Capital Standards and Core Principles for Effective Banking Supervision are imperfect substitutes for regional cooperation.

My own idea is to establish an Asian Financial Institute on the platform of ASEAN+3. The AFI would provide technical assistance to national agencies seeking to strengthen prudential supervision and regulation. It would run training programs for bank inspectors, securities and exchange commissioners, and accountants, exploiting economies of scale and scope by enrolling students from all of its members, and encouraging the efficient pooling of knowledge and

expertise. It would provide reserve management, clearing and settlement services to member central banks, not unlike the central banking services that the Bank for International Settlements provides to its members. Many financial market participants in Asia clear, net and settle their transactions using U.S. and European payments systems; liquidity and technical support for a pan-Asian payments and settlements system would obviate the need for traders and investors to go through third markets.

The AFI could be a venue for the negotiation of regional agreements on capital and liquidity standards and regulatory processes intended to promote the stability of banking systems, and of standards for information disclosure, securities listing and corporate governance designed to promote the development of regional financial markets. Such standards and codes are already being promulgated at the global level, by inter alia the Basel Committee of Banking Supervisors (in the case of capital adequacy for international banks), the Financial Stability Forum (in the case of prudential supervision and regulation), the IMF (in the case of data dissemination, transparency, and codes of conduct for monetary and fiscal policies), and the OECD (in the case of corporate governance). But having the AFI organize negotiations on the design of a separate set of regional financial standards appropriate to Asia's special circumstances would address concerns that global standard-setting initiatives are not sensitive to the special features of the Asian model.

ASEAN+3 is the logical grouping to back this initiative. It includes the three large Asian countries and can build on an already extant institutional infrastructure. Not only heads of state but also finance, economics, and foreign ministers as well as central bank governors and

senior officials already meet regularly under its aegis. ASEAN+3 is already in the business of providing technical assistance: at the Fourth ASEAN Finance Ministers Meeting (in March 2000), ASEAN+3 finance ministry and central bank deputies agreed to establish a network of research and training institutions. They have engaged in peer-review exercises and policy dialogues at finance and central bank deputies' meetings and finance ministers meetings, which typically in May at the time of the ADB annual meetings and can be seen as the precursors of a full-fledged surveillance process. As discussed earlier, the existing network of swap arrangements among this grouping of countries has already begun to stimulate efforts to establish a unified policy dialog or surveillance group that would meet on a more regular basis than is now the case of finance ministers or deputies. Thus, ASEAN+3 already possesses an infrastructure of regular meetings, a pool of financial resources, and a presumption that national policies are a matter of common concern.

Connecting the AFI with the Chiang Mai Initiative would have the further benefit of removing ambiguity about the purposes of the CMI. Its purposes would be defined as fostering financial stability and development, not stabilizing exchange rates. Whether fixed or flexible exchange rates were more conducive to financial stability and development would then be recognized as a separate question. The focus of the bilateral swaps made available to partner countries under the CMI would be to provide assistance in the event of exceptional disturbances to national financial systems – a stock market collapse, banking panic, or exchange-rate meltdown that threatened to inflict serious balance sheet damage on financial markets and institutions and to thereby set back the process of financial development. Acting as a group,

ASEAN+3 would in effect act as a collective lender of last resort to countries whose financial systems were at risk (countries with limited capacity to engage in LLR activities themselves), while linking financial assistance to the relevant financial conditionality.

Such an arrangement is better attuned to the context for cooperation than an exchange-rate stabilization agreement. It does not require open-ended financial commitments of a sort that are unlikely to be credible given the light touch characteristic of regional surveillance exercises. It does not require Asian countries to execute an about face on their attitude toward surveillance and pretend that they can make blunt public pronouncements about the inadequacies of their neighbors' policies. It does not require them to tie down market expectations by committing to an unrealistic goal like a single currency by the end of the decade. What is required, rather, is sharing information and expertise and coordinating national responses to those problems. What is required is collaboration in the design of regional financial standards and regulations, supplemented by limited financial assistance for countries that encounter difficulties in adjusting to those standards.

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