

Draft

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**Beyond the Chiang Mai Initiative:  
Prospects for Regional Financial and  
Monetary Integration in East Asia\***

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## **I. Introduction**

The 1997 Asian financial crisis has set in motion two interrelated financial developments in East Asia. Most of the East Asian countries including the crisis-hit ones have increased the pace and scope of domestic financial reform to liberalize and open their financial markets and also to improve corporate governance and risk management at financial institutions. The other development is the regional movement for financial cooperation and integration that has culminated in the Chiang Mai Initiative (CMI) and Asian bond Market Initiative (ABMI).

When the financial crisis that broke out in Thailand in July 1997 became contagious, spreading to other East Asian countries, Japan proposed the creation of an Asian monetary fund (AMF) as a framework for financial cooperation and policy coordination in the region. One of the major objectives of creating a regional monetary fund was to provide new lending facilities, in addition to those of the IMF, against future financial crises in East Asia. Although the proposal was well received throughout the region, the idea was shelved at the objection of the U.S, EU, and IMF.

The AMF idea was revived again when the finance ministers of ASEAN, China, Japan, and South Korea (ASEAN+3) agreed on May 6 2000 in Chiang Mai, Thailand to establish a system of bilateral swap arrangements among the ASEAN+3 countries in what is known as the Chiang Mai Initiative (CMI). Together with the swaps, the CMI has also institutionalized meetings of finance ministers (AFMM+3) and deputy ministers (AFDM+3) for policy dialogue and coordination and also the annual summit for ASEAN+3. As the second phase of the CMI for regional financial integration, ASEAN+3 has also launched the Asian bond market initiative (ABMI) – an initiative for the development of regional bond markets in Asia. Six working groups have been established to construct regional financial infrastructure and coordinate market practices and policies of individual Asian countries.

The CMI network of swap arrangements is designed to provide liquidity support for member countries that experience short-run balance of payment deficits in order to

prevent an extreme crisis or systemic failure in those countries and subsequent regional contagion. Emergency support facilities such as the CMI are similar in nature to other regional and international “lender of last resort” facilities. Because they are primarily for systemic purposes, they would likely be used very infrequently.

Since the intent of the CMI was to be proactive, it has to be based on a mutually agreed framework for inter-country cooperation within ASEAN and ASEAN+3 that could be used to render quickly and effectively emergency assistance at required levels when the need arises. Moreover, a group approach would ensure that any conditionality associated with the financial assistance would be consistent across all countries. The structure of financial cooperation conceived by the architects of the CMI covers the basic principles and operational procedures for the bilateral swap transactions. To serve as a full-fledged regional financial mechanism comparable to the European Monetary System, for example, further organizational and operational details will have to be worked out.

A regional financial arrangement (RFM) for economic cooperation and policy coordination in general comprises the following three institutional components; (i) a mechanism of short-term liquidity support for the members experiencing balance of payments deficits; (ii) a mechanism of surveillance for monitoring economic and policy developments in the member countries and for imposing policy conditionality on those countries receiving financial support; and (iii) a regional collective exchange rate system designed to stabilize the bilateral exchange rates of the member countries.

Questions have been raised as to whether regional financial arrangements, whichever forms they may take, are needed in East Asia and, if they were indeed, whether they would be effective in safeguarding the region from future financial crises. An East Asia that comprises ASEAN+3 may not constitute an optimal area for financial market integration. However, this does not mean that the creation of an RFM in East Asia is not justified. Depending on how it is structured and managed, an East Asian RFM could facilitate multilateral trade and financial liberalization, thereby contributing to global financial stability (Bergsten and Park 2002).

There is still the lingering doubt that the CMI could create moral hazard in managing balance of payment problems in East Asia because the participating countries would not be able to impose tight conditionality on other members borrowing from the swap system. Financial market participants have ignored the CMI as a defense mechanism against future crises because the amount of liquidity any member can draw from the system is small and worse yet it is uncertain whether it can activate the swap borrowing. Despite these criticisms and the market's disregard, ASEAN+3 has managed to close ranks to expand the scope of policy dialogue and to move to the second stage of integration

The purpose of this paper is to analyze recent developments in and prospects for regional cooperation for financial integration in East Asia through the consolidation of the CMI and promotion of the ABMI. Section II discusses the evolution, structure, and the ASEAN+3 plan for enhancing the effectiveness of the CMI. This is followed in section III by a review of the regional efforts at developing regional bond markets in East Asia. Section IV is devoted to a proposal for strengthening effectiveness and credibility of the CMI by reorganizing it into a multilateralized network of bilateral swaps. This network will not be an effective mechanism of financial support unless it is complemented by a monitoring and surveillance institution. A proposal for such an institution is found in section V. Concluding remarks are in a final section.

## **II. Structure and Development of the CMI**

### **II-1. Structure**

The CMI consists of two regional financial arrangements. One is the expanded ASEAN swap system and the other is the network of bilateral swaps and repurchase agreements among the eight members of ASEAN+3.<sup>1</sup> In 1977, the original five ASEAN

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<sup>1</sup> They are: Indonesia, Malaysia, the Philippines, Singapore, Thailand, China, Japan, and South Korea.

countries agreed to establish an ASEAN swap arrangement (ASA) – a short-term liquidity support facility for the participating countries suffering balance of payments difficulties. In May 2000, the ASA was expanded to include the other five members, and the total amount of the facility was raised to US\$ 1 billion from the initial amount of US\$ 200 million.

The currencies available under the ASA are the U.S. dollar, Yen, and Euro. The Euro, Yen, and Euro LIBOR interest rates are used as the base rates for swap transactions. Each member is allowed to draw from the facility a maximum of twice its committed amount for a period not exceeding six months subject to an extension for another period not exceeding six months.

The system of bilateral swap arrangements (BSA) among the eight members of ASEAN+3 is also a similar short-term facility for liquidity assistance in the form of swaps of U.S. dollars with the domestic currencies of the participating countries. The maximum amount that can be drawn under each of the BSAs is to be determined by the contracting parties. The BSA agreement allows an automatic disbursement up to 10 percent of the maximum amount of drawing. A country drawing more than the 10 percent from the facility is placed under an IMF program for macroeconomic and structural adjustments. In this sense, the BSA is complementary to the IMF lending facilities. The participating countries are able to draw from their respective BSAs for a period of 90 days. The first drawing may be renewed seven times. The interest rate applicable to the drawing is the LIBOR plus a premium of 150 basis points for the first drawing and the first renewal. Thereafter, the premium rises by an additional 50 basis points for every two renewals, but it is not to exceed 300 basis points. The BSAs include one-way and two-way swaps (see Table1). Since China and Japan are not expected to request for liquidity assistance to the ASEAN members, their contracts with the five Southeast countries are one-way BSAs from which only the ASEAN five can draw.

Bilateral repo agreements are used to provide short-term liquidity to a participating member through the sale and buyback of appropriate securities. The basic

features of the repo agreements are to be finalized through bilateral negotiations between the contracting parties. The securities used for a repo agreement are U.S. Treasury notes or bills with remaining maturities of no more than five years and government securities of the counterpart country.

The term of the repo agreement is one week but can be extended by agreement between the contracting parties. The minimum amount for each repo transaction requested is five percent of the total amount of the repo agreement. In each repo transaction, the buyer will be given a margin of 102 percent for U.S. Treasury notes or bills and 105 percent for government securities of the counterpart country

## **II-2. Status of Regional Financial Cooperation in East Asia**

The CMI has been a key initiative for Asian financial cooperation. Significant progress has been made in enlarging the CMI network. As of May 2004, the first round of CMI implementation has been completed by concluding the sixteen BSAs that amount to US\$36.5 billion in total. Japan has been playing a leading role in terms of both the number and amount: Japan concluded seven agreements with Korea, China, Indonesia, Malaysia, the Philippines, and Thailand, and Singapore. China also concluded five agreements with Korea, Indonesia, Malaysia, the Philippines and Thailand in addition to the China-Japan BSA. Similarly, Korea concluded five agreements with China, Indonesia, Malaysia, the Philippines and Thailand in addition to the Japan-Korea BSA (See Table 1).

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

(As of May 30, 2004)

<b>BSA</b>	<b>Currencies</b>	<b>Conclusion Dates</b>	<b>Size</b>
Japan-Korea	\$/Won (one way)	4 July 200	\$7 billion <sup>1)</sup>
Japan-Thailand <sup>2)</sup>	\$/Baht (one way)	30 July 2001	\$3 billion
Japan-Philippines	\$/Peso (one way)	27 August 2001	\$3 billion
Japan-Malaysia	\$/Ringgit (one way)	5 October 200	\$3.5 billion
Japan-PRC	Yen/Renmimbi (two way)	28 March 2002	\$3 billion
Japan-Indonesia	\$/Rupiah (one way)	17 February 2003	\$3 billion
Korea-PRC	Won/Renminbi (two way)	24 June 2002	\$2 billion
Korea-Thailand	\$/local (two way)	25 June 2002	\$1 billion
Korea-Malaysia	\$/local (two way)	26 July 2002	\$1 billion
Korea-Philippines	\$/local (two way)	9 August 2002	\$1 billion
PRC-Thailand	\$/Baht (one way)	6 December 200	\$2 billion
PRC-Malaysia	\$/Ringgit (one way)	9 October 2002	\$2 billion
PRC-Philippine	\$/Peso (one way)	29 August 2003	\$1 billion
Japan-Singapore	\$/Sing \$ (one way)	10 November 2003	\$1 billion
PRC-Indonesia	Rupiah/Renminbi(one way)	30 December 2003	\$1 billion
Korea-Indonesia	\$/local (two way)	3 December 2003	\$1 billion

BSA = Bilateral Swap Arrangement

- 1) The U.S. dollar amounts include the amounts committed under the new Miyazawa Initiative: \$5 billion for Korea and \$2.5 billion for Malaysia.
- 2) The first contract has expired. The two countries are now negotiating a two-way BSA

In East Asia, except for the CMI under the ASEAN+3 framework, other regional institutions or forums do not have any mutual liquidity support arrangement. In comparison with Europe, the CMI had a different motivation from the beginning. The European facilities were created with the purpose of limiting bilateral exchange rate fluctuations among regional currencies. The CMI started with high capital mobility and flexible exchange rates, although some members of ASEAN+3 have maintained a relatively fixed exchange rate regime. So far, the ASEAN+3 countries have not presumed any manifest exchange rate coordination. In the absence of exchange rate coordination, incentives for mutual surveillance will be limited because a member country facing a speculative currency attack may be free to float its exchange rate vis-à-

vis those of other neighboring countries (Wang and Woo 2004). Under the current ASEAN+3 policy dialogue framework, the purpose of the CMI and mutual surveillance system is to prevent the occurrence of financial crises and contagion in the region.

As long as the CMI is simply a source of financial resources supplementary to the IMF, the size of the swap borrowing does not have to be large enough to meet the potential liquidity need. Although the CMI can be managed without its own conditionality at this point, it does need to establish its own surveillance mechanism. Because up to 10 percent of each BSA swap can be disbursed only with the consent of swap-providing countries, the swap-providing countries need to formulate their own assessments about the swap-requesting country. The current practices under the ASEAN+3 process cannot effectively resolve the problems arising from the failure of repayment by swap requesting members.

A number of the participating countries have expressed reservations on the linkage of the BSA with the IMF conditionality and have proposed a gradual increase of the automatic 10 percent drawing and to abolish the IMF linkage after a period of transition. For instance, Malaysia advocates complete independence of the CMI from the IMF. Severance of the IMF linkage requires creation of a regional surveillance mechanism for the CMI. Many ASEAN+3 members have been reluctant to take that crucial step. At the fifth ASEAN finance ministers' meeting in April 2001 in Kuala Lumpur, the consensus was that the BSA should remain complementary and supplementary to the IMF facilities until a regional surveillance system is established. The ASEAN ministers also agreed that the terms and modalities of the BSA should take into account the different economic fundamentals, specific circumstances, and financing requirements of individual countries. This agreement implies that the contracting parties of the BSA could deviate from the basic CMI framework when setting the terms and conditions of the swap agreements.

Most participating countries agree in principle that the CMI needs to be supported by an independent monitoring and surveillance system, a system that monitors economic developments in the region, serves as an institutional framework for



policy dialogue and coordination among the members, and imposes structural and policy reform on the countries drawing from the BSAs. At the ADB annual meeting in Honolulu on May 2001, the ASEAN+3 finance ministers agreed to organize a study group to produce a blueprint for an effective mechanism of policy dialogues and economic reviews for the CMI operations. Japan and Malaysia were chosen to co-chair the group. The study group met in Kuala Lumpur in November of the same year to discuss the report on possible modalities of surveillance prepared by Bank Negara Malaysia and Japan's Ministry of Finance. However, the member countries were divided on the surveillance issues, agreeing only to institutionalize the ASEAN+3 meetings of deputies for informal policy reviews and dialogues.

In the long run, however, the participating countries are likely to wean themselves from their reliance on the IMF. If the CMI develops into more or less an independent financial arrangement from the IMF, then the regional financial arrangement should be designed to discipline the borrowers to adhere to sound macroeconomic and financial policies by imposing conditionality. However, the ASEAN+3 countries at the current stage do not seem well prepared for establishing a policy coordination mechanism in the surveillance process although collective efforts are made in this regard.<sup>2</sup> For instance, they are in the process of developing a system of monitoring short-term capital flows, known as the Capital Flow Monitoring System (CFMS). As part of the ASEAN+3 cooperative efforts, the Asian Development Bank (ADB) developed country-specific prototypes of the Early Warning System. The ADB has been installing an operational software for the system and providing technical assistance for its implementation to the participating countries. Japan has also established a fund, known as Japan-ASEAN Financial Technical Assistance Fund to

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<sup>2</sup> For instance, the ASEAN surveillance process is built on the basis of consensus and informality in keeping with the tradition of non-interference (Manzano 2001). East Asia in contrast to Europe lacks the tradition of integrationist thinking and the web of interlocking agreements that encourage monetary and financial cooperation (Eichengreen and Bayoumi 1999). Eichengreen and Bayoumi (1999) stress that East Asia does not meet the necessary intellectual preconditions for regional integration. For this reason, they conclude that it is unrealistic to speak of pooling national sovereignties. While there is no doubt considerable work to be done in promoting policy coordination in the region, it is wrong to say that it cannot be done in East Asia.

enhance the capacity of participating ASEAN countries in generating and compiling accurate and timely data on national income accounts, government finance and monetary statistics.

As the annual meeting of the ADB in April 2004 finance ministers of ASEAN+3, agreed to undertake a further review of the CMI to explore ways in which the CMI can be further expanded and consolidated. A working group, which is chaired by China, has been created to conduct the review and report the outcome by the end of 2004 to the meeting of deputy ministers of finance and deputy governors of central banks of ASEAN+3 (AFDM+3). A review of the report and recommendations by the deputies will then be reported to the ASEAN+3 Finance Ministers Meeting (AFMM+3) at the ADB annual meetings in May 2005.

The working group is expected to deliberate and produce a report on the five major issues related to a further development of the CMI. The amount of liquidity any country could draw from the CMI is small and at this stage of development, there is no guarantee that the BSAs will be activated as some of the swap providing countries may exercise their opting-out right. In order to remove this uncertainty, the CMI members have sought to institutionalize joint activation of the BSAs to ensure the timely availability of liquidity from the system.

The first issue is therefore whether and how the bilateral swap agreements can be multilateralized. Under the current arrangement of the CMI, any country wishing to obtain short-term liquidity must discuss the activation with swap providing countries individually. If a large number of the members refuse to provide swaps and different swap providers demand different terms and condition, then the CMI may cease to be an efficient liquidity support system. The discussion of the swap activation with a multiple of contractual parties may take time and hence may deprive the swap requesting country of the ability to mount an effective and prompt defense against a speculative attack. In order to avoid this bias inherent in the system, it has been proposed to create a secretariat or committee, which will determine joint activation of all swap contracts of the swap requesting countries, so that swap disbursements can be made in a concerted

and timely manner.

The second issue is to mobilize support within ASEAN+3 for an increase in the automatic drawing limit. As noted earlier, the swap requesting country can draw up to ten percent of the contract amount without subjecting itself to the IMF conditionality on policy adjustments. Some members of the CMI argue that the limit should be raised to 20 or 30 percent. However, the CMI members realize that multilateralization together with the increase in the drawing limit would not be possible unless a more effective surveillance system is established, a system that can impose policy conditionality on the swap drawing countries to ensure their repayment. As pointed out earlier, creating a surveillance mechanism for the CMI has been a controversial issue, and it is uncertain whether the working group could develop a system acceptable to all of the members.

A third issue is related to the structure and location of a CMI secretariat, assuming that the CMI members agree to its creation. If the CMI members were to agree on the multilateralization and creation of a regional surveillance unit, then their agreement would amount to establishing an institution similar to a regional monetary fund. The ASEAN+3 members may find it premature to set up such an institution, but they do need an institution that can manage and set terms and conditions of bilateral swap transactions and perform secretariat functions for the meetings of AFMM+3 and AFDM+3 and other formal and informal meetings for policy dialogues and coordination among the members. There have been several proposals for organizing an ASEAN+3 secretariat, but none has been seriously considered because the member countries have been divided on the structure and location of the secretariat.

A fourth issue involves the enlargement of the CMI. Several non-member Asian countries have expressed their interest in joining the CMI. At present, the consensus view is that until some of the operational issues of the CMI are settled the enlargement should be held over for the time being. Only the possible inclusion of some of the less developed ASEAN members in the CMI will be discussed at the working group.

Finally, in recent years foreign exchange policy issues have dominated policy debates and dialogues within ASEAN+3. With the growing need to stabilize bilateral

exchange rates among the ASEAN+3 states, proposals have been made to strengthen the CMI network so that it could serve as an institutional base for monetary integration in East Asia in the long run. Although a formal discussion of monetary integration has been put on hold, this issue may come up again at the next meeting of the AFMM+3 in 2005.

### **III. Asian Bond Market Development**

#### **III-1. The Asian Bond Market Initiative (ABMI)**

Since the 1997-98 East Asian crisis, many countries in the region have given priority of domestic financial reform to developing domestic capital markets in order to compliment the bank-based financial systems in the region (see Table2). Underdevelopment of domestic bond markets and the absence of efficient regional bond markets are also blamed for having exacerbated capital outflows in East Asia during the crisis, thereby multiplying the loss of output and employment. Since the crisis the absence of regional bond markets, it is often argued, has caused the massive increase in the region's overseas' portfolio investment (see Table 3).

While there is a clear need to develop domestic bond markets, except for Japan and China, other smaller East Asian countries may find that their small size does not allow supporting efficient domestic capital markets that are broad and deep in terms of the variety of financial instruments, issuers and investors. Even to larger economies, the costs of constructing financial and other institutional infrastructures could be so high that they may not be able to develop deep and liquid domestic bond markets. In the meantime banks remain the only source of financing, delaying further capital market development. To overcome these efficiency and cost problems of domestic capital markets, repeated calls have been made for East Asian countries to join forces to develop larger and more efficient regional capital markets.

**Table 2. Net Overseas Portfolio Investments of Asian Economies**

	Net Portfolio Investments of Private Sector (A)			Net Portfolio Investments of Public Sector*			Total (A+B)		
	1998	2002	2003	1998	2002	2003	1998	2002	2003
USD billions									
China	3.7	10.3	-11.4	6.2	75.2	117.0	9.9	85.5	105.6
Hong Kong	-22.1	38.8	30.5	-6.8	-2.4	1.0	-28.9	36.4	31.5
Indonesia	1.9	-1.2	-2.3	2.1	4.0	3.7	4.0	2.8	1.4
Korea	1.2	0.1	-10.7	31.0	11.8	25.8	32.2	11.9	15.1
Malaysia	n.a.	1.4	-1.1	10.0	3.7	10.3	10.0	5.1	9.2
Philippines	0.9	-1.9	0.7	1.9	-0.4	0.1	2.8	-2.3	0.8
Singapore	9.4	12.6	10.9	3.0	1.3	6.8	12.4	13.9	17.7
Thailand	-0.4	1.6	0.6	1.4	4.2	0.1	1.0	5.8	0.7
<b>TOTAL</b>	<b>-5.4</b>	<b>61.7</b>	<b>17.2</b>	<b>48.8</b>	<b>97.4</b>	<b>164.8</b>	<b>43.4</b>	<b>159.1</b>	<b>182</b>
<b>Memo item</b>									
Japan	39.2	106.0	98.7	-6.2	46.1	189.4	33.0	152.1	288.1
Taiwan	2.4	9.1	5.9	4.8	33.7	37.1	7.2	42.8	43.0

Source: IFS

\*Reflected by increase in reserves

**Table 3. Financing Structure of Asian Economies and Selected Countries in 1995 and 2003**

Country/ Economy	1995			2003		
	Bank Loans	Stock Mar ket	Bond Mar ket	Bank Loans	Stock Mar ket	Bond Market
	As % of total financing					
Hong Kong	39.6	55.6	4.8	23.3	69.7	7.0
Indonesia	60.2	38.0	1.7	42.9	51.3	5.8
Korea	44.6	29.4	26.1	45.7	23.9	30.4
Malaysia	22.4	65.3	12.4	29.7	47.9	22.4
Philippines	30.1	64.9	4.9	47.9	47.3	4.7
Singapore	31.5	60.0	8.4	32.5	47.5	20.0
Taiwan	62.9	31.2	5.9	42.5	43.1	14.4
Thailand	50.8	43.9	5.3	38.3	40.2	21.5
<b>Total</b>	<b>45.0</b>	<b>44.5</b>	<b>10.6</b>	<b>36.8</b>	<b>44.6</b>	<b>18.5</b>
United States	21.1	30.4	48.5	19.5	33.2	47.2
United Kingdom	42.5	44.5	13.1	44.7	38.8	16.5
Japan	43.4	27.8	28.8	33.7	21.9	44.4
<b>Total</b>	<b>30.2</b>	<b>30.7</b>	<b>39.1</b>	<b>25.1</b>	<b>31.4</b>	<b>43.5</b>

Sources: International Financial Statistics, International Federation of Stock Exchanges, Japan Securities Dealers Association, IFC Bond Database, Thai Bond Dealing Center, Thomson Financial, CEIC, and various central banks.

Notes:

1. Total financing is defined as total outstanding amount of bank loans, stocks and bonds.
2. Bank loans are domestic credit extended to the private sector. All bank loan data, except Taiwan, are reported in line 32d in the International Financial Statistics.
3. For 2003, all outstanding bond data are as of end-2003, except for Japan and Singapore (end-2002), Indonesia (end-2000) and the Philippines (end-1999). For 1995, all outstanding bond data are as of end-1995, except for the United Kingdom (end-March 1995). Figures are local-currency denominated debt.
4. Bond figures for Hong Kong, Korea, Malaysia, Taiwan, the United States, the United Kingdom and Japan are from central banks. Figures for Indonesia and the Philippines are from IFC Emerging Markets Information Center Bond Database. Figures for Thailand are from Thai Bond Dealing Center. Figures for Singapore are estimates based on data from MAS and Thomson Financial.
5. Percentage shares may not add up to 100% due to rounding.

At the informal AFDM+3 meeting in Tokyo in November 2002, Korea proposed discussion of the feasibility of creating new and improving existing Asian bond markets under the ASEAN+3 framework. This proposal received broad support among the thirteen members, and a month later, Japan introduced a comprehensive plan for the development of regional bond markets in Asia, the Asian Bond Initiative (ABI). The member countries agreed at the AFDM+3 meeting to organize six working groups on a voluntary basis to conduct detailed studies on various aspects of bond market development.

These six working groups are as follows:

Working Group	Chair
1. Creating new securitized debt instruments	Thailand
2. Credit guarantee mechanisms	Korea
3. Foreign exchange transaction and settlement issues	Malaysia
4. Issuance of bonds denominated in local currency by multilateral development banks (MDBs), government agencies and Asian multinational corporations	China
5. Local and regional rating agencies	Singapore and Japan
6. Technical Assistance Coordination	Indonesia (co-chairs: The Philippines and Malaysia)

The six working groups met in Tokyo on June 16, 2003 to discuss the respective roles of the private and public sectors in fostering the Asian bond markets. They concluded that the public sector's role was to improve and build the infrastructure, whereas the private sector would work to enlarging the borrower and investor base of the markets. The six working groups are engaged in analyzing (i) the prospects for facilitating market access though a wide variety of issues and (ii) creating an environment conducive to developing the markets. The issues concerning the market access to be examined include:

1. Bond issuance by Asian governments to establish benchmarks
2. Bond issuance by Asian governments' financial institutions (government) to finance domestic private enterprises
3. Creation of asset-backed securities markets, including collateralized debt obligation (CDOs)
4. Bond issuance by multilateral financial institutions and government agencies
5. Bond issuance for funding foreign direct investment in Asian countries
6. Issuance of bonds in a wider range of currencies and introduction of currency-basket bonds

On the creation of an environment conducive to active participation by both issuers and investors, the working groups have been assigned with the examination of the following issues:

1. Provision of credit guarantees
2. Improvement of the credit rating system
3. Establishment of a mechanism for disseminating information
4. Improvement of the settlement system
5. Development of the legal and institutional infrastructure for bond market development

While the ASEAN+3 has been primarily engaged in constructing a regional infrastructure for Asian bond markets and harmonizing various financial standards, regulatory systems, and tax treatments throughout the region, two other regional



institutions have taken initiative in generating the demand for Asian bonds by establishing Asian bond funds.

Thailand has been seeking the support of other Asian countries the development of Asian bond markets through the expansion of the activities of the Asian Cooperation Dialogue (ACD), a regional forum, which was established by Thailand's initiative for mutual cooperation in economic and social development in Asia. It has a membership of 22 Asian countries<sup>3</sup>. The idea of creating a regional forum for Asia-wide cooperation was first raised in September 2000 by Prime Minister Thaksin of Thailand, and the first ACD ministerial meeting was held on 18-19 June 2002 in Cha-Am, Thailand. It was initially created as an informal and non-institutionalized forum for Asian foreign ministers to exchange views on issues of their mutual interests.

Unlike the ASEAN+3, the objectives of the ACD are rather broadly defined to include cooperation in fields of trade, finance, science and technology, IT development, energy, and environment. Ultimately it envisions formation of an Asian Community. A number of member countries have volunteered to be prime movers in promoting cooperation in 18 areas in which they have expertise and interests.

At the second ministerial meeting on 21-22 June 2003 in Chiang Mai, Prime minister Thaksin proposed, as the future direction of the ACD, the development of an Asian credit rating agency, Asian currency denominated bonds, and an Asian fund management institution. Following up on this initiative, Thailand has established a working group on the development of Asian bond market in June 2003. The second working group meeting, which is scheduled to be held on 29-30 April 2004 in Thailand is expected to take up issues related to creating markets for bonds denominated in Asian currencies.

### **III-2. Structure of Asian Bond Fund I and II**

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<sup>3</sup> They are ASEAN+3 and Bahrain, Bangladesh, India, Kazakhstan, Kuwait, Oman, Pakistan, Qatar, and Sri Lanka

The eleven central banks of East Asia and Pacific belong to EMEAP (Executive Meetings of East Asia and Pacific Central Banks) have launched Asian Bond Fund (ABF) I and II.<sup>4</sup> ABF I invests only in dollar denominated Asian sovereign banks where as ABF II designed to purchase local currency denominated Asian bonds.

The establishment of ABF1 was announced in June 2003. All eleven EMEAP central banks invested in ABF1 at its launch, which had a capitalization of about USD 1 billion. The fund is now fully invested in US dollar-denominated bonds issued by sovereign and quasi-sovereign issuers in eight EMEAP economies (China, Hong Kong, Indonesia, Korea, the Philippines, Malaysia, Singapore and Thailand). ABF1 has had the promotional effect: it has generated second-round investor and issuer interest in the Asian bond markets, broadening the investor base and increasing market liquidity over time. The ABF1 initiative is a milestone in regional central bank co-operation. The successful launching of ABF1 has also sent a strong message to the financial markets that the regional authorities are committed to stepping up their cooperative efforts in promoting bond market development.

Building on the momentum of developing ABF1, EMEAP has proceeded to study the feasibility and design of ABF2. Owing to the complexity of the project and the likelihood of opening up the funds for private sector investment in the future, the EMEAP Group has appointed financial advisers from the private sector to advise on the design and structure as well as the construction of benchmark indices for ABF2.

In April 2004, the EMEAP Group issued a press release setting out the basic design and latest thinking behind ABF2. It was proposed that ABF2 would consist of two components: a Pan-Asian Bond Index Fund (PAIF) and a Fund of Bond Funds (FoBF) (Figure 1). While many issues regarding ABF2, such as fund size and detailed fund structure, have yet to be determined by EMEAP after having taken into account such factors as market conditions, the latest thinking on ABF2 is described below.

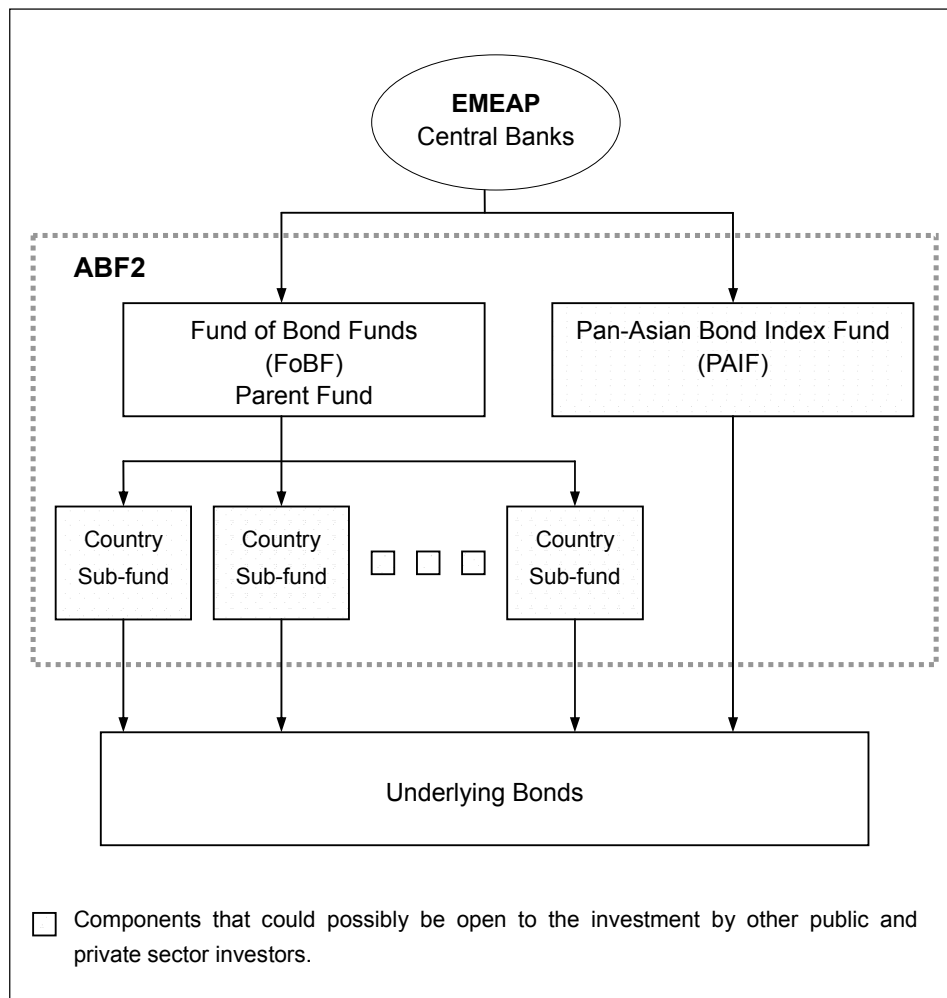
The PAIF is a single bond index fund investing in local-currency denominated bonds in EMEAP economies. It will act as a convenient and cost effective investment

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<sup>4</sup> They are Korea, China, Japan, Hong Kong, Singapore, Thailand, Malaysia, the Philippines, Indonesia, Australia, and New Zealand.

fund and new asset class for regional and international investors who wish to have a well-diversified exposure to bond markets in Asia.

**Figure 1. ABF 2 Framework**



The FoBF is a two-tier structure with a parent fund investing in a number of country sub-funds comprising local currency denominated bonds issued in the respective EMEAP economies. While the parent fund is confined to EMEAP investment, the country sub-funds are intended to provide local investors with low-cost and index-

driven investment vehicles and at the same time give regional and international investors the flexibility to invest in the Asian bond markets of their choice.

The ABF2 funds are intended to be passively managed against a set of transparent and pre-determined benchmark indices, covering local-currency bonds issued by sovereign and quasi-sovereign issuers in EMEAP economies. ABF2 is being designed in such a way that it will facilitate investment by other public and private sector investors. In addition to attracting additional money into the bond market as in the case of ABF1, ABF2 seeks to achieve a larger and longer-lasting positive impact on regional bond market development. Several features of the design of ABF2 are conducive thereto.

. In view of its small size, market participants believe that ABF I may have had little effect on the market for East Asian sovereign dollar bonds. If anything, the Fund's investment may have crowded out private investors. Creation of Asian Bond Fund II has been more controversial as the fund is expected to invest in local currency Asian bonds. The details of Fund II are yet to be worked out, but it is unlikely that an additional demand for high quality Asian bonds denominated in Asian currencies can increase the supply of these bonds. At present, there exists a strong private demand for high-grade Asian bonds denominated in either local or major international currencies. Managers of ABF II will certainly not touch Asian local currency bonds that private and institutional investors would not invest in. ABF II may then end up competing for a limited supply of high quality Asian bonds; in particular when the spreads on them are as tight as they are now.

There are also two other concerns raised on the viability of ABF II. Since ABF II is likely to invest in East Asian sovereign bonds denominated in local currencies, it may serve as a mechanism of financing fiscal deficits of some member countries by other members belonging to EMEAP. In such a case, the investment policy of ABF II cannot solely be dictated by profit motives alone, even though a private institution manages the Fund. If ABF II is of considerable size, then it is also possible to imagine that its investment operations could affect the foreign exchange and interest rate policies

of the EMEAP member countries whose bonds are purchased or sold by the Fund. Even if the amount of a sale or purchase is relatively small, the Fund's operations may send the wrong signals to the financial markets against the wishes of the EMEAP central banks. This signaling problem is likely to remain even if a private institution manages the Fund insofar as EMEAP central banks have a controlling stake in it. This signaling problem is the second concern. However, the EMEAP member central banks could contribute more to the development of Asian bond markets, if they were to use the ABF II leverage to strengthen the regional financial infrastructure to remove institutional constraints on the supply of high-grade Asian corporate and sovereign bonds.

### **III-3. Prospects of the ABMI**

At this stage of development, there is no guarantee that regional efforts, even if they can be organized, could succeed in fostering regional capital markets that are competitive vis-à-vis the global capital markets in North America and Europe. Furthermore, globalization of financial markets and advances in financial technology that allow financial firms in international financial centers to reach investors and borrowers in remote corners of the world raise questions as to the need and rationale for creating regional capital markets. It is also true, however, that given the dynamism of the East Asian economy and its enormous pool of savings, East Asia could accommodate large and efficient regional capital markets that are as competitive as global capital markets. If these markets are efficient and robust, they may improve the allocation of resources and also help safeguard the region against financial crises.

The architects of ABF I and II rightly argue that the two funds will serve as a catalyst for domestic financial reform in East Asia as they provide incentives as well as the rationale to East Asian policymakers to restructure their domestic bond markets and also to cooperate to develop regional bond markets as well. That is, ABF Fund I and II could encourage East Asian countries to increase the supply of bonds the Funds could

invest in

However, unless these cooperative efforts are carried out in conjunction with domestic financial reform in individual member countries, which will open their capital markets, efficient regional bond markets would not come into existence in Asia. Capital market development in East Asia has been hampered by many institutional weakness and regulatory controls. Among other things, the lack of professional expertise in securities business, inadequacy of the financial and legal infrastructures including regulatory systems, low standards of accounting and auditing one, opacity of corporate governance have been the major culprits. Unfortunately, however, the six working groups of ASEAN+3 are not expected to address the urgency of the domestic reform, as they cannot intervene in domestic affairs of individual members. ASEAN+3's inability to organize a collective program for domestic financial reform will in the end frustrate the efforts of ASEAN+3 at creating robust Asian bond markets. This is because without domestic financial market deregulation and capital account liberalization, Asian borrowers and investors will not be able to take advantage of regional bond markets as they will be restricted in cross border lending and investment.

#### **IV. Beyond the CMI: Developing a Regional Monetary Arrangement in East Asia**

Almost four years have passed since the inception of the CMI in May 2000. Much progress has been made in realizing the original plan of the CMI by increasing the number of bilateral swaps and establishing regular meetings of monetary and financial officials of the thirteen countries to exchange information and review policies among themselves. Nevertheless, the current structure of and liquidity support available through the CMI have not been viewed as an effective region-wide system of defense against future crises. Indeed, the CMI has a long way to go before developing into a credible and effective defense mechanism in the eyes of participants in international financial markets. To make the system more reliable as a preventive mechanism it is desirable to increase the contract amount of each BSA to a level that is realistic to ward

off future speculative attacks. The system of the BSA would be also more effective, if they can be activated simultaneously and automatically if a member country comes under attack.

The expansion of the available liquidity and collective activation would require a more formal organizational structure that includes an independent monitoring and surveillance mechanism. This section presents a blueprint for developing such a structure. As the title of this section indicates, the proposal made by this study goes beyond the agreed basic framework of the CMI. In order to propose an operational framework for consolidating the existing and proposed bilateral swap arrangements, this study will specifically focus on the issues of how the network of bilateral swap arrangements (NBSA) will be more efficiently and effectively managed to achieve the goal of the CMI. Attention will be paid to rationale and need for a decision-making body and extended regional surveillance for better management of the NBSA.

In formulating the NBSA, this study proposes an evolutionary process of financial integration in which requisite institutions are built over time financial at different stages of development. During the first stage, this study recommends that the ASEAN+3 increase the amount of each swap to a level that could make the system a credible defense mechanism. The effectiveness of the system would be bolstered, if these swaps can be activated simultaneously in case a member country runs into financial difficulties. Along with these structural changes, an independent system of monitoring and surveillance should be established as an integral part of the NBSA to support its efficient operations. At the second stage of the evolutionary process, a regional borrowing arrangement or a regional scheme of reserve pooling could be established as a forerunner of a regional monetary fund. Once the institutionalization and successful management of the borrowing arrangement is completed, then the last stage of the proposed institutionalization of regional financial integration would be devoted to the creation of a regional monetary fund in East Asia.

#### **IV-1. An Overall Framework for the Network of Bilateral Swap Arrangements**

As noted earlier, the CMI has two components: the ASEAN arrangement (ASA) and BSAs involving the ASEAN+3. This section discusses enlargement and consolidation of these two components.

- *ASEAN Swap Arrangement (ASA)*

The first task of the CMI expansion is to expand the existing ASEAN Swap Arrangement (hereafter ASA). The five original ASEAN countries, in pursuit of their common objective to promote financial cooperation, established the ASA in August 1977 for a period of one year. Since then, the ASA has been renewed several times in accordance with Article X laid down in the Memorandum of Understanding (MOU) of the ASA. The latest renewal, for an additional five years, was made in Kuala Lumpur on January 27, 1999. However, the ASA has been a very primitive financial arrangement, mainly due to the loose financial cooperation among ASEAN states. Furthermore, given that no meaningful regional lender of last resort exists, the total outstanding amount of U.S. dollars provided by each participant was limited to US\$40 million before the crisis. This amount was far from enough to fend off the volatile capital reversal that occurred during the Asian financial turmoil.

The level of utilization was very low before the crisis: from year 1979 to 1992 only four ASEAN countries activated this facility, i.e., Indonesia in 1979, Malaysia in 1980, Thailand in 1980, and the Philippines in 1981 and 1992. During the Asian financial crisis of 1997-98, the ASA was too small in terms of liquidity support to be utilized. Instead, seriously battered economies with the exception of Malaysia had no choice but to seek financial assistance from the IMF.

The ASA has been enlarged to US\$1 billion, effective as of November 17, 2000, and has as its participants all the ASEAN member countries. However, the total outstanding amount currently available still falls short of the needed amount in view of the liquidity support needed to manage the 1997-98 crisis. A major drawback of the existing ASA stems from the “equal partnership” condition, which stipulates that the other member countries in equal shares shall provide the amount of swap to be granted



to a swap-requesting member country. In addition, a participant may refrain from providing committed lending by merely informing its decision to the other member countries, and may, at its discretion, provide reasons for its decision. As a consequence, other participants, on a voluntary basis, are allowed to increase their shares. In the case where the total amount of swap committed collectively by the participants does not sufficiently meet the requested amount, the amount of swap granted shall be reduced accordingly. Looking into the future, the ASA would not help much to minimize the disruption of financial markets as long as a massive scale of liquidity provisions are required to finance the external imbalance caused by the liquidity run.

As long as the ASA cannot provide a meaningful amount of credit to an ASEAN member in financial distress, the ASEAN would benefit a great deal by linking the ASA to global liquidity facilities provided by the IMF or other regional liquidity facilities. For a possible linkage or merger, equitable financial obligations regardless of members' economic strength and voluntary participation where members are allowed to opt out from the contribution commitment at their own discretion may have to be revised in order to enhance its credibility. At present, the future expansion of the ASA will depend on a number of developments taking place in East Asia which include the discussion of converting ASEAN into a monetary union, negotiation of free trade agreements with PRC, Japan, and other countries, and the enlargement of the CMI. To the extent that the ultimate objective of the CMI is to promote economic integration, both in trade and finance, the ASA should be consolidated into the CMI at a certain stage of its development.

- *Creating a Network of Bilateral Swap Arrangements (NBSA): Restructuring of the CMI*

The Bilateral Swap Arrangements under the CMI provided a constructive starting point for developing common principles and standardized modality for bilateral swaps between pairs of ASEAN+3 countries. Building on the main principles of the BSA under the CMI this study considers a structured NBSA beyond the CMI. By the

“structured network,” this study implies there exists much room for improving effectiveness of the CMI by encompassing structured elements into the current version of the CMI, if agreed by the ASEAN+3 countries. The objective of the structured network called NBSA is to consolidate individual bilateral swap contracts into a formal multilateral network of swaps in which each participating country chooses feasible methods among the following options and negotiate specific conditions of the swap arrangements bilaterally with other participating countries.

More specifically, the NBSA need to be designed to develop a mechanism for joint activation (under a multilateral framework) and quick disbursement of swaps. It should establish a coordinated decision making process for collective activation and disbursement and create a monitoring and surveillance unit to support the swap operations and to serve as the NBSA secretariat. As noted in section II, the current network of the CMI is not sufficiently structured.

#### **IV-2. The Structure of the Network**

There are three different groups of participants or contracting parties in the current system of BSAs in the CMI: one between three Northeast Asian countries; another between the ASEAN members; and a third between three Northeast Asian countries on the one contracting party and the ASEAN members on the other.

The network consists of one-way and two-way swap arrangements. In one-way swaps, one contracting party is a swap-providing country and the other is a swap-requesting country. Japan, for example, is a swap-providing country. In two-way swaps, contracting parties have both a swap-providing and swap-requesting status. Each swap arrangement is divided into two tranches. The first is standing tranche, from which swap-requesting countries can draw automatically and without an agreement with the IMF as the first line of defense. It is comparable to the reserve tranche a la the IMF. The second is a conditional tranche, which requires approval by the decision-making body of the NBSA and serves as the second line of defense: it is comparable to the upper credit tranche a la the IMF.

This structure of the NBSA has several merits in both conceptual and operational sense. First, a total of 78 BSAs could be formed among the ASEAN+3 member countries if each member country would seek the BSAs with the 12 other members. If bilateral swaps among the ASEAN members do not materialize, the CMI would provide for 33 BSAs to be negotiated: 30 agreements between three Northeast Asian countries and the 10 ASEAN members in addition to three agreements between the three Northeast Asian countries.

The NBSA structure incorporates a number of features designed to make a multilateral arrangement. First, contracting parties involved would voluntarily determine the placement of the amount in each swap arrangement. If the ASEAN members on the one contracting party and the three Northeast Asian countries on the other party are conceptually treated as a single contracting party, however, the total amount which each country is actually committed to swap would be more easily calculable. Subsequently, the overall size of the credit available under the NBSA could be estimated. Based on the total credit outstanding available, the credit allocation among the participants would be determined by considering various economic conditions such as gross domestic product (GDP), foreign reserves, and so on. For example, one of the ASEAN member countries should decide how much she would commit herself to the BSA with three Northeast Asian countries and with other ASEAN members as well. The amounts provided by each country – either an ASEAN country or a Northeast Asian country – could vary.

Second, this structure of the NBSA considers the actual financing capacity of each participating country. The BSA is, by definition, reciprocal in that contracting parties basically have both swap-providing and swap-requesting status. In practice, however, the swap positions would not be symmetric. This conceptual demarcation would be useful in estimating the actual positions of lending and borrowing, not nominal ones. If these positions are clearly defined, the overall and individual size of the credit available under the NBSA could be determined in a transparent way.

Third, in addition to the classification of a one-way vis-à-vis two-way swap

arrangements, the classification of standing vis-à-vis conditional tranches in each swap arrangement can be introduced to maintain a balance between automaticity and conditionality. Quick disbursement from a standing tranche is comparable to the automatic drawing from the reserve tranche, as is the case with the IMF, which does not require approval by the IMF Executive Board. The amount drawn from the standing tranche is equivalent to each participant's contribution made in advance to the operating agency.

In designing the NBSA, it is important to examine the efficacy of the conceptual categorization of different types of the BSAs. Each BSA could be formed on the voluntary and uprightly bilateral basis; a simpler structure of the BSA would be more efficient and effective. However, the history of financial cooperation elsewhere suggests that the NBSA under the CMI will be but a first step toward integrated and structured financial cooperation in East Asia. Further deliberation on other cooperative initiatives would be expected to emerge sooner or later. At the same time, the European experience of monetary cooperation would be a point of reference for policy-makers and economic leaders in East Asia. For these reasons, a more concerted and structured framework would pave a way for member countries to be interlocked in various multilateral arrangements.

Given these structures of the NBSA, a decision-making body and a monitoring and surveillance unit shall constitute an integral part of the network. These institutional settings would not be costly and bureaucratic, unlike the proposal for the Asian Monetary Fund (AMF). The institutional requirements would be minimal.

The NBSA can be jointly activated with the ASA if an ASEAN member requests such action. In other words, the NBSA shall supplement the ASA. At the same time, the NBSA could be supplementary to the IMF facilities if the requesting member seeks IMF assistance. In this sense, the NBSA initiative would be a complement and supplement to the IMF by strengthening the financial capacity of the international and regional community.

### **IV-3. Phase-in Drawings: Two Tranche Swaps**

Under the current CMI framework, an initial drawing (standing tranche) of up to 10 per cent can be disbursed without an agreement with the IMF. However, the remaining 90 per cent of subsequent drawings (conditional tranche), including the renewal of the initial drawing, are subject to the IMF program. At this stage, it is unclear whether the linkage to the IMF will be untied at some later time. Even if the regional CMI facility is independent from IMF conditionality, there should be a clear structure of phase-in drawings.

The structure of the standing arrangements upon which the initial drawing shall be activated is as follows. This structure is similar to that of the CMI. It is, however, argued here that the automatic drawing should be increased up to 30 per cent of the committed amount within the next five years during which an independent surveillance unit for the NBSA is expected to be established.

For one-way swap, swap-providing countries shall deposit 10 per cent of their total NBSA commitments in U.S. dollars at an NBSA operating agency. Other parties contracting for one-way swaps shall deposit 10 per cent of the committed amount in their own currencies as collateral at the operating agency. The operating agency will pay interest (less operation fees) on deposits made by swap providing countries, where local currencies deposited as collateral will not receive any interest.<sup>5</sup>

For two-way swap, each participating country shall deposit 5 per cent of its total NBSA commitment at the operating agency in U.S. dollars since the country has both a swap-providing and swap-requesting status. On the other hand, each participating country shall deposit 10 per cent of the committed amount in its own currency at the operating agency. The agency will pay interest (less operation fees) to the countries depositing U.S. dollars; there would be no interest for local currencies deposited as

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<sup>5</sup> By the definition of swap arrangements, currencies involved would be mutually exchanged. However, local currencies exchanged in return for U.S. dollars are inconvertible in most cases and would only play a limited role as good collateral in the event of default, although the operating agency adjusts the deposit value of local currencies periodically.

collateral.

The inclusion of both U.S. dollars and local currency deposits in the operational fund would have two main consequences. First, at an early stage of its development, pre-arranged swaps fixed as a portion of the total NBSA commitment would lay a strong foundation for enhancing credibility and effectiveness of the NBSA. This structure would also help to ensure that the initial tranche is jointly activated and quickly disbursed. Although this study proposes 10 per cent of the total NBSA commitment as a predetermined ceiling for the standing arrangements, the proportion of standing vis-à-vis conditional arrangements in the total NBSA commitment could be further increased to 20 per cent within two years of inception and to 30 per cent eventually.

Certainly, the creation of an operating agency would impose additional costs. One way to save these costs would be to use an existing institution as the operating agency – such as the ADB. To minimize the operational costs of managing the fund, a swap-providing country could entrust the organization with highly liquid and convertible financial assets in return for U.S. dollars. Any interest earnings from those financial assets in the custody of depository institutions would accrue to the swap-providing country. However, the agreement would have to include a provision that this agency had an authorization to dispose those financial assets when the need for activation was needed. In due course, management of the fund would be transferred to the NBSA as it completes its organizational structure.

Subsequent drawings, including the renewal of the initial drawing, which exceed the predetermined ceiling, would need to be approved by the decision-making body, composed of swap-providing countries. This is assuming that the participating countries succeed in creating an efficient and credible monitoring and surveillance mechanism. Conditional swaps subject to the approval would not require any precedent currency deposit at the operating agency. However, an appropriate design of policy conditionality should be attached to the second tranche in cooperation with the IMF. The conditional tranche could be jointly activated with the IMF facilities if the requesting member

sought IMF assistance. Through constant monitoring and surveillance of the participating members, the NBSA would be managed more effectively and efficiently.

For one-way swap arrangements, the swap-providing country would be entitled to exercise its veto power if the swap-requesting country refused policy conditionality attached to the drawing from the second tranche. The swap-requesting country could additionally provide U.S. Treasury Bills as collateral instead of accepting the policy conditionality.

#### **IV-4. Drawing Amount and Allocation of Swaps**

Before the specific size of the ASA and actual placement of each BSA are to be determined, the overall size of the swap borrowing available under the NBSA should be sufficient to meet potential needs. In particular, two-way swap arrangements alone would limit the overall amount of financing available. A large amount of one-way swap arrangements would be critical to the effectiveness of the NBSA. In this regard, one-way swap-providing countries would serve as regional quasi lenders of last resort (LOLR). In the last episodes of Asian financial crisis, for example, Japan, with other industrial countries, was committed to provide a second line of defense to crisis-affected countries: US\$ 4 billion to Thailand, US\$ 5 billion to Indonesia, and US\$10 billion to South Korea.

For non-IMF Article VIII countries such as Cambodia, Lao PDR, Myanmar, and Vietnam, the BSA could be replaced by the ODA. These countries more seriously need long-term development assistance rather than any short-term measures to manage the liquidity crisis. When they become more deeply integrated into international capital markets, the source of financing will be more diversified, and thus the role of private capital will be more important. They could then seek such preventive measures as the ASA and the BSA to ward off volatile capital movement.

For a given total available credit, the actual placement of the NBSA among the participants would depend on the economic characteristics of the borrowing countries. An elaborate formula would be needed to calculate swap commitments of participating

countries. It could include various country data profiles such as external financing requirement (external debt profile), GDP and foreign exchange reserves. Given that such data profiles change, such a scheme would largely serve as a benchmark.

During the 1997-98 crisis, international financial institutions including the IMF, World Bank, and ADB along with Japan, and other countries were to provide a total of US\$118.3 billion to Indonesia, Korea, and Thailand to restore financial stability in these economies. This committed financial assistance amounted to about 14 percent of their combined GDP.<sup>6</sup> Now that many preventive measures have been put in place, it is highly unlikely that these countries will ever suffer such a magnitude in terms of loss of output due to a crisis. Therefore, the crisis experience could serve as a guide for estimating the total size of liquidity support available under the NBSA. Assuming that neither China nor Japan will borrow from the NBSA, this study proposes that the ASEAN+3 decide to increase the total availability of liquidity up to 5-7 percent of the combined GDP of the remaining eleven countries within a predetermined period of time, say within five years.

#### **IV-5. Terms and Conditions for the NBSA**

- *Currencies*

As the recent Asian financial crisis has shown, liquidity assistance provided by the International Financial Institutions (IFIs) was made in U.S. dollars. Unlike liquidity facilities under the European Monetary System (EMS), regional currencies, including the Japanese Yen, are at present not widely circulated in East Asia. Internationalization of the Japanese Yen or other regional currencies is an important issue that needs to be further explored when promoting monetary cooperation in East Asia. The Japan-China BSA is a symbolic step towards this, because it is a yen for renminbi swap.

Given these practical constraints, it would be more realistic that the BSA has a

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<sup>6</sup> The actual assistance those three countries have received from various sources amounted to US\$58.4 billion, which is equivalent to 7 percent of their combined dollar GDP.



form of swap transactions between U.S. dollars and local currency. A swap-providing country shall provide U.S. dollars in exchange for local currency. However, in principle, a swap-providing country can offer any equivalent amount denominated in the currency the swap-requesting country requests. The swap-requesting country in need for foreign exchange liquidity purchases U.S. dollars from the counter-party country with a contract of future selling, in exchange for selling its local currency with a contract of future repurchase at a specified price.

- *Interest Rates*

When a repurchase in any swap transaction is to be made, the swap-requesting country shall repay to the counter-party the original amount and interest. For the standing tranche, the interest rate should be lower than the IMF Supplemental Reserve Facility (SRF) rate. LIBOR (currently the one-year U.S. dollar rate is around 6.9 percent) plus 100 basis points will be charged on the swap borrower.

For the conditional tranche, the interest rate should be in line with the IMF lending rates. If an economic program for financial assistance agreed between the IMF and the swap-requesting country is already in existence, or the swap-requesting country intends to request IMF assistance, any applicable IMF lending rate will be charged. On the other hand, if a swap-requesting country does not seek IMF assistance, the interest rate shall be LIBOR plus 150-200 basis points.<sup>7</sup>

It is worth considering the case where a country seeks assistance from the NBSA but not from the IMF even though the NBSA interest rate is higher than the IMF lending rate. This could occur if the country wanted to avoid IMF conditionality. However, the NBSA would impose its own conditionality on countries that drew from the conditional tranche. To prevent a country that in reality should go to the IMF from relying on the NBSA, the decision-making body should not ease the conditionality required. However,

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<sup>7</sup> LIBOR plus 150-200 basis points would be most likely higher than the IMF lending rates. In this sense, the interest rate will not be concessional. Nevertheless, some participating countries might enjoy a lower spread than those of their sovereign bonds in the international market during the normal period. To prevent moral hazard on the part of borrowers and habitual use of the NBSA, a higher spread will be charged on renewal of drawing.

this would not mean that a country seeking lending from the NBSA would necessarily also seek IMF assistance. If a country experiences a pure liquidity crisis, then, in preference to using its standby arrangement with the IMF, it could draw short-term liquidity support from the NBSA, which should be sufficient to prevent a liquidity crisis from developing into a full-blown crisis.

- *Maturity*

Each new or renewed drawing by the swap-requesting country under the NBSA shall mature ninety (90) days after the day when such drawing or renewal of drawing takes place. If the swap drawing country wants to renew its initial drawing from the standing tranche, 90 days can be further extended if approved by the decision-making body. However, renewal of the initial drawing will be treated as a drawing from the conditional tranche. If the swap drawing country does not seek IMF assistance, but requests renewal of the initial drawing, the interest rate shall be LIBOR plus 150 basis points for the first renewal, 175 basis points for the second renewal, and 200 basis points for the third renewal. No further extension shall be allowed.

For the conditional tranche, the maturity should be in line with the maturity of similar IMF facilities. If the swap drawing country does not seek IMF assistance, but requests drawing from the conditional tranche, each drawing or renewal of drawing by the swap-requesting country shall mature in 90 days. The interest rate shall be LIBOR plus 150 basis points for the first drawing from the conditional tranche, 175 basis points for the first renewal, and 200 basis points for the second renewal. No further renewal shall be allowed

- *Collateral*

Swap-requesting countries provide collateral in its own currencies. Maintaining the value of good collateral is critical in this regional lender of last resort.<sup>8</sup>

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<sup>8</sup> The principles governing its lending activities should be reconciled with the classic Bagehot rules of (1)

For the standing and conditional tranche, the operating agency would adjust the deposit value of local currencies periodically – say annually or quarterly.

- *Opt-out Clause*

Since a crisis can be contagious to neighboring countries, some of the member countries may decide to opt-out from the NBSA. The decision to opt-out is permissible under the jurisdiction of the decision-making body. The NBSA would need to have a balance between flexibility and commitment. If the decision to opt-out is completely discretionary, a serious coordination problem may arise, weakening the credibility and effectiveness of the NBSA. If the opt-out clause was to be included, conditions for non-participation should be specified. A regular monitoring and surveillance process should be installed to promptly provide relevant information for assessing the economic conditions of the country exercising the opt-out clause.

The economic conditions of the country exercising the opt-out clause could be based on quantitative measures such as the degree of nominal exchange rate depreciation, the depletion of foreign reserves, and the instability of domestic financial markets. However, the NBSA should base its decision on qualitative assessment that would reflect the true state of the member countries' vulnerability to the crisis.

- *Functions of the Decision-Making Body*

A ministerial level decision-making body is required to ensure and coordinate joint activation. Simultaneous activation will be a key ingredient for the effective containment of a crisis. Under the current CMI framework, a group of swap-providing countries agree that one of them serve as the coordinating country for joint activation of the swaps. But if some countries were hesitant to provide swaps or postpone the immediate activation of swaps, the NBSA would not be a credible instrument. Thus, some enforcement mechanism to commit participating countries to this bilateral

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lending freely to a solvent borrower; (2) against good collateral; and (3) at a penalty rate.

contractual arrangement is required, because there is no central organizing body to disburse the tranche.<sup>9</sup> However, the BSA is in essence a product of bilateral agreement, so a decision-making body would not have legal status to enforce the contractual arrangement. The decision-making body would coordinate joint activation and specify the conditions for exercising the opt-out clause.

Members of the decision-making body would be three Northeast Asian countries (China, Japan, and South Korea) plus three rotating members from the ASEAN. The IMF and other international financial institutions may be invited as observers for consultation. The decision-making process should be consensus-based, but unanimous approval is not required.

The decision-making body would have the following functions: facilitate and coordinate joint activation and disbursement; assess and supervise regular monitoring and surveillance activities; conduct performance evaluation of swap-requesting countries; impose and enforce conditionality and covenants specified under the framework of the NBSA; identify the sources of systemic risks and causes of individual crises; determine conditions under which swap-providing countries can exercise their opt-out clause; provide liaison services for ASEAN+3 countries; and coordinate the activities of the NBSA with those of the IMF and other International Financial Institutions (IFIs).

- *Relationship with the IMF*

If this decision-making body and process is put in place, the proposed NBSA could be independent from the IMF or provide parallel lending with the IMF. Except for the standing arrangements, other liquidity assistance could be arranged in cooperation with the IMF. In particular, conditional arrangements could be supplementary to the

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<sup>9</sup> This point is also rightly recognized by Ito et al. (1999). If the NBSA is just a collection of non-committed pledges, it may take time to activate and disburse funds in the case of a crisis. Firm commitment must mean that, once the decision-making body of the NBSA decides to disburse funds for a swap-requesting country, it should not require any further approval from national authorities of the member countries.

IMF facilities if the swap-requesting country seeks IMF assistance. The IMF program could play a role as a credible guarantor to enhance the swap-requesting country's commitment to policy reform. The NBSA initiative would be a complement and supplement to the IMF by strengthening the financing capacity of the international and regional community. If the NBSA is somehow jointly activated with IMF facilities, there must be some potential conflicts between the competing conditionality of the NBSA and the IMF. The IMF conditionality could be used but it should be coordinated by the NBSA secretariat depending on the nature of crises.<sup>10</sup>

#### **IV-6. Establishment of Regional Arrangements to Borrow and Monetary Fund in East Asia**

The structure of the NBSA proposed in this study would provide a more effective defense mechanism for preventing future crises beyond the current setup of the CMI. However, the NBSA has many limitations as a regional financial mechanism. Given the opt-out option, some countries may not honor their swap commitments depending upon the economic circumstances they are in and the enforcement mechanism may not work. If these risks are present, then the joint activation of the BSAs, which is the key feature of the NBSA, may not be a reliable system. Even if the system can be made credible, activating simultaneously large members of BSAs would be costly and time consuming to the extent that individual contracts will have to be negotiated bilaterally if swap requesting countries draw more than the 10 per cent automatic drawing limit. In order to reduce the cost of managing the NBSA and to make the commitment more durable, the ASEAN+3 may consider restructuring the NBSA in a reserve pooling system, such as the Asian Arrangement to Borrow proposed in this section. This transition could be made to offer the CMI countries an opportunity to manage the NBSA successfully and build trust in coordinating policies.

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<sup>10</sup> Henning (2002) asserts that a division of labor whereby Asian governments provide financing while the IMF provides conditionality is attractive from the standpoint of staff resources and energy. He also points out that because such a division of labor enables Asian officials to avoid specifying political adjustments required of their regional partners, it is attractive for political reasons as well. However, at any rate, coordination between the NBSA and the IMF is required.

The NBSA and the ASA could be merged into the Asian Arrangements to Borrow (hereafter AAB). The AAB would not require any increase in quota subscriptions as they are based on the credit arrangements among the members as in the case of the ASA. While the swap size of each BSA is determined through bilateral negotiations, credit commitments to the AAB of the members would be based on a set of allocation criteria. It would be useful to have a fixed formula for calculating the credit commitments of the participating countries. By using a profile of country data including external financing requirements, the size of GDP, and the amount of foreign exchange reserves, an elaborate allocative scheme could be developed. However, since the data profiles always change, such a scheme should mainly serve as a benchmark.

The actual amount of borrowing by the three IMF program countries (Indonesia, South Korea and Thailand during the East Asian financial crisis) from international financial institutions including the IMF, World Bank, and ADB could serve as a useful benchmark for estimating a potential need for financial assistance under the AAB. In terms of GDP at the end of 1997, Indonesia, South Korea and Thailand received a pledge of amounts of financial support equivalent to 16.7, 11.5 and 11.4 per cent of their GDP respectively from various sources including the second line of defense. However, actual disbursements for the three countries amounted to 5.6, 6.75 and 9.3 of their GDP respectively. On average, liquidity assistance in the range of the 7 per cent of GDP was required to resolve an individual country crisis during the 1997-98 period.

Under the assumption that China and Japan would not be potential borrowers from the AAB, the total amount required for financial assistance in a very unrealistic case in which all eleven countries (ASEAN plus South Korea) come under a speculative attack would be US\$72 billion (7 per cent of nominal GDP at the end of 2000). This amount is tantamount to 9 per cent of total foreign reserves of the ASEAN+3 countries (US\$ 794.4 billion at the end of 2000). However, it is unlikely that all eleven countries would face a liquidity problem at the same time. This means that in general, a smaller amount of financial resources would need to be mobilized under the proposed AAB.

If the amount of credit commitment were set to be too large, however, some

countries would not be willing to participate in the AAB. Because the total amount of borrowing from the AAB by an individual participant should be proportional to its own credit commitment, a large credit assignment to each participant could run the risk of defaulting the repayment in case of a crisis. This risk would then threaten stability of the system. On the other hand, the AAB would not be regarded a credible credit facility, if the total amount of liquidity available is not perceived to be enough to prevent currency speculation. As in the IMF, which is essentially a credit union, the AAB would operate in partnership with all its members, based on their shared interests. However, unlike a typical credit union, there would be a clear demarcation between net lenders and net borrowers. Among the members, Japan (or possibly China, South Korea, and Singapore) would constitute the majority of lenders, whereas other ASEAN countries make up practically all of the borrowers of the AAB. If this bifurcation between lenders and borrowers is applied to the AAB, the gearing ratio of the AAB would be even greater than otherwise and more funds would be available to potential borrowing countries.

To address the moral hazard problem, a penalty rate should be charged when borrowing from the AAB facility. If the interest rate is too low with no conditionality attached, borrowers may not have sufficient incentive to strengthen their economic fundamentals to avoid future crises. In general, the countries eligible for borrowing from the AAB might take excessive risk, knowing that there is a cheap source of credit available if things turned out badly. The monitoring and surveillance activities could mitigate the moral hazard problem to some extent. However, to prevent the abuse of frequent borrowing from the AAB, the decision-making body should be able to impose stringent conditionality after thoroughly reviewing the track records of recent economic and financial sector performances of the borrowing countries.

Once the institutionalization and successful management of the AAB is completed, then creation of a regional monetary fund such as the Asian Monetary Fund (AMF) is the final stage of financial integration. By the time the AAB becomes fully operational, the ASEAN+3 will have created a regional financial mechanism similar to that of the IMF, except that it has no clear ownership structure. Assuming the thirteen

countries would emulate the IMF system, they could devise an ownership structure based on quota contributions of the participating countries. In Fact, management of the AMF would be less costly if the AAB together with quota contributions from the participating countries serves as means of mobilizing funds necessary for the operation of the AMF. If the AAB is to be managed in a manner similar to the IMF's General Arrangements to Borrow (GAB) or New Arrangements to Borrow (NAB), strict conditionality should be imposed on the borrowing country.

The AAB is technically an agreement between the AMF and its contributing creditors. The AAB is utilized as a credit facility to be activated in an emergency situation, while the AMF should attach the conditionalities similar to those of the IMF to avoid the issue of moral hazard. Without adequate lending discipline in place, the AMF would easily exhaust its resources, as it will be prone to be lax in the supervision of financial assistance.

## **V. Development of an Effective Policy Dialogue and Surveillance System**

Policy dialogue, along with a regular information exchange and surveillance process, is essential if a regional financial architecture could serve as a defensive mechanism for the prevention of crises. The collected information will help detect and identify the characteristic of the looming crisis at an early stage so that proper and timely remedial action can be taken and a joint exercise based on a region-wide early warning system will facilitate closer examination of financial vulnerabilities in the region. In addition, the regional policy dialogue process will contribute to ensuring effective implementation of individual or collective policy targets through peer pressure or rule-based enforcement mechanisms.

As part of the institutional structure of the CMI, a regional policy dialogue mechanism is being discussed under the ASEAN+3 framework. This section explores the possibility of this mechanism being used to support the operation of the NBSA. Different institutional settings will require different mechanisms for effective monitoring and surveillance. As the scope of financial cooperation increases and



economic integration deepens, different mechanisms and institutions for monitoring and surveillance will evolve along with other pillars of regional financial arrangements – liquidity assistance and exchange rate policy coordination.

#### **V-1. ASEAN+3 Policy Dialogue Process**

The necessity and the structure of the surveillance mechanisms depend on the objectives of the group of countries engaged in policy dialogue. Both intensive and extensive cooperation cannot be carried out in a vacuum unless the expected benefits would be great enough to induce the support of all participating countries. Only rhetoric would prevail in a policy dialogue in the absence of concrete action agendas and visible outcomes. For this reason, an effective surveillance mechanism presupposes well-defined objectives and ensures sufficient benefits for cooperation.

The envisaged objectives of the surveillance mechanism in East Asia are:

- sustaining stability of financial markets and
- promoting economic integration in East Asia

At present, the ASEAN+3 group finds it critical to enhance the policy dialogue and coordination among the participating countries to complement the CMI operation. Better monitoring and surveillance could help in identifying emerging issues and potential problems, and thus enable countries to take prompt corrective action at the national level or jointly at the regional level if necessary. As often observed in the IMF surveillance process, the symptoms of the crises and economic vulnerabilities have not been effectively captured. Regional initiatives could complement the IMF surveillance process in that the economies in the region have become much more interdependent through trade and financial channels over the last decade. Precisely because spillover effects in the region can be insidious, there is a pressing need to engage in regional monitoring and surveillance.

Although regional surveillance initiatives provide a potentially meaningful and substantive value-added contribution to existing multilateral and other mechanisms,

East Asian countries do not yet have specified common policy objectives. Crisis prevention or financial stability is rather broad and ambiguous as a policy objective for surveillance. A more sophisticated mechanism of surveillance will come along with intensification of monetary and financial cooperation. As the scope of the ASEAN+3 financial cooperation framework is broadened and other initiatives such as exchange rate coordination emerge, the objectives of a concomitant surveillance mechanism will be more clearly spelled out. In this regard, the policy dialogue process through peer review will be a good starting point, but it will not operate in a vacuum. The next main issue is then to identify the appropriate modalities and to design the necessary instruments, techniques, and institutions for an effective system of monitoring and surveillance.

An enhanced regional policy dialogue process could promote sound macroeconomic policies and prevent any moral hazard problems that might arise in operating the CMI II. Despite this recognition, the ASEAN+3 countries have been cautious, and as a result slow in creating a formal mechanism of surveillance. Since the inception of the CMI, informal economic reviews and policy dialogues have taken place at the ASEAN+3 Finance and Central Bank Deputies' Meeting (AFDM+3) and ASEAN+3 Finance Ministers' Meeting (AFMM+3). In order to enhance the existing process of economic reviews and policy dialogues, this group of countries made the decision to establish the Study Group at their meeting in Honolulu on 9 May 2001. The task of the Study Group is to examine ways of enhancing the effectiveness of ASEAN+3 economic reviews and policy dialogues to complement the BSAs under the CMI. It was agreed that Japan and Malaysia co-chaired the Study Group and that its membership, which is voluntary, would consist of finance and central bank officials from the ASEAN+3 countries.

At a meeting of the ASEAN+3 Study Group was held in Kuala Lumpur on 22 November 2001, Bank Negara Malaysia and the Ministry of Finance of Japan recommended an action agenda to be implemented in two phases. Phase 1 enhances the existing process of economic reviews and policy dialogues among the ASEAN+3

countries, and phase 2 constructs a new strengthened policy dialogue mechanism. During the span of phase one, the ASEAN+3 countries are to move one step forward in formalizing the current process. More specifically, the participants of the study group meeting agreed to hold an informal meeting of the AFDM+3 to focus on economic reviews and policy dialogues in September or October, back to back with the IMF/World Bank annual meeting. This meeting is informal in the sense that participation would be voluntary. However, the participants agreed that was essential that all of the countries involved in the network of the BSAs (namely the CMI countries) assumed the responsibility of participating in the informal meeting and circulate a brief report on their recent economic developments. A common template or format for the report will be developed to ensure the comparability of the reports submitted by countries at the meetings. This format serves as a guide and each country would be given some flexibility in preparing the report. In addition, the report may include issues of concern to the participating countries such as economic and policy assessments made by the IMF, World Bank, and ADB.

The second meeting of the ASEAN+3 Study Group was held in Myanmar on 2 April 2002. There was more intensive discussion of the possible specific modalities for phase 2 proposed by Malaysia. Under phase two, it is proposed that a group or an institution be designated to undertake high quality and in-depth reviews and assessments. As for the possible candidates for this group or institution, the following has been suggested for further discussion:

- developing the ASEAN secretariat;
- using an existing institution such as regional multilateral institutions, think-tanks, or universities; and
- operating through a working group.

Whichever option is chosen, however, the proposal makes it clear that the group or institution will not be a substitute for the Fund surveillance process and certainly will

not be another bureaucracy. Instead, the assessment by a working group or an institution could be used in negotiations for those countries requesting financial assistance from the IMF or under IMF programs by providing information and possible policy recommendations different from those prescribed by the IMF. The ASEAN+3 countries would also use these assessments, but they would only be used for peer review at the AFDM+3 and would not be available for public use.

Despite the general support for enhancing the policy dialogue process among the ASEAN+3 countries, the member countries could not reach an agreement on the concrete modalities of phase two. What they agreed is to institutionalize the ASEAN+3 meeting of deputies for informal policy reviews and dialogues. At this stage of development of the CMI, many countries are not prepared to create an independent regional monitoring and surveillance unit as part of the CMI.

## **V-2. Construction of a Surveillance Mechanism: A Proposal**

The discussion in the preceding subsections points to the need of establishing an independent monitoring and surveillance unit for the purpose of providing prompt and relevant information to the ASEAN+3 group in the long-run. Its monitoring activities in general cover (i) macroeconomic trends and policy changes in the region, (ii) financial market developments, and (iii) structural and institutional change. This unit is also required to develop a surveillance mechanism to enforce (i) implementation of common standards agreed among the members, (ii) policy changes and reforms required of those countries in need (particularly swap-receiving countries under the CMI framework), and (iii) economic policy coordination agreed among the members. The ASEAN Surveillance Process and the ASEAN+3 Surveillance Process would complement each other. However, both processes either require more institutionalized structure or need to be integrated into a unified process. Such a unit would have a better chance of success if it evolves over time as the participating countries build trust among them and accumulate experience in policy dialogue.

Although structured regional surveillance initiatives provide a potentially meaningful and substantive value-added contribution to the current ASEAN+3 policy dialogues, East Asian countries do not yet have specified common policy objectives. Crisis prevention is rather ambiguous as a policy objective for surveillance. Surveillance mechanisms should come along with other pillars of monetary and financial cooperation. As the CMI further develops and other initiatives such as exchange rate coordination emerge, the objectives of concomitant surveillance mechanisms will be more clearly spelled out. The policy dialogue process through peer review would be a good starting point, but it cannot sustain itself unless the CMI maintains forward momentum by articulating the objectives of the surveillance. This study proposes that the ASEAN+3 states explicitly the maintenance of financial market stability, and the promotion of economic integration in East Asia as the objectives of the surveillance mechanism in East Asia. An enhanced surveillance mechanism could then be constructed in the following three phases:

#### Phase 1: Building a regular policy dialogue framework

Member countries introduce a system for information sharing and enhancing the transparency of domestic economic policies through a peer review process. No independent surveillance unit is required to serve as a secretariat. Existing multilateral and other regional initiatives will be mutually reinforcing the surveillance function, but common policy objectives need not be specified in detail. It would also be desirable to institutionalize the ASEAN+3 meetings for policy review by requiring all of the CMI countries to participate in the informal monitoring process as well as increasing the frequency of informal meetings at the deputy minister level.<sup>11</sup> This policy dialogue also needs to review the IMF Article IV consultation staff reports of all member countries (including self-assessments) and conditionality of the program countries. Phase 1 may

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<sup>11</sup> The low frequency of meetings under the ASEAN+3 process means less intensive economic reviews and policy dialogues among the members. The fact is that without urgent issues to be discussed, many members are sensibly reluctant to have more meetings.

be tantamount to phase one proposed by the ASEAN+3 Study Group.

The ASEAN Surveillance Process (ASP) has been operation since its formal establishment in early 1999. The ASEAN Finance Ministers have agreed to conduct a peer review twice a year. However, there is no fact-finding mission to member states like the IMF's Article IV consultation mission. Instead, finance and central bank officials who are focal points for the ASP directly provide information on their latest economic and financial situations to the ASEAN Surveillance Coordinating Unit (ASCU). Based on this informal process of information gathering, the ASCU then performs an analysis of the latest economic and financial development in ASEAN while taking into account global development that could have implications on the region's economies. Outcomes of such analysis are summarized and emerging policy issues, including policy recommendations, are highlighted in a report initially prepared by the ASCU. The report, called the ASEAN Surveillance Report, is considered and finalized by the ASEAN Finance and Central Bank Deputies before it is tabled for the discussion of the ASEAN Finance Ministers during their peer review.

Under the ASEAN+3 framework, the ASP could be expanded to involve three Northeast Asian countries. However, it deems more suitable that three Northeast Asian countries establish its own monitoring and surveillance process, so called the Northeast Asian Surveillance System (NASP), independently along with the ASP. At the initial stage of development of the monitoring system, a two-tier independent monitoring and surveillance process would complement each other.

#### Phase 2: Introduction of an integrated policy dialogue mechanism

During the second phase, the two monitoring systems (ASP and NASP) are to be consolidated into a single independent surveillance unit is established to serve as a standing secretariat that manages the policy dialogue mechanism in the region. This unit may start on a modest scale. Given limited financial and human resources inside the unit, a network of government research institutions could be established for which the unit could serve as a coordinating agency.

This independent surveillance unit is expected to be a warehouse of information and a provider of warning signals for both individual countries and the group as a whole. By conducting extensive early warning exercises at the national and regional levels, this unit identifies the problems and prepares independent surveillance reports to the Group. Following the ASEAN tradition of non-interference into domestic policies, the report focuses on the provision of warning signals. The peer review process would result in specific recommendations later, if needed. In preparing for the surveillance report, the unit may need a fact-finding mission like the Fund surveillance. To avoid the duplication of the IMF's Article IV consultation, the unit may participate in the IMF surveillance jointly with the IMF staff. Combined with country reports submitted by all member countries, this unit's surveillance report will be a Compendium Report based on its own assessment.

The unit may also be entitled to conduct preparatory research on future cooperative issues such as exchange rate policy coordination and Asian bond market development. Since the weakest links in East Asian economic management are inappropriate exchange rate management and fragile financial systems, it cannot be overemphasized that the regional surveillance unit must not only be a watchdog of national macroeconomic and exchange rate policies, but also an overseer of the national financial markets, and the linkages between them and the rest of the world (Wang and Woo 2004).

At the second phase of monitoring development, the CMI goes beyond the supplementary role to the IMF and seeks independent conditionality. In case of liquidity assistance, the NBSA decision-making body would find it necessary to impose its own conditionality on a swap-requesting country. The independent surveillance unit is also expected to provide information based on its previous own surveillance activities.

A proper design of conditionality would be a point of debate. It would be useful to distinguish between technical assistance and financial assistance. There is no reason to discourage competition in the market for technical assistance. Governments should be free to choose the source of technical assistance with the best track record. However,

if multiple monetary funds were available, East Asian governments would have an incentive to shop around for the most generous assistance and the least onerous conditionality. If the NBSA does not attach the IMF-like conditionality, the international financial community might raise the issue of moral hazard. In this regard, relevant but binding policy recommendations should be imposed on the borrowing countries. Without an appropriate lending discipline in place, the NBSA would likely be dysfunctional due to the lax supervision of financial assistance.

When the NBSA decision-making body comes to design the conditionality attached to conditional swaps, the nature of the crisis should be thoroughly taken into consideration. Martin Feldstein (1998), Jeffrey Sachs (1998), and many other critics of the IMF program argue that what the crisis countries in East Asia needed (except, perhaps, Indonesia) was coordinated action by exposed foreign financial institutions to restructure their short-term debt by lengthening debt maturity and providing additional credits to help meet interest obligations. IMF officials dismiss these critics' arguments as reflecting ignorance of the real nature of the crisis because the IMF believes the collapse was caused by an accumulation of structural weaknesses rather than by short-run macroeconomic imbalances. To be fair, it is difficult to determine empirically at this stage whether structural weaknesses made a crisis inevitable or whether foreign investors triggered the crisis when they abruptly altered their expectations about the crisis country's development and withdrew their loans and investment.

In either or both cases, to reflect the very nature of a capital account crisis, policy conditionality should be differentiated from those conventional current account crises caused by poor macroeconomic fundamentals in conventional terms (Asian Policy Forum 2000).<sup>12</sup> A new structure of conditionality, along with a regional surveillance process that monitor financial markets and other indicators should be designed in such a way to correspond appropriately to new capital account crises. It is worth noting that even a modest depreciation of the exchange rate could contribute to

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<sup>12</sup> The East Asian crisis can be characterized as a capital account crisis, the origin of which was large inflows of private capital relative to the underlying current account deficit and of a largely short-term nature, followed by a sudden and massive reversal of capital flows (Asian Policy Forum 2000).



resolving a conventional current account crisis supported by restrictive macroeconomic policies, whereas in a capital account crisis, such depreciation could aggravate the currency mismatch problems in the balance sheets of enterprises and financial institutions and deepened the crisis. In order to manage the capital account crisis better and prevent future crises, the NBSA decision-making body must design policy conditionality different from the one designed for resolving a current account crisis in terms of short-and medium-term policy objectives.

The surveillance unit should be able to determine with the aid of quantitative information generated by warning indicator models whether an impending crisis is caused by expectational changes that provoke a sudden reversal of capital inflows or by an emergence of a large current account deficit symptomatic of structural imbalances. In the former case, immediate liquidity assistance should precede any decision to impose policy reform conditionality on the crisis-affected country. Once the speculative attack is fended off and financial stability is restored so that contagion of the attack is prevented, then in post mortem the decision making body of the NBSA would decide on appropriate policy reform to be imposed on the country which utilized the NBSA facility. As for the latter case of conventional current account crisis, prompt liquidity support may not be as critical as it is in capital account crisis and hence conditionality and liquidity support could be negotiated simultaneously between the borrowing country and the NBSA decision making body.

### Phase III. Monetary integration and strengthened surveillance process

The ASEAN+3 members at present appear to pursue financial cooperation in the absence of exchange rate coordination. It is not yet clear whether East Asia will emulate the European experience by adopting some form of monetary integration. However, if ASEAN+3 envisages monetary integration in East Asia in the long run, the regional surveillance mechanism would have to be structured and managed in order to support exchange rate policy coordination and developing a collective exchange rate system for the region. As the EU commission and European Monetary Institute (EMI) served as

facilitators to promote economic and monetary integration, ASEAN+3 may consider establishing politically independent institutions along with an official policy dialogue process. The professionals working at these independent institutions should be able to follow up on the decisions of politicians on integration and advance common policy objectives and related modalities more adequately by contributing their own ideas to the policy dialogue group.

## **VI. Concluding Remarks**

Over the past four years, the ASEAN states plus China, Japan, and South Korea have made considerable progress in constructing a regional cooperative arrangement for liquidity support and developing regional bond markets. The eight members of ASEAN+3 have concluded sixteen bilateral swaps contracts with a total size of the network amounting to \$36.5 billion. South Korea, which is the largest beneficiary of the CMI can draw \$12 billion from the system including the Miyazawa initiative. In the eyes of global financial market participants, however, the availability of liquidity to Korea and other members is too small to be of any significance for preventing future crises.

There is also the uncertainty that swap providing countries may not honor their swap contracts, invoking the opting-out right. Since the CMI has never been tested, it is difficult to assess its effectiveness as a regional arrangement for defense against future financial crises. However, it should be noted that contribution of the CMI is not so much the availability of liquidity it can provide as it is a milestone in policy dialogue and coordination in East Asia. Recognizing its deficiencies the ASEAN+3 has taken steps to explore ways of enhancing the effectiveness of the CMI including its multilateralization.

In parallel with expanding the network of the CMI ASEAN+3 has been leading the development of regional bond markets in Asia in cooperation with many other fora, such as APEC, EMEAP, and ACD. Already, several proposals have been made regarding the strategies for and modalities of constructing infrastructure for the regional

bond markets in East Asia. There is general consensus that the best strategy for facilitating cross-border trading in financial instruments including bonds in Asia is for Asian countries to open their domestic bond markets so that domestic issuers can issue bonds in any country of their choice and domestic investors can invest freely in foreign bonds.

At this stage of development, the degree of capital control varies a great deal from country to country in Asia and prospects for further capital account liberalization are not promising. Domestic bond markets of many Asian countries are also too small and underdeveloped to be opened to foreign investors. Under these circumstances, the proponents of the ABMI argue that the initiative will produce peer pressure and also give incentives to these countries to step up financial reform and to develop their capital markets and also pave the way for an orderly liberalization of cross-border investment in Asia. Regional bond markets in East Asia, if they obtain efficiency, will be able to cater to capital market financing needs of smaller Asian countries, which cannot support efficient domestic bond markets.

Supporters of the ABMI are beginning to find out how difficult it is to construct regional financial infrastructure including a regional clearing and settlement system, a regional credit rating agency, and credit guarantee institutions and also harmonize withholding taxes and different market practices in different countries. There is also the problem of coordinating activities of different regional and multinational institutions involved in Asian bond market development. Even if these problems are manageable, there is still the question of whether ASEAN+3 and other Asian countries are prepared to open their capital markets. In this regard ASEAN+3 holds the key to the success of the ABMI. If the ASEAN+3 members sustain their solidarity to push forward their plan to restructure the CMI into an effective liquidity support system, then it will be easier for ASEAN+3 to promote region wide capital account liberalization in East Asia.

In recent years, the fear of another round of a financial crisis has receded considerably in East Asia. At the same time, the ASEAN+3 members have amassed large amounts of foreign reserves for a war chest. Because of these developments,

although they still recognize the importance of strengthening regional financial cooperation, the members of ASEAN+3 have been less enthusiastic than before in creating institutions vital for improving the effectiveness of the CMI and also ABMI.

There are of course more serious structural obstacles to regional financial integration in East Asia. One of the impediments to financial and monetary integration in East Asia is, unlike in Europe, the region's lack of historical experience in cooperation for regional economic and political integration. Whatever economic benefits financial and monetary integration may bring, they are unlikely to be realized in the near future if each country is unwilling to cooperate in the political arena. Although the ASEAN+3 members have so far shown remarkable solidarity in working together for the development of the CMI and ABMI, it remains to be seen whether China, Japan, and other members of ASEAN+3 could overcome their differences in regional issues to sustain the movement for regional economic integration.

In predicting the future of regionalism in East Asia, therefore, one can at best entertain several scenarios. One possible scenario is that China and Japan may come to realize that they are the key to developing a common political will in East Asia, as France and Germany have been in Europe's integration process. This realization could soften their positions to compromise on an institutional setting and augmentation of the existing financial architecture of East Asia. For instance, China may accept Japan's demand for de facto control over monitoring and surveillance in return for Japan's pledge for a substantial increase in financial assistance in the form of one-way swaps and ODA to ASEAN members. China could agree to this scheme, if it is confident about concluding a free trade agreement with the ASEAN members in the near future. China's free trade pact with ASEAN could circumscribe Japan's influence on ASEAN affairs even if Japan is a major provider of financial resources to the region. In this process, Korea and ASEAN would play the role of a mediator in the cultivation of a common political will between China and Japan.<sup>13</sup>

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<sup>13</sup> Murase (2004) emphasizes the role of Korea by saying that "as East Asian monetary and financial cooperation move ahead, Korea can be expected to fulfill a similar role to that played by the Benelux countries in Europe. In the regional monetary system formation process, therefore, it could play a

Another scenario focuses on the possibility of China assuming a more aggressive leadership role in regional integration. In view of the uncertain prospects of the Japanese economy, China could emerge as the region's engine of growth over the longer term if it sustains its growth. Given the envisaged leadership role, China may choose to negotiate both the expansions of the BSAs and a free trade pact with ASEAN. In this case, the original CMI would become "ASEAN+1" in the sense that Japan could play the second fiddle. Realizing that financial integration is an integral part of a successful free trade area, China may indeed seriously consider this option. However, without Japan, ASEAN+1 will not be a viable arrangement for a regional financing scheme simply because China is hardly in a position to commit itself to financing the balance of payments deficits of all ASEAN member states. It is also questionable whether ASEAN will join any regional financial arrangement in which China is the dominant member.

A third scenario is the enlargement of the CMI to include Australia and New Zealand and possibly India from South Asia. This is the route favored by Japan because Japan would find it easier to deal with China when there are more countries supporting its strategy. However, many members of ASEAN+3 believe that at this stage forming a critical mass of the CMI should precede any enlargement. Since the enlargement is not likely to increase substantially availability of short-term financing, most members of ASEAN+3 would not take the third scenario seriously.

Perhaps the most realistic scenario is that the countries participating in the CMI will muddle through, discussing modalities of policy dialogue, the types of the surveillance system the CMI needs, and also augmentation of swap amounts without making any substantial progress. In this respect, the role of the working group will be critical. If the group develops a scheme for multilateralizing the CMI network acceptable to ASEAN+3, then East Asia will enter a new era of regionalism as it will be

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constructive role as a medium-sized industrialized economy supplementing Sino-Japanese leadership while representing the interests of smaller countries in the region. When it comes to setting up regional institutions sometime in the future, Korea could well rank alongside the key members of ASEAN as a possible location for the secretariat and other organizations."

compelled to create a Asian Arrangement to barrow, which will be a forerunner of a regional monetary fund while concluding a number of bilateral FTAs.

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