Ten Years After: Financial Crisis Redux or Constructive Regional Financial and Monetary Cooperation?

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Abstract

In response to the 1997 East Asian financial crisis many schemes were initiated to reform the international financial architecture. The proposed reforms had two wide-ranging objectives: (i) to prevent currency and banking crises and better manage them when they occur; and (ii) to support adequate provision of net private and public flows to developing countries, particularly low-income ones. Unfortunately the progress has been uneven, asymmetric, and patchy. This is largely because the structural problems related to the supply side of capital flows have not been addressed, particularly the unipolar character of the global financial system. As a result, many East Asian economies face many of the same conditions that prevailed immediately prior to the crisis: huge capital inflows heavily tilted towards hot money, rapid appreciation of currencies in real terms, surging stock prices, and little policy space to implement countercyclical measures in the event of a crisis. The difference is that many countries have accumulated a large amount of foreign exchange reserves but at the expense of domestic investment and economic growth. In order to resolve the problems that are posed by volatile capital flows it is important to accelerate East Asian cooperation and integration, particularly with regard to the objective of using regional savings for regional infrastructure projects. Political rapprochement between China and Japan is a necessary condition both to move regional cooperation and integration forward and to overhaul the unipolar global financial system.

Key words: international financial architecture, disaster myopia, capital flows, real effective exchange rate

Introduction

The global financial instability that was spawned by the 1997 East Asian financial crisis generated a broad consensus that the international financial architecture (IFA) had to be reformed. The proposed reforms had two wide-ranging objectives (Griffith-Jones and Ocampo, 2003): (i) to prevent currency and banking crises and better manage them when they occur; and (ii) to support adequate provision of net private and public flows to developing countries, particularly low-income ones. This paper is intended to be a succinct presentation and evaluation of the progress made in the reform of the IFA. The material is culled from many sources: Griffith-Jones and Ocampo, Wang (2004), Kawai (2005), World Bank (2005), Kawai and Houser (2007), and the Boao Forum for Asia Annual Report (2007).

Much progress has been made in terms of reform of the IFA during the past ten years. However, the progress has been uneven and asymmetric and in certain areas patchy.

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For example, there have been many advances in terms of regional financial and monetary cooperation in East Asia. Just last May 5, 2007, the ASEAN+3 nations agreed to pool the region's vast foreign currency reserves. However, the urgency of architectural reform in the G-7 countries has receded considerably (Wang 2004). This is echoed by Sakakibara (2003) when he argued that the lack of global governance, including a global lender of last resort and international financial regulation, is not likely to be remedied anytime soon. As long as the structural problems on the supply side of international capital such as volatile capital movements and G-3 exchange rate gyrations persist, the East Asian countries will remain as vulnerable to future crises.

There are many indications of the inadequacies in the reform of the IFA. For example, the chart in Figure 1 shows that real effective exchange rates in most of the 5 countries hardest hit by the 1997 crisis are generally following the same pattern observed prior to July 1997.[2] The development is largely brought about by a situation of excess global liquidity, which in turn is related to the problem of global macroeconomic imbalances. With the abundance of global liquidity, investors are lured into emerging markets which offer higher returns and the resulting inflow of capital has caused currencies of these economies to appreciate rapidly. Meanwhile, the Bank of Thailand attempted to mitigate the capital inflows by imposing a tax on inward portfolio investment similar to that used in Chile. Unfortunately, this move did not meet with great success indicating that either a regional or global response would have been more desirable.

Twenty-three years ago, business professors Jack Guttentag and Richard Herring coined the term ***disaster myopia*** to describe one of the causes of the prevailing international debt crisis at that time. The concept of disaster myopia connotes the differences between objective and subjective probabilities of unwanted events, particularly when cyclical recurrence would suggest such unwanted events may be approaching.[3] It would be interesting to analyze and determine whether a situation of disaster myopia prevails at the present time.

The second section of the paper identifies the areas where the IFA was to have been reformed and the problems that have been encountered. The issue of the trans-Pacific macroeconomic imbalance is incorporated in this section. The third section then looks at the progress achieved in regional financial and monetary cooperation in East Asia including specific issues and challenges. This leads to an analysis of prospects for moving the regional process forward and how it relates to challenges in reforming the IFA, which are discussed in the fourth section. Political economy issues are highlighted. The last section concludes.

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[2] Malaysia is a clear exception and this may be a result of policy inertia created by its imposition of capital controls in the aftermath of the crisis.

[3] Jack Guttentag and Richard Herring, 1984, "Credit Rationing and Financial Disorder" The Journal of Finance volume 39, number 5, pp. 1359-82. This information is obtained from http://en.wikipedia.org/wiki/Disaster_myopia. The same source provides an analogy by Arvind K. Jain taken from "Investor Behavior and Global Financial Crises", 2004: "Drivers are likely to drive cautiously soon after they have witnessed an accident. But as the memory of the accident recedes, they may go back to their old driving habits. The objective probability of the accident does not change as the time since the observation of the accident increases, only the subjective probability of an accident becomes lower in the mind of a driver as the time since the last reminder of an accident increases."

The International Financial Architecture

Finance ministers and Central Bank governors in April 1998 identified the following tasks that were needed to strengthen the international financial system (World Bank 2005): enhancing transparency and accountability; strengthening domestic financial systems; and managing international financial crises, including improving the role of the IMF and World Bank. These areas where condensed into two main areas, not unlike those mentioned earlier: (i) crisis prevention, and (ii) crisis mitigation and resolution.

Crisis Prevention[4]

According to the World Bank, most of the IFA initiatives have been directed toward crisis prevention. These entail measures to enhance transparency and accountability, promote sound policies, and strengthen institutional underpinning at the domestic, regional and international levels.

Initiatives aimed at promoting international standards and good practices. This is part of a wider strategy to promote a more stable and transparent financial system at the domestic and international level. The initiative, through the identification of potential weaknesses in domestic institutions and policies, should help promote needed reform and make institutions and markets more resilient to shocks. At the international level, standards can help foster international stability by facilitating better-informed lending and investment decisions and improving market integrity, accountability as well as policy credibility.

Initiatives aimed at enhancing surveillance and capacity building. These measures are related mainly to the efforts of the IMF and World Bank to help countries enhance their resilience to crises by means of the identification of strengths, vulnerabilities, and their impacts on macroeconomic environment. The joint Bank-Fund Financial Sector Assessment Programs (FSAP) has become the primary diagnostic instrument in the financial sector.

Contingent Credit Line (CCL) and Reserve Augmentation Line. The CCL was created by the IMF in 1999 as "a precautionary line of defense readily available against future balance of payments problems that might arise from international financial contagion." The Reserve Augmentation Line was proposed to replace the CCL which operated for 4 years without ever being used. Some analysts have posited that the IMF has yet to find a workable solution to the need for a precautionary financing arrangement that would help middle-income countries prevent a financial crisis. One reason is that there has been failure to reach consensus on the crucial issues of conditionality and automatic access.[5]

Being a crucial player in the entire process, the role of the IMF during the 1997 crisis has been closely scrutinized and evaluated. It has been argued that the IMF failed to respond appropriately during the crisis and the immediate aftermath in order to mitigate the adverse effects (e.g. Ito 2007). As a result there have been proposals to overhaul the entire Bretton Woods system, some of which will be referred to later.

[4]This section and the one on *Crisis Mitigation and Resolution* are largely based on World Bank (2005).

[5] A large part of the discussion on the CCL and RAL was obtained from "IMF crisis prevention: running on the spot" downloaded from http://www.brettonwoodsproject.org/art.shtml?x=548943.

Crisis Mitigation and Resolution

The experience with the 1997 crisis indicated the importance of mitigating financial spillovers and contagion. The primary objective is to prevent a disorderly process when a crisis-hit economy goes into default. This can be accomplished primarily through voluntary standstills.

<u>Sovereign Debt Restructuring Mechanism.</u> At end-2001, the IMF proposed a formal bankruptcy procedure to enable an insolvent government to seek legal protection from creditors, while negotiating a restructuring of its debt. The SDRM would enable creditors and debtors to negotiate a restructuring, aggregating across instruments, and ratifying an agreement binding on all by a specified super-majority. However, the requisite level of support among the IMF's membership to establish the SDRM was not reached.

<u>Collective Action Clauses</u>. CACs are supposed to impose debt-restructuring arrangements on creditors by modifying the terms on bonds by a substantial majority. However, CACs are only part of the solution. First, they do not generally provide for aggregation of claims by creditors of other bonds and cannot facilitate collective action by a super-majority of investors across different bond issues or types of creditors. Second, the degree of standardization in the design of CACs within and across jurisdictions is still uneven. Third, and more importantly, it will take many years before bonded debt with CACs becomes a significant portion of all outstanding bonded debt, and CACs become an effective instrument in crisis resolution.

<u>"Draft Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets"</u>. Recent experience suggests that debtor-creditor dialogue is critical to the success of the debt restructuring process and discussions within private and official sectors underscore the potential benefits of a code for creditors and debtors. The 'Principles" are aimed at developing a market-based, voluntary and flexible framework for enhanced creditor-debtor cooperation both at times of relative tranquility and in the context of crisis resolution.

<u>Dealing with Financial Volatility via Countercyclical Measures</u>. One aspect that has received a great deal of attention recently is the need to mitigate the pro-cyclical effects of financial markets and open 'policy space' for countercyclical macroeconomic policies in developing countries (Ocampo and Griffith-Jones, 2007). Measures related to this area straddle both the category of crisis prevention and the category of crisis mitigation and resolution. The underlying argument is that during crises, rising risk premiums and reduced availability of credit may eliminate the room for countercyclical monetary and fiscal policies, and may force developing economies to adopt pro-cyclical macroeconomic policies—i.e. high interest rates and tight fiscal policies.

Developing countries are particularly vulnerable to the boom-bust cycles of financial markets which are rooted in basic asymmetries that characterize the world economy: (i) incapacity of most developing countries to issue liabilities in international markets in their own currencies; (ii) difference in the degree of domestic financial and capital market development, which leads to an under-supply of long-term financial instruments; and (iii) the small size of developing countries' domestic financial markets vis-à-vis the magnitude of speculative pressures they face.

A number of measures have been suggested to reform the IFA to open policy space for countercyclical macroeconomic policies:[6] (i) explicit introduction of countercyclical criteria in the design of prudential regulatory and supervisory frameworks in capital source and developing countries; (ii) designing market mechanisms that better distribute risk faced by developing countries throughout the business cycle, e.g. GDP-indexed and local currency bonds; (iii) instruments that encourage more stable private flows, such as countercyclical guarantees; (iv) countercyclical official liquidity to deal with external shocks; and (v) macroeconomic cooperation among developing countries particularly regional macroeconomic consultation and common reserves funds or swap arrangements.

Problems with the Reform of the IFA[7]

Griffith-Jones and Ocampo (2003) identified four serious problems in the reform of the IFA. Two will be discussed in this paper. First, there has been no agreed international reform agenda. Furthermore, the process has responded to priorities set by a few industrialized countries that have not always been explicit and have varied through time.

Secondly, progress made has been uneven and asymmetrical in several key aspects. The focus of reforms has largely been on strengthening macroeconomic policies and financial regulation in developing countries, i.e. the national component of the IFA, while far less progress has been made on the international and particularly the regional components.[8] These are major weaknesses, as crises were not just caused by country problems but also by imperfections in international capital markets, such as herding, that lead to rapid surges and reversals of massive private flows, and multiple equilibria, that may lead countries in difficulties into self-fulfilling or deeper crises.

Another set of asymmetries relates to the excessive focus of the reform effort on crisis prevention and management, mainly for middle-income countries. Important as this is, it may have led to neglect of the equally, if not more important, issues of appropriate liquidity and development finance for developing countries, particularly the low-income ones. Meanwhile, within the realm of crisis prevention and management, progress has also been uneven. In the area of crisis prevention, much work has been done in relation to strengthening domestic financial systems in developing countries and in drafting international codes and standards for macroeconomic and financial regulation. On the contrary, aside from enhanced macroeconomic surveillance of developing country policies and a few ad hoc episodes of macroeconomic coordination among industrialized countries, few steps have been taken to guarantee a more coherent macroeconomic policy approach at the global level. Also, the drafting of new IMF financing facilities has received much more attention than international debt standstills and workout procedures.

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[6] This paragraph and the previous one were lifted from Ocampo and Griffith-Jones (2007). More details of the proposed measures can be found in this reference.

[7] This section draws heavily from Griffith-Jones and Ocampo (2003).

[8] This aspect has prompted a more concerted effort towards regional monetary and financial integration in East Asia as will be described in the third section.

The Heart of the Matter

The uneven and asymmetric progress in the reform of the IFA—particularly the inability "to guarantee a more coherent macroeconomic policy approach at the global level"— is a manifestation of the unipolar world of finance which has been characterized as unjust and unsustainable.[9] In the present global financial system most of the international trade is denominated in US dollars, most of the international reserves are held in US dollars, and the US can pay for its external deficits by printing dollars which it does not expect to be redeemed in the foreseeable future. The US-led private financial institutions intermediate a major part of international savings and investments and the US-led international financial institutions now play a decisive role in determining the macroeconomic policies of many developing countries.

Under the unipolar financial system, the US has been appropriating seigniorage that is created by expanding word trade and cross-border capital flows. Because the US gets tremendous benefits in terms of financial gain and ideological hegemony, it cannot be expected to surrender these gains voluntarily through a meaningful reform of the IFA. It is also a problem that those who benefit most from such reform in developed countries—e.g. shareholders and workers of companies trading and investing long-term in developing economies or who support development in low-income countries—are not represented properly in the key financial decision-making levels of developed economies (Griffith-Jones and Ocampo, 2003).

Ideally, the aforementioned seigniorage should be shared world-wide and preferably go to low-income countries. The system is thus clearly unjust. Because of the poor track record in reforming the IFA, the only viable alternative to the countries adversely affected by the unipolar financial world is to reduce their dependence on the current IFA and develop their own regional financial architecture. This was the primary inspiration behind the euro and East Asia is seriously following suit.

In the unipolar world of finance, the US has had a soft budget constraint in terms of its external deficit. The US has been able to combine a widening current account deficit with an appreciation in the real effective exchange rate—or at least one that is relatively stable—because of huge capital inflows. This has led to what has been referred to as the trans-Pacific macroeconomic imbalance. The US current account deficit reached $857 billion in 2006, equivalent to a historical high of 6.5 percent of GDP. As a point of comparison, the combined GDP of the ASEAN member countries was $884 billion in 2005 and approximately $1 trillion in 2006. Largely because of its soft budget constraint, the US has become the world's largest debtor nation with a net foreign debt of $2.7 trillion as of 2005.

The sustainability of the trans-Pacific macroeconomic imbalance has been a subject of debate and there is yet no consensus.[10] A major cause for concern, however, is that the annual balance of net income on domestic and foreign investments in the US was -$1 billion in 2006, making it the first year on record with a negative net income flow. If "net

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[9] A large part of this section is lifted from Agarwala (2004).

[10] The more appropriate term is "global macroeconomic imbalances" since the US has deficit also with the EU. For a succinct presentation of the debate, please refer to the ADB Asian Development Outlook Update, 2006, Box 1.1.2 "Global Imbalances: Consensus or dissonance?" page 9.

investment income" will continue to deteriorate, it will add to the current account deficit and increase the risk of a major reduction or reversal in the capital inflows into the US.

What is certain also is that many countries are accumulating reserves beyond the optimal level, either to self-insure against financial crises or to prevent nominal and/ or real appreciation of their currencies in the face of increasing capital flows. In emerging East Asia the stock of foreign exchange reserves rose from an average of $289.5 billion in 1990-95 to $1.71 trillion at the end of 2005. Based on Figure 1, policy makers in most East Asian economies have been largely unsuccessful in preventing a real appreciation of their currencies. The main reason for this has been the huge capital inflows into the region. Table 1 shows that aggregate net resource flows into developing countries reached $505 billion in 2005, the bulk of which comprised foreign direct investment and portfolio equity. This $347 billion in "hot money" is more than double the amount that poured into developing countries prior to the 1997 crisis.

Holding reserves above optimal levels is costly in terms of economic growth and development. There is evidence that the present levels of international reserves are constraining growth through investment levels below trend (World Bank 2005). Table 2 shows that investment rates in the five countries hardest hit by the 1997 crisis have not recovered and have been stagnant the past few years despite the successful financial and corporate restructuring. Meanwhile, several countries in Asia have a large part of their savings deposited in non-regional centers where the rate of return is several percentage points below what the regional borrowers have to pay to the lenders from outside the region (Agarwala 2004). The latter is related to the cost of sterilization of reserves which was estimated to be as high as 0.5 percent of GDP for India and Korea (Genberg et al. 2005). This financial cost is due to the fact that reserves are usually held in low-yielding US Treasury bills, whereas the bonds issued locally—to compensate for the monetary impact—have higher costs.

In order to partly address the inequity caused by unipolar financial system, the expanded use of Special Drawing Rights (SDRs) was recommended. The introduction of SDRs in 1969 created a truly world money to be used exclusively as a reserve asset, thus generating a more balanced distribution of seigniorage powers. Proposals to renew SDRs allocations followed two different models. The first was the temporary issue of SDRs during episodes of global financial stress, which could be destroyed once financial conditions normalize.

The second model focused on the issue of seigniorage, and regarded SDRs allocations as related to the increasing demand for international reserve assets. Allocations would thus have been permanent. Some variants of this proposal considered SDRs as a means of directly financing development and providing global public goods.

Unfortunately, these proposals have not been implemented. A recommendation for a third allocation of SDRs, though approved by 77 percent voting majority of the IMF in 1997, did not come into effect because of opposition by the US Congress. A background document issued by the World Bank and IMF dated April 14, 2005 states that the allocation of SDRs for developmental purposes is not possible under the existing IMF

Articles of Agreement.[11] However, the IMF-WB document acknowledges that nothing would prevent a redistribution of SDRs from advanced to developing countries, either for general development finance or for specific purposes. However, the memorandum discourages this proposal mainly because the transfer of resources from developed to developing countries can be accomplished through other instruments.

Regional Financial and Monetary Cooperation in East Asia

Reasons for Greater Financial and Monetary Cooperation

East Asia was at the epicenter of the 1997 financial crisis. Apart from volatility of international capital flows, analysts pointed to the interdependence of the economies of the region as a factor in the spread of the crisis. It was but logical that a regional response to the crisis be formulated. Hence, regional financial and monetary cooperation in East Asia was stepped up. The logic of economic regionalism has been carefully elucidated by Kawai (2005).

The first aspect is the deepening of economic interdependence. The primary example is increasing intra-regional trade as depicted in Table 3. Kawai argues that economic regionalism, through various types of policy coordination, can resolve the "collective action" problem by internalizing the externalities and spill-over effects that arise from interdependence.

The second aspect is the acceleration of European and North American regionalism. East Asian countries have responded by increasing their efforts to institutionalize their *de facto* economic integration. Governments in East Asia are concerned that unless they develop their own regional arrangement, their economies will be disadvantaged in global competition and multilateral negotiations.

The third aspect is the 1997 financial crisis. Kawai cites three specific factors:[12]

- The harsh lesson learned from the Asian financial crisis of 1997-98, i.e. the need to establish regional self-help mechanisms for effective prevention, management and resolution of regional financial crises;
- Dissatisfaction with the existing global financial arrangement governed by the IMF; and
- Regional financial stability as a basis for global financial stability as well as the region's willingness to increase the Asian voice in, and for, global financial management.

Kawai also points out that the global initiative for the new international financial architecture that intends to strengthen the international system—in terms of effective prevention, management and resolution of financial crises and contagion—has been unsatisfactory and disappointing. This sentiment is not unlike those expressed by Wang, Sakakibara, Griffith-Jones and Ocampo, and Agarwala as presented earlier.

[11] "Moving Forward: Financing Modalities Toward the MDGs" downloaded from: http://siteresources.worldbank.org/DEVCOMMINT/Documentation/20449410/DC2005-0008(E)-FinMod%20Add1.pdf
[12] Kawai (2005), page 37.

Progress of Regional Financial and Monetary Cooperation in East Asia

Reflecting the above arguments, the objectives of closer monetary cooperation and integration in East Asia have been to: (i) manage greater economic and financial interdependence in the Asia and Pacific region; (ii) establish regional "self-help" mechanisms for the effective prevention, management, and resolution of financial crises; (iii) secure regional financial stability, and thus also national and global financial stability; and (iv) channel Asian savings into infrastructure projects in the region.

The scope of cooperation in money and finance is broad, and initiatives aimed at fostering coordination usually take many forms. There are two areas of monetary and financial cooperation: cooperation in macroeconomic policies; and financial sector reform and development. Macroeconomic coordination consists of different types, from simple information coordination and surveillance to resource coordination and possible exchange rate coordination. Initiatives under macroeconomic coordination have been generally undertaken to achieve the following: (i) policy dialogue and surveillance; (ii) capacity building; (iii) regional financial arrangements and regional capital market developments; and (iv) research.

An update of the progress of financial and monetary cooperation in Asia and the Pacific is provided by the Boao Forum for Asia 2007 Annual Report. A list of various initiatives and membership is provided in Table 4. The major highlights are as follows.

A broader scope of cooperation among finance ministers, at least in terms of membership, emerged as the ASEAN expanded its external relations with other East Asian countries namely, China, Japan, and Korea. Building on cooperative mechanisms individually forged with these three countries in previous years, the ASEAN+3 economies issued a joint statement on East Asia cooperation in November 1999 that served as the main framework for increased cooperation and closer ties in East Asia. The member countries agreed to strengthen policy dialogue as well as coordination and collaboration on financial, monetary, and fiscal issues of common interest; hence, the ASEAN+3 Finance Ministers' Process was created.

Aside from initiatives in resource coordination and bond market development, various other initiatives were borne out of the ASEAN+3 Finance Ministers' Process. A study group composed of senior finance and central bank officials was formed in May 2001 to look into how economic reviews and policy dialogues could be made more effective. The creation of the ASEAN+3 Economic Review and Policy Dialogue (ERPD) was thus created. At its regular meetings every 6 months, ASEAN+3 finance and central bank deputies discuss economic and policy issues, with the help of economic surveillance reports from ADB and the International Monetary Fund (IMF). The first ERPD meeting was held in April 2002. The ERPD process involves (i) assessing global, regional, and national economic conditions; (ii) monitoring regional capital flows; (iii) analyzing macroeconomic and financial risks; (iv) strengthening banking and financial system conditions; and (v) providing an Asian voice in the reform of the international financial architecture.

Closely related to the abovementioned information-sharing initiatives are surveillance mechanisms primarily aimed at providing peer review and an opportunity to influence the policy actions of member countries. Economic surveillance deepens financial cooperation as it involves more than just an analysis of the macroeconomic and financial conditions of member countries. It also identifies vulnerabilities in the economies and appropriate policy responses to these vulnerabilities, with the intention of inducing good policy actions from member countries through peer pressure.

Under the auspices of the ASEAN Finance Minister' Process, the ASEAN Surveillance Process (ASP) was created in February 1998 during the 2nd ASEAN Finance Ministers' Meeting. ASP operates on the principles of peer review and mutual interest among ASEAN member countries. It has two mechanisms for carrying out its mandate. The monitoring mechanism allows early detection of emerging problems in the economy based on assessments of macroeconomic variables and sectoral and social policies. The peer review mechanism facilitates the consideration of policy options for the member countries to address issues identified in the monitoring activities promptly. With the creation of the ASEAN+3 grouping in 1999, ASP now includes the China, Japan, and the Korea.

Another dimension of monetary and financial cooperation in Asia that goes beyond information coordination and surveillance, and thus promotes deeper and stronger cooperation, is resource coordination. Also known as reserve pooling, resource coordination provides liquidity support for participating countries experiencing short-term balance-of-payments difficulties. Considerable progress has been attained in this area since the institutionalization of the ASEAN Swap Arrangement (ASA), a multilateral swap arrangement, in August 1997. Central bank and monetary authorities of the original five ASEAN member countries have agreed to establish reciprocal currency and swap arrangements. Since its inception, ASA has expanded its coverage to include all 10 ASEAN member countries. Swap arrangements under ASA amounted to $2 billion as of May 2006.

Subsequent efforts to further strengthen self-help and support mechanisms in East Asia culminated with the Chiang-Mai Initiative (CMI), the hallmark liquidity support facility in East Asia initiated by the ASEAN+3 Finance Ministers in May 2000. With the core objectives of addressing short-term liquidity difficulties in the region and supplementing current international financial arrangements, the creation of CMI formed a network of bilateral swaps and repurchase agreements among the PRC, Japan, the Republic of Korea, and individual member countries of ASEAN. Japan's Ministry of Finance reports that the swap arrangements under CMI amounted to $75 billion as of May 2006.

The CMI arrangement allows member countries requesting liquidity support to immediately obtain 10% (increased to 20% in 2005) bilateral swap arrangement drawings without IMF programs. Subsequent drawings have to be linked to IMF programs and, hence, to conditionalities. In May 2004, a working group was formed by the ASEAN+3 Finance Ministers to review the CMI and explore ways of making it more effective. By May 2005, the CMI framework had incorporated various enhancements including: (i) enhanced ASEAN+3 economic surveillance; (ii) a clearly defined swap activation process; (iii) a collective decision-making mechanism for the bilateral swap arrangements, as a step toward multilateralization; (iv) a significant increase in the size of the swaps; and (v) an improved drawdown mechanism allowing withdrawals of 10–20 percent without IMF-supported program. Last May 5, 2007, the ASEAN+3 Finance Ministers agreed that a self-managed reserve pooling arrangement governed by a single contractual agreement is an appropriate form of multilateralism. They instructed the Deputies to carry out further in-depth studies on the key elements of the multilateralization of the CMI including surveillance, reserve eligibility, size of commitment, borrowing quota and activation mechanism.

Corollary to the information and resource coordination initiatives mentioned above are integrated cooperation efforts in the development of regional financial and capital markets. In consonance with the ASEAN+3 cooperation framework, the Asian Bond Markets Initiative (ABMI) was endorsed by the ASEAN+3 finance ministers in August 2003. ABMI is aimed at developing efficient and liquid bond markets in Asia, to improve the use of Asian savings for Asian investments. Under the ABMI, ADB has provided support through technical assistance for regional studies by examining the feasibility of establishing a regional guarantee mechanism and a regional clearing and settlement system, as well as introducing new securitized debt instruments and an improved local credit rating system. Six working groups were formed and reorganized in May 2005 into four with an ad hoc support team for the focal group and a technical assistance coordination team.

The Executives' Meeting of East Asia and Pacific Central Banks (EMEAP) has been in the forefront of bond market development in the region with its Asian Bond Fund Initiative. The first phase of the Asian Bond Fund (ABF1) was launched in June 2003, to harness the sizable official reserves held by Asian economies and channel them into investment instruments issued by EMEAP member economies. ABF1 was a sizable fund worth $1 billion focused on purchases of US dollar–denominated bonds issued by sovereign and quasi-sovereign players in EMEAP member countries, except Australia, Japan, and New Zealand. Bolstered by the success of ABF1, a second phase (ABF2) was launched in December 2004. With a total investment of $2 billion, ABF2 consists of a Pan-Asia Bond Index Fund (investing in local currency–denominated sovereign and quasi-sovereign bonds in eight EMEAP bond markets) and eight single-market funds (investing in the same bonds in the respective markets). The implementation phase of ABF2 began in May 2005, after the $2 billion funding was completed and fund managers were appointed. In June 2006, EMEAP's working group on financial markets released a review of the ABF2 initiative. According to the report, six ABF2 funds were successfully offered to the public, raising about $400 million by the end of April 2006.

To complement ABMI and ABF initiative and to promote a better allocation of Asia's accumulated savings it could be useful to establish an Asian Investment Corporation which would pool a portion of Asia's reserves and manage them on commercial grounds as a national wealth fund (Genberg et al. 2005).

Issues and Challenges

Despite the progress charted so far, some issues and challenges impede the potential gains from financial and monetary cooperation. One key issue is the limited scope and depth of the structure of economic policy dialogues. This limitation prevents more effective peer review, more candid discourse among member countries, and better policy decisions (Kawai and Houser 2007). Important elements of an effective peer review and pressure mechanism are: (i) timely and reliable data for assessing and analyzing relevant issues; (ii) high-quality, objective, and neutral analyses and assessments; (iii) appropriate policy measures, and; (iv) inducements to encourage countries to make appropriate policy adjustments.

The role of regional oversight bodies should be further enhanced through continued capacity building and technical assistance by institutions with adequate resources. The membership of such bodies should be expanded to add dynamism to the groupings and to forestall the formation of fragmented sub-regional groupings in Asia. Meanwhile, large Asian economies can serve as effective conduits for Pan-Asian integration. India can bring to the fore the concerns of South Asian countries, while Australia and New Zealand can have a major role in increasing Pacific Island representation in monetary and financial policy dialogues in the region.

A fundamental constraint on financial and monetary cooperation is the disparity in financial sector development among countries in the region. The degree and scope of cooperation is constrained by the weak structure of the markets where collaborative mechanisms operate. Related to this structural limitation are regulatory impediments in the form of differing regulatory standards and procedures, which continue to hold back the development of a fully integrated regional financial market. This remains a key concern especially in regional bond market development.

Regional cooperation and integration in general, and financial and monetary cooperation in particular, may have limits in fostering the sustained development of member economies. Potential gains from collaboration, especially in monetary and finance matters, are largely constrained by the macroeconomic structures of individual economies. Efforts at RCI should therefore facilitate mechanisms that support the economic resilience and dynamism of domestic economies in an increasingly integrated economic environment. To this end, economies in the region should continue to pursue broader policy dialogues built on information coordination and knowledge sharing, efficient pooling of resources, stronger financial markets, and effective institutions.

The IFA and East Asia Cooperation: Prospects and Challenges

Regional financial and monetary cooperation in East Asia is at a critical juncture. The way forward has tremendous implications for the IFA. The ‘easy’ phase of the reform process in East Asia is at its tail-end. Policy makers in the region now have to agree to a blueprint for financial sector development in the foreseeable future, the long-term objective of which Kuroda (2004) succinctly identified as the establishment of a single currency in East Asia. The main elements of the blueprint are: 1) the structure of regional financial cooperation in terms of reserve pooling and exchange rate coordination; 2) the relationship between regional cooperation and the domestic financial system, including required domestic economic reforms; 3) the institutional set-up in the region that will underpin implementation of the blueprint; and 4) the non-economic objectives of regional financial cooperation.

The last two elements have important political economy considerations. More specifically, they involve establishing a political consensus which is difficult in East Asia due to differences in political systems, “history” issues and the lack of mutual trust (Kawai 2005). No single economic power plays a dominant role in East Asia similar to that of the US in the Western Hemisphere, not does any bipolar relationship exist similar to the Franco-German alliance in Western Europe. Japan has been mired in economic stagnation over the last decade and China, while recently emerging as an economic power, has yet to achieve full transition to a market economy and, more fundamentally, political transition.

Promoting non-economic objectives highlights the political economy issues that are involved. In light of the European experience, an important consideration in evaluating the trade-off between the potential benefits to be reaped from exchange rate coordination and the potential costs associated with the loss of macroeconomic policy independence arising from the implied need for broader macroeconomic cooperation, is whether the ultimate goals of financial cooperation in East Asia are wholly economic or also partly political. The goal could ultimately be political if the objective of fostering increased regional economic integration is paramount, and that objective is itself an instrumental one designed to achieve political goals. These could include, as in the European case:

(i) The desire to defuse potential regional political conflicts. An important assumption driving European integration was that enhanced economic interdependence would induce European countries to focus on common interests.

(ii) Allowing the region to speak *more effectively* with one voice in international affairs. This was also an important motive in Europe, and has played a role in other regional integration initiatives. As the world economy becomes increasingly globalized and international negotiations on financial and commercial issues intensify, its importance may be increasing over time.

Grenville (2003) similarly points out that:

> "Regional groupings are the principal way of addressing this 'democratic deficit'. There seems little room for debate that this region is inadequately represented in many of the forums which determine the important issues of globalization. There seems little doubt, also, that the region pays a price for this. East Asia, with an IMF quota of less than 15 percent, accounts for more than 20 percent of world GDP, almost a quarter of world trade, and almost half of world foreign exchange reserves."

In other words, the process of institutionalizing East Asian regional cooperation should be a venue where common interests of the countries can be articulated. Subsequently, it can be a vehicle by which these interests are pushed in the global setting.

The inability of East Asia to effectively speak with one voice, particularly with regard to the IFA, is one major reason why reform of the latter has become uneven, asymmetric and patchy. A case in point are proposed measures to address the trans-Pacific macroeconomic imbalance. Currently, policy proposals that are played up in the media are focused on revaluing East Asian currencies, particularly the yuan. However, China is not that large an economy to be responsible for the US deficits or to be able to correct them. Between 1997 and 2004 the US current account deficit deteriorated by $529 billion and over the same period China's current account position improved by only $35.6 billion (Genberg et al. 2005).

A united East Asian front could throw its weight towards a solution that emphasizes fiscal consolidation by the US, which makes more economic sense. For example, imposing a 50 percent fuel tax in the US will address many outstanding problems: 1) the surge in international fuel prices and depletion of oil reserves; 2) instability of international capital flows; 3) the US fiscal deficit; and 4) the trans-Pacific macroeconomic imbalance itself. A united East Asian front could subsequently advocate for fundamental reform of the IFA, particularly with regard to its current unipolar structure.

Another important issue is that of capital controls, which have proven be effective in several economies (see for example Epstein, et al. 2004). This is evident with the behavior of the Malaysian ringgit and Chinese yuan compared to other currencies in the region (Figure 1). However, with the advent of greater financial integration, capital controls, particularly on inflows, have to be endorsed at the international level in order to be effective (Grenville, 2007). Given that this would require IMF endorsement, international backing of any form of capital controls is unlikely. Hence, endorsement at the regional level would be a second best solution. A united East Asian front could subsequently advocate for fundamental reform of the IFA, particularly with regard to its current unipolar structure.

Concluding Remarks

It is quite unfortunate that reform of the IFA has stalled in many areas leading to a clear case of disaster myopia. However, strengthening regional financial and monetary cooperation has evolved into a viable alternative in East Asia. To push the regional agenda further it is important to achieve an effective and enduring political consensus. The latter is necessary to establish the required regional institutions and also to project East Asia' interests more effectively in the global setting. This begs the question of how to achieve the political consensus.

An interesting point of view was provided by Kawai (2005):

"It is essential that Japan and China, the two economic powers of the region, work together for closer economic regionalism. To some extent, healthy rivalry between the two major powers is desirable as long as it enhances market-driven competition and does not impede mutual trust and sense of community in East Asia. The two countries must jointly work hard on the following issues:

- To resolve the "history" issue permanently so that the two countries can rebuild mutual trust for greater economic integration;
- To cooperate to nurture emerging economic regionalism in East Asia particularly on trade, investment, and financial issues, including the formulation of an East Asian-wide FTA, a zone of stable Asian currencies, and eventually an East Asian Economic Community; and
- To strengthen various types of bilateral economic policy dialogue including, for example, investment rules, protection of intellectual property rights, macroeconomic policy management, food and energy security, etc."

Meanwhile, Urata (undated) proposed that East Asian countries need to deepen mutual understanding at all levels, from top leaders to young people, to increase the awareness of the importance of an integrated regional market and regional political and social stability. Leaders' meetings should be held regularly and policy makers should establish close communication links. This was echoed by Yuan (2005), who proposed that Beijing and Tokyo should develop mechanisms for regular high-level exchanges on issues of bilateral concern. He argued that lack of dialogue allows worse-case scenario assessments to influence policy formulation, further heightening mutual suspicions and leading to acrimony. Businessmen, bureaucrats, academics and students should participate in exchange programs and the framework for such exchange programs should be established. This is aptly described as contact at the grass-roots level.

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Figure 1. REER and Nominal ER ($/local currency), 1994-2007
(Vertical line indicates June 1997; left axis for REER) *Source: OREI, ADB; IMF*)

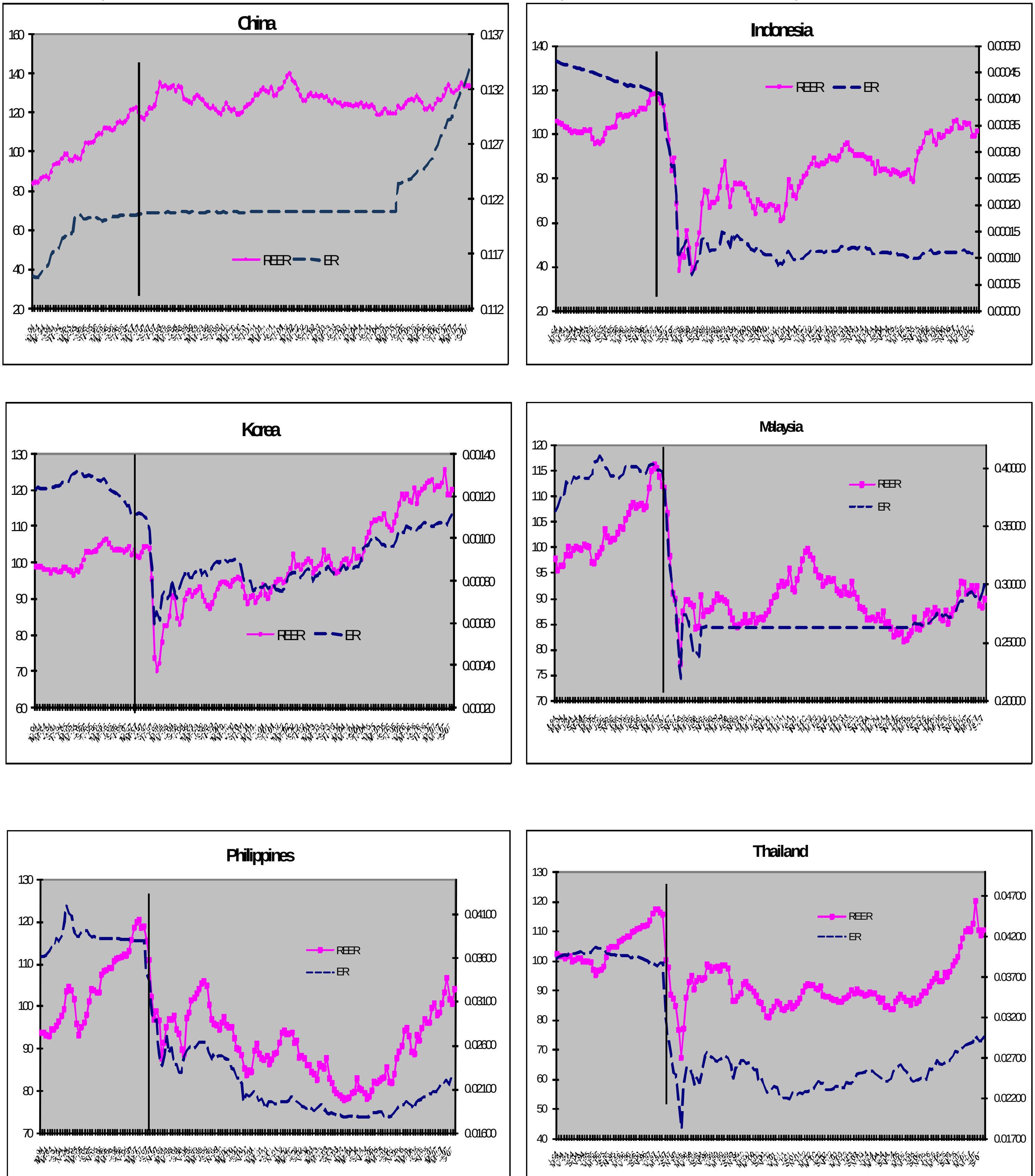

Table 1. Net Resource flows to Developing Countries, 1990-2006

Year	Aggregate net resource flows	Of which, net private flows	Net FDI	Net Portfolio Equity
	(US$ billion)	(US$ billion)	(US$ billion)	(US$ billion)
1990	97.96	38.87	24.58	3.39
1991	114.92	53.30	34.98	5.76
1992	148.40	95.71	50.34	9.40
1993	197.17	145.87	67.30	32.16
1994	204.10	158.01	88.80	28.52
1995	223.26	169.51	104.51	13.82
1996	264.03	234.71	127.92	27.59
1997	319.90	284.85	169.38	31.17
1998	305.71	258.79	170.00	5.83
1999	257.54	212.92	177.97	11.61
2000	226.70	193.32	166.51	13.45
2001	223.18	188.13	170.99	5.56
2002	192.04	168.64	157.07	5.78
2003	248.31	219.04	159.97	24.31
2004	382.25	344.12	217.84	39.85
2005	505.25	483.72	280.79	66.68
2006	566.69	562.81	316.40	94.10

Source: World Bank, Global Development Finance, 2007

Table 2: Gross Domestic Investment (% of GDP)

Item	Indonesia	Republic of Korea	Malaysia	Philippines	Thailand
1994	31.1	37.0	41.2	24.1	40.3
1995	31.9	37.7	43.6	22.5	42.1
1996	30.7	38.9	41.5	24.0	41.8
1997	31.8	36.0	43.0	24.8	33.7
1998	16.8	25.0	26.7	20.3	20.4
1999	11.4	29.1	22.4	18.8	20.5
2000	22.2	31.0	26.9	21.2	22.8
2001	22.0	29.3	24.4	19.0	24.1
2002	21.4	29.1	24.8	17.7	23.8
2003	25.6	30.0	22.8	16.8	24.9
2004	24.1	30.4	23.0	16.7	26.8
2005	24.6	30.1	20.3	14.4	31.5
2006	24.6	29.8	20.7	13.8	28.6

Note: 2007 figure for the Philippines is 14.2 percent. Source of data: ADB

Table 3 Intra Regional Trade Share, 1990-2005 in percent

	1990	1995	2000	2001	2002	2003	2004	2005
ASEAN10 +6	33.7	40.8	40.5	40.6	41.3	42.8	43.3	43.4
East Asia 15	43.1	51.9	52.1	51.7	53.7	55.6	56.1	55.6
Emerging East Asia	32.9	39.1	40.6	40.9	43.1	45.0	45.3	45.6
ASEAN+3	29.4	37.6	37.3	37.1	37.9	39.4	39.6	39.2
NIEs-4	11.9	15.5	15.5	14.9	15.5	15.0	14.4	13.7
ASEAN10	18.8	24.0	24.7	24.1	24.4	27.6	27.6	28.1
SAARC	2.7	3.9	3.9	4.3	4.8	5.6	5.2	4.8
Central Asia			7.2	7.2	6.2	5.3	6.4	5.8
NAFTA	37.9	43.1	48.8	49.1	48.4	47.3	46.4	45.0
MERCOSUR	10.9	19.2	20.3	17.9	13.6	14.7	15.2	15.0
EU-15	66.2	64.2	62.3	62.2	62.5	63.0	62.2	60.1
EU-25	67.0	67.4	66.8	67.2	67.8	68.6	68.0	66.2

Source of Basic Data: IMF Direction of Trade, September 2006

ASEAN = Association of Southeast Asian Nations, EU = European Union, MERCOSUR = Mercado Comon del Sur, NAFTA = North American Free Trade Agreement, NIEs = newly industrializing economies, SAARC = South Asian Association for Regional Cooperation, % = percent Source of Basic Data: IMF Direction of Trade, September 2006

(a) Intraregional trade share is defined as: Xii /{(Xi. + X.i)/2} where Xii is exports of region i to region i, Xi. is total exports of region i to the world, and X.i is exports of the world to region i.

(b) East Asia-15 includes Emerging East Asia-14 and Japan. Emerging East Asia-14 includes ASEAN+2 countries; Hong Kong, China; and Taipei,China.

(c) ASEAN 10 includes Brunei, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand and Viet Nam.

(d) ASEAN10 +3 includes ASEAN 10 plus People's Republic of China, Japan and Republic of Korea.

(e) ASEAN10+6 includes ASEAN+3 plus Australia, India and New Zealand.

(f) NIEs4 includes Hong Kong, China, Republic of Korea, Singapore and Taipei,China.

(g) EU15 includes Australia, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and United Kingdom.

(h) EU25 includes EU15 plus Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia. Computed from IMF, Direction of Trade Statistics, CD-ROM and CEIC database.

Table 4 Membership of Asian Countries in Monetary and Financial Cooperation Initiatives	ACD1/ (28)	ACRAA (11)	APEC (21)	ASEAN initiatives 2/ (10)	ASEAN +3 initiatives 3/ (13)	ASEM (39)	EMEAP (11)	MFG (14)	SAARC Finance (7)	SEACEN (14)	SEANZA 1/ (20)
Australia			O				O	O			O
Bangladesh	O	O							O		O
Bhutan	O								O		
Brunei Darussalam	O		O	O	O	O		O		O	
Cambodia	O			O	O	O					
China	O	O	O		O	O	O	O			O
Hong Kong			O				O	O			O
India	O	O							O		O
Indonesia	O	O	O	O	O	O	O	O		O	O
Japan	O	O	O		O	O	O	O			O
Kazakhstan	O										
Korea	O	O	O		O	O	O	O		O	O
Lao PDR	O			O	O	O					
Malaysia	O	O	O	O	O	O	O	O		O	O
Maldives									O		
Mongolia	O									O	O
Myanmar	O			O	O	O				O	
Nepal									O	O	O
New Zealand			O				O	O			O
Pakistan	O	O							O		O
Papua New Guinea			O							O	O
Philippines	O	O	O	O	O	O	O	O		O	O
Singapore	O		O	O	O	O	O	O		O	O
Sri Lanka	O								O	O	O
Taipei,China		O	O							O	
Thailand	O	O	O	O	O	O	O	O		O	O
Viet Nam	O		O	O	O	O					

ACD = Asia Cooperation Dialogue, ACRAA = Association of Credit Rating Agencies in Asia, APEC = Association of Pacific Economic Cooperation, ASEAN, Association of Southeast Asian Nations, ASEM = Asia-Europe Meeting, EMEAP = Executives' Meeting of East Asia and Pacific Central Banks, Lao PDR = Lao People's Democratic Republic, MFG = Mizuho Financial Groups, SAARCFINANCE = Network of Central Bank Governors and Finance Secretaries of the SAARC Region, SEACEN = South East Asia Central Banks, SEANZA = South East Asia, New Zealand, Australia

1/ Also includes Iran.
2/ ASEAN Initiatives include Finance Ministers' Process; Surveillance Process; and Swap Arrangement.
3/ ASEAN+3 Initiatives include: Finance Ministers' Process; Economic Review and Policy Dialogue (ERPD); ReseaRch Group; Chiang Mai Initiative (CMI); and Asian Bonds Markets Initiative (ABMI).
Source: Kuroda and Kawai (2002). Updated to include new information.