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The Case for Financial Regionalism

The fundamental question posed by Asian regional financial cooperation is whether international financial relations should be organized primarily on a multilateral basis, with the International Monetary Fund at the center, or whether multilateral institutions can usefully be supplemented with regional arrangements. This chapter presents the case for a *mix* of multilateral and regional arrangements in principle.[1] (This study treats the merits of regionalism as it has evolved in practice in East Asia in the form of the Chiang Mai Initiative in chapter 3.) The rationales for regionalism are economic, institutional, and political.[2]

To begin with, the progressive integration of markets in East Asia has conferred upon the countries of the region a *commonality of economic interest*. Intraregional exports reached more than 50 percent of total exports in 2000, slightly below the peak prior to the financial crisis. Exports to the region reached 42.4 percent of Japan's total exports, 49.9 percent of China's total exports, and higher percentages of many other countries'

1. This argument should be distinguished from the case for regional *instead of* multilateral arrangements. It is not necessary to choose between cooperation at the two levels.

2. The case presented here benefits in many places from work advocating East Asian financial arrangements, including but not limited to Wang (1999, 2000); Kim, Ryou, and Wang (2000); Yoshitomi and Shirai (2000); Rajan (2000); Park (2001a); Park and Wang (2001); Sakakibara (2001); de Brouwer (2002); Rana (2002); Parkinson, Garton, and Dickson (2002); and Bird and Rajan (2002a). The reader should bear in mind that rationales (part of normative analysis) should not be confused with motives (part of positive analysis) of the governments in the region.

total exports in 1997. For the region as a whole, intra-Asian exports represented about 11.3 percent of regional GDP in 2000. Although exports to East Asia were only 3.3 percent of GDP for Japan, they represented between 10 and 20 percent of GDP for China, South Korea, Australia, and New Zealand in 2000. In that same year, the ratios for Indonesia, the Philippines, Taiwan, Thailand, and Vietnam were between 20 and 40 percent, and those for Malaysia, Hong Kong, and Singapore were above 60 percent.[3] The economies of the region thus have a substantial interest in the stability of trade and investment relations among them, which financial arrangements can foster.[4]

Second, as the Asian financial crisis amply demonstrated, the countries of the region are vulnerable to *contagion* from one another. During 1997 and into 1998, contagion was transmitted through several channels, including regional trade and investment flows, and it substantially followed regional lines.[5] Contagion thus strongly reinforces the shared interest in crisis prevention and stabilization among countries in the region that is distinctive in nature and intensity from interests shared with countries outside the region.

Third, since recovering from the crisis, East Asian countries have increased their holdings of foreign exchange reserves dramatically to secure greater room for maneuver in any future crises (see figure 2.1) They have done so despite also switching to much greater flexibility in their exchange rate regimes and despite the augmentation of the IMF's resources, demonstrating widespread concern about access to these resources on acceptable terms. However, their current reserve holdings are very high in relation to trade and GDP, and arguably are inefficient. To the extent that reserves are accumulated through current account surpluses, countries outside the region, such as the United States, run correspondingly excessive current account deficits. By giving greater confidence of access to a safety net, advocates argue, the mobilization of the region's reserves in a crisis could enable countries to *reduce reserve holdings*.[6]

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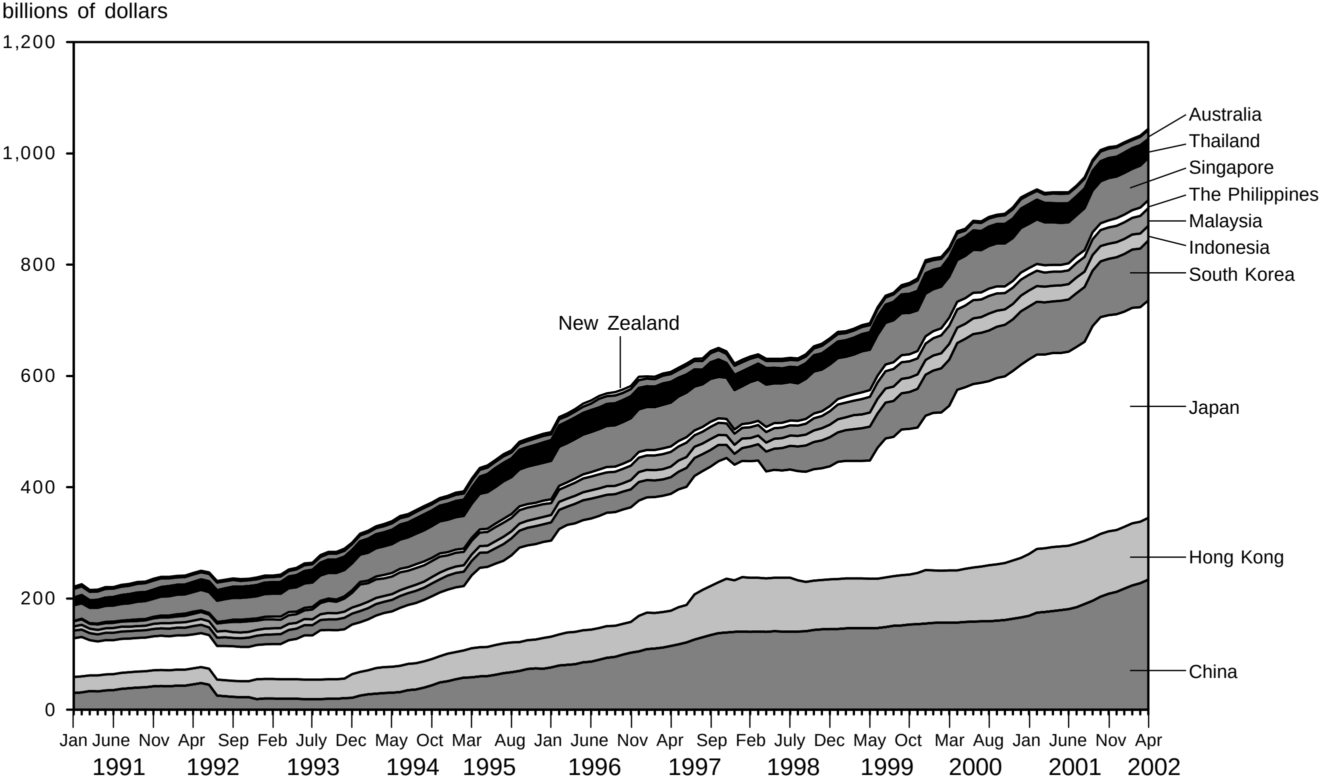
3. Calculated from IMF, *Direction of Trade Statistics*, 2002.

4. Note that the countries of the region need not be relatively more integrated with one another than they are with the rest of the world for regional cooperation to be compelling. Absolute levels of regional interdependence determine the size of the benefits from regional cooperation. Dependence on markets outside the region merely argues for multilateral cooperation to be sustained while introducing regional arrangements.

5. The regional dimension of contagion is well documented. See, among other work, Calvo and Reinhart (1996); Glick and Rose (1999); Drazen (2000); Kruger, Osakwe, and Page (1998); and Kaminsky and Reinhart (1999). Also see Masson (1998). Rose (1998) and Rajan (2001a, 2001b), among others, apply the regional character of contagion to the case for regional cooperation.

6. See, e.g., Rajan (2000); Fischer (2001, 6-7); Park (2001a); Park, Chung, and Wang (2001); Stiglitz (2002); and Bird and Rajan (2002b). Preeg (2000) argues that high levels of reserves in East Asia reflect undervaluation of currencies in the region.

Figure 2.1 East Asian foreign exchange reserves



Note: The reserves of Myanmar, Laos, Vietnam, and Cambodia are not displayed because they are quite small in relation to those of others in the region.

Source: IMF *International Financial Statistics.*

Fourth, the experience of 1997-98 shows that the sheer *size* of international financial markets, and indeed of even single financial firms, is a source of vulnerability for relatively small emerging-market countries. By linking themselves to regional partners through swaps and other financial facilities, the more vulnerable governments can help to *redress the asymmetry in size* between their national markets and international financial firms.[7]

Fifth, advocates of the CMI and more ambitious financial cooperation in East Asia have argued that the size of the IMF and the diversity of its membership, though sources of strength, are also causes of weakness. They require broad consensus and involve extended consultation and relatively slow decision making. Small groups of countries are able to block access to IMF resources, and programs are not always flexibly adapted to local circumstances. The variability of political support for the IMF and its activities in the US Congress, and the possibility that US approval for important IMF decisions can be blocked or delayed by relatively narrow groups, is particularly worrisome.

Among a regional grouping of a limited number of more like-minded countries, *decision making* can be less cumbersome and more *expeditious*, enabling financial assistance to flow more quickly. To the extent that financial crises are driven by collapsing confidence, which played a larger role in some countries than in others during the 1997-98 period, speed of disbursement is especially important. Given uncertainty about the future evolution of the international financial architecture, and the ability of the region's countries to access the resources of multilateral institutions, regional financial cooperation is a prudent hedge.

Sixth, regional facilities will *supplement the resources* of the IMF and other multilateral institutions. Supplementing resources appears particularly compelling to countries in East Asia whose borrowing capacity may be constrained by their undersized IMF quotas. Borrowing constraints will be especially tight if access limits are enforced and bilateral second lines of defense are eliminated.[8]

Seventh, swaps and financial facilities can provide a focal point for the enhancement of *regional surveillance* and policy dialogue. Governments and central banks in the region can thus better assess their vulnerability to future crises, anticipate such crises, preempt (or respond to) them with policy adjustments, and cooperate outside the financial sphere when crises emerge. Regional policy dialogues can supplement surveillance and early-warning exercises based in the IMF. Sharing regional markets in goods and capital, neighbors sometimes have superior, more up-to-date

7. See, e.g., de Brouwer (2001).

8. E.g., the administration of George W. Bush has made a point of not providing bilateral loans to Argentina and Turkey, although in August 2002 it provided a bridge loan to Uruguay and agreed to the waiving of Brazil's access limits at the IMF.

information about countries in crisis than multilateral institutions and Group of Seven governments and a stronger material interest in corrective action.

Moreover, financial cooperation can support regional integration in functionally related economic areas and over the long term. Financial facilities, capital-flow monitoring, and policy surveillance could serve as underpinnings for future regional monetary initiatives. A number of officials and analysts in the region have proposed joint exchange rate pegs and common currencies.[9] With respect to trade, subregional arrangements are proliferating throughout Asia. China, Japan, and South Korea are each considering, with varying degrees of seriousness, separate economic arrangements with the Association of Southeast Asian Nations ("10 plus 1 times 3").[10] Although such agreements would not be concluded for some time, they might eventually be combined into an East Asian trade area that would comprise the members of ASEAN+3 and be complemented by its financial arrangements.

In addition, financial cooperation can support regional political objectives. On political and security dimensions, East Asia contrasts sharply with Western Europe. Although the Cold War is over in Europe, many political conflicts in Asia remain unresolved. Regional cooperation can nonetheless limit the damage to economic relations when political conflict breaks out. By raising the economic cost of political disputes, moreover, such cooperation provides additional incentives for peaceful resolution of conflicts. Regional cooperation would create a context in which the emergence of China could be managed, in particular.

Advocates of China's entry into the World Trade Organization argue that its membership will contribute to its political as well as economic reform over the long term. Regional financial cooperation would be a further piece in the mosaic of international institutional commitments for China. Similar arguments could be made with respect to other countries in the region, notably the new members of ASEAN. If East Asian regional economic arrangements were able to provide even a portion of the pacifying benefits of Western European integration, the world would benefit substantially.

Finally, regional financial cooperation could enhance Asian influence in multilateral organizations and in negotiations over the international financial architecture. Although redistributing such influence is a zero-sum exercise when viewed narrowly, it would arguably advance the interest of the international community as a whole because it would

9. See, among others, the proposals of Yam (1999); Ito, Ogawa, and Sasaki (1999); Kuroda (2001); Estrada (1999); Williamson (2000); Mahathir (2001); East Asia Vision Group (2001); and Kuroda and Kawai (2002). For a critical assessment, see Eichengreen (2001).

10. Bergsten (2000, 2001); Choi and Schott (2001); Scollay and Gilbert (2001); Schott and Goodrich (2001); Munakata (2001).

contribute to a better balance in these organizations, the IMF in particular, to greater equity in representation, and to greater legitimacy.

The case presented here does not incorporate every argument that has been offered in support of East Asian financial cooperation. The case for regionalism, in particular, does not revolve around an alternative diagnosis of financial crises that is at odds with an orthodox neoliberal diagnosis to which the IMF staff and management might subscribe.

The debate over the causes of the Asian financial crisis of 1997-98 and the appropriate remedies is important and wide-ranging[11]—but it is not necessary to resolve that debate here, and this book does not do so. Those who believe that the IMF's economic analysis is irredeemably flawed might naturally be attracted to alternatives. Nonetheless, even the most devout adherent to the so-called Washington Consensus can support financial regionalism for the economic, institutional, and political reasons cited above. Let us now consider the Chiang Mai Initiative as it actually materialized from 2000 to 2002.

11. For some of the contributions to the alternative diagnosis, see footnote 14 in chapter 4. Some of the contributions to the dominant school include the IMF's reports on the Asian crisis: Lane et al. (1999), Lindgren et al. (1999), and Boorman et al. (2000).