Progress and Prospects of Regional Financial Arrangements and Cooperation in East Asia: A Critical Survey

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I. Introduction: Another Crisis?

1. Exactly five years have passed since the Asian financial crisis hit the Thai foreign exchange market in July 1997. The crisis-stricken East Asian countries have shown significant and remarkable recovery progress with a varying degree, thanks to far-reaching structural reforms. ADB recently predicted that the East Asian nations would grow faster than expected this year and on. (ADB, July 2002) For example, Korea would grow 6.1 percent this year and 6.0 percent in 2003. The Korean Government carried out its promises to the IMF, including the reform of the financial sector and *chaebol*, the closing of non-viable merchant banks, bank recapitalization, the expansion of foreign exchange fluctuations, and the accommodation of global standards.

2. One of the most important lessons that we learned from the 1997 Asian crisis is that strong macroeconomic fundamentals are not enough to prevent currency crises. Up until the time of the ERM crises of 1992-1993 and the Mexican crisis

of 1994-1995, explanations and models of currency crises stressed the role of macroeconomic fundamentals—the ‘first-generation’ models. The Asian crises have shifted the focus of attention from the role of macroeconomic fundamentals in currency crises to that of financial sector weaknesses and the increase in an economy’s vulnerability to an external speculative attack which could be triggered by a sudden and unexpected shift in market expectations—the ‘second-generation’ models.

3. Due to the increased globalization of financial markets, a change in expectations or investor sentiment can induce a sudden, sharp reversal in capital flows, precipitating a currency crisis. A crisis can take place more rapidly, unrelated to macroeconomic fundamentals, than in the past. Crises tend to become more severe and even less predictable since the risks of spillover and contagion are even greater. They have also tended to be regional. [IMF May 1999]

4. A remarkable feature of the Asian crisis was the degree to which it spread from Thailand to other countries in the region, including Indonesia, Malaysia, the Philippines, and Korea, very quickly, in the span of a few months. There have been different explanations and proposals for how and why contagion spread so quickly in the region: macroeconomic similarities, trade links across countries, and cross-country financial links. Careful examinations of macroeconomic indicators around the outbreak of the currency crises in the crisis-stricken nations have revealed the relative irrelevance of macroeconomic fundamentals with the eruption and contagion of the 1997 Asian crisis. (Radelet and Sachs 1998, Chang and Velasco 1998)

5. The swift and global-scale contagion of the recent crises seems to support financial links, rather than trade links, as the key channel of contagion. The ultimate determination of the relative roles of the different channels of contagion in the case of the Asian crises is an empirical question. Relevant issues to financial links may include the existence of a common lender for emerging economies, market imperfections with information asymmetries, and portfolio diversification and leverage adjustment for financial asset liquidity. Krugman (2001) recently argued that the next generation of crises might affect not only

6. Jeon (2002a) provided evidence of financial linkages across countries as a channel of contagion for currency crises in the case of the 1997 Asian crisis using high-frequency data, focusing on the hardest hit countries in the region: Thailand, Indonesia, Malaysia, and Korea. Stock markets in the region were found to play an important role in transmitting initial and local shocks beyond its country of origin to other emerging economies during the 1997 crisis. Stock market linkages seem to have contributed importantly to the quick and wide-scale contagion of the ensuring exchange rate crisis across countries in the 1997 Asian crisis.

7. The first channel of spreading crises via stock market contagion will be the erosion of confidence by investors. A decline in confidence caused by a currency crisis in the crisis-origin will result in falling stock prices with greater volatility. The spillover effects of falling stock prices to another country will further reduce the investors' confidence in other countries and lead to a sharp decline in the value of its currency and currencies in those countries. Stock market linkages provide an effective path for the spread of eroded confidence across countries. Speculative attack and self-fulfilling pessimism, which created the initial currency crisis in the origin country, are repeated in stock markets in other vulnerable emerging economies.

8. Stock market linkages also work as an indirect channel of contagion through the role of foreign investors. When international investors are increasingly concerned about the prospect of crisis-stricken emerging economies, they try to withdraw from the emerging market economies and rebalance their portfolio positions. Liquidity difficulties facing international investors as a result of currency crises also force the investors to liquidate their positions in other national markets, consequently spreading the crises.

9. The recent turbulence in global financial markets has been increasing uncertainties and risk factors in the world economy. In particular, emerging markets have been seriously affected. A downfall at the New York Stock Exchange, caused by the collapse of the reliability of U.S. business due to the Enron scandal and the forged accounting by WorldCom and poor performances in corporate earnings by US firms, has also been triggering an across-the-board downfall in the share prices of Korea, Japan, and major ASEAN countries. Western institutional investors put Asian stocks up for sale, dropping stock prices further and withdrawing their funds from the Asian local markets.

10. Analysts said that the weakening share value in Asian stock markets has been due to foreign investors fleeing these markets on the hunch that a global crisis may result from the Argentine crisis of recent months. The Argentine crisis has rattled global financial markets recently. Furthermore, the recent downhill slide of the U.S. dollar, caused by the anxiety of the shaky U.S. economy stagnating during the post-September 11 period, has threatened the competitiveness of Asian exports of goods and services in the global market place.

11. The growth of East Asia has been dependent through many direct and indirect channels on an export machine for which U.S. demand has been the most important, final demand source. The ultimate question is how to protect the East Asian economies from the reoccurrence of a similar financial crisis in the future in more uncertain and risky environments?

12. The main purpose of this paper is to provide a brief survey for the progress and prospects of regional financial arrangements/cooperation among the East Asian nations and present the summary of various conflicting points of discussion about the strategies on the establishment of an effective regional financial arrangement in the region. I hope this brief critical survey will be useful to the participants of the International Finance Seminar as an effective source of their group discussions.

II. Do we need RFA/RFC in East Asia?

1. In retrospect, there have been various sources of dissatisfaction within the region in dealing with the 1997 crisis, which played a role in enhancing cooperation on the economic and financial aspects among Asian countries. Those main sources of dissatisfaction include (Sussangkarn 2000):

- unprepared financial liberalization which leads to an excessive influx of short-term foreign capital and a lack of risk hedging vehicles

- volatile currency trading and speculative activities by Western investors and difficulty in establishing an appropriate exchange rate regime in light of such volatility, exchange rate misalignments, aggravated by unstable values of key currencies, during the pre- and post-crisis periods

- lack of sufficient and prompt liquidity support from inside and outside the region in the early stage of the crisis and the lack of self-help mechanisms within the region

- inappropriate, excessive, and uniform one-size-fits-all prescriptions imposed by the IMF as so-called IMF conditionality, ignoring country-specific elements of the crisis situation and crisis management.

2. A collective approach is believed to serve better than an individualistic approach to manage the crises. Some academics have argued that if East Asian nations had shown more solidarity in responding to the initial crisis in 1997, especially in defending the values of Asian currencies from the attack of speculative hedge funds, the severity of the crisis might have been reduced.

3. As mentioned earlier, the cross-country contagion in the 1997 Asian crises was observed to be swift, large-scale, and regional. Currency crises based on financial linkages should not be matters of indifference to neighboring countries in the region. Strong fundamentals in an economy do not guarantee the protection of the nation from exposure to speculative attacks and contagion. Outside investors in Asia often regard the region as one class of investment out of

either ignorance or a lack of transparent information for proper screening, which has created financial panic and bandwagon effects.

4. A new regionalism has been emerging in East Asia. There has been recognition of the need to work much more closely together among themselves on financial and monetary matters for the interests of the region as a whole. Several reasons for a rise of Asian regionalism have been identified (Ito 2002): a failure of initiating a new WTO round in Seattle, the experience of the Asian currency crisis, the emergence of the single market and currency in Europe, and the proliferation of FTAs in the rest of the world.
Asians started to realize that they are 'on the same boat' so it makes sense to help each other to solve their own problems in the region.

5. The economies of East Asian nations have become increasingly interlinked. Financial cooperation within the region needs to be developed in line with trade and investment linkages in order to achieve the sustainable development and growth of the region as a whole.

6. The Asian regionalism has not been fully endorsed by Westerners. For example, the proposal for the creation of a regional monetary fund in East Asia was strongly opposed by the U.S., the European countries, and the IMF for a number of reasons. A more serious challenge was that East Asians were not ready to create and manage an effective regional monetary fund. Another accusation was an overlapping role with ~~the~~ existing institutions, such as the WTO and IMF. However, it would be possible that regional arrangements in Asia should be set up to be consistent with and complementary to existing multilateral arrangements.

III. Progress toward RFA/RFC

1. Having suffered from the havoc of the economic crises of 1997, many countries in East Asia started to realize the urgent need for financial and monetary cooperation in order to prevent the reoccurrence of a similar crisis in

the region in the future. A regional framework has been taking shape as a consequence of the AMF proposal, the Manila Framework and the Chiang Mai Initiative. [Note: There were several RFAs in the ASEAN and East Asian nations, but they were not very effective.]

2. In September 1997, Japan proposed an “Asian Monetary Fund” (AMF) to prevent the reoccurrence of another Asian financial crisis and to institutionalize financial cooperation among the countries in the region. Strong objections from the U.S. and the IMF, among other reasons, almost killed the idea of AMF, leading to no further tangible progress toward establishing a regional monetary institution in East Asia, although there has been heated debate on how to prevent and manage further crises in the region. The main argument was that it would overlap with the IMF and lead to an increased moral hazard problem.

3. In November 1997, a new framework for improved regional financial cooperation, called the ‘Manila Framework’ was announced in a meeting of finance ministers and central bankers from 14 Asia-Pacific countries in Manila to discuss further responses to the Asian financial crisis. (Note: The 14 member nations are Australia, Brunei Darussalam, Canada, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore, Thailand and the U.S.) The Manila Framework included the following four initiatives (The FTF Mtg. Document: FTF21-016, Singapore, June 2001):

- Regional surveillance – As a mechanism to complement the global surveillance administered by the IMF, the Manila Framework conducts surveillance within the region. Finance ministers and central bankers meet twice a year to discuss macroeconomic policies, foreign exchange policies, and appropriate financial systems in each of membership nations.

- Technical assistance for strengthening the financial sector: The Manila Framework recognized the importance of providing technical assistance for strengthening financial assistance to its member nations. It also called on international financial institutions such as the IMF to support

- Request for strengthening the IMF's ability to cope with financial crisis: The Manila Framework recognized that it is to the benefit of each member that the IMF strengthens its ability to deal with financial crises. The Manila Framework sought to achieve the effectiveness of the New Arrangement to Borrow, and a review of the access limit within the IMF financial program. It further requested consideration of a mechanism for the provision of short-term loans to troubled economies.

- Establishing cooperative financing support arrangements to stabilize Asian currencies: The Manila Framework has agreed on the need to establish a cooperative financing support arrangements by which member economies in the region can provide other troublesome economies with complementary financing for IMF-supported programs. This is basically additional and complementary to financing support from the IMF in order to increase the international reserves of an economy in need of emergency liquidity support.

4. The Manila Framework was reinforced by the New Miyazawa Initiative, which prepared funds amounting to Yen 3 trillion (approx. US$30 billion) to be used for short-term liquidity support and long-term bilateral assistance to troublesome member nations. The initiative also augmented the significance of providing a forum for periodic surveillance among regional members.

5. The search for regional financial arrangements gained momentum in May 2000, when the ASEAN + 3 finance ministers agreed to expand the existing network of swap arrangements by including all ASEAN countries, China, Japan, and Korea, designed to better withstand future financial crises by helping central banks of other countries in the region. [Note: "The Initiative involves an expanded ASEAN Swap Arrangement that would include all ASEAN countries, and a network of bilateral swap and repurchase agreement facilities among ASEAN countries, China, Japan and the Republic of Korea." The Joint Ministerial

Statement of the ASEAN+3 Finance Ministers Meeting, May 6, 2000, Chiang Mai, Thailand.]

6. The plan, called the Chiang Mai Initiative (CMI), is considered as a major step toward strengthening financial cooperation among the East Asian countries. The rationale of the CMI was to strengthen the self-help and support mechanisms in East Asia by establishing a regional financing arrangement to supplement existing international facilities.

7. Subsequently, the ASEAN nations agreed, at the ASEAN+3 summit conference held in Singapore in November 2000, to expand the size of the multilateral currency swap facility from $200 million to $1 billion Three bilateral currency swap agreements between Korea and Japan ($7 billion, Korean won and Japanese yen based), Malaysia and Japan, and Thailand and Japan, a total of $6 billion, were also signed in May 2001. Financial assistance under the bilateral swap agreement would be made when IMF facilities are to be activated in the near future. [Note: The government-to-government currency swap deal provides that one country may borrow funds from the other country in the contract and has the effect of building up a country's foreign exchange reserve.]

8. In November 2001, Korea reached an agreement with China and Thailand to swap ($ based) $ 2 billion, and $1 billion, respectively, in case of an emergency. The currency swap deals were expected to lessen the impact of rapid fluctuations in the value of the U.S. dollar, interest rates, and stock prices in the wake of the September 11 terrorist attacks on the United States.

9. Many other areas of RFA among the East Asian nations have been identified and discussed, despite little tangible progress, including: the ASEAN surveillance process, capital flow monitoring, capital market development, and a preliminary discussion of the possibility of a monetary union.

IV. Prospects for RFA/RFC: Several options

1. The ultimate objective for establishing RFA/RFC in East Asia should be to prevent the reoccurrence of another economics crisis in the region, which is being prepared collectively at the regional level. A specific agenda for reform will include establishing an early warning system, strengthening regional surveillance, establishing ~~a~~ new, quick financing facilities as a complement to the IMF facility, strengthening financial market supervision and regulation, and reshaping the G-7 led international financial architecture reform efforts by including capital controls and regulations of speculative hedge funds.

Option 1: An Asian lender of last resort?

2. The IMF has often been described as an international lender of last resort (LLR). Member countries turn to the Fund when no one else will lend to them on affordable terms. Do the East Asian nations need their own LLR? An LLR is an institution that is willing and able to supply unlimited amounts of short-term credit to financial institutions when they are threatened by a creditor panic, which would do serious damage to the real economy. The LLR should lend freely to illiquid banks but not to insolvent banks, which require prudential supervision and screening ability. The Asian LLR will serve as the ultimate bulwark against creditor panic, because no other institution can take on that task.

3. Some critics insist that the Asian countries should not have been asked to tighten their fiscal and monetary policies; they were the victims of creditor panic, not misguided domestic policies. (Kenen 2001) The critics of conditionality were revived in 2000 by the Meltzer Report, commissioned by the U.S. Congress, which described conditionality as being both intrusive and ineffective. Asians must know themselves better than outsiders. It would be harsh or unjust to ask crisis-stricken countries to pursue far-reaching structural reforms in the midst of a crisis. It inspired the attempt to promote regional financial/monetary cooperation in Asia.

4. The original idea of a self-help RFA, known as the Asian Monetary Fund (AMF) was proposed by Japan in August 1997. The resources that could be mobilized from Asian countries could be pooled together and used as a regional LLR. The

U.S. and European countries, along with the IMF, squashed the Japanese attempt to establish the AMF. The main accusations were the AMF's functional overlap with existing institutions, such as the IMF and World Bank, and a serious moral hazard problem caused by the so-called soft conditionality and lack of discipline among peer group nations.

5. The advocates of the AMF stress the need for a regional lender of last resort because global emergency resources for East Asia, including the IMF and the World Bank, are insufficient, considering the size of the East Asian economies in the face of volatile capital flows in and out of the region. Furthermore, a regional monetary organization is nothing new: the Arab Monetary Fund (1976) and the Latin American Reserve Fund (1991).

6. Other cases for an Asian LLR include: augmented sources of short-term liquidity to member nations in need of short-term assistance (the first line of defense or the second line of defense), cut the probability of financial contagion in the region, increasingly linked regional economies, maintaining exchange rate stability with less volatility, more accurate acquaintance with member countries' socioeconomic-political-cultural background in the region, and more reliable and updated peer review by insiders than by outsiders.

7. Several variants of the AMF proposal have been presented in an attempt to address the concerns mentioned above. For example, the Asian Policy Forum (APF) 2000 proposed an RFA that would provide a LLR facility together with the implementation of an effective surveillance system over Asian economies and complement the activities of the IMF through close collaboration with each other.

Option 2: Pulling resources of international reserve assets

8. A weaker form of RFA/RFC would be pooling international reserve assets and sharing the pooling resources among member nations in the region. An example of the weak form of resource pooling would be the bilateral/ multilateral currency swap agreement under the Chiang Mai Initiative.

9. Other form would be a common decentralized reserve pooling mechanism, in which each member nation contributes a specified share of its international reserve assets to a common pool. Each country would then be eligible to draw on the pool for an amount up to a predetermined multiple of the amount deposited. (KRP 2002)

10. The combined international reserves held by ASEAN+3 nations amount to US$ 781 billion as of August 2000, of which Japan made up 43 percent, followed by China with 20 percent, Korea with 11 percent, and the remaining 26 percent from 10 ASEAN member nations. The challenge would be to decide what percentage of international reserves held by each member nations is to be contributed to the total regional pool, how the ceiling of facilities is to be determined, and in what form of contingent credits these resources are to be made available. (Tan and Chen 2001)

11. Since the resource pooling needs decisions on the disbursement of the funds as short-term liquidity assistance, based on accurate assessments of each member nation's situation, smooth and active flows of information among member nations in the region is expected.

12. A participating nation in the resource pooling can economize on their own reserve accumulation by gaining access to the total regional pool of liquid funds, and, as a member of the group, each country gains some influence over the policies of other members.

13. For example, Korea's foreign currency reserve which decreased to USD 3 billion during the financial crisis of 1997, increased considerably to more than US$112 billion, and Korea became the country which has the 4th largest amount of international reserves in the world, after Japan, China and Taiwan. As the foreign currency reserve of Korea sharply increased since the 1997 crisis, there are controversies over whether Korea which is thirteenth in economic size, should retain the large foreign currency.

14. According to a report on proper retaining exchange of emerging nations by the IMF in September 2001, sufficient foreign currency reserves will be a

breakwater of the foreign exchange risk, but excessive reserves are the squandering of the nation's resources. Accordingly, it is somewhat undesirable that some countries experienced in the financial crisis have retained larger amounts of reserves than needed.

[Note: The IMF advises emerging countries to retain the foreign exchange over adding the size of estimated withdrawal of residents to the short-term foreign loan, which must be repaid within one year. It means that the proper foreign currency reserves of Korea is around US$ 63.2 billion ~ US$ 70.5 billion. However, Park Seung, the governor of the Bank of Korea announced, "In a future financial crisis, the proper level of maintaining the nation's credit would be around US$ 90 billion."

15. Objections on this option include: insufficient pool of reserve stock, likelihood of spreading contagion due to reserve pooling itself, lack of commitment especially by strong-currency countries and existence of opt-out clauses, and the probable weak conditionality imposed on the disbursement out of a pooled stock of reserves. (ADB, May 2002)

Option 3: Regional Surveillance Institute in East Asia?

16. The most important precondition for successful RFA/RFC in the region is the institutionalization of a monitoring and surveillance mechanism. Surveillance means monitoring the status and prospects of economic conditions by a multinational forum or an international body. Effective surveillance should include the monitoring of economic conditions, international capital flows in and out of countries in the region, and potential vulnerabilities in the member countries. (Ito 2001)

17. Approval of financial assistance by an Asian LLR or pooled resources requires monitoring and surveillance of the macroeconomic conditions of each of the member nations and their capital flows. The development of a regional early warning system (EWS) will be possible only when an effective monitoring and surveillance system is launched.

18. For the enhancement of the current regional surveillance process within the ASEAN+3 framework in the form of the Chiang Mai Initiative (CMI), an independent Regional Surveillance Unit has been proposed. (KRP 2002) The Unit or Institute will be an independent source of information on the state of regional economies and analysis of regional economic developments, supplementing those of international financial institutions.

19. An effective regional surveillance system is expected to contribute to crisis prevention by providing accurate and updated information on the individual and regional economies and capital movements, detecting early signs of economic/financial vulnerabilities, and enabling an expedited injection of short-term liquidity to a member nation in need of emergency support in the form of international liquidity.

V. Challenges and obstacles to RFA/RFC: Long-run issues

1. Several obstacles that need to be overcome for successful regional financial cooperation among the East Asian nations include the diversity and heterogeneity of the countries' economic characteristics, a wide spectrum in terms of economic development and lack of economic convergence in the region, and the lack of political will and commitment to regional cooperation and integration. (KRP 2002)

2. The ongoing CMI framework needs to elaborate on various important, practical questions: Under what terms will financing be extended on a regional basis? Is it likely to stabilize or destabilize international capital flows? What will the CMI relationship be to the IMF and other official financial institutions? Could they provide the basis for broader integration of the East Asian region? (Henning 2002)

3. Another important but practical question is who will and is able to lead harmonious efforts toward establishing an effective and solid RFA/RFC in the region – Japan, China, or a collective form participated by inside and/or outside East Asia.

4. A long-term strategy and vision will lead the East Asian nations to an intensive form of financial and monetary integration, which may create an Asian monetary union and a single Asian currency. (Note: KRP (June 2002) sets the year 2030 as the target year for launching an Asian single currency and the establishment of an Asian economic and monetary union.)

5. This critical survey can derive a list of viable and practical strategies for establishing an effective RFA/RFC scheme in the East Asian region in order to prevent the reoccurrence of a financial/economic crisis and large-scale contagion in the region in the future. We put them to the discussion by International Finance Seminar participants:

- to enhance the "political will" of implementation and commitment to the development of a self-help support mechanism beyond the CMI framework in the East Asian region,

- to create an environment of supports from the IMF, ASEM and G-7 nations by, first, pushing a regional RFA/RFC scheme, such as the CMI in progress, to be structured to complement, not contradict to, the IMF and other international institutions, and, second, eliminating moral hazard concerns by establishing a set of clear operational guidance and principles in extending financial facilities to member nations. A strategic alliance with ASEM will be a good option to mitigate oppositions from outside of East Asia.

- To convince Westerners that first, a regional fund could monitor and respond to crises in the region more appropriately and swiftly, and second, the East Asians have the commitment, ability and know-how to establish and run an independent but supplementary RFA/RFC in East Asia by developing an effective regional surveillance system,

- To present a clear vision based on a gradual and progressive approach to expanding the CMI of the ASEAN+3 toward the AMF, or alike, as an Asian LLR, and the eventual establishment of the AMU in the future,

- And to seek for stable and productive sources of foreign capital with long-term maturity, including FDI and bond-market financing. (Jeon and Ahn 2001, Jeon 2002b)

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