

The IMF and East Asia: A Changing Regional Financial Architecture

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1. Introduction

The financial crises of 1997 and 1998 have had a profound effect on east Asia's view of international financial and monetary arrangements, including the role of the International Monetary Fund in international policy dialogue and financial cooperation.¹ There has been a tectonic shift in the policy landscape of the region.² While there are differences between and within countries, no longer is east Asia content to rely almost exclusively on global forums, mechanisms and institutions; it now wants to develop a complementary regional structure. The process of developing a regional economic and financial architecture may be in its early stages but the political and policy dynamics under way make it irreversible.

There are many elements to the expansion of regional arrangements - ranging from strengthened policy dialogue, greater financial cooperation, deeper economic and trade integration, and even common currency arrangements. Much of the content of the evolving debate and policy on regional financial arrangements is tied directly to the region's discontent with the IMF and its concomitant, disillusion with the way the United States dealt with the financial crisis in east Asia. It is also motivated by a profound sense that deep economic and financial integration in east Asia can be of substantial benefit, both nationally and internationally, to countries in the region. At the same time, the European experience is seen as compelling.

The IMF is widely seen in east Asia as having performed poorly in the financial crises of 1997 and 1998, although its performance did improve

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¹ The east Asian region includes China, Hong Kong SAR, Japan, Korea and Taiwan, the 10 ASEAN countries (Brunei, Burma, Cambodia, Indonesia, Laos, Malaysia, the Philippines, Singapore, Thailand and Vietnam), and Australia and New Zealand. The latter two countries are included because they are deeply economically integrated with the region, in both trade and in finance, and have a long history of policy interaction with many countries in the region: this was acknowledged by Japanese Prime Minister Koizumi's inclusion of them in his January 2002 Singapore speech outlining his vision of an East Asian Community.

² It is an oversimplification to say that a region as large and diverse as east Asia has any particular view, but that does not mean it is not possible or incorrect to attempt to describe broad sentiment at times.

later in the crisis and it is credited with being more responsive to the region's concerns since then. The Fund's sins in east Asia are perceived by its critics to be many: it initially interpreted the crisis incorrectly, it forced countries to adopt macroeconomic and structural policies which did not support confidence and recovery,³ it was rigidly ideological in its analysis of hedge funds and initial dismissal of the possibility of destabilising speculation in financial markets,⁴ and it was not able to garner the support of the United States and Europe in dealing with the crisis at critical stages in 1997 and 1998. Rather than being credited as a key independent player, it was seen as US-run and dominated, ideological and inflexible, and obsessed with protecting its own bureaucratic interests.⁵

Despite this experience, there is no appetite in (most of) the region for doing away with the Fund. It plays far too valuable a role: it is a key resource for technical assistance and analysis; it is essential in dealing with broad-based or global financial crises, including securing private-sector involvement; it is a useful tool for politicians to push domestic reform; it provides a voice for smaller countries at the global level; and it is a key device in securing US and European interest in the world outside their borders and immediate regions. But there is a profound sense in much of east Asia that international financial policymaking and cooperation cannot proceed only on the global level; it must be complemented by strong well-designed regional financial arrangements. These financial arrangements encompass strengthened policy dialogue, financial cooperation, and perhaps common currency arrangements in east Asia.

This paper analyses the regional financial architecture that is emerging in east Asia. It looks first in Section 2 at the motivation for the new regional financial architecture. There is a layering of reasons behind the push for strengthened regional financial arrangements, with complex economic, strategic, and chauvinistic components. The interplay of these factors has changed since mid 1997, with some of the bite of the emotionally charged elements moderated by the practicalities and broader strategic interests of the region. Understanding the motivation is important in deciding how to respond to the new Asian regionalism: opponents who summarily dismiss it are likely to fuel the fire because they ignore crucial strategic and

³ For references and the IMF staff's explanation and defence, see Boorman, Lane, Schulze-Ghattas, Bulir, Ghosh, Hamann, Mourmouras, and Phillips (2000).

⁴ See chapter 3 in de Brouwer (2001). As shown by its Capital Market Reports in 1999 and 2000, the Fund, or parts of it, may have subsequently become less sceptical.

⁵ It is hard to source public quotes by officials along these lines, but this was certainly the private sentiment of many officials in the region.

chauvinistic elements at play. The aim in Section 2 is to characterise the general views of the region (and not the author's own opinion).

Section 3 looks in more detail at the policy agenda on regional financial arrangements. It examines the development of policy dialogue in the region and critically assesses the value of regional policy dialogue and the functioning of these forums. It then critically examines regional financial cooperation, looking at what is meant by financial cooperation, whether it should be regional or global, and what the state of play is in east Asia. It briefly looks at the issue of common currency arrangements. Section 4 concludes the paper.

2. Motivation for a New Regional Financial Architecture

The debate about regional financial arrangements is complex. The motivation for the new regional financial architecture has economic, strategic, and chauvinistic dimensions. I briefly consider these in turn.

2.1 Economic Reasons

The economic rationale for new regional financial arrangements has two main aspects.

The first is the perceived need for a mechanism for *regional* financial support to prevent or resolve financial crises. This is meant at least to supplement global mechanisms, if not to replace them in certain circumstances. The focus here is on the perceived failures of the International Monetary Fund. It is probably correct to say that there is broad consensus within east Asia that the IMF rescue packages for Thailand, Korea and Indonesia suffered from flaws in terms of their involvement and their conditionality.

One strategic aim of IMF membership for many countries is to secure the interest of the United States and other 'big' countries in their circumstances. This is especially important since capital account crises are now so large that they are beyond the direct resources of the Fund and rely on broader official support through bilateral loans.⁶ Indeed, the IMF normally relies on other

⁶ A total of \$17.1 billion, \$36.2 billion, and \$58.9 billion were committed to Thailand, Indonesia, and Korea respectively in 1997 and 1998. The IMF components were \$3.9 billion, \$11.2 billion, and \$20.9 billion respectively. The World Bank was also involved in these programs but its involvement seems to many to be beyond the scope of its charter. The size of the financing requirements also raises the need for private sector involvement in the prevention and resolution of financial crises.

international financial institutions and bilateral supporters in its country programs in order to demonstrate wider endorsement of the policy measures in the programs.⁷ There is a sense in the region that the IMF was not successful in securing US interest and involvement early enough in 1997. The United States, for example, did not contribute bilaterally to the Thai package, although it did later commit to the Korean and Indonesian packages (although the second line of defence was not drawn on in either case). Indeed, the only countries to be involved bilaterally in all three east Asian packages were two countries in the region: Australia and Japan.

The other flaw in the IMF packages was the nature of conditionality. There are two dimensions to this. One is that the nature of the crisis was not well identified early enough by the Fund. Looking at Thailand, the initial IMF policy diagnosis and assessment were that it was a conventional demand-management problem – excessively easy fiscal and monetary policy and deteriorating current account – requiring a general policy tightening. But what was happening was not a current account crisis but joint capital account and financial system crises – requiring supportive fiscal policy and not prolonged tight monetary policy. The Fund took a long while to change its view (February 1998 in the case of Thailand), longer than occurred in the region,⁸ and this took a long while to filter through to policy change at the national level. The other dimension was the focus on deep extensive structural reform as part of the conditionality for an IMF package, and the at-times naïve way reform was implemented.⁹ While such reform is no doubt desirable and important, requiring immediate wholesale structural adjustment in an exchange-rate crisis may not be realistic.¹⁰

Whatever the merit of the criticisms and notwithstanding the fact that many in the region do understand, and were involved in promoting, the use of such packages as a vehicle for pursuing domestic economic and structural reform, the IMF packages and reactions are widely thought to have exacerbated, rather than alleviated, the crisis at critical times in 1997 and 1998. If the global mechanism embodied in the IMF does not work as well as expected and cannot be fully remedied, the view in much of the region is that action has to also be taken at the regional level to prevent and manage financial crises.

⁷ See Costello (1999).

⁸ This is based on the author's discussions with policymakers in the region. See also Macfarlane (1997a,b) and Grenville (1997, 1998).

⁹ An oft-quoted example is the closure of 16 banks in Indonesia in November 1997. It led to widespread panic because depositors feared that this was just the start of a wave of closures.

¹⁰ See, for example, Yoshitomi and Ohno (1999).

The second economic motivation for regional financial arrangements focuses on exchange rate arrangements in east Asia. The causes of the east Asian financial crisis were many, and one aspect that has received considerable attention in east Asia, and Japan in particular, is the heightened vulnerability to external shocks caused by implicit-dollar pegging in a number of crisis-affected economies, notably Thailand but also Indonesia and Korea.¹¹

As the dollar appreciated relative to the yen and mark from the mid-1990s onwards, the implicit dollar peg meant that these countries' currencies also appreciated relative to the yen and mark. Their export competitiveness weakened and their current account positions deteriorated, making them vulnerable to downward pressure on the exchange rate and susceptible to economic and financial shocks and changes in market sentiment. Had these countries tied their exchange rate, even loosely, to a basket peg - meaning some weighted combination of the dollar, yen and mark (now euro) - they would have experienced less appreciation of the effective exchange rate and hence been less vulnerable in 1997.

This is not merely of historical interest. The argument goes that these same countries have now returned to an implicit dollar peg, at least to some extent.¹² If these countries are not genuinely floating their currencies as they say they are (because of the 'fear of floating'), then the rationale for a basket peg currency arrangement is even greater. Given the rise in intra-regional trade in non-Japan east Asia, some also argue that the weights in the basket peg should be common for the region, or some subset of it. But others fear that a basket peg would be too slow to respond to changes in economic fundamentals and so would be subject to speculative attack.

2.2 Strategic factors

While these economic reasons are important in their own right and warrant serious analysis, they mask the strategic plays by countries in the region. It is much easier and less threatening to use arguments about economics than arguments that make explicit strategic regional and global positioning in the debate about regional arrangements.

¹¹ See, for example, Ito, Sasaki and Ogawa (1998), Williamson (2001), Kawai and Akiyama (2000), Kawai and Takagi (2000) and Yoshino, Koji and Suzuki (2000).

¹² See Ogawa (2000) and Kawai (2001). De Brouwer (2002a) looks at alternative explanations.

Dealing with the United States ...

The central play is directed at the world's sole superpower, the United States. It has the dual aims of using regional arrangements as a bulwark against US economic influence in the region and balancing US influence in global policymaking forums like the IMF.

Many of the arguments raised about the IMF's performance before and during the east Asian financial crisis are criticisms of US policy and power and how they were exercised. The IMF is widely seen by policymakers and academics in east Asia as a US-run institution:¹³ the United States has effective veto power over key decisions in the Executive Board; the IMF's head office is in Washington, D.C. only a few blocks from the US Treasury; and the powerful First Deputy Managing Director (who does many of the sensitive negotiations) is a US citizen often with close links to the US Treasury.

If the region believed that the United States was sufficiently responsive to its needs and aspirations and that it had an effective voice in the IMF, then the enthusiasm for regional financial arrangements, especially in terms of regional financial cooperation, might be weaker. But it does not.

This needs to be spelled out a bit more. The east Asian financial crisis had a radical effect on the region's perception of the United States as a reliable partner *in the domain of international finance*. The emphasis is intentional. A number of countries regard the United States as their primary partner in security and many regard the United States as a leading partner in trade and investment.¹⁴ The region recognises and values the unique contribution the United States makes to maintaining security and stability in east Asia. There is no appetite to reverse this. But this does not mean that they are satisfied in all dimensions of international relations. While east Asia is heterogeneous and there are differences of opinion and emphasis between and within countries, the common view in east Asia is that the region was not well served in 1997 and 1998 by its reliance in international finance on the United States. Consider three examples that are in the minds of policymakers in the region.

First, Thailand felt 'betrayed' by the United States.¹⁵ Thailand allowed itself to be the platform for the United States in the war against communism in Vietnam but the United States did not offer bilateral financing support

¹³ See, for example, Lee and Yang (2001).

¹⁴ See, for example, Yamamoto, Thiparat and Ahsan (2001).

¹⁵ This is how a pro-US senior Thai journalist described local sentiment to the author.

during the crisis. Indeed the US Treasury was perceived by some in Thailand to be bent on exposing weaknesses in that country even if that meant inducing a crisis in a traditional ally. Thais resented the apparent ready willingness of the United States to help ‘bail out’ South Korea, which is of clear strategic importance to the United States, but not Thailand.

Second, there is a perception in the region that the United States took advantage of the crisis to undermine Suharto’s rule in Indonesia in January 1998 and was willing to do the same in Malaysia to undermine Mahathir later that year.¹⁶ The United States was seen as being willing to undermine undemocratic regimes even at the risk of great economic and social cost. The robust and fulsome assertion of democracy in Cambodia, Indonesia, South Korea, the Philippines, Taiwan and Thailand in the past few decades shows just how much east Asia values democracy. But the region also places a high premium on political stability, especially in large heterogeneous nations like Indonesia, and there was deep bewilderment and disillusion with the perceived words and deeds of parts of the US Administration.

Third, countries were upset at the time by the United States’ apparent two-faced position on hedge funds. On the one hand, the United States vigorously denied that the New York-based macro hedge funds and proprietary trading desks of international investment banks and securities firms played any particular destabilising role in Asian currency and equity markets in 1997 and 1998, in spite of the size and concentration of those positions and evidence of market manipulation.¹⁷

But, on the other hand, it organised a bailout of Long-Term Capital Management because of the concern that unwinding that hedge fund’s positions could have a negative impact on US financial prices, markets and institutions in September 1998. This sounded a touch inconsistent to east Asians long-lectured by the US Treasury and Federal Reserve about the evils of cronyism and dangers of moral hazard; the inconsistency led to talk in the region about the capture of US policymaking by Wall Street.

Some in the region also felt this to be implicitly racist or at least anti-Asian, as discussed in the next section on the chauvinistic motivation for east Asian regionalism. The 1998 IMF study on hedge funds was also viewed widely in the region as a whitewash of the issues (a sentiment which is most strongly felt in Malaysia and Thailand).¹⁸

¹⁶ This is the assessment of a variety of senior officials across the region based on their discussions with some senior members of the US Administration in 1998.

¹⁷ See Financial Stability Forum Working Group on Highly Leveraged Institutions (2000).

¹⁸ See de Brouwer (2001).

It is understood in east Asia that US policymaking is divided between the Administration and Congress, and achieving consensus is especially difficult when different and antagonistic political parties occupy each seat of power. This was certainly the case in 1997 and 1998: not only was Congress very reluctant to support the Clinton Administration but the antipathy of many members of Congress to bailouts by the IMF, let alone the United States, was at its peak. The D'Amato amendment, passed by Congress after the Mexico crisis, also prohibited the US Treasury from using the Exchange Stabilization Fund at the time of the Thai rescue package, but had expired by the time of the Korean and Indonesian packages. It may be true that the Administration could not have supported Thailand (and Indonesia) more even if it had wanted to. But to the region, this just shows more starkly the unreliability of existing mechanisms and the consequent need for some sort of additional regional mechanism.

These criticisms are made notwithstanding the region's recognition of the central importance of the United States in the world economy and the fact that sustained strong US economic growth in the aftermath of the crisis provided much-needed external demand for Asian goods and services. While the increase in the US current account deficit at the time was welcomed in east Asia, it is viewed in the region as more the outcome of US policymakers letting their own economic expansion continue to run than explicitly deciding to underpin east Asia's economies. The fact that US economic growth helped underpin east Asia was a happy coincidence.

The challenge for the region is how to maintain US economic and strategic involvement in east Asia but at the same time secure the sort of engagement in international financial policymaking that it wants from the United States. One way to do this is to emphasise that economic prosperity and security in east Asia are unambiguously in US interests, and that, consistent with the express policy aims of the Bush Administration,¹⁹ it is time for the region to be more self-sufficient in providing a market-oriented economic and financial infrastructure for itself. The regional financial architecture should be marketed as an example of east Asia being willing to take on its financial responsibilities, and that the possibility of overlapping regional and global institutions or frameworks should be seen constructively as a device for avoiding excessive concentration of power in one institution.²⁰

¹⁹ See Rice (2000).

²⁰ Loosely analogous to the aim of balance enshrined in the separation of powers in the US constitution. This is an argument that was used, for example, by Federal Reserve Chairman Greenspan in 1999 against the consolidation of prudential supervision in the United States into one institution.

The sense after the crisis that the United States was an unreliable partner in matters to do with international finance spilled over automatically into disillusion with the IMF. The region does not feel that it can exercise its voice within the IMF, and so the region's 'problems' with the Fund cannot be readily addressed through normal processes.

There is a strong feeling in the region that it is wronged by the under-representation of Asia and over-representation of Europe in the Executive Board of the Fund.²¹ There is little expectation of remedying this: why would the Europeans, especially the small countries, ever agree to reduce their influence? Japan also feels excluded from the US-Europe 'agreement' that the Managing Director of the Fund be European and the First Deputy Managing Director be American. Japan's nomination of its former Ministry of Finance Vice-Minister for International Finance, Dr Eisuke Sakakibara, as a candidate for Managing Director in 1999 was an assertion of its discontent.

There is also a sense in non-Japan east Asia that one reason the United States has been able to dominate the IMF and other forums is because in the past Japan has not spoken up for the region as loudly as it could have. Observers of the IMF note that one aspect of the Fund is that it is a device for the major economies to champion the interests of their regions. The United States and Europe have long been robust supporters in a range of forums for Latin America and for developing central and eastern Europe and North Africa respectively.

But Japan is not seen as having done this to the same extent for east Asia. Whatever the reasons - the legacy of colonialism and war, Japan's dependence on US security, a preference for consensus, the diversion of policymakers' focus to domestic economic problems ... - the result is that east Asia's champion has let itself be squeezed out. This has certainly started to change in the past few years but requires effort and persistence to remedy. There are also concerns that Japan's focus on regional financial architecture signals that it is less prepared to work in reforming global forums and representing the region's interests in them.

... and asserting national interests

But the strategic play is not only about giving the region a stronger voice in global affairs and limiting the hegemony of the United States. It is also very

²¹ Based on GDP, Europe is over-represented by about 6 per cent in IMF quotas, while Japan and the United States are under-represented by 12 and 9 per cent respectively. The Dutch, Saudi Arabian, and Belgian constituencies are the most over-represented in terms of IMF quotas.

much about who has a voice and perhaps the strongest voice in regional arrangements. In other words, the play is not just about limiting the influence of the United States in the region but also about asserting a country's own influence at the same time.

The interests of countries in the region vary but they tend to coincide in the promotion of regionalism and its embodiment, regional financial cooperation. Take three examples: Japan, China and ASEAN.

Japan is concerned with its place in the world. The 1990s have had a profound effect on that country's self-confidence. At the end of the 1980s, Japan felt that it was poised to become the world's leading economy: its assets were highly priced, its banks looked like they were about to dominate world finance, and its manufacturers were leading global industrialisation. The collapse of its asset price bubble and world financial empire and a decade of stagnation and four recessions have undermined its confidence in its ability and its future. The dominance of the dollar, the introduction of the euro and the deepening of European economic and financial integration have left Japan with a deep sense that it is losing its place as a key G-3 economy. At the same time, the rise of China leaves it with the fear of losing its economic pre-eminence in east Asia.

This has meant that Japan has tried to assert a greater role in regional infrastructure. The Miyazawa plan for the recovery of crisis-affected economies, the proposal for an Asian Monetary Fund, the proposal for a common basket exchange rate peg arrangement for some ASEAN countries, and the detail of the ASEAN+3 Chiang Mai swap agreement have been led by Japan.²² These have been proposed and argued on their perceived intellectual merits but they also meet Japan's strategic aim of entrenching itself permanently as the centre of regional arrangements.

The basket peg arrangement, for example, is proposed as a way to minimise the effects of volatility in the G-3 countries' exchange rates on developing east Asia. But it is also anticipated that one effect of the arrangement - greater stability against the yen - will encourage more trade, investment and financial transactions to be conducted with yen. That is, it supports Japan's commitment to internationalise the yen, commensurate with its status as a G-3 economy.

China is also aware of its growing status in the regional and world economy. While it opposed Japan's proposal in 1997 for an Asian Monetary Fund,

²² A swap involves exchanging domestic currency for a fixed amount of foreign currency, typically US dollars, for a fixed period at a predetermined price.

largely because it was suspicious about Japan's motivation, it has since supported (or at least not vetoed) greater regional financial cooperation. China has judged that such cooperation is not only a useful balance against US financial power but enables it to secure a stronger strategic position at the centre of the region. China's proposal for an AFTA-China Free Trade Agreement is part of this play for greater political influence in the region.

Regional cooperation, especially ASEAN+3, also provides China with a valuable forum for dialogue with Japan and Korea through additional bilateral and trilateral meetings on the fringe of the ASEAN+3 meetings. The +3 (that is, China, Japan and Korea) dialogue is also seen as a major advantage from the viewpoint of Japan and Korea, and was a primary goal in setting up ASEAN+3.

From the ASEAN point of view, the regional arrangements are a substantial advance in outside recognition of ASEAN as a political entity, rather than merely as another collective expression for southeast Asia. Aware that they are 'small' relative to the big economies of northeast Asia, the ASEAN countries are keen to develop a subregional entity which can have more weight in dealings with the 'big three'.²³

The promotion of these varying strategic interests within east Asia has gravitated towards a common agenda for stronger regional arrangements, financial and otherwise. While it means that there is now genuine support for deeper cooperation and integration in east Asia, it does reveal two vulnerabilities (which are not necessarily unique to the region). First, consensus based on reconciling competing strategic interests means that agreed outcomes tend to the lowest common denominator. As will be discussed in Section 3, reaching agreement has been time-consuming and progress has been modest. Second, the consensus is fragile to changes in how countries, especially the key players, perceive their strategic interests. This is not to say that arrangements made so far will come undone but it does mean that the path forward is not fixed; it could advance rapidly and substantively or it could not progress further for a while.

2.3 Chauvinistic motivation

Given the tumultuousness and nature of events in the past few years, it is not surprising that there has also been a chauvinistic and emotional element in

²³ At the same time, they are wary of being swallowed up by the big three.

the development of east Asian regionalism. This was most intense during and immediately after the crisis, but it still persists to some degree.

The crisis damaged the region's confidence and ego, not only by the terrible economic and social damage it caused but also by the exposure of flaws in domestic systems and policies and the reliance of the region on outside influences, especially the United States and the IMF. The ability of the region to come together so quickly and fulsomely to support Thailand (when the United States refused to) is a matter of regional pride. But parts of the region also feel shame that it did not have the comprehensive internal resources and wherewithal to deal with the crisis on its own, as the Europeans did in 1992.²⁴ The desire to both feel and assert a confident and capable east Asian identity is strong and is the rallying cry for building regional institutions.

The emotional intensity of this desire was exacerbated by the interaction between east Asian and US policymakers during the crisis. The sense in east Asia was that US and other western policymakers regarded east Asia's commitment to market-oriented economic and financial processes as weak. The region felt that its policymakers were viewed by outsiders as relatively unreliable, opportunistic, inferior, and incapable.

An example of this is the assessment by Eichengreen and Bayoumi (1999: 361-364) that east Asia does not meet the necessary *intellectual* preconditions for regional integration. They argue that, in Europe, 'the ideal of integration is intimately connected with the liberal and democratic principles of the Enlightenment and has roots in centuries of history. ... [B]y 1945 the intellectual preconditions for European integration were in place', to be ignited by the 'spark of the Marshall Plan' into a regional commitment and agenda to cooperate at the deepest levels, including the unprecedented action of granting supranational authority to regional entities.

They argue that east Asia could not be more different. Not only does the region lack the necessary 'political solidarity and cohesion', but internal resistances to integration in east Asia are substantial and overwhelming. In the case of Europe, such resistances were 'overcome partly by the intervention of an outside agent, the United States' but this is missing in east Asia's case. They characterise east Asia as dominated by a colonial and insular military tradition, ideological conflict (communist China versus

²⁴ See Kim, Ryou and Wang (2000) and Kim and Yang (2001). The EMS and east Asian crises were, however, different types of crisis requiring different policy responses; the former was a monetary crisis, the latter a financial crisis.

market-oriented economies elsewhere), and a complete unwillingness to allow outside parties to interfere in domestic affairs.

Indeed, they go on to say that east Asia is inherently incapable of substantive regional integration:

At a deeper level, East Asia lacks a Benthamite/Rousseauan/Saint-Simonian heritage of collective democratic governance through integration, As Katzenstein puts it, “the notion of unified sovereignty ... central to the conception of continental European states, does not capture Asian political realities.” As in China today, the regions resist the attempts of the center to exercise its politics through the operation of political and legal institutions. The idea of a centralized state with a monopoly of force that regiments its citizens through the superimposition of a common set of institutions is a European conception, not an Asian one. Asian civil society is structured by ritual, ceremony, and economic networks more than by military force or the rule of law. The notion of strong, cohesive nation-states in the Western mode being foreign to Asia, it is unrealistic to speak of pooling national sovereignties which do not exist. (page 363)

This type of assessment has not been well received in east Asia.²⁵ It is seen as a selective and glorified reading of European history and an assertion of European superiority. It is also seen as a subjective caricature which is far removed from the reality of modern east Asia. It is intellectually flawed in its assertion that there is only one institutional route to integration - the European way of creating (what are viewed from the outside as bloated, self-interested, poorly governed) regional bureaucracies, rather than regional cooperative policymaking supported by flexible secretariats. While there is no doubt considerable work to be done in strengthening markets and policy dialogue and cooperation in the region, it is wrong to say that it cannot be done in east Asia.

The nature of cross-Pacific dialogue has also encouraged Asian chauvinism. At times, US officials and economists have talked down to and hectorated their east Asian colleagues.²⁶ And at times, they have delivered their message aggressively. This has created bad feeling and been counterproductive to the willingness of the recipients to accept - and be seen to accept - the message, even if they agree with its substance.

²⁵ See, for example, Kim, Ron and Wang (2000). They summarise the views of ‘western scholars’ and say that, “[n]evertheless, regional financial arrangements could be structured and executed so as to be complementary to the role of the IMF.”

²⁶ See Yamamoto, Thiparat and Ahsan (2001). This is not just felt with respect to the Americans. Some in the region also find the ASEM discussions a little one-sided at times, with the perception being that the Europeans are there to teach and the Asians are there to learn, rather than a focus on genuine dialogue and exchange.

3. The Policy Agenda

Dissatisfaction with the international and regional financial architecture after the crisis has set off a new program for integration and cooperation in east Asia. This has three main elements: policy dialogue, financial cooperation, and common currency arrangements. Consider these in turn.

3.1 Policy dialogue

The crisis revealed a number of weaknesses in the structure and nature of official policy dialogue on economics and finance in the region. Most strikingly, it showed the lack of a regional forum for comprehensive and substantive discussion of economic and financial issues and for the advancement of regional interests in global forums and institutions.

The need for such a forum is largely viewed as self-evident in the region. In the first place, it brings policymakers together at the political and official level to talk, develop trust, and assess the economic and policy structures in place. It allows consensus views to be formed (or not, as the case may be) and for these to be presented beyond the region.

This might be important in expressing the region's views in global forums and in defending the region's interests in international policymaking. This is important because other regions - Europe, the Americas, Africa and numerous sub-continental groupings – have at various times used their group in order to increase their influence. Indeed, it is difficult to see how other regions could oppose the principle of enhanced regional policy dialogue in east Asia when they have they themselves use their own groupings to influence policy.²⁷

A regional policy forum is also important in deepening outsiders' understanding of the region. Region insiders have a comparative advantage over region outsiders in understanding the structure and operation of economies and policy structures in the region; it is hard to dispute the claim that the deepest understanding of the east Asian economies resides in east Asia, not the United States or Europe.

A number of forums for officials from east Asia to meet and discuss issues of common concern were well in place before the crisis, including meetings of the APEC finance ministers and officials, ASEAN finance ministers and officials, the EMEAP central bank governors, deputies and officials, and the

²⁷ See Henning (2002).

Four Markets Group. Table 1 provides a summary. Some of these forums, like APEC, have comprehensive regional participation and also include countries outside the east Asian region. The coverage of these policy forums also varies. APEC and ASEAN finance ministers cover a wide range of economic and financial issues in their meetings. Others are more specialised: EMEAP is focused on central banking matters (like financial markets, payments systems, and supervision) and the Four Markets Group is focused on financial markets and institutions.

Table 1: Forums for Economic Policy Dialogue in East Asia

Group	Established	Members	Authorities	Coverage
APEC	1989/95	Australia, Brunei, Canada, Chile, China, Hong Kong SAR, Indonesia, Japan, Korea, Malaysia, Mexico, New Zealand, Papua New Guinea, Peru, Philippines, Russia, Singapore, Taiwan, Thailand, United States, Vietnam	ministries of finance and central banks, IMF, World Bank, Asian Development Bank	all economics and finance
ASEAN	1967	Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam	ministries of finance and central banks	all economics and finance
ASEAN+3	1999	Brunei, Cambodia, China, Indonesia, Japan, Korea, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam	ministries of finance and central banks	all economics and finance
EMEAP	1991	Australia, China, Hong Kong SAR, Indonesia, Japan, Korea, Malaysia, New Zealand, Philippines, Singapore, Thailand	central banks	financial markets, payments system, bank supervision
Four Markets	1992	Australia, Hong Kong SAR, Japan, Singapore	ministries of finance and central banks	financial markets
Manila Framework (MFG)	1997	Australia, Brunei, Canada, China, Hong Kong SAR, Indonesia, Japan, Korea, Malaysia, New Zealand, Philippines, Singapore, Thailand, United States	ministries of finance and central banks, IMF, World Bank, Asian Development Bank	economic surveillance and technical cooperation

Notes: APEC trade ministers first met in 1989 but APEC finance ministers first met in 1995; APEC stands for Asia Pacific Economic Cooperation; ASEAN stands for Association of South East Asian Nations; EMEAP stands for Executive Meeting of East Asia Pacific.

But none of them meets the need of east Asia for a regional forum which is comprehensive in membership and coverage, discusses the key issues in a substantive and frank manner, and has the strong political support essential to influencing global institutions and policymaking.

APEC, for example, is a useful forum for identifying agreement and commitment in the Asia-Pacific region and for commissioning policy work and analysis. But its size makes it less useful as a forum for informality and extended negotiation, and the inclusion of the United States and others

means that it is not an east Asian forum. The smaller specialist forums, like EMEAP and the Four Markets Group, include only regional economies, but their role is in promoting specialist discussion in the region. They also tend to be removed from the political process: being ‘outside’ the political orbit means that they can more readily concentrate on issues of policy substance rather than political form, but they also then tend to lack direct political influence and support.

Two new forums for policy dialogue were established as a result of the crisis. The Manila Framework Group (MFG) was established in November 1997 by a number of APEC members to progress financial cooperation and surveillance in east Asia. The MFG is a framework designed as a mechanism for regional surveillance, economic and technical cooperation, strengthening the IMF’s capacity to respond to financial crises, and developing a cooperative financing arrangement to supplement that of the IMF.²⁸

By end-2001, there had been nine meetings of the MFG. Participants say that the value of MFG lies in the frankness and coverage of dialogue between policymakers. But many participants also feel that the discussion is one-sided, in the sense that they are subject to scrutiny by the United States and the IMF but not the other way round. And the participation of the United States and Canada means that it does not meet the aspirations of east Asia for a separate *regional* forum. The MFG has not been at the forefront of regional thinking about cooperative financing arrangements: it has considered the development of cooperative financing arrangements in the past few years but ASEAN+3 remains the preferred focus of most participants.²⁹

The ASEAN+3 heads of state first met as such on 28 November 1999 and issued a ‘Joint Statement on East Asia Cooperation’, calling for strengthened policy dialogue and collaboration, among other things.³⁰ The value of ASEAN+3 is that it is closer to being a regional forum and has strong political support. But it is still in its early days. Participants say that it is yet to achieve the openness and coverage in discussion that characterises other policy forums. And its regional coverage is not uniform, in the sense that it

²⁸ See the statement, A New Framework for Enhanced Asian Regional Cooperation to Promote Financial Stability, www.mof.go.jp/english/if/if000a.htm.

²⁹ See the Chairman’s Summary of the 8th Finance and Central Bank Deputies Meeting of the Manila Framework Group, 8-9 March 2001, Beijing, available at www.mof.go.jp/english/if/if037.htm. and the Press Release of the 9th Meeting of the Manila Framework Group on 4-5 December 2001.

³⁰ This and some other ASEAN+3 statements are available at www.mofa.go.jp/region/asia-paci-asean and at the ASEAN website, www.aseansec.org.

does not include regional economies such as Taiwan, Hong Kong SAR, Australia and New Zealand.

For greater financial collaboration in the region to be effective, it must be associated with improved policy dialogue, and a willingness to frankly discuss key issues, including the policy stance and state of play in member economies. The tradition of not interfering in the domestic policies of countries in the region, especially in ASEAN but also in China, is a challenge to building effective meaningful policy dialogue in east Asia. But it is one that is on the minds of policymakers and more thought is being given to ways to improve the effectiveness of dialogue.

There is interest in looking at the experience of other regions in building up policy dialogue, as shown by the discussions between east Asia and Europe in ASEM. The European experience does shed some light.³¹ For example,³² developing and maintaining close working relationships between policymakers has been important in promoting effective policy dialogue. Policy meetings in Europe in the first few decades of the post-war period were dominated by many of the same people, and this served to promote effective working relations, trust, and a common vision. In this respect, duplication and overlap in forums, especially at early stages of region-building may be a useful tool.

One feature of the dialogue forums that ‘worked’ in Europe was that the chair of the forum did not rotate between members (every six months in the typical pattern) but was fixed for a relatively long period of time. Another feature that ‘worked’ in OECD discussion has been the use of an independent outside chair, namely the IMF chief economist, to open and lead discussion on economic and financial issues. It may also be the case that widening the membership to other economies in the region may change the dynamics of policy dialogue, as well as make it fully representative of the east Asian region.

Building up well-functioning forums for policy dialogue can take a long time. It is not a linear process and it is unreasonable to expect perfection at the start. Europe’s experience in building regional policy dialogue was

³¹ The way in which groups of countries develop policy dialogue depends in part on the issues that they meet to discuss and in part on the history of their interaction. What works in one case may not work in another. East Asia is different from Europe: economic development is a key priority in a region as diverse as East Asia; openness and market-orientation are essential to a region like East Asia which depends on broad-based world economic growth; and the history of interaction in east Asia is different from that of Europe.

³² See Wyplosz (2001), Rollo (2002) and Pisani-Ferry (2002).

piecemeal and iterative. Policymakers were opportunistic in the sense that they took advantage of opportunities to strengthen dialogue when they arose. The approach in east Asia has been, and is most likely to continue to be, similar in this respect. The process is likely to be messy, with progress going back and forth. But it is now underway and the commitment to it is strengthening.

3.2 Financial cooperation

The financial crisis led to a deep shift in the thinking within the region about the need for substantive forms of regional financial cooperation. The disillusion with the Fund's performance during the crisis has meant that some reliance on regional mechanisms is inevitable. This has been underpinned by high expectations but poor progress in international forums in dealing with key issues about the international financial architecture that are important to east Asia, like private sector involvement, highly leveraged institutions and destabilising speculation, and reform of the IMF.³³

One purpose of strengthening policy dialogue in east Asia has been to determine the structure, conditions, and eligibility criteria for regional financial cooperation. The ideas have ranged anywhere between the two extremes of no regional financial architecture, with only a reliance on IMF facilities and the New Arrangements to Borrow (NAB), to only a regional architecture for financial support, thereby dropping the IMF out altogether.

What is financial cooperation?

The debate and policy action are still at a relatively preliminary stage. In part, this is because policymakers are still coming to grips with the aims of regional cooperation. Financial cooperation, be it regional or global, can be of three broad types. It can be a mechanism for providing very short-term temporary liquidity support, say because of a mismatch in funding.³⁴ The amounts in this case are likely to be small.

Or it can be a device for preventing crises: a financial crisis is more likely to occur, among other things, the weaker are economic fundamentals and

³³ See Kim, Ryou and Wang (2000), SaKong and Wang (2000) and de Brouwer (2001). Following recent interventions by Anne Krueger, the First Deputy Managing Director of the IMF, the prospects for setting up mechanisms for private-sector involvement in financial crises now seem brighter.

³⁴ The distinction between funding a short-term liquidity shortfall and preventing a financial crisis may be an artificial one: it is hard to see how in practice a country can have a short-term liquidity problem in international payments without generating a financial crisis.

financial structures. Much of the work on crisis prevention has focussed on reducing domestic vulnerabilities, reflected in the IMF's focus on developing and implementing standards for reporting and policy.

Crisis prevention measures also include making more funds available to deal with crises. In standard models, strong fundamentals are associated with the stock of foreign currency reserves.³⁵ Building up the armoury of reserves through access to IMF facilities or bilateral swap arrangements - which are essentially one country lending its foreign exchange reserves to another - can be a device to prevent a crisis from occurring. This is most likely to work in a country where the economic fundamentals are broadly okay, so that the signal that the increase in reserves gives about the fundamentals is an accurate and credible one. The amounts required in this case are likely to be large.

There is another, more recent dimension to financial cooperation to prevent crisis prevention: contagion. Even countries with fairly sound economic and financial structures may be adversely affected by changes in investor and speculator sentiment due to weakness in another country.³⁶ The possibility of contagion led the IMF to establish a new lending facility in 1999, the contingent credit line (CCL), which is available to countries in good economic condition which experience investor reversals because of a crisis elsewhere.

Financial cooperation can also be directed at resolving a financial crisis once it has begun. In this case, credit is provided to a country to boost its reserves to meet international payments, subject to conditions set by the lender. This sort of financial cooperation is designed to restore market and investor confidence and underpin economic recovery. This is standard IMF fare and, as shown by the financial crises in 1994, 1997 and 1998, the amounts required are likely to be large.

Should financial cooperation be regional or global?

The substantive issue facing east Asia is how regional financial cooperation fits in with multilateral mechanisms centred on the IMF. Is regional cooperation designed to provide temporary liquidity support, prevent

³⁵ See Obstfeld (1996) and Corsetti, Dasgupta, Morris and Shin (2000).

³⁶ See Dornbusch, Park and Claessens (2000). This does not imply that the events of 1997 and 1998 were only due to contagion; see de Brouwer (1999, 2001). There is also considerable debate between economists about the existence and prevalence of contagion; see, for example, Edwards and Susmel (2000), Bordo and Murshid (2000), and Rigobon (2001).

financial crises, or help in the resolution of these crises once they have begun? The merits of regional, as opposed to global, mechanisms need to be spelled out with respect to each of these types of financial cooperation.

The simplest case of financial cooperation is the provision of short-term liquidity support to cover a temporary shortfall in funds. This type of funding need is not generally provided by the IMF³⁷ and is typically provided by regional networks, such as through bilateral or regional swaps. In this respect, there is no inherent tension between regional and global financial temporary liquidity support arrangements. In fact, well-structured regional arrangements are important because they reduce the risks of a crisis caused by a short-term liquidity shortfall. Moreover, the policy dialogue that accompanies these arrangements helps increase intra-regional understanding of economies and markets.

The more complex cases are the crisis prevention and resolution processes. At the risk of oversimplification and caricature, there are three standard arguments against regional processes in east Asia for financial cooperation.

1: The primacy of global cooperation

The first is that regional processes undermine global processes. The strong statement of this view is that the existence of any other financial support mechanism weakens the global mechanism.

The primary concern is that regulatory arbitrage will occur and weaken global systems. If the terms and conditions of the regional support mechanism differ from the IMF facility, then the putative borrower will seek the loan with the best terms (like lower interest rate and longer repayment schedule) and easiest conditions (less reform, easier policy stance). If the terms and conditions are easier on regional loans than on IMF loans,³⁸ then there will be a general weakening of conditionality and a drift away from the IMF and global cooperation. A subsidiary argument is that when crises occur across a mix of regions, the costs of coordination and risk of inconsistent outcomes are higher.

³⁷ IMF lending for a liquidity squeeze depends on the nature and size of the shock. The Compensatory Financing Facility (CFF), for example, is available to countries which experience a sudden shortfall in export earnings or increase in the cost of food imports caused by fluctuating world commodity prices. See the IMF website, for example at www.imf.org/external/np/exr/facts/howlend.htm, for a summary of the IMF lending facilities.

³⁸ This is the standard assumption, but it is just an assertion. See Henning (2002) for an interesting discussion.

The counterargument made in east Asia proceeds as follows. The starting premise is different: there should be no presumption that a global arrangement is better than a regional arrangement in all cases. The criterion to judge which arrangement is better is that which best achieves the aim of preserving stability, not whether it is global or regional. For example, if the terms and conditions set by the IMF are inappropriate while those set by the regional body are appropriate, then the regional arrangement is preferred, all else given. And as for argument that it is easier to preserve consistency at the global level, it is hard to make the claim that the IMF stands above political pressures and is always consistent in its programs.

These are reasonable counterarguments. It cannot be assumed that regional arrangements in east Asia would be inherently worse than IMF arrangements: it ultimately depends on how the institutions and instruments of cooperation are organised in practice. There are five dimensions to this.

First, the crucial issue is whether regional or global frameworks have a comparative advantage in delivering appropriate conditionality. There is no doubt in most people's minds that the IMF made serious errors of judgment in the crisis. This is well worn ground. The issue from here on in should not be payback: the past is past. It should be whether the IMF is more likely to repeat the same kind of mistakes again in the future and whether a regional arrangement is likely to do any better. Frankly, this is impossible to answer since it depends on too many unknown factors.

One factor is the level of knowledge and understanding about east Asian economies, markets, and political processes. There is considerable technical knowledge, data and analytical power at the Fund but this does not mean that it has a solid understanding and experience with economic, institutional and market processes in the region. This sort of knowledge is generally found at the national and regional level.

The issue then is whether the regional body has sufficient expertise, experience, and 'distance' to marshal the resources, frame the conditions of the package and set them with the borrowing country. Moreover, the IMF has broad and extensive experience when it comes to dealing with financial reform after a crisis and facilitating the write-down of existing debt; more than a regional body ever could. The conundrum is that the IMF may be more likely to be able to impose policy conditions in a package and provide expert advice in resolving the crisis than a regional body, but that the regional body is likely to better understand the economy, institutions and markets.

Another factor is the nature of the institution making the decision. One criticism of the Fund is that its view of the world – how it interprets a crisis and the policy that it recommends – changes slowly. This is exacerbated by its bureaucratic structure and size: the institutional view is a highly persistent reaction to the past. A regional institution which is less bureaucratised (like a secretariat) may be more flexible. It also depends on the intellectual bias or culture of the institution. Some criticise Fund economists as being too ideological and fundamentalist about markets. But the criticism of a regional body is that its intellectual culture may overstate the institutional differences in Asia at the expense of economic forces. There is also the problem of whether a large regional body would be able to attract the quality of staff and policy formation that global institutions, like the IMF and World Bank, can.³⁹ Another factor is whether countries are more likely to take ownership of reform if it comes from within the region or without. These are clearly open questions.

Second, regional arrangements are adequate if there are sufficient pressures in place to ensure that the public monies used to fund regional financial support are responsibly allocated – in short, that they are provided subject to terms and conditions. It would seem, on balance, that sufficient pressures do exist in east Asia. Most countries in the region are democracies and policymakers are sensitive to their civic responsibilities and pressure from the electorate, especially after the large-scale exposure of official corruption and featherbedding of recent years.

The likely lender countries - China, Japan and Korea - have no appetite for wasting their own funds, as shown by the strict terms and conditions that they have attached to the network of ASEAN+3 bilateral swaps (discussed below). The public in many countries is not prepared to accept it. The public mood against bank bailouts in Japan, for example, has made politicians unwilling to use public funds to buy out banks' bad debts: they are not going to tolerate their money being used to bailout some other country.

Third, the relative merit of global and regional mechanisms depends on the effectiveness of governance over the lending intermediary – the IMF at the global level and, say, an Asian Monetary Fund at the regional level. It is not clear which provides the best governance mechanism. Governance by

³⁹ The Asian Development Bank, for example, has many excellent and capable professionals, but it is generally regarded as less prestigious than the World Bank and unable to attract the same quality of staff.

member governments of IMF staff and management through the Executive Board is weak.⁴⁰

The role of east Asian governments in the governance of the IMF is also weak. This is in part because the voting power of Fund members and constituency representation on the Executive Board is biased towards Europe, the Middle East and Africa, at the expense of east Asia, especially Japan. But it is also because some east Asian countries do not take advantage of their position to be actively involved and lead discussion in meetings, for any number of reasons – resentment, a distaste for directness or confrontation, relatively poor English language skills, a poor grasp of the issues, or a reluctance to take a global rather than regional or national perspective.⁴¹

Whether governance would be better at the regional level is an open question. It depends on some critical factors. If regional arrangements are centred in a large bureaucracy with policymaking powers (akin to the IMF), then the institution is likely to be harder to govern by national governments. If it is more like a well-run secretariat (perhaps akin to the way Andrew Crockett ran the Bank for International Settlements), then governance and control of policy are easier since policymakers at the national level retain control over the policy agenda and its implementation. East Asian policymakers are much more inclined to secretariat-type regional institutions. On the other hand, effective governance also requires policymakers to participate actively and openly in governing forums.

Fourth, the ability of an institution to garner broader international interest and support is a crucial element in organising a rescue package. The IMF failed to garner additional support from the United States for Thailand (and Indonesia). This weakened the credibility of the program and was the

⁴⁰ The weakness of the Executive Board in monitoring staff and management and leading the Fund's policymaking is a serious and complex issue. On the one hand, governance is weak because management and staff bypass the Board. For example, management use 'side letters' in packages that the Board does not review, although these are now used less than before the crisis. Management also at times pre-empt the Board in critical matters, as occurred with the Russian emergency package in 1998. There is widespread dissatisfaction at the Board with the narrow policy options and limited information presented to it by staff. But, on the other hand, the Executive Board does not exercise its duties as well as it could. Some Board members are appointed for convenience, seniority or prestige rather than on merit. Some members of the Board have leaked sensitive material for political gain, which led to the use of side letters in the first place. And, from the management point of view, there is little appetite at the Board for taking responsibility and making decisions. The effectiveness of the Board ultimately depends on the commitment of national governments to the Fund.

⁴¹ See Stanley Fischer's (2001) exhortation to Asian policymakers to improve the quality of their representatives on the Executive Board and engage more with IMF staff and management at the Executive Board.

impetus for Japan's proposal for an Asian Monetary Fund in September 1997. A regional fund is one way to lock in regional support. And it may also be a high-profile device to influence the IMF and other country lenders.

Fifth, regional lending facilities may in fact be more effective than global arrangements in preventing crises because of contagion. The IMF's Contingent Credit Line (CCL) facility was designed to prevent contagion: a country with reasonably good fundamentals would sign on to the facility to boost its reserves position in the event of financial contagion. But it has not been activated since it was introduced in 1999. There are two main reasons for this. In the first place, countries which meet the entry criteria are concerned that signing up to the facility would send a bad signal to financial markets, force up borrowing costs and even start a crisis. They are also afraid that exiting the facility, especially if they are forced to because they no longer meet the entry criteria, would create a loss of market confidence in them and also create a crisis. The problems with the CCL are the signals created by entry and exit, rather than the facility itself.

A regional financial arrangement which is available to members when they face contagion may overcome this problem. There is no adverse signal from entry or exit since there is no entry or exit from access to the facility: funds can be disbursed immediately on approval by the regional body (and at the discretion of the regional body). The credibility of the facility would depend on the credibility of the regional body. One way of acquiring credibility would be to allow for the IMF to make a statement of support of the regional action, if it considered this to be appropriate.

Put together, these five considerations suggest that there is a complementarity between global and regional arrangements. On the one hand, global arrangements allow policymakers to deal consistently with crises. They create distance between the borrower and lender so the risk of the lender being 'captured' by the borrower is smaller. And international institutions have the requisite expertise to deal with the aftermath of a crisis. On the other hand, the best understanding of countries in a region resides in the region. Regional arrangements are more likely to prevent countries slipping through the global net because they are not important enough to the United States or Europe. And preventive arrangements at the regional level might be more effective than those at the global level, like the CCL.

This goes some way to addressing the question implicit in this analysis of whether an Asian Monetary Fund could have dealt better with the crisis than

the IMF.⁴² It is a natural question to ask but it is also a nonsense question because the counterfactual is unknowable. There is no way of providing a firm answer one way or the other.

The crisis could have been handled better. There is widespread agreement that the Fund made some serious errors in terms of judging the nature, effects and severity of the crisis, and the policy recommendations to deal with it, including tight fiscal and monetary policies and excessive focus on structural defects in the economy in an exchange rate crisis. Others, including in the private sector, also made these mistakes.

But could regional policymakers left to their own devices have done better? The exchanges between officials in the region and those at the Fund and elsewhere outside the region are not on the public record. But those involved say that there were serious representations to those outside the region from senior officials within the region about these matters from the start of the crisis. If these views had influenced thinking outside the region, the effects of the crisis may have been dampened. If there had been a regional fund and this perception had influenced its thinking then things may have been better.

But new problems could have arisen, especially if only a regional fund were involved - like resource constraints in a widespread regional crisis, finding sufficient expertise in the region to deal with the financial and institutional problems, and ways to involve private-sector institutions from outside the region (like US and European banks) in crisis resolution. The set of criticisms in the counterfactual may have been very different.

⁴² Some would argue that a regional fund would have made the crisis worse by weakening the commitment to reform and by raising the stakes in the game. On the latter point, the macro hedge funds faced no external financing constraints from the investment banks and securities firms that funded their short speculative currency positions in 1997 and 1998, and could have increased their positions as the level of reserves increased (FSF Working Group on HLIs 2000; de Brouwer 2001). Whether this would have happened is unknowable, and would probably have depended on the credibility of the regional fund and package.

2. Resource constraints

The second argument against regional financial cooperation is that the region would not have the resources to deal with a region-wide shock because countries will need their own reserves and will not be able to share them. If all countries are affected or if a major financial shock were to hit the principal lenders in the region and limit their ability to lend, then the regional arrangement may not work.

The counterargument made in east Asia is that this means that global arrangements and regional arrangements must be complementary. It is not a case of ‘either or’. In some situations, a regional response may be appropriate and in some cases, such as a major regional or cross-regional crisis, a global response through the IMF would be appropriate. Even in the latter case, coordinated regional support as a first or second line defence may be important in putting an adequate financing package together.⁴³

3. Inadequate policy dialogue

The third argument against regional support arrangements is that the policy dialogue processes needed to underpin successful financial cooperation are too weak in east Asia. Countries in the region are not willing to expose themselves to surveillance and monitoring of domestic economic conditions and policy by their peers. This is particularly so with ASEAN’s policy of non-interference in its members’ domestic policy, including in both public and private discussion.

This was probably right five years ago but while it remains a serious issue things are starting to change. Policymakers understand that policy dialogue has to be strengthened and improved, and there is now increasing political will to do this. They also realise that progress is piecemeal, uneven and iterative. This will take a while but it is unreasonable to expect all the pieces to be in place immediately.

Whatever the case, the real test of any regional arrangement will be in how it performs in future financial crises. There are arguments for and against regional financial arrangements of various sorts and it is not possible to conclude which is right on the basis of the arguments alone. It really depends on how they are implemented. Global and regional cooperation can be effective and stabilising or they can be ineffective and/or destabilising. The proof of the pudding is in the eating.

⁴³ See Parkinson, Garton and Dickson (2002) for a discussion on first and second tier financing.

The effectiveness of financial cooperation at both the regional and the global level depends in part on how cooperation is structured. This includes not just the terms and conditions of the support lending, but also the institutional and dialogue forms in which it is activated. In practice, the evaluation of the instruments cannot be isolated from the institutional structures in which they are nested.

As a final comment, the success or otherwise of regional financial cooperation should be measured by how the regime as a whole prevents or resolves future financial crises in east Asia. The focus should *not* be whether regional mechanisms and institutions are established. Minimising crises is the matter of substance; creating mechanisms is a matter of form.

One hope of the talk and action on regional policy dialogue and financial cooperation is that it will influence global policy dialogue and financial cooperation. A new entrant makes the 'market' for dialogue and cooperation contestable and may change the reaction of incumbents. The formation of regional dialogue and cooperation was driven by deep dissatisfaction with the IMF's performance in 1997 and 1998 and the perception that the US support is unreliable. Developing regional processes is partly aimed at changing the reaction function of the IMF and other countries, to make them consider the needs and characteristics of the region and to recommend and apply appropriate policies. But the 'threat' of entry is probably not sufficient to do this; actual entry may be required to change the reaction of the IMF and major countries outside the region.

The state of play in financial cooperation in east Asia

The first proposal for greater regional financial cooperation as a result of the crisis occurred fairly early, when Japan proposed an Asian Monetary Fund in September 1997. Japan was willing to commit half of the proposed \$100 billion AMF. This proposal soon failed in the face of opposition by the United States, because of perceptions that it would undermine the IMF, and China, because it was suspicious of Japan's intentions.⁴⁴ What has eventuated so far in terms of financial cooperation has been much more modest.

There have been two developments in regional financing initiatives since 2000 both under the umbrella of the Chiang Mai Initiative (CMI) of May 2000. The first is the expansion of the ASEAN swap arrangement

⁴⁴ Australia and Hong Kong also opposed the AMF proposal at the time.

established in August 1977. Under this arrangement, the five original ASEAN members agreed to provide up to \$40 million to other members. This amount was obviously too little to be of help except for minor liquidity shortfalls. It has been used only four times and was not used in the 1997-98 financial crisis.⁴⁵ The ASEAN swap arrangement was widened to all ASEAN members and increased to \$1 billion in May 2001. The expanded arrangement is still too small to deal with financial crises but can be used for liquidity shortfalls.

The second development is the establishment of a full series of bilateral swap and repurchase agreements between the ASEAN+3 countries. The network of bilateral swaps in ASEAN+3 will be fully in place by mid-2002. The bilateral swaps are secured by government guarantees and range in amounts of \$1 billion to \$5 billion, and total to around \$30 billion. Ten per cent of the swap can be allocated on the discretion of the lender and the remaining 90 per cent is allocated on the discretion of the lender and is subject to the borrowing country meeting IMF conditions for financing.⁴⁶ The swaps can be rolled over a specified number of times and the borrowing country is required to provide additional information regularly to the lending country.

In its current state, the CMI is far too small to be directed at crisis prevention or crisis resolution by itself. The total size of the bilateral swaps may sound large but, compared to the capital flows and size of speculative positions in place in 1997 and 1998 it is not.⁴⁷ The short positions on the baht alone in mid-1997, for example, were about \$27 billion, the size of the Bank of Thailand's foreign exchange reserves. The size of the short positions on the Australian dollar, Hong Kong equities and Hong Kong dollar, New Zealand dollar, ringgit, and Singapore dollar in mid-1998 are thought to have been roughly about \$47 billion. The size of the short positions on the yen in mid-1998 are thought to have been between \$200-300 billion. And the size of these positions was endogenous to the exchange rate policy and level of reserves at the time.⁴⁸

⁴⁵ See Kim, Ryou and Wang (2000: 29-30) for details.

⁴⁶ Including IMF conditionality was controversial but agreed to because it was thought important to link regional arrangements with global arrangements and ensure that appropriate conditionality is applied. This helps establish the credibility of the system and assuage concerns that regional arrangements are designed to subvert global arrangements.

⁴⁷ See Financial Stability Forum Working Group on Highly Leveraged Institutions (2000) and de Brouwer (2001).

⁴⁸ The main macro hedge funds involved in these positions had essentially limitless access to fund their positions (Financial Stability Forum Working Group on Highly Leveraged Institutions 2000). Their

The CMI in its current form can be used in conjunction with an IMF facility to minimise a financial crisis. And it can be used by itself to fund a temporary shortfall in liquidity between a member country, which may help avoid a crisis. The CMI is widely seen as only the first step in the process of regional financial cooperation and is due for review by ASEAN+3 in 2004.

The target of a number of countries is to create an Asian Monetary Fund-type institution which could be a first port of call in dealing with financial crises within the region. For most, if not all, countries, an AMF is seen as complementary to the IMF's regional and global responsibilities but would also be independent of the IMF. It is widely recognised that it will take time to develop and that progress towards it is not likely to be smooth since it depends on the sustained convergence of competing strategic interests in the region and the formation of consensus. The response of the United States is also important.

One intermediate step has been proposed by Korea. Kim, Ryou and Wang (2000) have proposed an Asian Arrangements to Borrow (AAB). The AAB would operate analogously to the New Arrangements to Borrow (NAB) and General Arrangements to Borrow (GAB),⁴⁹ which provide a mechanism for the IMF to supplement its resources for lending in a financial crisis. The AAB would be a regional mechanism for creditor countries to contribute to a pool of funds that could be disbursed under specific terms and conditions to east Asian countries facing or experiencing financial crisis. They propose that the AAB be managed within the region.

The proposal needs refinement. For example, the trigger for the AAB is not well defined. Kim, Ryou and Wang (2000) say that the AAB is a device to prevent a crisis and suggest that it could be triggered when a country with sound fundamentals experiences a large currency depreciation, say 20 per cent. But this is probably already too late. It also leaves open what is meant by sound fundamentals.

3.3 Common currency arrangements

The third leg in regional financial arrangements is the adoption of some kind of common currency arrangement within east Asia or some subset of it. Common currency arrangements range from common basket pegs (to the dollar, yen and euro) and regional currency units (a weighted sum of

positions would most likely have been larger had reserves positions and the commitment to maintain exchange rates at prevailing levels been greater.

⁴⁹ See Kim, Ryou and Wang (2000) and www.imf.org/external/np/exr/facts/gabnab.htm.

regional convertible currencies) to formal currency union. While there is regional consensus on strengthening policy dialogue and financial cooperation, there is no consensus on common currency arrangements.

There is a wide mix of views about common currency arrangements in the region. Japan is a strong proponent of common basket pegs.⁵⁰ Korea favours the use of an Asian Currency Unit, not only for its perceived stabilising effect but because it does not concentrate decision-making and seignorage returns on Japan.⁵¹ ASEAN has also commissioned research on whether ASEAN should have a common currency.⁵²

While the general view is that cooperative or common currency arrangements are still some time off, they are increasingly being thought of as a long-term policy aim. Deepening and developing regional policy dialogue and financial cooperation are important to the way in which common currency arrangements will evolve in east Asia. Strengthening financial cooperation is seen as particularly important in this respect since exchange rate cooperation must be backed by unequivocal financial cooperation if it is to work. At this stage, such commitment does not exist in the region.

The IMF will be included in the analysis of these issues but the degree to which the region seeks its advice and involvement will ultimately depend on the stance it takes on these issues. The IMF seems to be attracted largely to a bipolar view of the suitability of exchange rate regimes, and that the room for intermediate exchange rate regimes exists but is small.⁵³ There is, in particular, little support among Fund staff for common pegged exchange rate systems because experience with such regimes is that they tend to come undone in a costly manner. While many in the region agree with this - and so regard formal currency union in the longer term as the more viable common currency arrangement - others, especially in Japan, do not.

⁵⁰ See Goto and Hamada (1994), Ito, Ogawa and Sasaki (1998), Council on Foreign Exchange and Other Transactions (1999), Murase (2000), Ogawa and Ito (2000), Ogawa (2000), Kawai and Akiyama (2000), Kawai and Takagi (2000), Yoshino, Koji and Suzuki (2000). Dornbusch and Park (1999), Williamson (1999, 2001) and Kwan (2001) are also supportive. See de Brouwer (2002b) for an alternative view.

⁵¹ See Kim, Ryou and Wang (2000), Moon, Rhee and Yoon (2000), Ryou and Kim (2001), and Moon and Rhee (2001).

⁵² See Bayoumi and Mauro (1999).

⁵³ See Mussa, Masson, Swoboda, Jadresic, Mauro and Berg (2000) and Fischer (2001).

4. Conclusion

The financial crisis – and particularly the way in which it was dealt with by the IMF and the United States - has been a key force behind the assertion of the new Asian regionalism and its talisman, new regional financial arrangements. This has been boosted by Europe's experience with monetary union and by increasing trade openness and integration in east Asia.

Over the past few years there has been a clear shift in policy preferences to strengthen regional policy dialogue, create new forms of regional financial cooperation - including using new instruments for cooperation, developing regional financial markets, and establishing new institutions for cooperation - and to think more seriously about common currency arrangements in east Asia, or at least part of it.

Stronger regional financial arrangements are mostly viewed in east Asia as being complementary to global financial dialogue and cooperation, embodied in the IMF. The IMF is still seen to be an important and necessary institution, not least in being there to provide assistance in large or global financial crises but also in giving countries a voice in international policymaking and securing greater interest from the United States and Europe in events beyond their own regions. But it failed the critical test in 1997 and 1998 in providing expert policy direction and in garnering international support. Regional initiatives are a way to deal with this failure.

The two crucial elements of developing regional financial arrangements at this stage are strengthening policy dialogue and deepening financial cooperation. Strengthening policy dialogue is important in its own right: it improves understanding of regional economies and markets and gives the region a stronger voice in global dialogue and policymaking. It also is a necessary condition for effective financial cooperation.

Developing new forms of regional financial cooperation and support is also important in helping protect the region from further crises. At the most elementary level, arrangements to deal with temporary liquidity shortfalls are not comprehensively provided at the global level but can be at a regional level.

There are usually three arguments made against regional support arrangements: they can weaken global arrangements, especially with respect to terms and conditions; they are too limited to deal with large regional or global crises and can cause coordination problems and inconsistency; and they need to be backed by adequate policy dialogue and surveillance processes. But none of these arguments is decisive.

First, the presumption that global arrangements are necessarily better than regional ones must be tested by actual circumstances. The IMF did poorly in the east Asian financial crisis on a number of fronts. But, having accepted this, it is time to move on and look to the future with balance. Global arrangements have particular advantages in creating a bit of distance between borrower and lender and in providing expertise in dealing with problems in financial institutions and firms after the crisis. Regional arrangements have particular advantages in understanding economic processes in the affected countries better, ensuring that someone is interested even if the United States and Europe are not, and in providing a practical way to deal with localised contagion. They may also be a substantial boost to the Fund's financial resources. By increasing the contestability of policy advice and action, they may affect the reaction of the IMF in future crises and improve international involvement and terms and conditions. Global and regional arrangements, properly structured, should be seen as complementary.

Second, large regional or global crises cannot be prevented or resolved just at the regional level and so there is a first-order argument for global arrangements, as exist with the Fund. Again the aim of regional arrangements should not be to supplant the Fund but to complement it.

Third, strong effective policy dialogue, including surveillance, is necessary for well-functioning arrangements for financial support. The region is not there yet, but policymakers understand this and are working to improve dialogue. This will take time, as will the evolution of working financial support arrangements.

Progress on strengthening regional financial arrangements has been modest. Policy dialogue has been expanded through the Manila Framework Group and ASEAN+3 Finance Ministers meetings, although both forums have different relative strengths and weaknesses. Financial cooperation has been expanded through the ASEAN+3 framework, expanding ASEAN swaps and introducing a comprehensive network of bilateral swaps between ASEAN+3 countries, which aggregate to about \$30 billion. While important symbolically as a first step in ASEAN+3 cooperation, the amounts involved are too small to use in a financial crisis.

There is still a long way to go in developing regional policy dialogue and financial cooperation, let alone common currency arrangements, in east Asia. The path of financial and economic integration in east Asia is not predetermined. The ultimate form and substance of regional financial

arrangements is highly contingent on future circumstances and the willingness of countries in the region to engage and cooperate with each other. The process is iterative and messy. But it is underway, and the policy and political dynamic behind it is irreversible.

As regional financial arrangements progress, a major challenge for the region is to articulate and then actualise the sort of relationship it wants with the IMF. While resentment and disillusion with the Fund still run deep – although less intensely than in 1997 and 1998 – the region needs to think pragmatically and strategically about the issue. The IMF is an essential part of the global financial architecture. Regional mechanisms and institutions can be an important complement to global ones but it is unrealistic to expect them to fully replace global ones. Developing regional policymaking at the expense of better global policymaking may be ultimately self-defeating: the more the region disengages from global processes and the IMF, then the less likely is the IMF to be suitably responsive to the conditions and needs of the region in future crises. A regional financial architecture is most unlikely to have the financial and technical capacity to deal with every financial crisis that affects east Asia. To be most effective, the development of a new regional financial architecture has to go hand-in-hand with renewed commitment to, and the exercise of leadership in, the Fund by the region.

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