

Chiang Mai Initiative as the Foundation of Financial Stability in East Asia

Tadahiro Asami

IIMA

March 1, 2005

Introduction

1. Regionalism in East Asia

- (1) Malaysia's initiative
- (2) Japan's support for multilateralism
- (3) Increased inter-dependence among regional economies

2. Asian Financial Crisis and Regionalism

- (1) Financial crisis in Thailand and regional cooperation
- (2) Japan's proposal for an AMF and the New Miyazawa Initiative
- (3) Formation of regional groups

3. ASEAN+ 3

- (1) The ASEAN+3 meeting
- (2) China and the CMI
- (3) United States reaction

4. Regional Financial Agreements

- (1) Agreement on the CMI
- (2) The CMI's outline
- (3) Shortcomings of the CMI
- (4) How to overcome the shortcomings
- (5) Regional surveillance

5. From the CMI to an AMO

- (1) Objectives
- (2) Membership
- (3) Multi-faceted agreement

6. The Relationship between an AMO and the IMF

- (1) The role of an AMO as a complement to the IMF
- (2) Burden sharing based on the stage of a crisis

7. East Asian Regionalism and United States

- (1) East Asian strategy of the United States and APEC
- (2) Acceptance of East Asian regionalism
- (3) East Asian Community

8. Conclusion

Introduction

The Chiang Mai Initiative (CMI), which is a regional financial arrangement for East Asia, was agreed upon at the Finance Ministers' meeting of the South East Asian Nations plus China, Japan and Korea (ASEAN+3) held in May 2000 in Chiang Mai, Thailand. The CMI's objective is to establish a network of bilateral swap agreements among the ASEAN+3 members to provide liquidity support to countries experiencing balance of payments difficulties. The CMI is one of the tangible accomplishments of ASEAN+3, which met for the first time in December 1997 shortly after the onset of the East Asian financial crisis, to promote regional financial cooperation. The CMI is an invaluable symbol of the development of East Asian regional financial cooperation.

In spite of its important symbolism, however, the CMI could end up without providing a meaningful regional mechanism if it remains in its present form. In order for it to function properly, the CMI needs to be developed as a well-defined effective and efficient regional financial arrangement. It will serve as a basis for crisis prevention and resolution, while maintaining regional financial and monetary stability. This must be pursued in the course of deepening regionalism in East Asia.

This paper studies the development of regionalism in East Asia which led to the creation of the CMI, providing the base for discussions on deepening financial regionalism. The paper reviews the functions of the CMI and considers what should be done and how the system could be developed as a regional financial arrangement in the medium to long-term, paying attention to its relationship with multilateral institutions such as the IMF. In order to establish a stronger self-help and support system, the CMI needs to be developed as a multilateral institution. The establishment of a regional institution such as an Asian Monetary Organization (AMO) in the long-run is also studied in this paper.

A key element which is necessary for an AMO to function is the establishment of an effective surveillance mechanism in East Asia which is compatible with the global system. While it is difficult to envision that a regional security arrangement would provide a political basis for regional cooperation in East Asia in the medium-term, cooperation in the monetary and financial areas supported by a well-functioning surveillance mechanism, if realized, will nurture regional integration. The paper concludes by stressing the need to develop the CMI, through a step by step approach, into a regional

financial institution such as an AMO which will maintain a harmonious relationship with multilateral institutions such as the IMF and the United States.

1. Regionalism in East Asia

(1) Malaysia's Initiative

In the early 1990s, when East Asian regionalism was rarely discussed in the region, Mohamad Mahathir, then Prime Minister of Malaysia, proposed the formation of the East Asia Economic Group (EAEG) as a response to the European Community and plans by the United States, Canada and Mexico to form a North American Free Trade Agreement (NAFTA). The proposed scheme aimed to form an East Asian Economic Group consisting of ASEAN members (six at the time¹), North East Asian countries (China, Japan and South Korea), Hong Kong, Taiwan and Vietnam.

After official discussions, this initiative developed into the East Asia Economic Caucus (EAEC), which was less exclusive than the EAEG, and was debated at the ASEAN Summit held in Singapore in January 1992. One of the interesting topics discussed at that time was the relationship of the EAEC with APEC, the later which was established in 1989 with strong support by the United States and Australia. The United States considered the EAEC as a threat to both APEC and to the United States presence in East Asia. While China showed interest in joining the EAEC, it insisted that the EAEC members should be sovereign states only and that Taiwan and Hong Kong should not be included. In the end, Japan and South Korea expressed reluctance, taking the negative attitude of the United States into consideration, and this in effect, led to the termination of the EAEC initiative.

Although the United States together with Canada and Mexico created the NAFTA in 1992 to counter the expansion of the European Union (EU), the United States did not accept the establishment of a new regional group in East Asia. The United States attitude lacked fairness, but Japan chose not to support the East Asian economic integration scheme due to the opposition from the United States. This episode shows how, in that period, Japan was unable to officially support regional integration in East Asia because of its policy of maintaining a harmonious relationship with the United States.

(2) Japan's Support for Multilateralism

¹ Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand

While economic globalization intensified and enveloped many countries and regions, Europe and the United States pursued regional integration, which seemed to go against the trend of globalization. The Maastricht Treaty signed in 1992 led to the creation of the European Union. The three North American countries formed the NAFTA in the same year, and it came into effect in 1994. In comparison with such movements in Europe and North America, the interest in regional integration was quite weak in East Asia as was seen in the failure of the EAEC proposal.

Globalization was welcomed and accepted in East Asia as it enhanced domestic investment by bringing in foreign capital, increasing exports to the United States and Europe, resulting in higher economic growth. There were those who argued that regionalism would tend to reverse the flow of globalization. This was perhaps a predictable reaction in East Asia since its economies depended upon exports to the United States and Europe. Regionalism was perceived as an important issue by East Asian countries only after the Asian financial crisis occurred. In this sense the Asian financial crisis of 1997-98 served as a catalyst to draw the attention of the countries in the region to regional monetary and financial cooperation as a defensive measure under economic globalization.

Japan has been a supporter of the multilateral process and multilateral financial institutions such as the IMF and the World Bank. Likewise, Japan supported the global GATT/WTO approach with regard to the trade regime. In the last decade, many countries, except for East Asian countries, promoted bilateral free trade agreements (FTAs) reaching over 100 FTAs. When East Asian countries finally attuned to the significance of regionalism, Japan realized that it was behind the trend, along with China and South Korea, none of which had formed FTAs.

Japan began to adopt a bilateral approach along with a multilateral one and signed its first FTA, an Economic Partnership Agreement (EPA) with Singapore in 2002. Japan and Singapore reached an agreement in a relatively short period of time since there were basically no complicated agricultural issues between them. Upon this success, Japan began negotiations for FTAs with South Korea, Mexico (signed in September 2004, but not yet effective) Malaysia, the Philippines, Thailand and other countries. China concluded a Closer Economic Partnership Agreement (CEPA) with Hong Kong which was implemented in January 2004, and also entered into a comprehensive framework agreement with ASEAN in 2002 with an aim to reach an agreement on an ASEAN-China

FTA by 2010, while an early harvest clause is now effective in agriculture. South Korea signed its first FTA with Chile, which became effective April 2004. This was followed by the FTA with Singapore, concluded in November 2004.

(3) Increased inter-dependence among regional economies

Although the concept of regionalism has been focused upon only recently, economic inter-dependence has been accelerated in the region through trade, investment, finance and macro-economic relations. A de facto economic zone has in effect been created in the area of trade and investment based on market principles, despite the political, social and historical differences among the countries in the region. In contrast to the EU, where organizations and systems were created first, inter-dependence among the countries has led the process of regionalism in East Asia. Hence, integration in East Asia will follow a different process from that of the EU.

Increasing regional inter-dependence in trade and investment is, to some extent, closely related to China's integration into the regional as well as the world economy. However, at the same time, East Asian economies are also closely tied to the United States and European economies. In this sense, East Asian economic integration should not be seen as exclusive in nature, but as open to other regions.

2. Asian Financial Crisis and Regionalism

After APEC was established as an annual event under the leadership of the United States, the EAEC was put on the back burner. At that time, regional cooperation was deemed not to be necessarily limited to neighbouring countries and APEC, consisting of Pan Pacific countries, was promoted as the key alternative organization to facilitate regional cooperation. However, the East Asian financial crisis of 1997-98 dramatically changed this view.

(1) Financial crisis in Thailand and regional cooperation

The East Asian financial crisis erupted in July 1997 when the Thai government was forced to abandon the fixed exchange rate regime to adopt a flexible exchange rate, resulting in a substantial depreciation of the Thai baht. Since the fundamentals of the East Asian economies were generally strong, the countries had attracted an enormous amount of direct investment as well as short-term foreign capital after the deregulation of capital accounts in the early 1990s. Since the markets were opened hastily despite the fact that domestic financial systems remained weak, short-term capital began to flee

when confidence in the economy was lost, creating havoc in the financial system and ultimately leading to the bankruptcy of businesses. The financial crisis was a capital account crisis brought on by the liberalization of capital transactions rather than a current account crisis.

When the crisis occurred in Thailand in July 1997, the Japanese government was the first to propose financial support. In early August 1997, Japan together with the IMF convened a conference in Tokyo, inviting governments of East Asia and Oceania as well as the United States and Europe to discuss financial support for Thailand. A financial package of US\$17.2 billion was agreed upon with contributions from multilateral financial institutions and individual countries including Australia, China, Indonesia, Japan, Malaysia, Singapore and South Korea. The United States and European countries did not participate in this financial support package. It was the neighboring East Asian countries and Australia that agreed to assist Thailand when it was hit by a capital accounts crisis as a result of globalization. This reality made those countries acutely aware that regional cooperation was critical in order to protect themselves from future financial crises.

The financial crisis quickly spread to the neighboring countries. The outflows of short-term foreign capital that took place in Thailand spread to Hong Kong, Indonesia, Malaysia, South Korea and others. Indonesia, which had accumulated a large amount of sovereign and private sector debts under President Suharto's autocratic rule, and South Korea, where banking and business sectors had accumulated a huge amount of short-term foreign debt, suffered an especially serious "capital account crisis." A global rescue facility centered on the IMF was put into place for Indonesia and South Korea. Japan, recognizing that the emergency support of the IMF and foreign governments to crisis-hit economies was insufficient, decided in October 1998 to make an additional contribution of US\$30 billion (Miyazawa Initiative) to five East Asian countries (Indonesia, Malaysia, South Korea, Thailand and Vietnam) as a regional support program.

Since the usable resources of the IMF are limited and the IMF facilities are concentrated in a few countries such as Brazil, Turkey and Argentina, the funding capacity of the IMF has been under constrain. When the amount of usable resources were drawn for Indonesia, Thailand and South Korea during the Asian crisis in 1997-98, the IMF's usable resources dropped to such an extent that the IMF resources, known as

the General Resources Account (GRA) were not enough to support further lending. Furthermore, since the IMF quotas allocated to East Asian countries are generally small in terms of the size of their economies, the financial gap between the possible funding requirement and the amount of resources the IMF can provide need to be filled by other international financial institutions, bilateral assistance, or by restructuring external debt owed to private sector creditors.

In addition, the rescue plan organized by the IMF came with strict conditionality for emergency loans, such as tight monetary policies, a flexible exchange rate, higher interest rates, fiscal restraint, drastic restructuring of banking, financial systems and businesses. These policies were identical to the IMF prescription applied to the Latin American debt crisis in the 1980s and were inappropriate prescriptions when dealing with the East Asian financial crises. The East Asian economies, which were in a “capital account” crisis, were further damaged by the stringent macro-economic policies of the IMF.

The Malaysian government chose to adopt policies that were contrary to the macro-economic policies of the IMF. Prime Minister Mahathir applied measures to stimulate the domestic economy by lowering interest rates, increasing fiscal expenditure and pegging the ringgit to the dollar (3.8 ringgit to one US dollar) in September 1998, while implementing restrictions on cross-border capital transactions.

Many lessons have been learned by the financial crisis in East Asian countries. They include the need to introduce preventive measures in order to avoid future financial crises and the need to reform weak financial system of East Asian countries. In the context of regional financial integration, the creation of a self-help and support system is needed to enhance closer cooperation among the countries in East Asia, in view of the limited resources available at global institutions and the need to establish better policy coordination among countries in the region. The affected governments became acutely aware of these issues which created the momentum for regional financial cooperation.

(2) Japan’s proposal for an AMF and the New Miyazawa Initiative

The successful conclusion of a financial package for Thailand in August 1997, only a month after the onset of the financial crisis, made the countries acutely aware of the value of regional cooperation. In September of that year, Japan proposed establishing an Asian Monetary Fund (AMF) as a framework for promoting financial cooperation and

policy coordination in the region, at the annual meeting of the IMF and the World Bank held in Hong Kong. Japan's proposal was a response to strong requests for regional cooperation from countries in the region which were suffering from severe financial crisis. Detailed information on the proposal is not available but it was apparently made without prior consultation with the United States. Although the proposal received a positive response from East Asian countries, the United States, European countries and the IMF strongly objected to it on the basis that a) a regional facility for a liquidity provision that extends easy money without IMF conditionality would create a moral hazard, and b) it would duplicate the existing global system created around the IMF. Australia joined the United States and China voicing its objection to the scheme. Japan withdrew the proposal promptly and since then, the Japanese Finance Ministry has not mentioned an AMF.

(3) Formation of regional groups

The proposed AMF did not refer to the important question: which countries would be members of the group. Although the AMF scheme was withdrawn, East Asian governments were fully aware of the need for regional financial cooperation and various forums were created to discuss regional financial cooperation. One of the choices available at that time was APEC encompassing the Asia-Pacific, a geographically broad area including countries from East Asia, Oceania, North and South America. However, the group chosen by the East Asian governments was ASEAN+ 3 which has become the core organization for regional cooperation by holding numerous meetings and spearheading the effort towards regional integration.

The inaugural Asia-Europe Meeting (ASEM) was held in Bangkok in March 1996 with an aim to strengthen Asian-European relations which were weak compared to relations between Asia-North America and Europe-North America. Since then, the ASEM summit has been held every two years to discuss political, economic, social and cultural issues. One of the characteristics of the ASEM is that it serves as a meeting of two regions, i.e. the EU and basically ASEAN+3 rather than an APEC-type meeting of member countries.

3. ASEAN+3

(1) The ASEAN+3 meeting

The basic framework of the ASEAN+3 has its origin in the EAEG proposed by Mahathir Mohamad in 1990, then Prime Minister of Malaysia. The ASEAN leaders did not reject Mahathir's initiative out of respect but were more interested in APEC, led by the United

States. The general attitude of leaders was not to consider EAEG seriously at that time. Seven years later, in December 1997, the historic inaugural ASEAN+3 leaders' meeting was held, the same year the Asian countries faced the financial crisis. Prime Minister Ryutaro Hashimoto of Japan and President Jiang Zemin of China attended the meeting hosted by Prime Minister Mahathir. It is said that both Hashimoto and Jiang failed to agree with Mahathir's suggestion of holding the meeting regularly. In December 1998, however, the second meeting of ASEAN+3 was held in Hanoi and it was then agreed that leaders of ASEAN+3 would meet regularly every year. The ASEAN+ 3 Summit was regarded as a meeting that plays an important role in promoting regionalism and it has been held every year since then.

In April 1999, a meeting of the ASEAN+3 Finance Ministers was held for the first time and that set the precedent for holding a regular Finance Ministers' meeting during the ADB annual meeting. During the ADB annual meeting held in Chiang Mai, Thailand, in May 2000, the ASEAN+3 Finance Ministers for the first time discussed economic outlook and policy issues. In the meeting they agreed on the Chiang Mai Initiative (CMI), a scheme for bilateral swap arrangements. Since then, various ASEAN+3 meetings have regularly been held at the ministerial level, discussing such issues as the economy, finance, trade, investment, environment, and transportation. Notably, meetings discussing economic/financial issues are held frequently at the ministerial, deputy and working levels. According to the ASEAN secretariat, there are currently 48 forums, from Summit meetings to specialists meetings within the ASEAN+3 framework.

(2) China and the CMI

Although China did not initially show much interest in regional cooperation as seen from its objection to the AMF proposal, China changed its attitude around 1999 to become an active supporter of regional cooperation. China's support of the Chiang Mai Initiative in 2000 made it possible to create a network of bilateral swaps among the ASEAN+3 countries. Furthermore, in 2001, China agreed with ASEAN to conclude a FTA by 2010. As these facts show, China is now an enthusiastic promoter of East Asian regional cooperation, which it regards as strategically important. Since China began to take a positive attitude towards regional cooperation in 1999, ASEAN+3 became more firmly established as a group. The ASEAN+3 countries have had a strong impetus to support regional cooperation and the effort to deepen regionalism has gathered momentum. The CMI is symbolic of this effort since it is the first regional financial agreement ever created in the ASEAN+3.

(3) United States reaction

Contrary to its negative reaction to the plans for the EAEC or the AMF proposals, the United States appears not to have intervened in the establishment of ASEAN+3 and the formation of the Chiang Mai Initiative.

4. Regional Financial Agreements

(1) Agreement on the CMI

The original concept of the CMI came from the ASEAN Swap Arrangement (ASA) which the five original ASEAN countries (Indonesia, Malaysia, Philippines, Singapore and Thailand) established in 1977. The ASA was a short-term liquidity support facility for a member country in need of short-term balance of payments assistance. In May 2000, the ASA was expanded to include five new members of the ASEAN and the total facility amount was increased to US\$1 billion from the original US\$200 million. The arrangement, however, has never been used, even in the 1997-98 Asian financial crises. The purpose of the CMI was to expand the ASA to form a network of bilateral swaps and repurchase agreement facilities among ASEAN+3. The East Asian countries succeeded in creating a regional system to address future financial crisis, in addition to the global mechanism led by the IMF. The CMI includes an agreement to establish a regional framework to monitor capital flows and a network to facilitate regional surveillance in order to coordinate and monitor the economic and financial systems. The details of the CMI had been explained to the United States in advance by Japan, and the initiative was pursued without United States interference.

(2) The CMI's outline

The outline of the CMI so far disclosed by the authorities is as follows:

- (a) The CMI consists of two parts: one is an ASA of US\$1 billion and the other is a network of bilateral swaps. As of January 25, 2005, 15 bilateral swaps, totaling US\$37.5 billion, have been agreed upon including a US\$1 billion ASEAN facility (currently five of the ASEAN countries together with China, Japan and South Korea are parties to the swaps).
- (b) Individual bilateral swap agreements appear to have different arrangements and there is no standard documentation. This means that, if a country wants to withdraw a necessary amount of money from more than one source, the country must negotiate individually with each of the swap providing counterparts.
- (c) The term of the swap is three months and can be extended six times, up to two years.
- (d) Up to 10% of the swap facility can be drawn in cash and the remaining 90% can be

drawn when the borrowing country accepts an IMF program.

(e) Currencies used in swap agreements are mostly US dollars against a local currency. For instance, in the case of Japan-Thailand, they contracted in US dollars-baht. In the case of Japan-China, they used yen-renminbi.

(f) Other conditions such as applicable interest rates, bearer of credit risks, exchange risks and collaterals for swap transactions have not been disclosed.

(3) Shortcomings of the CMI

The CMI has several shortcomings as a financial arrangement, leaving room for improvement.

(a) Shortage of available funds

If East Asia should face another financial crisis in the future, it is more likely to be some form of capital account crisis, like the East Asian financial crisis of 1997-98, rather than a sovereign debt crisis such as those in the 80s in Latin America caused by the accumulation of current account deficit. Since huge amounts of capital flows are involved in a capital account type of crisis, rescue packages require a large amount of multilateral, regional and bilateral support. In the East Asian crises, for instance, the amount of external financing for Indonesia, South Korea and Thailand amounted to the order of US\$20 billion to US\$60 billion each. Although the CMI is a regional arrangement and contributions from global resources can be expected, the amount available under the CMI is far from sufficient for future capital account crises.

(b) Dependence upon the IMF Process

The CMI is a regional financial arrangement but it is in fact dependent upon the IMF since 90% of swap funds can be drawn subject to the borrowing government's acceptance of the IMF program. This is because currently a regional surveillance mechanism does not exist in East Asia, so the CMI has no choice but to depend upon a global surveillance mechanism. In order for the CMI to become a viable regional arrangement, an independent and well-administered regional surveillance mechanism must be put in place². It would be desirable to have a balanced share of responsibilities between the IMF and the CMI. In addition to the linkage between the drawing of funds under the CMI and the IMF program, the relationship between the IMF, as a global institution and the CMI, as a regional arrangement, needs to be defined.

(c) Inefficient financial arrangement

² East Asian Economic Regionalism by Edward J. Lincoln P.259

In order to address the capital account type of crisis in the future, the swap arrangements must be readily available to allow timely disbursement. In order to meet such a need, the CMI must be carried out under a multilateral operational framework instead of the present bilateral swap agreements which do not have a standard documentation.

(4) How to overcome the shortcomings

These shortcomings can be overcome by improving and modifying the CMI. If these shortcomings are corrected, the CMI can be developed into a full-fledged efficient financial arrangement.

First, the amount of available funds can be increased to a sufficient level that can meet the necessary funding requirements to address future financial crises. East Asia, as a region, holds nearly US\$2 trillion as foreign currency reserves. It takes only 5% of the total reserves to create a fund of US\$100 billion³. Since it is a facility, a cash contribution will be a small portion of a total earmarked fund. Second, the role and function of the CMI as regional arrangement shall be clarified, distinguished from that of the IMF as a global institution. Third, the CMI function must be strengthened step by step to eventually form a multilateral regional institution named as, for example, the Asian Monetary Organization (AMO), a regional international organization responsible for regional financial and monetary stabilization.

The first step is to set up a secretariat which can oversee regional surveillance for the ASEAN+3. Since the ASEAN already has a Secretariat, it could be expanded or a Secretariat of the plus 3 countries could be created which would eventually merge to form the ASEAN+3 Secretariat. The purpose of a Secretariat is to exercise surveillance over short-term capital flows and to make closer coordination possible among the regional economies. The second step is to transform the CMI into an AMO, which will be a multilateral regional institution established under a charter signed by the member countries.

As agreed at the ASEAN+3 Finance Ministers' meeting, the CMI is due to be reviewed

³ International Reserves (minus gold) as of August 2004 in billions of U.S. dollars□

Japan 818, China 501, Hong Kong 118, Korea 170, Thailand 43, Indonesia 35, Malaysia 54, The Philippines 13, Singapore 102, totalling US\$1,854 billion. Source: International Financial Statistics

in May 2005. It is a golden opportunity for finance officials of the ASEAN+3 as well as the parties concerned to review the CMI to make the initiative truly effective for the financial and monetary stability in East Asia.

(5) Regional surveillance

The East Asian economies have become more interdependent as regional trade and investment have increased remarkably. Under such circumstances, regular exchange of information and careful economic policy coordination among the governments are critical to the stability of the regional economy, finance and exchange rates. It is especially vital among others to exchange information frequently on short-term capital flows and to discuss and coordinate regularly on foreign exchange policies in order to prevent regional financial crisis. Setting up of an early warning system is also an important task. Several forums have been formed for the purpose of promoting regional surveillance:

ASEAN Surveillance Process

The ASEAN Surveillance Process (ASP) was established in accordance with the proposal made by the ASEAN Finance Ministers' meeting in 1998. The objective of the ASEAN Surveillance Process is to strengthen cooperation by (a) exchanging economic data among the member countries, (b) providing an early warning system, (c) highlighting possible policy options, and (d) monitoring and discussing global economic and financial developments. The ASEAN Surveillance Process is supported by the ASEAN Surveillance Coordinating Unit (ASCU) established at the ASEAN Secretariat in Jakarta. The ASCU is responsible for preparing surveillance reports, with technical assistance by the ADB, using the same data supplied to the IMF in conjunction with its Article IV consultations.

However, since ASEAN has a politically established principal of non-interference to other member's internal affairs, peer pressure or policy coordination may not work as they needed to be. This constitutes a serious limitation to the effectiveness of the surveillance process for the ASP.

Manila Framework:

The Manila Framework was established in November 1997 in Manila, in order to develop a concerted approach to restoring financial stability in the East Asia. The framework is comprised of the countries and regions in East Asia (Brunei, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, Philippines, Singapore and Thailand),

Australia, Canada, New Zealand and the United States. The IMF, the World Bank, the BIS and the ADB also attended the meeting. The Manila Framework took an initiative, among others, to create a mechanism for regional surveillance complimentary to the global surveillance by the IMF. The Manila Framework terminated its functions in November 2004 after meeting 12 times. The failure of the Manila Framework is said to be attributable to the lack of mutual trust caused by the strong presence of non-regional members and the lack of a professional secretariat.

ASEAN+3 Economic Review and Policy Dialogue

The concept of surveillance was introduced to the ASEAN +3 in the form of the Economic Review and Policy Dialogue (ERPD) in May 2000 in the Finance Ministers' Meeting. The major objective of the ASEAN+3 ERPD is to identify possible financial crises and to prevent them, monitoring regional capital flows, strengthening the banking and financial systems, reforming the international financial architecture and enhancing the self-help and support mechanisms in East Asia. However, an independent, professional and permanent organization for surveillance has not yet been established for the ERPD. Therefore the ERPD cannot exercise surveillance on a daily basis.

In addition to the above, there are several other regional forums which have been established to conduct surveillance among respective groups of countries. They include ASEAN Finance Ministers' Meeting, ASEAN Deputy Finance Ministers' Meeting, APEC Finance Ministers' Meeting, EMEAP Governors' and Deputy Governors' Meeting. Among these, EMEAP is considered to be the most prominent group of regional central bank forums. The EMEAP was organized in 1991 with the leadership of the Bank of Japan and the Reserve Bank of Australia. Its major objectives include enhanced regional surveillance, the promotion of financial market development and strengthening the cooperative relationship among member central banks. Given the important role of central banks in financial markets, the central bank Governors should participate in the ASEAN+3 Finance Ministers' meeting, like the G7 Finance Ministers' meeting to which central bank Governors are regular members, while central bank officials should be more actively involved in the ASEAN+3 surveillance process.

It is of vital importance to establish a strong ASEAN+3 surveillance system which can oversee the East Asian region to cope with issues which may arise from time to time before the issue is taken to a global institution. Regional self help and support programs will contribute to maintain regional financial stability and thus help the multilateral

process. In order to strengthen the surveillance process, the establishment of a proper secretariat for ASEAN+3 is required.

In this respect, the EU's history of regional surveillance is of particular interest. In the case of the EU a multilateral surveillance mechanism did not work until the early 1990s, although the origins of multilateral surveillance can be traced to the 1970s. In the meantime, however, institutional arrangements of the Monetary Committee and the Committee of Central Bank Governors within the European Communities played a vital role in reviewing and assessing economic and financial conditions. This function was essential to maintain the European Monetary System which contributed to the stability of exchange rates through monetary policy coordination.

5. From the CMI to an AMO

The CMI could be developed into a more efficient institution that provides a sufficient amount of financing in a timely and efficient way, underpinned by an effective surveillance to enable member countries to overcome financial crises. When the CMI is strengthened by the arrangement of a regional surveillance mechanism, the creation of a multilateral institution such as an AMO is desirable. A variety of ideas and schemes could be brought up before eventually arriving at an AMO.

The following is an overview of the AMO as it might function in the future.

(1) Objectives

The CMI was designed as a means to resolve a crisis in the event it occurs in the region. On the other hand, an AMO could expand the functions of the CMI to deal with widely-defined objectives like contributing to the stability of the regional financial and monetary system which will further contribute to the global economic equilibrium. It will oversee short-term capital flows, exchange rate equilibrium, capital account liberalization, monetary and financial policies in the region. An AMO will engage in regional surveillance to foresee and to prevent vulnerabilities which may lead to future financial crisis and in the event a financial crisis should occur, an AMO should resolve the crisis together with the IMF. The AMO will also provide short-term liquidity for currency stabilization.

(2) Membership

The AMO should be a regional financial institution whose members are comprised of ASEAN+3 countries but it should adopt, in principle, an open membership policy.

Membership of countries like Australia and New Zealand, should be considered at a later date when required.

(3) Multi-faceted agreements

The AMO should be established as a regional organization by an agreement signed and ratified by member countries. The AMO should rely upon its members' contributions to finance its operations. The amount of contributions should be determined by a quota system which assigns each member, a quota relative to its GDP, foreign exchange reserves, or other economic indicators. If members are to contribute 5% of their foreign exchange reserves, the initial fund would amount to about US\$100 billion.

6. The Relationship between an AMO and the IMF

(1) The role of an AMO as a complement to the IMF

When the Japanese government first proposed an AMF in September 1997, they made it clear that the role of an AMF should not overlap that of the IMF, but that the AMF would be specialized in regional activities to supplement the functions of the IMF. The closer the regional economies are integrated, the easier it becomes to solve issues such as regional financial and exchange problems through peer pressure and policy coordination among the regional governments at an insipient stage. This will help to ease the burden on global organizations. Whatever spare resources that become available as a result, can be used for other purposes. If the role of an AMO is made clear and redundancy and overlapping are eliminated, responsibilities can be placed unambiguously, increasing efficiency. The roles played by the AMO and the IMF should be divided according to the nature and the stage of a crisis. The amount of assistance provided by each institution should be decided upon consultation on a case-by-case basis.

The CMI does not function as an alternative to the IMF, but plays a complementary role to it, when the situation requires the two institutions to work in tandem. However, there will be a sense of competition between an AMO and the IMF with regard to the prescription for a country, when the two institutions deal with the country in question independently.

(2) Burden sharing based on the stage of a crisis

The nature of the crisis differs from case to case, but there are always early signs of monetary or currency problems. The countries that can detect such subtle signs quickly

and accurately are usually the neighboring countries which have closer economic relations with the country, provided that there is sufficient information and a data sharing mechanism with room for peer review and peer pressure to work. The AMO surveillance mechanism would be useful to sense problems at an insipient stage, and to correct them through peer pressure through the exchange of information and ideas among the countries in the region. However, if there are no regional institutions such as an AMO to take the leadership to prevent crises from getting worse, the burden of global institutions will be much larger.

The roles which can be played at various stages are as summarized below:

(A) Times of Normalcy

The fundamentals of the economy are considered sound and are under control of policy managers. The economy has an access to international capital markets and can raise funds at a reasonable cost. There is enough dialogue between debtors and creditors. Monitoring functions of macro-economic management is working through the surveillance mechanism within the region. When an economy is disturbed by external causes and volatility is observed in the foreign exchange market, official market intervention and other measures with the help of the AMO, if necessary, are taken to improve the situation.

(B) When external disequilibrium is observed

When an economy falls into disequilibrium or the economy becomes imbalanced due to some internal or external factors, it can be observed through various economic indicators. It is the time when peer review works most effectively under the AMO surveillance mechanism with frequent exchange of information and close policy dialogue among member countries. Short-term liquidity would be provided to the country, if necessary, to enable it to overcome balance of payments difficulties. There are cases where the domestic political situation prevents the government from adopting appropriate economic policies. As the economic imbalance becomes more serious, the cost of raising capital in the international capital markets will increase. It is necessary to promptly adopt effective macro-economic policy measures and to regain market confidence at this stage. The AMO could play a central role to help the member country adopt necessary economic policies.

(C) Insipient Stages of a Crisis

As the economic conditions deteriorate, the funding cost increases, and access to the

international capital markets becomes increasingly difficult, resulting in unsustainable international balance of payments. Foreign exchange reserves decrease and external debt service becomes difficult. This is a typical form of a current account crisis. The AMO would intensify consultations with the IMF, by exchanging information, examining appropriate prescriptions for the country, setting forth conditionality and deciding on a financial assistance program before a crisis deteriorates. On the other hand, if the financial crisis is mainly caused by a temporary liquidity shortage resulting from speculative movement of cross-border capital movement rather than a structural issue, the liquidity support by the AMO together with other sources such as international financial institutions and bilateral government assistance would be appropriate.

(D) Financial and currency crisis

An economy loses access to markets and faces a financial crisis. At this stage, the IMF as a global organization would take the leadership. If the crisis is a current account type, sovereign debt service will be suspended temporarily and a rescue package will be formed based on financial support provided by international financial organizations such as the IMF, World Bank and the AMO and through bilateral government assistance. At this stage external sovereign debt from private creditors would need to be restructured. If a crisis is a capital account type, such as in the Asian crisis of 1997-98, not only sovereign debt but also foreign debt owed by financial institutions and businesses need to be restructured. If regional and global efforts do not succeed for some reason and the crisis reaches the level where the country loses its ability to sustain external debts, then the IMF, with its experience of addressing such crisis, should assume responsibility.

An AMO will be most effective at stages A and B. At stage B, the AMO could induce member countries to adopt appropriate macro-economic policies through peer pressure based on the surveillance mechanism. At the same time, it could provide necessary short-term loans to the country to overcome balance of payments difficulties and to stabilize exchange rates. When there is a possibility that a crisis might reach stage C, the AMO would consult with the IMF closely on the macro-economic policies that have to be taken by the country. Stage D is an IMF prerogative.

As the present CMI is heavily dependent on the economic package developed by the IMF, there is no strong incentive to strengthen its surveillance system. Hence, when the CMI is reorganized into a regional financial institution like an AMO, its success will depend on how well the regional surveillance will work. It is not exaggerated to say that

it all depends on whether surveillance is conducted meticulously on a day to day basis and whether it creates the necessary confidence in the AMO among the countries in the region.

7. East Asian Regionalism and the United States

(1) East Asian strategy of the United States and APEC

Germany and France that have led the European integration made every effort to gain the understanding and cooperation of the United States at every stage of integration. This was because the support of the United States was indispensable for security, economic development and regional integration after World War II. The United States has supported the European recovery and integration through the Marshall Plan and other measures. The EU would not have come into existence without U.S. support. U.S. assistance was provided because there was a common understanding that European economic recovery and integration would be beneficial to waging the Cold War. The role played by the United States in the European integration should be taken into consideration when the East Asian regional integration is proposed.

The United States perspective on East Asian regional cooperation is based on the strategy that the United States interests are best served through strengthening bilateral relationships with Asian countries. The United States has huge economic and security interests in Asia. Its policy towards East Asia is based on bilateral relationships but it also maintains a presence in Asia through APEC, which the U.S. has supported to play a central role in the region. Consequently, it has objected to any regional integration that excludes the United States in Asia. There were high expectations for APEC in the beginning but it is losing steam now and is gradually becoming obsolete.

(2) Acceptance of East Asian regionalism

The G7 Finance Ministers, in a statement issued at the Summit held in Okinawa in 2000, stated that they welcome regional cooperation:

“We agree that regional cooperation through intensified surveillance can help contribute to financial stability by strengthening the policy framework at the national level. Co-operative financing arrangements at the regional level designed to supplement resources provided by the international financial institutions (IFIs) in support of IMF programs can be effective in crisis prevention and resolution. In this context, we welcome the recent developments in Asia and North America. In a

different institutional context, economic and financial integration mechanisms, and monetary unification in Europe are also contributing to the economic and financial stability of the global economy.”

It is clear that the United States is no longer continuing to oppose regional integration nurtured in East Asia. However, it is essential for Japan to discuss with the United States, the movement towards regional cooperation and integration in the region for the sake of the US-Japan alliance.

(3) East Asian Community

The ASEAN+3 summit meeting held at Vientiane on November 29, 2004 reached an agreement that the first East Asian Summit would be held in Malaysia in 2005. In order to sort out the divided views of the East Asian countries on the East Asian Community, the ASEAN+3 Foreign Ministers’ meeting will discuss the modalities of the East Asian Summit on the occasion of the ASEM meeting to be held in Kyoto in May this year. The first East Asian Summit is planned to be held in Kuala Lumpur in December of this year. As the eight-year history of ASEAN+3 shows, regional integration has been centered on economic spheres, in particular, monetary cooperation rather than political initiatives. But, if the East Asian Summit is realized, East Asian regionalism may expand into diversified areas including political initiatives. That is why the East Asian Summit in Kuala Lumpur this year could be deemed to mark a turning point in the development of East Asian integration.

8. Conclusion

Regional cooperation in East Asia has less than a ten year history, and it is at an early stage of integration. East Asia, unlike Europe, does not have a regional security framework. Accordingly, strong economic integration cannot be built based on a political framework. The situation may change all of a sudden, but for the medium term, the prospect for the establishment of a regional security framework backed by strong regional political support is unlikely. On the contrary, the region may face serious security deterioration arising from two hot issues, i.e. North Korea and the Taiwan Strait.

Apart from political uncertainty, cooperation among ASEAN+3 countries has been strengthened in the economic sphere and this will undoubtedly bring large benefits to the area. The ASEAN+3 has clearly been the core of economic integration in the region and

it will most likely continue to be so. The objective of this paper is to propose the eventual establishment of an AMO as a regional arrangement in East Asia. The success of the CMI or an eventual AMO will depend upon whether the surveillance system in East Asia can work as effectively as expected. A mechanism that enforces exchange of information and applies peer review and pressure through policy coordination is the right approach to boost the confidence of the countries in the region. It is strongly expected that the up-coming review of the CMI in May this year by finance officials of the ASEAN+3 will reach a broad agreement on deeper regional monetary cooperation in the medium-term, whereby the CMI will be developed step by step towards a more effective and efficient regional arrangement.

Economic and financial integration is justified as long as it contributes to the well-being of the people in the region. In that sense, an AMO and the ensuing mechanism to stabilize regional financial and currency systems should be promoted.