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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?*

The Case for Regional Financial Cooperation in East Asia

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Introduction

The fundamental question posed by Asian regional financial cooperation is whether international financial relations should be organized primarily on a multilateral basis, with the IMF at the center, or whether multilateral institutions can usefully be supplemented with regional arrangements.[1] This presentation makes the case for a *mix* of multilateral and regional arrangements. This argument should be distinguished from the case for regional *instead of* multilateral arrangements: choosing between cooperation at the two levels is simply not necessary.

I will first briefly review the rationales for financial regionalism in East Asia, discuss some of them in greater detail, and then address several of the critiques of the skeptics. The presentation concludes with some thoughts about the future development of the Chiang Mai Initiative and the agenda of the PECC Financial Forum.

Overview

The rationales for regionalism, in a nutshell, are economic, institutional and political.[2]

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[1] These remarks are drawn from the author's manuscript, "East Asian Financial Cooperation after the Chiang Mai Initiative," forthcoming from the Institute for International Economics, September 2002.

[2] The case presented here benefits from, among other work, Wang 1999 and 2000; Kim, Ryou and Wang 2000; Yoshitomi and Shirai 2000; Rajan 2000; Park 2001; Park and Wang 2001; de Brouwer 2002; Rana 2002; Parkinson, Garton and Dickson 2002; Bird and Rajan 2002.

At the economic level, the region has a commonality of economic interest, as defined by the regional integration of markets, reinforced by mutual vulnerability to contagion, which has a strong regional dimension. Regional financial facilities enable countries to economize on reserves -- which are excessive, exceeding $1 trillion in the region[3] -- and supplement the resources of the IMF.

At the institutional level, the CMI can: help redress the under-representation of East Asian countries in the IMF; expedite decisionmaking and the disbursement when crises strike; provide a basis on which to build an effective regional surveillance mechanism and contribute to broader economic integration (specifically in the monetary, investment and trade areas).

Financial cooperation can also support political objectives in the region. Of course, it can't transform security conflicts into close friendships. But, by raising the economic cost of political disputes, it provides additional incentives to resolve conflicts peacefully. It creates a context into which the emergence of China in particular can be managed.

Another political consideration is support for the IMF in the United States, especially the Congress. This is shaky. There is also opposition to use of the Exchange Stabilization Fund. These were serious problems during the crisis in 1997-98. I think that Americans must acknowledge that congressional politics are unpredictable and can sometimes be hijacked by particular interests, and that this could hinder crisis management in the future. By creating useful redundancy in the system, financial

[3] including NZ, Aust. and HK, but not Taiwan

cooperation in East Asia reduces the region's vulnerability to deadlock (or liquidity shortage) at the IMF arising from American politics.

Note that the case for financial regionalism that is presented here does not revolve around an alternative diagnosis of financial crises that is at odds with an orthodox diagnosis embodied in the so-called Washington Consensus. The posture that Asian governments adopt in this debate over economic ideology will affect the administration of regional arrangements. But it is not necessary either to resolve that debate nor to argue that the IMF's analysis is irredeemably flawed to support the CMI and its further development. That case can be built without reference to those arguments.

Rationales

The progressive integration of markets in East Asia has conferred upon the countries of the region a *commonality of economic interest*. Intra-regional exports reached more than 50 percent of total exports in 2000, slightly below the peak prior to the financial crisis. Exports to the region reached 42.4 percent of Japan's total exports, 49.9 percent of China's total exports, and higher percentages of many other countries' total exports in 1997. For the region as a whole, intra-Asian exports represent about 11.3 percent of regional GDP in 2000. Although exports to East Asia are only 3.3 percent of GDP for Japan, they represent between 10 and 20 percent of GDP for China, South Korea, Australia and New Zealand. The ratios for Indonesia, the Philippines, Taiwan, Thailand and Vietnam are between 20 and 40 percent, and those for Malaysia, Hong Kong and Singapore are above 60 percent. The members of the region thus have a substantial interest in the stability of trade and investment relations among them, which financial arrangements can foster.

Second, as the Asian financial crisis amply demonstrated, the countries of the region are vulnerable to *contagion* from one another. Transmitted through several channels, including the regional integration of markets for goods and capital, contagion substantially followed regional lines during 1997 and into 1998.[4] Contagion thus strongly reinforces the shared interest in crisis prevention and stabilization among countries in the region that is distinctive in nature and intensity from interests shared with countries outside the region.

Third, advocates of the CMI and more ambitious financial cooperation in East Asia have argued that the size of the IMF and the diversity of its membership, while sources of strength, are also causes of weakness. They require broad consensus and involve extended consultation and relatively slow decisionmaking. Small groups of countries are able to block access to Fund resources and programs are not always flexibly adapted to local circumstances. Among a regional grouping of a limited number of more like-minded countries, *decisionmaking* can be less cumbersome and more *expeditious*, enabling financial assistance to flow more quickly. Given the prevalence of the view among officials in the region that inherent instability in international financial markets was the explanation for the 1997-98 crisis, speed of disbursement is perceived to be especially important. Given uncertainty about the future evolution of the international

[4] The regional dimension of contagion is well documented. See, among other work, Calvo and Reinhart 1996; Glick and Rose 1999; Drazen 2000; Kruger, Osakwe and Page 1998; Kaminsky and Reinhart 1999. See as well Masson 1998. Rose 1998 and Rajan 2001a and 2001b, among others, apply the regional character of contagion to the case for regional cooperation.

financial architecture, and the ability of countries of the region to access the multilateral institutions, regional financial cooperation is a prudent hedge.

Fourth, regional facilities will *supplement the resources* of the IMF and other multilateral institutions. Supplementing resources appears particularly compelling to countries in East Asia whose borrowing capacity may be constrained by their under-sized quotas at the IMF. Borrowing constraints will be especially tight if access limits are enforced and bilateral second-lines-of-defense are eliminated.[5]

Fifth, since recovering from the crisis, East Asian countries have increased their holdings of foreign exchange reserves dramatically to secure greater room for maneuver in any future crises. (See Figure 1) They have done so despite their also switching to much greater flexibility in their exchange rate regimes and despite the augmentation of the IMF's resources, demonstrating widespread concern about access to those resources on acceptable terms. However, current reserve holdings are very high in relation to trade and GDP and arguably inefficient. To the extent that reserves are accumulated through current account surpluses, countries outside the region, such as the United States, run correspondingly excessive current account deficits. By giving greater confidence of access to a safety net, advocates argue, the mobilization of the region's reserves in a crisis could enable countries to *reduce reserve holdings*.[6]

Sixth, the experience of 1997-98 shows that the sheer *size* of international financial markets, and indeed of even single financial firms, is a source of vulnerability

[5] The present Bush administration has made a point of not providing bilateral loans to Argentina and Turkey, for example.

[6] See, for example, Rajan 2000; Fischer 2001, 6-7; Park 2001; Stiglitz 2002. Preeg 2000 argues that high levels of reserves in East Asia reflect undervaluation of currencies in the region.

for relatively small emerging-market countries. By linking themselves to regional partners through swaps and other financial facilities, the more vulnerable governments can help to *redress the asymmetry in size* between their national markets and international financial firms.[7]

Seventh, swaps and financial facilities can provide a focal point for the enhancement of *regional surveillance* and policy dialogue. Governments and central banks in the region can thus better assess their vulnerability to future crises, anticipate such crises, pre-empt (or respond to) them with policy adjustments, and cooperate outside the financial sphere when crises emerge. Regional policy dialogues can supplement surveillance and early-warning exercises based in the IMF. Sharing regional markets in goods and capital, neighbors often have superior, more up-to-date information about countries in crisis than multilateral institutions and G-7 governments and a stronger material interest in corrective action.

Eighth, many Asian countries confront a common problem in fragility of their banking and financial systems. Confronting these problems squarely creates pain in the short-term for benefits over the long-term. Because realistic acknowledgement of nonperforming loans will expose weaknesses in banking systems that might not have been fully discounted in international markets, there may be considerable "first-mover" *dis*advantages, which would be especially compelling for myopic governments.[8] Although regional facilities might not be decisive, they could encourage East Asian governments to take more ambitious steps toward financial sector restructuring by providing greater reassurance that external financial stability can be maintained.

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[7] See, for example, de Brouwer 2001.

Moreover, financial cooperation can support regional integration in functionally related economic areas and over the long term. Financial facilities, capital-flow monitoring and policy surveillance could serve as underpinnings for future regional monetary initiatives. A number of officials and analysts in the region have proposed joint exchange-rate pegs and common currencies.[9] With respect to trade, subregional arrangements are proliferating throughout Asia. China, Japan and Korea are each considering, with varying degrees of seriousness, separate economic arrangements with ASEAN ("ten plus one times three"). Although such agreements would not be concluded for some time, they might eventually be combined into an East Asian trade area that would comprise the members of ASEAN+3 and be complemented by its financial arrangements.[10]

In addition, financial cooperation can support regional political objectives. On political and security dimensions, East Asia contrasts sharply with Western Europe. While the Cold War is over in Europe, many political conflicts in Asia remain unresolved. Regional cooperation can nonetheless limit the damage to economic relations when political conflict breaks out. By raising the economic cost of political disputes, moreover, it provides additional incentives for peaceful resolution of conflicts. Regional I cooperation would create a context into which the emergence of China can be managed, in particular. Advocates of WTO entry argue that membership will contribute to constructive political as well as economic reform in China over the long term.

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[8] I thank Edward M. Graham for this insight. See also Graham 2001 and Dobson 2002.
[9] See, among others, the proposals of Yam 1999; Ito, Ogawa and Sasaki 1999; Kuroda 2001; Estrada 1999; Williamson 2000; Mahathir 2001; East Asia Vision Group 2001; and Kuroda and Kawai 2002.

Regional financial cooperation would be a further piece in the mosaic of international institutional commitments for China. Similar arguments could be made with respect to other countries in the region, notably the new entrants to ASEAN. Were regional economic arrangements able to provide even only a portion of the pacifying benefits of Western European integration, the world would benefit substantially.

Finally, regional financial cooperation could enhance Asian influence in multilateral organizations and in negotiations over the international financial architecture. While redistributing such influence is a zero-sum exercise when viewed narrowly, it would arguably advance the interest of the international community as a whole because it would contribute to better balance in these organizations, the IMF in particular, greater equity in representation, and greater legitimacy.

Critiques of Financial Regionalism

Critics of the CMI and East Asian regional financial cooperation more broadly make several arguments. These fall under the subject headings of necessity, moral hazard, additionality of resources, political support, covariation of shocks, and worst-case scenario and are evaluated below. They apply not simply to the CMI as it currently stands, which is generally regarded as benign, but also to these arrangements as they might evolve through enlargement of the swaps and the membership of the group.

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[10] Bergsten 2000 and 2001; Choi and Schott 2001; Scollay and Gilbert 2001; Schott and Goodrich 2001; Munakata 2001.

Necessity

Some critics argue that the CMI is unnecessary because the IMF, United States, European governments and non-Asian international community have already accommodated a large portion of the legitimate Asian objections to the multilateral response to the 1997-98 crisis. The new paradigm, which began to emerge as early as autumn 1997, stresses or accepts standards, codes and transparency; *ex ante* conditionality (as opposed to negotiating conditionality in the heat of the crisis); quick disbursement into crises; and complementary bilateral financing (as in the second line of defense). The IMF has rethought the conditionality that it applies and developed a more nuanced posture toward capital controls. Private sector involvement in crisis resolution is also on the agenda, although the outcome is so far inconclusive.

There have also been a number of reforms to IMF facilities in particular. In December 1997, the Supplemental Reserve Facility (SRF) was introduced, allowing countries to draw more funds more quickly than was previously possible and at higher interest rates. In November 1998, the New Arrangements to Borrow (NAB) came into effect and were activated in December. In January 1999, the hard-fought quota increase came into effect.[11] Thus the liquidity position of the Fund has been enhanced considerably. The Fund lists "usable resources" at SDR101.3 billion and "net uncommitted usable resources" at SDR61.7 billion as of March 2002. [12] At the same time, there has been a sea-change in exchange rate regimes with only a handful of medium-sized emerging markets maintaining pegged rates. In East Asia, only China,

[11] "IMF Chronology" at http://www.imf.org/external/np/exr/chron/chron.asp.
[12] IMF Financial Activities – Update March 29, 2002, www.imf.org.

Hong Kong and Malaysia maintain fixed exchange rates; the others maintain exchange-rate regimes with a certain degree of flexibility and allowed rates to move substantially over the course of 2001 and early 2002. (See Figure 2)

In the presence of the new crisis-prevention paradigm, reforms in IMF financial facilities and the stronger liquidity position of the Fund, critics argue that the creation of a large network of swap agreements is tantamount to preparing to fight the last financial war rather than confronting more likely contingencies. In cases where IMF resources must be supplemented, doing so on an *ad hoc* basis, as for Brazil in 1998-99, would be preferable.

Proponents of East Asian financial cooperation would argue, on the other hand, that while the Fund might have a generous liquidity cushion at the moment, those resources could be quickly exhausted in a crisis that matched the severity and contagion of 1997-98. Standing arrangements provide assurance that needed funds can be provided quickly. Even when the IMF remains liquid, access to its resources could be denied to some Asian countries on various grounds, including economic ideological or political reasons.

Even when access to IMF resources is secure, a second line of defense might be desirable or indeed necessary. The multilateral system departed from exclusive reliance on the IMF a long time ago, as we will see in the discussion of other regional arrangements. It did so most recently in 1995 when U.S. money paralleled IMF funds to Mexico and then, at least in principle, with the second line of defense for Asian countries in 1997. Proponents note that during the 1997-98 crisis the amount of funds pledged under the second line of defense exceeded those pledged by the IMF by a large margin.[13] They decry the failure to mobilize most of those funds and note the complete absence of second-line-of-defense lending from outside the region.[14] Regional arrangements such as these could be regarded as simply another, more deliberate and reliable way to organize second lines of defense.[15]

The agreements among the governments and central banks of East Asia are confined, to date, mainly to financial matters – the swap arrangements, monitoring of financial flows, and mutual surveillance. They have not yet embarked on robust exchange rate or monetary cooperation. Ambitious monetary cooperation would require correspondingly ambitious financial cooperation. But regional financial cooperation can serve several important purposes in the absence of monetary cooperation, just as the IMF serves useful purposes in the absence of the Bretton Woods exchange-rate regime.

Moral Hazard

Opponents suggest that the creation of a large standing pool of funds for crisis management would contribute to *moral hazard* on the part of both potential borrowers (governments and central banks) and international banks and investors. Originating as a

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[13] Rose 1998.

[14] Bilateral funds that were actually disbursed exceeded IMF funds in the case of Thailand but were exceeded by IMF funds in the cases of Indonesia and Korea.

[15] On second lines of defense, see, Parkinson, Garton and Dickson 2002, Bird and Rajan 2002, Rajan 2001. Proponents must acknowledge, however, that the IMF link slows disbursement to the pace of IMF decisionmaking. The regional objective of more expeditious action is met under the CMI only to the extent that funds can be disbursed in anticipation of agreement on a Fund program, faster that IMF funds once a program has been put in place, and within the 10 percent limit before which an IMF program is not necessary.

response to the AMF scheme, this argument is also applied to non-pooled reserves held by national central banks but earmarked for bilateral swap arrangements. The moral-hazard critique represents a specific (regional) case of the general argument against international financial rescues.

Some critics worry that East Asian political authorities will mistakenly conclude that the present CMI is a bulwark against financial crises, when in fact the swap arrangements are insufficient in size to be effective. Overestimating their protection against financial crises, governments of the region could well delay adjustment, thus aggravating the severity of crises when they strike. Under this particular moral-hazard scenario, the creditors refuse to activate, or activate and then fail to avert the crisis.

Governments in the region appear to be coldly realistic about the level of protection afforded by present (and even future) financial arrangements, however. The ability of regional creditors to refuse to activate the BSAs is one basis for their caution. The continued sense of financial vulnerability, as reflected in the extraordinary pace of reserve accumulation in the region since 1998 (Figure 1), is another. Circumspection is also reflected in the insistence on the part of most governments that present regional arrangements be closely linked to the IMF and its facilities, surveillance and conditionality.

More fundamentally, the moral-hazard critique applies to the multilateral institutions as well as to regional arrangements. Analysts who believe that the moral-hazard problem is intractable advocate abolition of the IMF completely. Opposition to regional financial arrangements is the logical extension of their arguments. Others believe that the moral-hazard problem can be managed, as it is in a wide variety of other contexts, and should not bar financial multilateralism. The posture of these defenders of the IMF toward regional cooperation is left undetermined by this logic.

The dispute over moral hazard is a larger debate than we can or need to resolve here. Suffice it to say, to the abolitionists, that moral hazard can and should be controlled in international finance just as it is in, for example, insurance and consumer and fire protection -- through codes, regulation and "deductibles," among other devices. Just as we would not advocate eliminating these other services, this author would not accept the abolition of financial multilateralism or deny a role for financial regionalism on moral hazard grounds. To analysts in the broad (though perhaps shrinking) ideological center who defend the IMF, suffice it to say that they confront a consistency problem with respect to regionalism. Specifically, they shoulder the burden to demonstrate that moral hazard is somehow more intractable in East Asian regional arrangements than at the Fund.

Additionality

Opponents question whether the financial resources supplied through a regional arrangement will be truly "*additional*," suggesting that other lenders, such as the IMF and the United States acting bilaterally, will reduce their contributions to crisis packages by the amount available from within East Asia. A natural division of labor applied in the cases of other regional arrangements, whereby the G-10 swaps, for example, provided short-term bridge-financing to longer-term IMF financing. Critics argue that, owing to the adoption of the faster-disbursing SRF at the IMF, regional short-term swaps such as those in the CMI now overlap in function with the Fund and can be expected to reduce SRF financing in particular.[16]

The validity of the additionality critique is difficult to assess *ex ante*. The problem arises in principle whenever there are multiple sources of finance yet appears to have been managed successfully in numerous historical cases. Despite the cooperative division of labor between the IMF and other regional arrangements, there were potential conflicts as well, the most prominent case being the European medium-term financial facilities. Potential conflicts were nonetheless generally avoided though coordination provided in part by the United States and European governments. Rescue packages marshaled during the crises of the late 1990s suggest a "piling on" rather than "crowding out" of alternative facilities. Pledges of funds under the second lines of defense in particular do not appear to have crowded out IMF funds.[17]

Owing to the size and sophistication of financial markets, large amounts of funds are needed to confront crises. But, while the central purpose of any package must be to restore confidence on the part of private actors, the amount of funds needed to achieve this objective is nearly impossible to quantify and the "financing gap" is correspondingly difficult to estimate. The international community thus does not have the luxury of simply subtracting an Asian contribution from a confidently-estimated financing gap to determine the amount of the IMF contribution. It must instead present a financing package that is likely to exceed the IMF's capacity and draw on contributions from a number of institutions; in practice, every source is welcomed. Moreover, given that the market learned to discount the second lines of defense substantially, if not completely,

[16] As it competes with that facility with lower interest rates.

during the Asian crisis, supplementary financing will have to be more credible in the future than during 1997-98 to be effective. The CMI is a mechanism to organize regional assistance more credibly.

The availability of multiple of sources of funds has imparted flexibility to the system of official international finance. Having to assign the financial burden among alternative facilities is a cost of maintaining useful redundancy in the system. Whether CMI funds are additional, moreover, is at the discretion of the IMF rather than a mechanical consequence of the formation of the BSAs. The IMF can choose to maintain its commitment, if that is desirable. If it chooses to reduce its commitment by a portion of the amounts contributed under the CMI, the Fund husbands its resources for other crises. Therefore, even if East Asian funds were not additional for a particular country, they would be additional for the system as a whole. In either case, the IMF benefits from having the option of treating Asian financing as additional or as a substitute.

Political Support

A variant of the additionality critique suggests that the international community could become less engaged and supportive of the global institutions as regional financial arrangements strengthen. In particular, some critics fear, the existence of regional financial arrangements could undercut *political support* for the multilateral institutions. This critique applies particularly to support for the IMF and multilateral development banks in the U.S. Congress, which has been least forthcoming among national

[17] Thailand in 1997 may be an ambiguous case.

legislatures and most insistent on setting terms and conditions on its government's participation in these organizations.

Proponents would argue that the critique mistakenly reverses the actual historical sequence of events. Congressional support for IMF quota increases has become increasingly dubious over the decades. Even in the teeth of the Asian crisis, Congress delayed the granting of the quota increase and the approval of the creation of the NAB. Only when the Russian default produced a global "flight to liquidity" in autumn 1998, which carried the prospect of a global recession, did the Congress approve these measures. During 1999, certain members of Congress rejected the IMF's plan for selling gold to finance debt relief for Highly-Indebted Poor Countries (HIPC), threatening extraneous amendments as in the case of the quota increase. A decline in political support for the IMF in the United States preceded, rather than followed, Asian financial cooperation.

Two further considerations suggest that the creation of a regional financial mechanism in East Asia could raise, rather than reduce, political support in the United States for multilateral financial institutions. The first derives from a desire to control the terms on which financial stabilization programs are conducted and, more generally, lead international financial relations. As a senior Treasury official said to one Senator in October 1997, when the U.S. wants to participate in crisis resolution, "You have to pay to play." The prospect of the loss of U.S. influence in East Asian and within the IMF could induce Congress to support the Fund more steadily.[18] Second, the willingness of East Asia to carry a larger share of the financial burden of crisis stabilization could well be

[18] See, also, Bergsten 2000.

regarded favorably in the United States. After all, "burdensharing" was a rallying cry for many members of Congress when insisting that the IMF participate along with the United States in the rescue package for Mexico in early 1995. Thus, the impact of the formation of East Asian arrangements on American political support for the IMF is, at a minimum, ambiguous.

Covariation

Another critique departs from the observation that contagion plunged many of the members of the ASEAN+3 group into financial crises in rapid succession during 1997. Weakness and opaqueness of a number of the national banking systems in the region render the grouping particularly prone to simultaneous crises. Members would be well advised to conclude financial stabilization agreements with countries with which the *covariation* of financial shocks is negative rather than positive. The membership of the IMF is a better group across which to spread the risk of crises.

A universal group would indeed be better inoculated against crises than any regional group. Universality ensures that the country to which capital flees from any given crisis will be among the support group. However, the threat of contagion also creates an immediate and compelling interest on the part of neighbors in nipping a regional crisis in the bud, particularly a liquidity problem that could become a balance-sheet problem across the region. Moreover, financial cooperation at the two levels is complementary: financial risk can be spread across the multilateral system, reaping the benefit of negative covariation, while regional cooperation provides the several benefits enumerated in section two. While insightful, therefore, the critique is not decisive.

Moreover, considerations of risk-spreading are diametrically opposed to considerations of optimum currency area (OCA) theory. OCA theory judges countries that are subject to negative covariance of shocks ("asymmetric shocks") to be unsuitable for a monetary union, unless they meet a demanding set of criteria that provide alternatives to the exchange rate as an instrument of balance-of-payments adjustment. Some East Asian governments have ambitions for regional exchange-rate cooperation and currency stabilization.[19] Multilateral institutions and governments outside the region are averse to accepting risks associated with regional currency stabilization. Any regional currency arrangement must therefore be backed by a regional financial facility.

Finally, this and many of the other arguments of opponents of East Asian regional financial cooperation could be used equally against plurilateral, regional and multilateral facilities. The necessity, additionality, moral hazard, and covariance critiques, specifically, could be raised against the European medium-term arrangements, NAFA, and even the ESF. The IMF itself is also vulnerable to some of these critiques. Yet many opponents of Asian regionalism have vigorously supported and defended these other regional and multilateral facilities.

Worst-Case Scenario

Some opponents, while unconcerned about the CMI in its present form, worry about the direction in which it might evolve in the future. They are particularly concerned that ASEAN+3 might not only develop more robust financial arrangements

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[19] These are analyzed, among other places, in Eichengreen and Bayoumi 1994; Cohen 1998; Eichengreen, Bayoumi and Mauro 1999; Kwan 2001; Adams and Semblat 2002.

but also abandon the IMF link without first developing its own high-quality, regional conditionality. When faced with crises, governments in the region could then borrow from the regional creditor on conditions that are more permissive than those of the IMF. Critics would point to the original AMF proposal as evidence for such a tendency on the part of the region. This section examines the basis of this concern and the risk associated with this scenario.

Fears that regional conditionality would be “soft” or permissive rest in large measure on concerns about distortions and inefficiencies in Asian countries’ banking and financial systems. Since the 1997-98 crisis, the stock of nonperforming loans in Japan and China has grown, rather than decreased, and credit has expanded quickly in some other Asian countries, where financial reform continues to be quite gradual in some cases. Because they take a different view from the IMF and Anglo-Saxon governments on the evolution and regulation of these markets, the argument goes, Asian governments are less likely to introduce transparency, strict accounting, balance-sheet restructuring, consolidation of fragile financial institutions and recapitalization of banks. Consequently, they are less likely to insist that neighboring countries that are undergoing crises undertake such reforms. Asian officials might be prone to misdiagnosing a crisis that is driven by financial-sector fundamentals as one driven by fickle foreign banks and investors, a ”liquidity crisis.”

Creating a regional capacity to provide financial assistance in emergencies, critics fear, could thus have two undesirable consequences. First, that capacity could be used to bail out governments that had unwisely provided guarantees to their domestic financial and corporate sectors in the past.[20] The mere prospect of such bailouts could undercut the vigor with which governments and central banks pursue financial sector reform. Second, creditor governments, such as Japan, might employ these facilities to bail out, effectively, their own banks with exposures to borrowing countries.[21] By lending under such arrangements, Asian creditors might socialize at the regional level the costs of guarantees made at the national level and delay needed adjustments.

Worse yet, having exhausted the BSAs without achieving adjustment, countries in the region could *then* go to the IMF. In the meantime, economic conditions in the crisis-stricken country and the region more broadly could well have worsened. Moreover, the creditors from within the region that had extended financing (unsuccessfully) will now have a strong interest in being "bought out," so to speak, by IMF funds and could thus advocate a softening of conditions in order to facilitate an agreement. This combination of economic and political pressure could well limit the choices of the IMF, placing it in an untenable position.

There are several reasons, however, why these fears should not be exaggerated and should not lead the international community to reject East Asian financial cooperation. First, despite suspicions among some analysts that the Japanese government funneled large amounts of money into the 1997-98 crisis to the benefit of Japanese banks and corporations, statistical evidence that this occurred on a large scale is difficult to identify. Second, while financial fragility in the region is still worrisome, supervision

[20] A number of governments in the region have clearly socialized the costs of bad lending and business decisions. For discussion, see Haggard 2000 and IMF 1999, among other works. This temptation is not by any means unique to Asian governments, of course.
[21] Japan's original AMF proposal was viewed, both within and outside the region, as at least partly an effort to bail out Tokyo-based banks with exposure in ASEAN countries.

and regulation has improved and is likely to continue to do so. Third, more importantly, the evolution and structure of the CMI to date is reassuring. In particular, the activation rules of the BSAs provide a safeguard against bailouts of international and local banks. Finally, the interests of creditor countries provide a natural check on the abuse of CMI swaps.

Those who fear the worst-case scenario raise concerns that have some merit. Countries of the regions should pursue financial restructuring and be guided in that effort by multilateral codes and standards. Any regional arrangement, whether or not it develops its own conditionality, should coordinate its policies and operations with the IMF. Such coordination must take place at the outset, rather than only after a regional effort might have failed to stabilize a country in crisis. However, these concerns are better addressed by instituting safeguards against abuse rather than opposing East Asian financial cooperation entirely.

Recommendations

These arguments generate a set of recommendations for the international community and for countries in the region.

First, CMI deserves the support of the international community. The United States and other G-7 governments should encourage its evolution in ways that are compatible with multilateral institutions.

Second, the members of the IMF should formally adopt a set of principles that specify the compatibility of regional financial arrangement with countries' multilateral obligations -- the financial equivalent of Article XXIV of the GATT – and how such arrangements should work with the Fund operationally. These principles would perpetuate the presumption in favor of regional arrangements that is embodied in the status quo. But under them, among other things, regional financial arrangements must consult with the IMF on disbursement of funds and could not undercut IMF conditionality. These principles would also provide formally for notification to, and review by, the IMF.[22]

Third, ASEAN+3 confronts long-term and immediate issues. Among the long-term issues are the expansion and centralization of the bilateral swap arrangements under the CMI: whether movement toward an Asian Monetary Fund is desirable. Among medium-term issues, I have recommended that the relationship between the CMI and the CCL be modified, allowing access to BSAs on prequalification.

The most pressing matters concern regional surveillance, however. Progress on developing the regional policy dialogue, or lack of it, will reveal the political commitment within the region to further development of financial cooperation. Progress on monetary and exchange rate cooperation will also hinge on the policy dialogue.

To develop a robust surveillance process, the group will have to strengthen the institutional underpinnings. The task of supporting regional surveillance should be clearly assigned to a single organization with a mandate to collect information from national governments and central banks, organize and analyze the information, disseminate it to group members and lead off the peer-review session at ministerial and

[22] Henning 2002.

deputies meetings. The discussion should be firmly connected to corrective action and planning for crisis contingencies.

Two aspects of surveillance that deserve high priority are the exchange-rate policy dialogue and current account adjustment. During 2001-2002, squabbles over the depreciation of the Japanese yen were quite public. Avoiding outright currency conflicts is a de minimus test of the seriousness of regional monetary cooperation. Relatedly, East Asia will have to accept a substantial portion of the global current account adjustment wrought by the recent (and continuing) depreciation of the U.S. dollar. Members of the region will want to avoid mutually self-defeating efforts to slough that burden onto one another.

The PECC Finance Forum can contribute to the effort to strengthen surveillance in several ways. First, from the review of regional institutions, the group can distill best practices on surveillance. Second, by mapping the preferences of regional governments, it might hope to identify a path to political agreement on more robust procedures. Third, the Forum can encourage governments, individually and collectively, to accept greater transparency with respect to economic conditions and policies and to deliver and accept more critical peer review when national policies endanger the financial stability of the region as a whole.

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