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Japan's perspectives on Regional Financial Cooperation[1]

Takatoshi Ito[2]

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[2] Professor, Research Center for Advanced Science and Technology, The University of Tokyo, 153-8904; tito@rcast.u-tokyo.ac.jp.

1. Introduction

Japan’s interest in regional financial cooperation has recently grown for four reasons. First, the experience of the Asian currency crisis that was highly contagious has shown that the Asia and Japan have been “on the same boat.” Their strong trade and financial linkages mean that one country’s financial difficulties affect others quite easily. Preventing a financial crisis in one country, if possible, is of others’ interest. Second, the less-than-perfect performance of IMF in managing various stages of the Asian currency crisis has given an interest in building a regional framework that is substitutable or complement to IMF. Third, success in economic and currency integration in Europe shows that it is indeed possible for a region to unify the currency. Of course, there are many steps before monetary union. But, Europe clearly shows a model for a group of advanced and middle-income emerging market economies to integrate real economies and financial markets. Fourth, there is a fear factor. Asia may be left behind in rush toward regionalism. The EU is poised to expand to the east and the NAFTA may be expanded to the Free Trade Area of the Americas (FTAA). Fragmented Asia may suffer in any trade negotiations or trade wars as each of the Asian economies may be dwarfed by the expanded Euro Area or the “dollarized” Americas.

The proposal of the Asian Monetary Fund (AMF) could have been a defining moment in the history of financial integration in Asia. Instead, it became a source of controversy in the following three years, putting fetters on any regional effort toward financial cooperation. Although elements of the AMF proposal were quite sensible, the package was presented without coordination among Asian countries. It was quickly painted as a substitute for IMF, as a challenge to global institutions, and as an inward-looking framework for mutual “self-help” without tough economic reform.

2. Rationale for Regional Financial Cooperation

If countries in the region can pool resources to advise a near-crisis country to avert a crisis and to help a crisis country to get out of the crisis before it becomes too late, that would be the best. Even if a country falls into a crisis, financial cooperation may be able to lessen the damage. Countries in the region have self interest to help each other.

(1) OLD reasons before the Asian currency crisis

Prior to the Asian currency crisis, an interest for regional cooperation was limited. A proposal for a regional grouping, East Asian Economic Caucus (EAEC) was once proposed but rejected. Japan looked reluctant to take leadership in the region. It seemed that there is no shared value or common interest among Asian countries. Both ASEAN and APEC have “voluntary” actions as a basic principle; and domestic economic policies as well as political regimes were regarded as untouchable in the discussion.

(2) IMF reform during and after the Asian currency crisis

During the Asian crisis, several factors contributed to the growing sense of regionalism. First, the crisis spread to neighboring countries from Thailand quite quickly. Reasons for the “contagion” have been debated, but most economists agree on at least two factors: institutional investors’ decision to put Asian in one basket; and negative spillovers through a trade linkage.

When a crisis occurs, it works as a “wake-up call” for institutional investors. They start looking for weak countries to look out for who’s-next. Investors start withdrawing funds from countries they think vulnerable and similar to the initial crisis country. This happened in the Mexican crisis as well as the Thailand crisis. Moreover, sometimes mutual funds are organized by geographical grouping. For example, when Thailand falls into a crisis, shareholders may want to cash out, so perceived by fund managers. Fund managers sell equities and bonds in the fund to fatten cash reserves. Therefore, securities and currencies in the fund will be sold and negative pressures on bonds, stocks, and currencies will result of the rest of the region. This is a contagion process through investors.

Contagion can be caused by trade link. When Thailand goes into a serious crisis, demand for goods—some of them imports—will decrease. Those countries that export to Thailand will suffer from declined aggregate demand. This may be amplified as spillovers go into a spiral of aggregate declines.

From these reasons, contagion occurred. The exchange rates of Asian currencies declined together from July 1997 to January 1998, although degree of correlation varies from one country to another. The sense of “we are on the same boat” was enhanced greatly.

Contagion occurred in the Mexican crisis of 1994-95. Pressure was applied to Argentinean and Brazilian markets. However, contagion was stopped before it caused devaluation in other countries, thanks to IMF program to Argentina in March 1995. In the case of Asia, IMF policies were not effective in stopping a crisis. Some think that the IMF policies even aggravated the downturn of the economies in some countries. For the Thai crisis, the IMF arranged a "package" of US$17.2 billion, in which IMF contributed US$4, and Japan also US$4, with the rest came from the World Bank, ADB, and group of Asian countries. Countries like Korea, China, and others contributed US$1 billion dollars each. It was notable that the United States or any European countries contributed to IMF package. These developments contributed to a notion that Asian countries should help each other in preventing and managing crisis. The regional self-help is important.

Japan provided financial assistance, that is, short-term and long-term loans through Japan Export-Import Bank, of its own under the new Miyazawa initiative from 1998. This alleviated some acute credit crunch due to banking crisis in the aftermath of the currency crisis.

(3) NEW reasons

In 1999, the Euro was introduced. This was the last major step in the long history of European economic integration. This stimulated the interest in regional integration among Asian countries. As the EU has succeeded in deep integration, and the NAFTA seems to be expanded to an entire Americas (FTAA), the Asia seems to be hopelessly fragmented. The newly revived interest in regionalism in Asia has been fueled by defensive considerations.

The failed attempt to launch WTO rounds in Seattle also put some pressure toward regional initiatives. Although a new round was launched two years later in Doha, now the regional FTAs are considered to be building bloc rather than a stumbling bloc.

3. Status of Regional Financial Cooperation

There are many forums and framework for financial cooperation in the region. The following table summarizes the functions and status of the major grouping in the region.

Regional surveillance Fora in Asia

Grouping	Structure	Focuses	Mandate
Manila Framework Group (MFG) **Established in 1997**	The group of Finance and Central bank officials from 14 member countries (Australia, Brunei Darussalam, Canada, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore, Thailand, and the United States of America), and senior representatives from IMF, WB, ADB, BIS	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) streaming 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

Grouping	Structure	Focuses	Mandate
APEC (Asia-Pacific Economic Co-operation) **Established in 1989**	Led by Heads of Governments, finance ministers (initially Foreign Affairs and Trade Ministers) of 21 countries (Australia, Brunei Darussalam, Canada, Chile, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, Mexico, New Zealand, Papua New Guinea, Peru, the Philippines, Russia, Singapore, Taiwan, Thailand, the United States of America, and Viet Nam)	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…

			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
Grouping	Structure	Focuses	Mandate
ASEAN (Association of South East Asian Nation) **Established in 1967** **ASEAN Surveillance Process** **Established in 1998**	The association of 10 member countries (Indonesia, Malaysia, the Philippines, Singapore, Thailand, Brunei Darussalam, Vietnam, Laos, Myanmar, Cambodia) The institutional bodies consists of ASEAN Finance Ministers Meeting (AFMM), ASEAN Select Committee and ASEAN Central Bank Forum	The objective range from free trade to environmental protection, social, cultural and scientific development 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…
Grouping	Structure	Focuses	Mandate
ASEAN (Association of South East Asian Nation) plus 3	Led by Finance Ministers of ASEAN, China, Japan, and Korea	Enhancing policy dialogues and regional cooperation activities,	The joint Ministerial Statement of the ASEAN+3 Finance Ministers Meeting

Established in 2000 (based on "Joint Statement on East Asia Cooperation" issued by the ASEAN+3 Leaders at their Informal Meeting in 1999)		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	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…

Grouping	Structure	Focuses	Mandate
EMEAP (the Exectives'Meeting of East Asia and Pacific Central Banks) Established in 1991	A cooperative organization of central banks and monetary authorities of 11 economies: Australia, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore, and Thailand	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	Goverors' 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.

Grouping	Structure	Focuses	Mandate
SEACEN (South East Asian Central Banks) Established in 1982	A organization of central banks of 11 Economies: Indonesia, Korea, Malaysia, Myanmar, Mongolia, Nepal, the Philippines, Singapore, Sri Lanka, Thailand, Taiwan	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…
SEANZA (South East Asia, New Zealand, Australia) Established in 1956	A regional policy forum of central bank governors from British Commonwealth countries in Asia Pacific region	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…
BIS Asian Consultative Council Established 2001	The council within BIS, comprising the Governors of the BIS member Central Banks in the Asia/Pacific region (The secretariat are provided by the BIS Representative Office for Asia and the Pacific in Hong Kong.)	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 (IOSCO APRC) (IOSCO: International Organization of Securities Commissions, Established 1976)	One of the four Regional committees of IOSCO (a world-wide forum for securities regulators) consists of 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 Num 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)
Notes: Ito, Takatoshi, "Regional Surveillance Mechanisms in East Asia", a report submitted to Institute for International Monetary Affaires, March 2002. (Unpublished)			

3. Surveillance and Monitoring of existing Framewors.

(1) What is surveillance

Macroeconomic surveillance means monitoring the status and prospects of the economic conditions and by a multi-national forum or an international body. Macroeconomic surveillance has regularly (in most cases, annually) conducted by IMF, the World Bank, and OECD, for their member countries. Economic surveillance is not only an observation of economic indicators, but an assessment of macroeconomic and structural and trade policies and an assessment of potential financial risk,. After a series of currency crises triggered by massive capital flows, surveillance on risk in the capital and financial markets and soundness of financial institutions has become a priority of economic surveillance. Effectiveness of surveillance is based on peer pressure. In most cases, a failure to satisfy recommendations would not lead to any penalties but to an embarrassment and loss of influence in the organization. (The Maastricht treaty and some other EU integration processes have been more than just surveillance, but they contain penalties.)

Surveillance requires data collection, often with help from the authorities. Data should be compared to other countries, or best practices, for soundness of the country's policy. Surveillance requires face-to-face discussions in addition to regular correspondences. IMF and OECD send missions to the countries under review. When some unsatisfactory policies are detected, a surveillance organization may issue warnings. Cooperation in the international organization is essential, and mutual help should be highly valued. Sometimes, those warnings may be welcome in the sense, it may break domestic opposition by vested interest groups to desirable reforms. In the case of financial assistance and deeper integration like EU, penalties (or suspension of assistance) may be necessary, as lack of reform may hurt the other members of the organization.

One can categorize surveillance mechanisms and international organizations by geographical category and their main functions.

Table 2: Various surveillance mechanism

	Trade	Macro and Finance
Global	WTO	G7, OECD, IMF,
Regional	EU, NAFTA, MERCOSUR AFTA	European Payments Union European Monetary Cooperation Fund Arab Monetary Fund Latin American Reserve Fund Chiang Mai Initiative

		Manila Framework ASEAN APEC ASEM

(2) IMF, OECD, G7, G10

The IMF conducts an annual (Article IV) review on all of its member countries that include both advanced and developing countries. The review includes macroeconomic assessments on monetary and fiscal conditions and policies, capital and financial markets reviews, and external (export and import) balances. In addition, for those who receive assistance from the IMF are subject to more frequent reviews. However, policy measures promised by recipient countries of IMF assistance—Stand-by Arrangement, Enhanced Structural Adjustment Facility, etc—are not called as surveillance, as they are more strict conditions than peer pressure. The OECD also conducts annual reviews on its members, who are all advanced countries. The IMF and OECD reviews are more institutionalized and go through a transparent process of drafting and approving reports.

The OECD has another forum that is known to be strong in surveillance. The Working Party 3 (WP3) of Economic Policy Committee is composed of ten chairs—G7, the Netherlands (with Belgium), Sweden (with Denmark and Norway), and Switzerland. The WP3 grouping is roughly the same as the G10, that is composed of 11 countries, namely G7, the Netherlands, Belgium, Sweden, and Switzerland. Both WP3 and G10 are joined by IMF and ECB. Representatives from the Ministry of Finance and the central bank (usually, Vice Ministers of the Ministry of Finance and the Deputy Governors, or their deputies) meet for a one-day, closed-door meeting four times a year, without issuing reports or statements. Discussions are very frank, and detailed, covering macroeconomic issues of major economic regions (North America, Japan, and Europe), as well as risk in emerging markets countries and commodity markets.

Another forum that meets and communicates each other frequently is Group of Seven (G7) Finance Ministers meeting and their deputies meeting. The G7 is consisted of seven largest economies in the world, and coordinates their policies on the matter that are of great concern for the global economy. Frequency of the meetings and communication is very high, and most of them are in fact informal. Only when the Ministers meet, about three times a year, a formal communiqué is issued.

The international community realized that it is important to involve key emerging markets countries in the discussions of global financial issues. This was made aware by the recent currency crises: in Mexico, 1994-95; in Asia, 1997-98; in Russia, 1998; in Brazil and Turkey, 1999-2000; and in Argentina, 2001-2002. When a country of certain sizes develops a currency crisis or a banking crisis, that affects stability of the global financial system. Advanced countries, represented by G7, became growingly concerned that the new type of crises in Mexico and Asia would potentially be repeated in the future to affect the world adversely. Emerging market countries, on the other hand, must have felt that they were under increasing scrutiny from the international community, including G7, G10, and IMF, without having their views and voiced, fairly represented in the process. Many Asian economies regarded that liberalizing domestic financial markets and external capital flows were potentially risky to the stability of financial markets, although advanced countries were pushing liberalization strongly to emerging market economies. After the Asian crises, many Asian economies regarded that hedge funds activities speculating on the currency were part of difficulties that small open economies experienced during the volatile period in 1997 and 1998. In order to have more frank discussions involving emerging market economies, advanced economies, led by G7, created two new forums. First, the Financial Stability Forum (FSF) was created under a leadership of Andrew Crocket, Chief Manager of the BIS. The FSF moved quickly to establish three working groups, highly-leveraged institutions, capital flows, and offshore financial centers. In addtioin to core members of G7, the three working groups involved several emerging market economies. Subsequently, the FSF is creating more activities. Second, a larger grouping that G7 that would include emerging and developing countries that are "systemically important" to the stability of the global financial system was created. Large 20 economies—19 economies plus the chair of EU—were chosen to form the G20. The G20 is a collection of larger advanced countries, G7, and large (either by population or income) developing countries. Like G7, there is no legal mandate, international treaty, or permanent secretariat for the G20. However, there is a potential that G20 may develop into an important international forum that will conduct surveillance on the global financial issues.

After the Asian crises, considerations were given how to strengthen international financial institutions (IFIs). Efforts to reform IFIs were commonly referred to as building a new international financial architecture.[3] Many academic put forward radical reform plans, from abolishing IMF to transforming IMF into an international bankruptcy court. Actual institutional changes were much more modest. One of such institutional changes was to make the Interim Committee of IMF into a

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[3] See Eichengreen (1999) and Kenen (2001) for reviews on new international financial architecture.

permanent body called the International Monetary and Financial Committee (IMFC), creating a Deputies meeting.

Streamlining IMF roles and lending facilities were discussed, but the discussion resulted in very minor changes. The IMF and its Governors introduced several internal changes. The Interim Committee was transformed into the International Monetary and Financial Committee (IMFC), with a creation of its deputies' meetings. The IMFC, which parallels the IMF Board Chairs, can discuss both institutional issues of IMF and current global economic and financial issues. The IMF also created a new department that is dedicated to capital markets surveillance.

On the financing side of the IMF, there were two important developments. First, a quota increase of the IMF occurred, so that IMF is better endowed to deal with larger scale financial support packages to emerging market economies. Second, when and if the IMF develops a short-term liquidity problem, supposedly supporting many crisis-hit countries simultaneously, the IMF can borrow from rich countries. The General Agreement to Borrow (GAB) have been in place for this purpose from the inception of IMF. The GAB membership is the same with the G10. After the Asian crises, it was recognized that GAB arrangement may not be enough in the future crises. The expansion of G10 was discussed but rejected for an alternative solution. The New Arrangement to Borrow (NAB) was created with 25 members, including richer developing and emerging market economies. All in all, some progress has been made in terms of creating new forums and some internal reorganizations in the IFIs to strengthen surveillance on financial issues. However, more radical and serious reorganization of any of the existing IFIs did not occur.

********* BOX: Membership of different groups and forums *********

(1) G7: US, Japan, Germany, France, UK, Canada, Italy
(2) G10: G7 plus Sweden, Switzerland, Belgium and the Netherlands (11 countries)
(3) G20: G7 plus Russia, Turkey, Indonesia, China, Korea, Australia, Brazil, Argentina, Mexico, Saudi Arabia, South Afraica, and EU Chair.
(4) IMFC: G7 plus the Netherlands, Finland, Switzerland, Russia, Indonesia, China, Australia, India, Brazil, Argentina, Venezuela, Saudi Arabia, Egypt, Iran, Gabon, South Africa. (24 countries)
(5) NAB: G10, Luxemburg, Spain, Austria, Finland, Denmark, Norway, Malaysia, Singapore, Thailand, Hong Kong, Korea, Australia, Saudi Arabia, Kuwait. (25 countries)

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(3) Financial Surveillance Organizations

Although emerging market economies were found to be especially vulnerable to currency and banking crises in the currency crises of Mexico, Asia, Russia, and Argentina, these crises were not limited to emerging market countries. Banking crises were common even among advanced countries—most notably, the Savings and Loans crisis in the United States, and banking crises in Sweden in the beginning of the 1990s and in Japan in the late 1990s.

A forum of banking supervisors, the Bale Committee on Banking Supervision (BCBS) have been active since the mid-1980s in promoting information exchanges and developing banking standards. The Bank for International Settlements (BIS) has been helpful in providing facilities for these bank supervisors meetings. The capital adequacy standard developed in 1988 had a large impact on the soundness of internationally active banks. The 8% rule has been accepted globally as a minimum standard that international banks have to achieve. The newly revised standard, recommending more complex risk management, is under review. In the new standard, internationally active banks are expected to introduce a sophisticated model-based risk management model.

Parallel to the bank supervisors' organization, the securities industry has International Organization of Securities Commissions (IOSCO), and the insurance industry has International Association of Insurance Supervisors (IAIS).

The trio of supervisors, BCBS, IOSCO, and IAIS, has become an important core to develop codes and standards for financial institutions. Of course, there are some concerns for having a unified global standard. Even among the advanced countries, regulations are different. To name a few, Germany has been known for its universal banking, while the United States and Japan have traditionally separated the banking and securities businesses. Developing countries and emerging market countries often lack basic financial and legal infrastructures. However, the trend has been set that if countries want to be integrated in the global financial and capital markets, the countries' supervisory regime has to be conformed to "best practices" of the global standard. As investors from advanced countries have increasingly taken positions in emerging market economies, advanced countries have become more demanding on the state of the supervisory regime. If financial institutions from any of emerging market economies wish to do substantial businesses in the advanced countries, credibility of main supervisors, that is home country supervisors, will be under scrutiny. Accounting statements of banks, securities businesses, and corporations that borrow from them have to be reliable in order to do effective supervision. The international standard has been developed in the area of accounting. Standard setting activities in the International Accounting Standards Committee (IASC) have become very important.

Organizations like BCBS, IOSCO, IAIS and IASC set “codes and standards” and they themselves do not practice surveillance activities. However, discussions and standards set by them are extremely relevant for surveillance activities among IFIs. Let us cite one example.

Surveillance for financial soundness will be enhanced in the future. Vulnerability in the banking sector often causes the attack on the currency, while a sharp depreciation often causes bank failures. The twin crises—banking and currency crises—have been observed repeatedly among emerging market economies in the recent history. After the Mexican crisis, *The Core Principles for Effective Banking Supervision*, was developed by the BCBS with a cooperation with the IMF and the World Bank. The “Principle” is a document that set out broad guidelines on how the supervision regime should be set out in one country. It has been agreed upon later that The principles will be implemented in the IMF surveillance process. Accordingly, progress in financial supervision will be monitored in Financial Sector Assessment Program (FSAP) for each country. This will be an effective surveillance system.

<u>(4) Regional Mechanism</u>

The Asian region traditionally had not had regional group for financial cooperation. The Asian financial crisis has been a catalyst in thinking about the regional financial cooperation. Let us review the Mexican and Asian crises so that why the regional mechanism became an important topic of discussion.

On July 2, 1997, the Thai baht was floated, and quickly depreciated by 15 percent.[4] However, the baht did not depreciated more than 20% before the IMF with Japan and Asian countries put together a package of $17.2 billion in late August. The IMF contributed $ 4 billion, Japan contributed $ 4 billion, other Asian countries—China, Australia, Hong Kong, Malaysia, Singapore,—contributed $1 billion each and Korea, Indonesia, and Brunei contributed $ 500 million each. The rest came from the World

[4] In Thailand, initially the impact of floating the exchange rate of July 2, 1997 was not substantial. The exchange rate depreciated by 15 percent but not in the order of 50 percent in the case of Mexico. Some thought that a successful exit from the *de facto* dollar peg was achieved. However, when the IMF program was announced, accompanied by the disclosure of the amount that the central bank owe to the market by forward contracts, confidence was not restored. This delayed the recovery, and in the meantime, the economy went into a recession, thanks partly to an austerity plan as the IMF conditionality. Many find IMF erred in prescribing an incorrect prescription to the Asian type crisis, in particular fiscal austerity in the midst of weakening economy. Even IMF (see Lane (1999)) admitted later that fiscal austerity was a mistake. The fiscal deficits were not the core problem, unlike the Latin American crisis. Therefore, planning fiscal surpluses did not enhance confidence of investors.

Bank and the Asian Development Bank. The United States was conspicuously absent from the Thai package. However, on the same day of IMF package announcement, the Bank of Thailand was forced to reveal the amount of forward contract, amounting to $23.4 billion, that would result in foreign reserve losses in the near future. Therefore, the package for Thailand was viewed in the market as too small.

This kind of "package" was necessary because of the access limit, namely the IMF cannot lend under Stand-by Agreement (SBA) beyond 3 times of the quota of the country. A similar arrangement was necessary when the Mexico, after devaluation in December 1994 needed a financial assistance from IMF. Since a large amount was necessary for Mexico not to default on outstanding *Tesobonos*, the United States agreed to co-finance the IMF support to Mexico. In case of Mexico, the access limit was raised to 5 times as an exceptional case. In the package of $ 50 billion, the IMF was contributing only $ 17.8 billion—even with higher than usual access limit—, while the bilateral help from the United States amounted to $ 21 billion.

So, the first motivation for the regional arrangement (that is, the United States for Mexico, or Japan and the Asian countries for Thailand) was the access limit and the lack of resources in IMF.

After Thailand but before Indonesia and Korea, there was a proposal on the Asian Monetary Fund (AMF). The proposal was put forward by Japan and the ASEAN countries. It was supposed that the participating countries of the AMF would contribute some of their foreign reserves to a central fund, and the fund would be used to help liquidity shortage in a currency crisis of the member county. This was a response to a frustrating realization that IMF resources were not enough to cope with a 21st century type currency crisis, and putting together a package with bilateral help would take time and efforts, as was the case for Thailand. The AMF proposal was opposed by the United States and the IMF (plus China) on two grounds: Soft conditionality and duplication. To provide financial help without stringent conditionality leads to easy money. Not only soft conditionality would not reform a crisis country out of crisis, but money would be at risk. In order to carry out strict surveillance, one needs a large number of high-quality staff. However, creating such an organization is a duplication of an already existing organization such as IMF. The idea of AMF died in the meeting on the margin of the Fund-Bank Annual Meeting in Hong Kong, September 1997. In order to enhance regional surveillance, the Manila Framework Group meeting was created in November 1997. However, Manila Framework Group was not helpful when the crisis spread to Indonesia and Korea.

In the initial Indonesian package (November 1997) and the initial Korean package (December 1998), the resources that could be mobilized to fight liquidity crisis were quite limited. Although their packages were large in the announced dollar terms ($40 billion for Indonesia and $57 billion for Korea), the bilateral supports, including those from Japan and the United States, were labeled as the "second-line of defense". Without a clear guideline on how to trigger the second line of defense, the market discounted the effectiveness of the package. The actual disbursement from the IMF and bilateral partners for Indonesia and Korea was not large enough to calm down the market. The exchange rate did not rebound on the day of the IMF program announcement for either country. For the lender of the last resort type (LLR) operation, IMF packages for the Asian countries were too small, thus failed to stabilize the market quickly.

The Asian currency crises made it clear that contagion is dangerous. The crisis spread from Thailand to Indonesia, to Korea in the matter of several months. Likely contagion is another reason that regional help is desirable.

There have been several attempts to form regional economic cooperative arrangements in East Asia. Some attempts were successful, like ASEAN free trade arrangement (AFTA) and some were unsuccessful, like Asian Monetary Fund (AMF). Some arrangements have only regional members, like AFTA, and some with other Pacific Rim countries, like APEC. Some groupings are new and some are old.

Three aspects are salient in the new trend in Asia. First, a recent trend is to form intra-regional groupings, such as ASEAN plus 3, rather than Pan-Pacific ones, such as APEC. Second, free trading arrangements seem to be in vogue. Third, Japan and China seem to be more enthusiastic about an intra-regional grouping than before. The creation of ASEAN plus 3 owes to a change in the attitudes of both Japan and China.

Traditionally, trade arrangements are most important and prominent regional arrangements in the world. Many existing regional groupings started with some sort of preferential trade arrangements. European economic cooperation started with a customs union, and developed into a single currency full-fledged economic area. MERCOSUR and NAFTA are two free trade arrangements in the Americas. On this front, Asia has been lagged behind other regions in the world. Although ASEAN countries agreed to create a free trade area, AFTA, speed toward free trade is slow, because any member seems to have a veto power. The most recent ASEAN drive to accelerate toward free trade was halted by Malaysian reluctance to open its automobile market. The APEC Bogor declaration envisioned that free trade will prevail in the Asia-Pacific advanced countries by 2010 and others by 2020.

Until 2001, Japan and Korea had been only OECD countries without preferential trading arrangement. However, recently, this is changing. Japan and Singapore have just signed a free trade agreement. Korea and Japan have studied a free trade agreement, but the drive seems to be halted.

China has proposed a free trade agreement between China and ASEAN. The idea of the China-ASEAN free trade area seems to have only a distant chance to be created any time soon. However, the ASEAN countries countered to propose a ASEAN-plus-three free trade agreement. The ASEAN plus 3 FTA would create a large market in Asia, if it is successfully implemented.

(5) Financial Arrangements

Financial cooperation in the region has progressed recently. In the wake of devaluation of the Thai baht in July 1997, the Asian countries led by Japan put together a financial support package with the IMF to help Thailand. (IMF 4 billion; Japan 4 billion pari passu) The support package was the first in joint efforts of the Asian countries to help each other in an acute financial crisis. The fear of further attack on a currency in the region, combined with a seeming success, at that point, in stabilizing the floated baht, made Asian countries to propose the Asian Monetary Fund (AMF). The AMF, proposed in August-September 1997, was an extension of the Thai package in which Asian countries put together their financial resources to help a crisis country in the region. In order to save time for negotiating country shares of financial support, the AMF was envisioned to pre-arrange and pool resources for financial support. The AMF proposal, which was never publicly detailed, drew criticism from IMF, the United States, and China.

Shortly after the World Bank-IMF Annual meeting in Hong Kong, September 1997, the AMF idea was dropped due to the oppositions. Instead of financing mechanisms, a surveillance mechanism in the Asia-Pacific region was created. The first meeting of such a surveillance mechanism was held in Manila in November 1997, and subsequently named as the Manila framework group meeting. The Manila Framework Group (MFG) meets twice a year since then. The MFG membership extends to the United States, Australia, and New Zealand in addition to Asian economies that provided financing to the Thai package. However, the crises spread to Indonesia and Korea in November and December of 1997. The Manila framework group contributed little to crisis prevention or management of Indonesia or Korea. The support packages for Indonesia and Korea had the so-called second line of defense, in addition to first line of defense, that is IMF, the World Bank, and the Asian Development Bank. Japan and the

United States with the Asian countries pledge contributions in the second line of defense. When and how the second line of defense was never detailed, and it was never triggered.

The new Miyazawa initiative, a large financial supports to help economic recovery in the region, was launched in 1998. The total size of the new Miyazawa initiative was 30 trillion yen in which a half was for short-term liquidity support and the other half for medium-term and long-term projects. The financial support was to help crisis countries getting foreign currency liquidity. The money could be used to ease problems in credit crunch that hurt even trade financing. Financing was supposed also to help fiscal deficits that were results of stimulating the economy in the sharp recession after the crisis. During the period of putting the economy on the recovery path, extra financing for budgetary gaps by the new Miyazawa initiative was quite helpful.

In May 2000, the Chiang Mai Initiative (CMI) was launched. It is envisioned that a network of bilateral swap agreement (local currency to US dollar or Japanese yen) will be developed among the northeastern Asian countries (Japan, China, Korea), and between one of the northeastern Asian countries and one of 10 ASEAN countries, as well as strengthening an intra-ASEAN swap agreements. Several swap agreements, including Japan-Korea, Japan-Thailand, Japan-Malaysia and Japan-Philippines, were successfully concluded. The ASEAN swap agreement was also enhanced to cover all 10 countries, and the size was increased to 1 billion dollars. It remains to be seen whether the ASEAN-plus-3 framework will be developed into more regional cooperative scheme in the future.

(6) Global vs. Regional mechanism

In the preceding section, it is argued that there are several reasons why the Asian regions started financial cooperation. First, resources at IMF are limited, so that regional support to a crisis country was desirable. The LLR role in the region is complementary to IMF program so long as they are invoked at the same time. This reasoning is somewhat weakened after the Supplementary Reserve Facility (SRF) was established. IMF can now finance a quite large support package if necessary.

The second motivation for the regional mechanism was to prevent regional contagion. Countries in the same region have more common stakes and mutual interest to help each other. The problem in the financial-integrated regional economies is best addressed regionally rather than globally. In the currency crises after the Asian crisis, contagion has been less important, it cannot be sure that contagion may return in a future crisis.

Why do we need regional surveillance? First, the global mechanism is not enough. Second, ASEAN+3 framework requires surveillance. An approval of financial assistance—crisis management; preventing crisis—requires monitoring of capital flows, and high frequency is a key; Surveillance helps policy soundness.

4. Leadership, linkage to IFIs

Leadership in the region should and will be shared among China, Japan, Korea, and ASEAN collectively. In some issues, Japan takes leadship, and on some other issues, China takes leadship. In case of the failed attempt to create an AMF, Japan took a leadership, but China opposed to the proposal. In case of ASEAN plus three, the ASEAN took a lead to invite the three countries. The CMI under the ASEAN plus three has been promoted under the leadership of Japan.

In the future, Japan has to continue taking a leadership role in financial matters as a largest financial creditor and a wealthiest nation in the region. China seems to be taking leadership in proposing a free trade agreement between China and ASEAN. Competition for leadership may be confusing, but may result in hastening an integration process.

The CMI has a clause that 90 percent of bilateral swap under CMI has to be linked to an IMF program. Therefore, the bilateral swap under CMI is clearly complementary to IMF program. Currently, there is no independent institution for regional surveillance, and the role of surveillance had to be filled by international organizations for the time being.

5. Future Direction

Further deepening in trade and financial cooperation is expected in the Asian region. Different groups will coexist and contribute to regional integration from different perspectives. Which grouping is most appropriate is somewhat a tricky issue. Currently, ASEAN plus three has a momentum in deepening cooperative arrangement on a financial and surveillance matter.

Free trade agreements (FTA) or financial cooperation arrangements should set standard for accession to membership. That would solve a question on which grouping is most appropriate or a problem of some countries being left out. For example, ASEAN plus 3 may consider an accession clause to the bilateral swap agreement mechanism (CMI). For example, the existing members may decide to invite anyone who wants to join the CMI and satisfy certain conditions, such as to provide a swap line with at least two-thirds of the existing member.

ASEAN plus three has a potential to become a nucleus of economic and currency integration. As economic integration proceeds, a temptation increases for currency cooperation (just like a snake in European monetary system or a basket band crawl system) and eventually monetary integration (just like introducing the Euro).

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