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# Korea's Perspective on Regional Financial Cooperation*

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## 1. Introduction

The growing interdependence in the world through trade and financial integration has heightened the need to engage in international and regional economic cooperation. This was never demonstrated more clearly than during the Asian financial crisis of 1997. The reality is that financial instability is unlikely to remain within the national borders of the country of origin. Cooperative efforts at both regional and global levels are therefore needed to counter the negative spillovers. The IMF's surveillance activity is just such an example of the provision of global public goods. By the commonsense logic of "two heads are better than one," regional initiatives could complement the IMF surveillance process.

The large currency crises of the last decade have been regional in nature. Clearly, neighboring countries have a strong incentive to engage in mutual surveillance and to extend one another financial assistance in the face of potentially contagious threats to stability. Regardless of whether the sudden shifts in market expectations and confidence were the primary source of the Asian financial crisis, foreign lenders were so alarmed by the Thai crisis that they abruptly pulled their investments out of the other countries in the region, making the crisis contagious. The geographical proximity and economic similarities (or similar structural problems) of these Asian countries prompted the withdrawal of foreign lending and portfolio investment, whereas differences in economic fundamentals were often overlooked. If the channels of contagion cannot be blocked off through multilateral cooperation at the early stage of a crisis, countries without their own deep pockets of foreign reserves could not survive independently. Hence, neighbors have an interest in helping put out a fire (a financial crisis) before it spreads to them. As long as a crisis remains country-specific or regional, there is no urgent political need for unaffected countries to pay the significant costs associated with playing the role of a fire fighter.

The formation of a regional financial arrangement in East Asia also reflects frustration with the slow reform of the international financial system. The urgency of architectural reform in the G7 countries has receded considerably. The slow progress has been further complicated by the perception that the current international architecture is defective. As long as the structural problems on the supply side of international capital such as volatile capital movements and G3 exchange rate gyrations persist, the East Asian countries will remain as vulnerable to future crises as they were before. It would be in the interest of East Asians to work together to create their own self-help arrangements. The CMI of

ASEAN+3 is one such available option. However, it is equally important that East Asian countries continue to undertake financial sector restructuring and development. Without sound financial institutions and adequate regulatory regimes, Asian financial markets will remain vulnerable to external shocks. Regional policy dialogue should also contribute to strengthening the efforts to restructure the financial markets in East Asia.

The three pillars of liquidity assistance, monitoring and surveillance, and exchange rate coordination are essential elements for regional financial and monetary cooperation. However, the development of regional financial cooperation and its related institutions will be evolutionary as shown in the case of European monetary integration. A shallow form of financial cooperation may comprise no more than a common foreign reserve pooling or mutual credit arrangement such as bilateral swaps. In other words, some kinds of shallow financial cooperation are conceivable without any commitment to exchange rate coordination under which exchange rates of the participating countries are pegged to each other or vanish through the adoption of a common currency. East Asian countries presently appear to pursue this form of financial cooperation. Although a full-fledged form of monetary integration is not viable at this stage, East Asia may begin to examine the feasibility and desirability of cooperation and coordination in exchange rate policies.

Before the Asian financial crisis broke out in 1997, few would have seriously argued for the creation of regional financial cooperation in East Asia. Only a market-led integration process was taking place in East Asia. However, the financial crisis that erupted in 1997 was a major financial breakdown that gave East Asians a strong impetus to search for a regional mechanism that could forestall future crises. This search is now gathering momentum and opening the door to possibly significant policy-led integration in East Asia.

Evidently, there is a rising sense of East Asian identity today. After the AMF proposal was shot down, the leaders of ASEAN responded by inviting China, Korea and Japan to join in an effort to seek economic cooperation in the region. The ASEAN+3 summit in November 1999 released a “Joint Statement on East Asian Cooperation” that covers a wide range of possible areas for regional cooperation. Recognizing the need to establish regional financial arrangements to supplement the existing international facilities, the finance ministers of ASEAN+3 at their meeting in Chiang Mai, Thailand, in May 2000 agreed to strengthen the existing cooperative frameworks in the region through the “Chiang Mai Initiative (CMI).”

Significant progress has been made in implementing the CMI. The ASEAN Swap Arrangement (ASA), one of the main components of the CMI, has increased to US$1 billion, effective as of November 17, 2000, and encompasses all ASEAN member countries. Regarding the network of bilateral swap agreements (BSAs) under the CMI, substantial bilateral agreements have been reached and are currently under negotiation. Japan has been playing a leading role in number and amount: Japan concluded five agreements with Korea, China, Malaysia, the Philippines, and Thailand, while negotiating two more agreements with Singapore and Indonesia. Korea also concluded two agreements with China and Thailand in addition to the Japan-Korea BSA. Korea is also expected to conclude BSA negotiations with Malaysia and the Philippines [See Table 1].

The purpose of this paper is to provide a Korean view on the current process and future prospects of regional financial cooperation. Since it is extremely difficult to make explicit the sources of the views expressed in this paper (mainly due to confidentiality and sensitiveness of the issues considered), this paper is basically based on my earlier works (sometimes co-authored) listed in the references.

## 2. Rationale for Regional Financial Cooperation (Q1)

The Asian financial crisis provided a strong impetus for East Asia to reform and strengthen its domestic financial systems (markets and institutions). At the same time, a strong need has emerged for developing a framework that can support regional financial cooperation to prevent and manage such crises in the future. However, the terminology – regional financial cooperation – seems ambiguous and thus needs to be more clearly specified. No one can deny the need for regional financial cooperation in the genuine sense, but when it comes to discussing the details and specifics of concrete proposals, there is disagreement all around among insiders and outsiders alike. One clear example is the proposal for the Asian Monetary Fund (AMF), which was shot down in 1997.

The adoption and implementation of the CMI could be counted as a major step toward strengthening the financial cooperation among the thirteen East Asian countries. However, ASEAN+3 countries will face much tougher challenges and tasks in exploring developments beyond the CMI. East Asian countries need to clarify to the international community what their motivations are, how they will develop an action plan, and how they believe it fits in with the existing global financial system.

The creation of a regional monetary fund in East Asia was strongly opposed by the United States, European countries and, of course, the IMF for a number of reasons. Opponents dismiss the contention that an East Asian regional fund may have a comparative advantage in diagnosing regional economic problems and prescribing appropriate solutions. In this regard, the CMI and its follow-up implementation are acceptable to many detractors of the regional monetary fund. The CMI does not require a new institution like the AMF, and it is also tightly linked to IMF conditionalities.

Let me further consider the issue of moral hazard, one strong argument against the regional monetary fund. At this stage of development, East Asians may not be prepared to negotiate an international treaty that includes provisions for sanctions and fines for countries that do not adjust their domestic policies accordingly (Eichengreen 2000).[1] This unwillingness would make it difficult for the regional monetary fund to impose politically unpopular policies on the member countries and, hence, may pose a serious problem in policy discipline. However, it has not yet been made clear why an East Asian monetary

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[1] Eichengreen, Barry, 2000, "Strengthening the International Financial Architecture: Where Do We Stand?" *ASEAN Economic Bulletin* 17:2, pp. 175-192.

fund would suffer more from the moral hazard problem than the IMF. The IMF itself is also not immune to the moral hazard problem. An East Asian monetary fund could provide additional resources to the IMF while joining forces to work on matters related to the prevention and management of financial crises. At the same time, it could also support the work of the IMF by monitoring economic development in the region and taking part in the IMF's global surveillance activities.

Eichengreen finds it useful to distinguish between technical assistance and financial assistance. True enough, there is no reason to discourage competition in the market for technical assistance. Governments should be free to choose the source of technical assistance with the best track record. However, his concern is that if multiple monetary funds were available, East Asian governments would have an incentive to shop around for the most generous assistance and the least onerous terms. He seems to believe that AMF conditionalities would be much softer than IMF conditionalities. At the end of the day, his concern should be well taken when we consider further development beyond the CMI that assumes IMF conditionality as a given.

When the Asian crisis broke out in 1997, advocates of the AMF avowed the need for a regional monetary fund, referring to the fact that the IMF allocation of funds for East Asia was not sufficient to meet the need of sizeable emerging market economies. The international community at that time widely recognized that the IMF's financial resources were not sufficient to provide necessary emergency assistance to other mid-size emerging market economies such as Russia and Brazil. As a response, the IMF decided in its September 1997 annual meeting in Hong Kong after the Asian financial crisis to increase the quota of 182 member countries by 45 percent.[2] The IMF's resources were further replenished through the establishment of the New Arrangements to Borrow (NAB), effective as of November 1998.

Although the IMF's financial position has improved since the Asian financial crisis, it is also a reality that the IMF alone cannot provide all necessary liquidity to the crisis country. As was seen in the case of the 1994-95 Mexican peso crisis, a group of countries including the United States had to provide liquidity support in tandem with the IMF to fill in the financing gap. A more formalized regional financial arrangement could play a role as a

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[2] The quota increase was not immediately put into force mainly due to the delay in approval by the U.S. Congress. During the 11th General Review of Quotas (January 22, 1999), the quota was finally increased from SDR 145.6 billion to SDR 212 billion.

parallel lender instead of ad hoc (mostly determined on a geopolitical basis) group of parallel lender countries.

More seriously, most East Asian countries are underrepresented in the quota formula. East Asian countries are willing and prepared to contribute to more resources for the operation of the IMF. Commensurate with their enlarged contribution, the East Asians should be accorded greater representation both on the board of directors and in management. At the same time, they could receive an enlarged package of liquidity based on their increased quota. However, quota reform is not simple politics. Increased voting rights for currently underrepresented members would be allowed only when currently overrepresented members agreed to reduce their proportionally greater voting rights. Since any reallocation of quotas and voting rights is seen as a zero-sum game, even a perfectly designed quota formula would not satisfy the political interests of all members involved.

The Supplemental Reserve Facility (SRF), created on December 17, 1997, could be an answer to enlarged liquidity assistance exceeding the normal stand-by quota disbursement. In principle, any country may use the SRF. However, it is intended for situations where the effects of difficulty in one country may potentially destabilize the international financial system. The disbursement takes place when there is a chance of improvement in the balance of payments during a short period, based on bold restructuring and monetary policies. Korea, Russia, and Brazil have received assistance from the SRF. However, it is still not clear whether those countries were recipients simply because of the systemic consequences that would arise in the event of their financial collapse.

As mentioned in the introduction, contagion is geographically concentrated, so that a regional grouping for support is logical. In addition to providing financial assistance in tandem with international support, a regional financial cooperation mechanism may conduct policy reviews and initiate a dialogue process. Policy dialogue, including monitoring and surveillance, is the bedrock on which coherent policy formation under the regional financial arrangements rests. A monitoring and surveillance process would provide prompt and relevant information for assessing the situation of countries in trouble and the potential contagious effects of a crisis to neighboring countries. Furthermore, a joint exercise based on a region-wide early warning system would facilitate closer examination of financial vulnerabilities in the region. In addition, the regional policy dialogue process would contribute to ensuring effective implementation of high-quality banking and financial standards, and promoting financial market development in East Asia.

Although regional financial cooperation is desirable in a broad sense, the devil is in the details. If a scheme for regional financial cooperation is effective in preventing and managing future financial crises as well as promoting financial market development in the region, no one can deny the desirability of the regional arrangement. However, whether a Pan-PECC financial cooperation scheme is desirable or not is another matter. Various regional institutions have different memberships and different goals for regional financial cooperation. If some institutions cannot achieve the collectively set goals, they should be closed and new institutions created. As in the case of the EU enlargement process, forming a critical mass should precede any enlargement. In this regard, a more important task is to identify those regional institutions that perform effectively to achieve their stated goals.

**3. Status of Regional Financial Cooperation (Q2)**

The form of regional financial cooperation and institutions depends on the stage of regional financial and monetary integration. In principle, regional institutions range along a spectrum from simple information exchange and informal consultation forums to a supranational entity like the EMU – the exact form is a function of the degree of integration.

At the most elementary stage of zero institutional integration, when governments simply take the policies of other governments as a given and do not attempt to influence them, the existence of policy spillovers means that it would still be useful for governments to exchange information and consult each other in a setting free of any formal pressure. When regional cooperation moves to the level of mutual liquidity provision, then moral hazard creates a strong case for monitoring and surveillance, and a clear need for specific enforcement mechanisms. An appropriate reference point for such regional activities would be the linkage of the CMI with IMF conditionalities. Finally, when the regional group agrees on deepening regional integration through exchange rate coordination, then monetary policy coordination becomes as crucial as mutual economic surveillance. The appropriate reference point in this case would be the process through which Europe progressed from the Common Market to the European Union.

In East Asia, except for the CMI under the ASEAN+3 framework, other regional institutions or forums do not have any mutual liquidity support arrangement. Even the CMI has nothing to do with exchange rate coordination. In comparison with Europe, the

CMI has a different motivation from the beginning. The European facilities were created with the purpose of limiting bilateral exchange rate fluctuations among regional currencies. The CMI started with high capital mobility and flexible exchange rates, although some members of ASEAN+3 have maintained a relatively fixed exchange rate regime. So far, the ASEAN+3 countries have not presumed any manifest exchange rate coordination. In the absence of exchange rate coordination, incentives for mutual surveillance will be limited because a member country facing a speculative currency attack may be free to float its exchange rate vis-à-vis those of other neighboring countries. Under the current ASEAN+3 policy dialogue framework, the purpose of the CMI and mutual surveillance system is to prevent the occurrence of financial crises and contagion in the region.

Another important remaining issue is the linkage of the CMI to the IMF. As long as the CMI is simply a source of financial resources supplementary to the IMF, the size of the swap borrowing is not necessarily sufficient to meet potential needs, because there exists another deep pocket of financial resources provided by the IMF.

Although the CMI does not need to design its own conditionality at this point, it does need to establish its own surveillance mechanism. Under the CMI framework, 10 percent of the swap arrangements can be disbursed without IMF involvement. But because this 10 percent of swap can be disbursed only with the consent of swap-providing countries, the swap-providing countries need to formulate their own assessments about the swap-requesting country. At present, the current practices under the ASEAN+3 process cannot effectively capture emerging problems. In this regard, the immediate task is now to establish an independent surveillance unit as a standing secretariat to support the ASEAN+3 policy dialogue process. This unit may start on a modest scale, and some existing institutions may undertake the role before a new unit is created. The ASEAN+3 Study Group, established by the decision of the ASEAN+3 finance ministers at their meeting in Honolulu on 9 May 2001, now examines ways of enhancing the effectiveness of ASEAN+3 economic reviews and policy dialogues to complement the BSAs under the CMI. Although there has been no consensus so far, the main issue is now clearly defined as the establishment of a support unit to carry out the surveillance activities and the functions of an expert group.

The current structure of the CMI does not require a new institution like the Asian Monetary Fund (AMF) because the primary purpose of its surveillance mechanism is to enable liquidity assistance, and not to formulate a structural adjustment program for swap-requesting countries. It should be noted that the existence of this regional surveillance mechanism also enhances the collective efforts to strengthen the financial systems in the region.

**4. Evaluation of Existing Regional Institutions (Q3 & Q12)**

There are several mechanisms developed for regional financial cooperation in East Asia. [See Table 2] Two major initiatives include the ASEAN+3 framework and the Manila Framework Group. In addition to these two, there are EMEAP and SEACEN for central banks, the APEC and ASEM for trans-regional policy dialogue, as well as small groups such as Four/Six Markets Group. As mentioned above, except for the CMI under the ASEAN+3 framework, other regional institutions or forums in East Asia do not have any mutual liquidity support arrangement. Although various regional institutions or forums may serve as mechanisms for information exchange, policy dialogue, and economic surveillance, the ASEAN+3 framework is the only mechanism to develop two of the three pillars of regional financial cooperation – liquidity assistance and mutual surveillance. The one pillar it has not developed is exchange rate coordination. In this regard, the added value of each regional institution or forum should be thoroughly evaluated.

For instance, the Manila Framework Group (MFG), established on 18-19 November 1997, has 14 member economies mainly in the Asia-Pacific region. Although the MFG has no formal status, there are now biannual meetings among 14 members plus the IMF, World Bank, and Asian Development Bank. The MFG is seen by some observers as the preeminent forum for regional surveillance and peer pressure. The IMF's Regional Office for Asia and the Pacific provides the Technical Secretariat for the Group. However, the MFG involves only a limited number of the economies in the region compared to the ASEAN+3 framework. More importantly, it is very doubtful that this group has the vision to further lead financial cooperation in the region. The MFG has not been very successful as a mechanism for regional financial cooperation. First, because the MFG has not yet clearly specified the objectives of information exchange and surveillance, no priorities, targets and rules have been set for the process of information exchange. Second, because there is no actual peer review process in the MFG, the surveillance process is simply a cursory discussion of the global and regional economic outlook, with no attempt to formulate any country-specific or region-wide recommendations for policy actions. Third, because the issues related to financial sector reform are only discussed cursorily, the MFG process has not contributed to the development of the region's financial market.

Although the current ASEAN+3 framework is incomplete, it is the appropriate grouping for regional financial cooperation. It intends to develop a clear vision for East Asia. The ASEAN+3 summit meeting also provides a basis for political support. From the beginning, the financial and monetary cooperation is a political task. As demonstrated by the European experience, what matters most in seeking economic and monetary integration is the political will to do so rather than the economic incentives to do so. Although the political preconditions for monetary unification in East Asia are not in place, the ASEAN+3 countries would be potential candidates for future monetary integration. But other regional institutions do not have that kind of vision.

The region also has inter-regional forums with the Americas and the European Union – APEC (Asia-Pacific Economic Cooperation) and ASEM (Asia-Europe Meeting). These two giant forums have complex sub-organizations to conduct various activities, one of which is the APEC and ASEM Finance Ministers Meeting. Since the objectives of APEC cover comprehensive issues including trade and investment liberalization and economic cooperation in general, financial cooperation was not a main agenda even during the Asian financial crisis. Only when calm and confidence returned to the Asian financial markets in late 1998 did APEC pursue a cooperative growth strategy. However, various collaborative initiatives were carried out through the exchange of views and non-binding policy recommendations. The issues covered by the APEC Finance Ministers Meetings was not focused on regional financial arrangements, but on financial market development such as enhancing financial supervision, developing bond markets, and strengthening corporate governance.

ASEM, a European version of APEC, was originally designed to initiate a process for strengthening partnership between East Asia and the EU. The ASEM Finance Ministers Meeting was established in September 1997, just after the Thai crisis. Three meetings have been held so far, once every two years. Starting in 2002, the Meeting will be held annually. In contrast to APEC, the ASEM Finance Ministers launched the Kobe Research Project in January 2001 when ministers gathered in Kobe. The project was designed to facilitate inter-regional research cooperation on the issues of monetary and financial cooperation in East Asia, taking into account the lessons learned from the European integration experience. Six subjects were chosen and a number of academic researchers were invited to carry out the joint research.[3] The research was concluded and will be presented to the Fourth ASEM Finance Ministers Meeting, to be held in Copenhagen in July 2002. Although ASEM is not an institution for pursuing economic integration, it has the potential to provide a value-added contribution to East Asian monetary and financial integration in the future.

## 5. Monitoring and Early Warning Signals (Q4 & Q5)

A simple peer review process without a specific enforcement mechanism may be found among various policy dialogue groups. The G7 process is an obvious point of reference. Informal peer pressure is the only mechanism to encourage members to implement the recommended policies. A regular monitoring process is essential for the prevention of crises. The information collected through monitoring will help detect and identify the characteristics of economic and financial vulnerabilities at an early stage so that a proper menu of policy actions can be taken in a timely manner. Economic and financial sector monitoring will keep a close watch over (a) macroeconomic trends and policy changes, (b) financial market developments including cross-border capital flows, and (c) institutional and legal changes. This rather broad coverage of economic monitoring will be useful for a better understanding of the economic situations. However, a selection of quantitative indicators would be more convenient though it might entail the risk of omitting important information.

Since the Asian financial crisis, attention has been increasingly directed to preventing the outbreak of crises by devising a warning system that can diagnose early symptoms of crises for administering timely policy responses. The methodology applied to developing an early warning signal largely draws on the leading indicator approach commonly found in business cycle literature. Thus, an early warning system (EWS) consists of leading indicators that signal in advance the onset of a crisis. The development of leading indicators presumes that an economy exhibits consistent and regular patterns of behavior prior to a crisis. Hence, selecting reliable indicators is the crucial step in formulating the early warning system. However, not all crises are alike, and consequently one would not expect the same indicator to be a good signal for each type of crisis. Furthermore, one

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[3] Six subjects include (i) exchange rate regimes for emerging East Asian and EU accession countries, (ii) currency regime: European experience and implications for East Asia, (iii) strengthening financial cooperation and surveillance, (iv) enhancing regional monitoring and integration, (v) the European and Asian financial systems in perspectives, (vi) China in a regional monetary framework.

observation is that banking and currency crises in emerging markets do not typically arrive without any warning.

In my view, the early warning system itself may lack credibility from the perspective of investors in the sense that it is just a statistical exercise with no credible content, especially when one considers the quality and availability of the published data. In fact, the difficulty with constructing an early warning system for developing countries arises from the lack of reliable statistics, which are largely distorted or superimposed with other non-economic factors. This is an old problem. The international community has repeatedly stressed that provision of comprehensive, timely and accurate economic data by member countries is essential for effective Fund surveillance.

In addition to the data problem, precisely because crises and economies can vary in nature, "one size may not fit all" when it comes to leading indicators. Thus, a broader set of indicators should be considered. Political and institutional variables also have some predictive power in anticipating a crisis, but one usually cannot get high-frequency measurements on them. The sad situation is that the accurate forecasting of the timing of a crisis is likely to remain an elusive goal for academics and policy makers alike.

At present, the MFG and the ASEAN+3 Surveillance Process may be relevant regional institutions for exercising early warning signals for the purpose of preventing future financial crises. However, the current practices are not effective and still remain to be strengthened. As regards to the MFG, the IMF focused on global economic outlook and financial sector reform. The World Bank and the Asian Development Bank presented the issues for structural reforms in the Asia-Pacific region and regional economic outlook and development issues respectively. The participation of the IMF and two multilateral development banks in the MFG did not make any value-added contribution to region-specific surveillance because their analyses are already easily available from other sources. Furthermore, many participants of the MFG feel that the discussion is one-way, in the sense that they are subject to scrutiny by the United States and the IMF but not the other way round.

The current practices under the ASEAN+3 process also cannot effectively signal the early warning of potential risks to facilitate the required individual or collective policy responses. The issues of concern and emerging problems are not sufficiently addressed mainly due to the fact that the discussions at the ASEAN+3 meetings, which are carried out on a voluntary basis, currently tend to focus on recent economic developments of member countries. The substance of surveillance recommendations in the peer review process and the actual implementation of surveillance recommendations still remain to be developed.

As regards to the development of a regional early warning system, the Asian Development Bank is providing technical assistance by developing a prototype that would help detect emerging macroeconomic, financial, and corporate sector vulnerabilities. The regional EWS prototype includes four components: (a) a set of macro prudential indicators, broadly defined as indicators of the soundness and stability of financial systems. These indicators can be classified into two categories, the so-called CAMELS (capital adequacy, asset quality, management soundness, earnings, liquidity, and sensitivity to market risk) and indicators of macroeconomic developments and external shocks (i.e., growth performance, balance of payments positions, monetary and fiscal conditions, interest rates, exchange rates, and asset prices); (b) a non-parametric EWS model designed to assess the probability of currency crisis within a 24-month time horizon based on the signaling approach; (c) a parametric EWS model designed to assess the probability of currency crisis within a 24-month time horizon based on the probit regression analysis; and (d) a set of economic leading indicators of business cycles.

The ADB's work on the regional EWS prototype is still continuing. Further work should include the following: (a) identifying a set of core macro prudential indicators; (b) improving the parametric and non-parametric EWS model; (c) integrating the parametric EWS model with the non-parametric EWS models; and (d) extending the analysis of leading indicators of business cycles to more countries where high frequency data are available.

**6. Leadership Issue (Q6)**

The leadership issue is very delicate. No country would ever clearly raise this important issue. However, as we see in the recent progress of the CMI, Japan provides a de facto leadership in implementing the CMI as a key provider of financial resources and a designer of the current framework with other members. In his recent paper, Yung Chul Park considers this issue in the following passage:[4] .

[4] Park, Yung Chul, 2002, "Can East Asia Emulate European Economic Integration?" a paper prepared for the 2002 APFA/PACAP/FMA Finance Conference hosted by the International University of Japan, July 15,

"If the thirteen countries have a more ambitious goal of developing a collective exchange rate mechanism similar to the ERM with the long-term objective of adopting a common currency for the CMI group, they will have to increase the number and amounts of the BSAs. As the European experience shows, such an extension requires leadership that could keep the thirteen countries as a coherent group by compromising different interests of different members. China and Japan, who are expected to provide leadership in forging regional support for expanding and consolidating the BSAs as a regional institution, have not been able to agree on a number of operational issues including the surveillance mechanism. Except for Japan no other potential swap lenders including China are prepared to increase the amounts of their bilateral swaps with other contracting parties. Japan could increase its swap amounts with the ASEAN states and Korea (China is not expected to borrow from Japan) to make the CMI a more credible financing scheme. However, unless Japanese authorities receive some sort of assurance that their short-term lending will be repaid, they are not likely to lead the expansion and institutionalization of the CMI. As a minimum condition for expansion of the CMI, Japan would demand the creation of an effective surveillance mechanism for the region in which it can exercise its influence commensurate with its financial contribution. China feels that it cannot play the second fiddle to Japan in any regional organization in East Asia. This stalemate appears to be the most serious roadblock to further development of the CMI."

Historically, international economic integration has not been led by economic motives but by political ones. The discussion for European economic integration was sparked by the political ambitions of politicians after World War II. It was German Chancellor Helmut Schmidt and French President Giscard d'Estaing who accelerated the stalled integration process at the end of the 1970s. The joint initiative of Chancellor Helmut Kohl and President François Mitterand resulted in a great leap towards EMU in the beginning of the 1990s. France and Germany have become the core for the integration process in Europe as it was the political will of these two countries that motivated further integration.

In East Asia, there is no core country or countries to lead the economic and monetary integration. Japan is economically strong enough to take the initiative for integration but politically its representation is too weak. China behaves as if it has the political vision for economic integration but its political will is not matched by its economic power. Other countries are not strong enough economically or politically to lead the integration process.

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2002 in Tokyo.

These are the reasons why the CMI is has virtually no effect in terms of advancing the economic integration process.

**7. Key Role Players in the CMI (Q7)**

In May 2000, the three Northeast Asian countries of China, Japan and Korea joined together and proposed a draft of principle points of the standard agreement for bilateral swap arrangements (BSA) under the CMI. Based on the agreed framework for the BSA, each pair of countries is expected to choose feasible arrangements and negotiate the swap amount and other specific conditions bilaterally. However, a number of the ASEAN countries have expressed reservations about linking the BSA with the IMF conditionality. In particular, Malaysia advocated complete independence of the CMI from the IMF. Severance of the IMF linkage requires creation of a regional surveillance mechanism for the CMI. Without beefing up the surveillance system, the three Northeast Asian countries would not be able to start the CMI independently from the IMF. Malaysia agreed to the IMF linkage with the condition of establishing a study group to examine the type of monitoring and surveillance mechanism the CMI would require to function as an independent regional financial arrangement. However, it is not yet clear that the linkage of the CMI with the IMF conditionality is only temporary until a formal surveillance mechanism is put in place.

At the first meeting of the ASEAN+3 Study Group, Bank Negara Malaysia and the Ministry of Finance, Japan, prepared a joint paper entitled "Possible Modalities to Enhance the Effectiveness of Economic Reviews and Policy Dialogues among the ASEAN+3 Countries." The paper recommended an action agenda to be implemented in two phases. The first phase enhances the existing process of economic reviews and policy dialogues among the ASEAN+3 countries, and the second phase constructs a new strengthened policy dialogue mechanism.

The second meeting of the ASEAN+3 Study Group was held in Myanmar on 2 April 2002. There was more intensive discussion of the possible specific modalities for the second phase proposed by Malaysia. However, the member countries could not reach any agreement on the surveillance issues except for institutionalizing the ASEAN+3 meetings of deputies for informal policy reviews and dialogues. It is highly unlikely to produce an effective surveillance mechanism any time soon.

## 8. Degree of Cooperation and Agenda for Deeper Cooperation (Q8 &Q9)

At present, East Asian countries have not yet specified common policy objectives. Crisis prevention is rather ambiguous as a policy objective for surveillance and policy coordination. In this regard, the CMI lies between cooperation and coordination, but closer to cooperation on the spectrum.

Two main components are being implemented under the ASEAN+3 framework. One is regional financial facility under the CMI, while the other is development of a regional surveillance mechanism to complement the CMI. However, those two pillars have not yet been completed. Many members have found them to be in need of amendments. The BSA under the CMI will be reviewed in 2004. At that time, East Asian countries may decide to maintain, amend or abolish the current arrangements. The modalities of regional surveillance mechanisms are now under discussion. As mentioned above, it is highly unlikely that an effective surveillance mechanism will be put in place any time soon, unless a clear vision of future financial arrangements is agreed upon.

## 9. Linkage with the IMF (Q10 &Q11)

Under a loose and informal policy dialogue framework, formal enforcement mechanisms to impose sanctions and fines on countries that do not comply with agreed policy guidelines and recommendations may not be needed. In keeping with the ASEAN policy of non-interference, the regional surveillance mechanism in East Asia may be built on the basis of consensus and informality. If the ASEAN+3 surveillance mechanism cannot impose politically unpopular policies on the member countries, severance of the IMF linkage under the CMI may pose a serious moral hazard problem.

Assume that there exist the IMF and a regional fund. The IMF will play the role of an insurance firm that has its own monitoring and surveillance device. However, the presence of a regional fund as a cooperative partnership fund will complicate the welfare consequences, depending on whether the regional fund is in a better position to monitor the effort than the insurance firm. If the regional fund cannot effectively harness its monitoring capabilities to reduce the moral hazard problem, countries may become less cautious; the IMF will tend to provide less insurance. The regional fund may crowd out the more effective insurance provided by the IMF, thus becoming completely dysfunctional. In this regard, a strong surveillance mechanism and proper conditionality for liquidity assistance are essential for controlling the moral hazard involved in the partnership.

As long as the CMI maintains the linkage with the IMF, the moral hazard problem associated with liquidity assistance can be addressed by the IMF conditionality. If the CMI goes beyond the supplementary role to the IMF to seek independent conditionality by establishing a regional fund (AMF), then the CMI should have its own strong surveillance process to diagnose economic problems in the region and prescribe appropriate policy recommendations (or conditionalities). At present, the ASEAN+3 countries have chosen to rely on the IMF for imposing and enforcing policy conditionality for those countries drawing from the CMI. However, a number of the ASEAN countries that have been concerned about linking the CMI with the IMF conditionality have proposed to gradually increase the 10 percent independent drawing limit and finally abolish the linkage altogether after a period of transition. If this is the case for a future regional financial arrangement, then the ASEAN+3 countries should now prepare for creating a regional surveillance mechanism for the AMF. Without a due lending discipline in place, the AMF would likely be exhausted due to lax supervision of financial assistance. Also, the long history of European surveillance shows that an effective surveillance process cannot be achieved overnight but needs many years of constant interactions and mutual trust building.

**10. Moving Towards Further Financial Cooperation (Q13 &Q14)**

Looking into the future, financial arrangements in East Asia will be evolutionary. The East Asian Vision Group (EAVG) submitted its Report to the Leaders of ASEAN+3 in Brunei on November 5, 2001. In this report, the 26 Vision Group members propose that East Asian governments adopt a staged, two-track approach towards greater financial integration: one track for establishing a self-help financing arrangement and the other for coordinating a suitable exchange rate mechanism among countries in the region. Regarding regional financial arrangements, the Vision Group proposes that a full-fledged regional financing facility such as the East Asian Arrangements to Borrow or an East Asian Monetary Fund be established in the future. It is not yet known whether the Leaders and Finance Ministers of ASEAN+3 will reach a consensus to explore new instruments and techniques beyond the CMI. However, it is worthwhile to note that European monetary integration was also evolutionary. Although exchange rate stability has been considered as the lynchpin of efforts to achieve trade integration, there has never been any detailed master plan, nor any set deadlines.

At its inception, the European Community almost completely dismissed monetary cooperation as a regional project although the European Payments Union (EPU), which was set up in 1950, could be credited for having contributed to the resumption of intra-European trade. No serious consideration of a regional exchange rate mechanism was taken simply because the Bretton Woods system could provide stability for European currencies. The Werner Plan was completed in 1970 and endorsed by the Council of Ministers in 1971 just before the Bretton Woods system collapsed during 1971-73. The Werner Report had recommended the rapid adoption of a single currency. However, not surprisingly, the Plan was deemed wholly unrealistic, and was immediately scuttled. As late as 1988, when the idea of a monetary union resurfaced, it was widely met with the same skepticism. It took an exceptional event, the collapse of the Berlin Wall, to trigger a serious reassessment that no political leader would have predicted just a few weeks before. Even the celebrated countdown to monetary union, with a terminal date set in concrete, was only accepted in Maastricht at the last minute (Wyplosz 2001, p.15).[5] Wyplosz concludes that Europe's number one lesson is that what matters is a political will to seek closer economic and financial integration, but not necessarily tied to any precisely defined plan or schedule.

For over a half century, European countries have worked very hard to develop a wider web of political and diplomatic agreements which encouraged their cooperation on monetary and financial matters. Certainly, such a web does not exist in East Asia. If the European experience is any guide, East Asia may take many years to develop effective cooperative arrangements and institutions. However, some observers also note that East Asia may be on the brink of a historical evolution, as Europe was half a century ago. Having suffered such a painful and costly financial crisis, the East Asian countries seem to be prepared to work together to develop a region-wide self-help system against future crises.

East Asian governments hold divergent preferences with respect to the pace, extent and direction of regional financial cooperation. This is mainly due to the fact that East Asian economic systems, patterns of trade and levels of economic development are far more

[5] Wyplosz, C., 2001, "Regional Arrangements: Some Lessons from Postwar Europe," presented at the conference on *The Role of Regional Financial Arrangements in Crisis Prevention and Management: The Experience of Europe, Asia, Africa, and Latin America*, organized by the Forum on Debt and Development (FONDAD) in Prague on 21-22 June 2001.

diverse than those manifest in the European Community. Although political willingness could be the most important trigger as shown in the experience of postwar Europe, that may not be conceivable without a smooth convergence of the economic attainment levels. In this regard, East Asia has a long way to go beyond the CMI and other types of regional financial arrangements. At this critical juncture, however, East Asia should not miss the opportunity if regional financial arrangements are deemed ultimately desirable in the long run.

As mentioned above, the immediate task is now to establish an independent surveillance unit as a standing secretariat to support the ASEAN+3 policy dialogue process. This unit may start on a modest scale, and some existing institutions may undertake the role before a new unit is created. If one existing institution such as the ASEAN Surveillance Coordination Unit (ASCU) within the ASEAN Secretariat, Regional Economic Monitoring Unit (REMU) within the Asian Development Bank, and the ADB Institute in Tokyo cannot assume the role of a standing secretariat, a joint collaboration scheme may be conceived.

As the EU Commission and European Monetary Institute (EMI) served as facilitators to promote economic and monetary integration, East Asia should establish politically independent institutions along with an official policy dialogue process. The region should have its own human resources to provide valuable input in paving the road to economic and monetary union in East Asia. These professionals will be able to follow up on the decisions of politicians on integration and advance common policy objectives and related modalities more adequately by adding their own creative ideas to the policy dialogue group.

**Table 1. Progress on the Chiang Mai Initiative**

(as of June 25, 2002)

| BSA | Currencies | Conclusion Dates | Amount |
|---|---|---|---|
| Japan-Korea | USD/Won | July 4, 2001 | US$ 7 billion (a) |
| Japan-Thailand | USD/Baht | July 30, 2001 | US$ 3 billion |
| Japan-Philippines | USD/Peso | August 27, 2001 | US$ 3 billion |
| Japan-Malaysia | USD/Ringgit | October 5, 2001 | US$ 3.5 billion (a) |
| China-Thailand | USD/Baht | December 6, 2001 | US$ 2 billion |
| Japan-China | Yen/Renminbi | March 28, 2002 | US$ 3 billion equivalent |
| China-Korea | Won/Renminbi | June 24, 2002 | US$ 2 billion |
| Korea-Thailand | USD/Baht | June 25, 2002 | US$ 1 billion |
| Korea-Malaysia | Under negotiation | | |
| Korea-Philippines | Under negotiation | | |
| Japan-Singapore | Under negotiation | | |
| Japan-Indonesia | Under negotiation | | |
| China-Malaysia | To be negotiated in the near future | | |
| China-Philippines | To be negotiated in the near future | | |

Note: (a) The US dollar amounts include the amounts committed under the New Miyazawa Initiative, US$5 billion for Korea and US$2.5 billion for Malaysia.

## Table 2. Regional Fora for Finance Ministries and Central Banks

| | Financial Ministries and /or Central Banks | | | | | Central Banks | | |
|---|---|---|---|---|---|---|---|---|
| | ASEAN (10) | ASEAN+3 (13) | MFG[a] (14) | APEC (21) | ASEM[b] (25) | SEANZA (20) | SEACEN (11) | EMEAP (11) |
| Year Established | 1967.8 | 1999.4 | 1997.11 | 1994.3 | 1997.9 | 1956 | 1966.2 | 1991.2 |
| Japan | | O | O | O | O | O | | O |
| China | | O | O | O | O | O | | O |
| Korea | | O | O | O | O | O | O | O |
| Hong Kong | | | O | O | | O | | O |
| Taiwan | | | | O | | | O | |
| Singapore | O | O | O | O | O | O | O | O |
| Brunei | O | O | O | O | O | | | |
| Cambodia | O | O | | | | | | |
| Indonesia | O | O | O | O | O | O | O | O |
| Laos | O | O | | | | | | |
| Malaysia | O | O | O | O | O | O | O | O |
| Myanmar | O | O | | | | | O | |
| Philippines | O | O | O | O | O | O | O | O |
| Thailand | O | O | O | O | O | O | O | O |
| Vietnam | O | O | | O | O | | | |
| Mongolia | | | | | | O | O | |
| Macao | | | | | | O | | |
| Papua New Guinea | | | | O | | O | | |
| Australiz, New Zealand | | | O | O | | O | | O |
| Nepal, Sri Lanka | | | | | | O | O | |
| Bang., India, Iran, Pak. | | | | | | O | | |
| USA, Canada | | | O | O | | | | |
| Chile, Maxico, Peru | | | | O | | | | |
| Russia | | | | O | | | | |
| EU-15 | | | | | O | | | |

Note: (a) MFG includes the IMF, World Bank, ADB and BIS.
(b) ASEM includes European Commission.

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