7

Conclusions and Recommendations

Consider now a review of the findings discussed above, a set of principles that could guide the evolution of regional finance, recommendations for the international community, and some specific advice for ASEAN+3 governments and central banks.

Summary of the Case for Regionalism

The preceding chapters have shown that other plurilateral and regional arrangements raised similar concerns about necessity, conditionality, additionality, and the centrality of the International Monetary Fund. Although there were elements of complementarity between the regional and multilateral arrangements, there were also elements of potential conflict. When the creation of the Group of Ten swaps, European financial facilities, the North American Framework Agreement, and even the Exchange Stabilization Fund suited their needs, nonetheless, the United States and European governments either dismissed, managed, or otherwise finessed their conflicts with multilateral financial institutions. In the face of numerous precedents, there is a heavy burden on those who would argue against East Asia having its own regional arrangements.

As originally proposed in 1997, an Asian Monetary Fund could have had deleterious consequences for the system and region. The present Chiang Mai Initiative is very different, however, being smaller, decentralized in mainly bilateral arrangements, tied substantially to IMF conditionality, and generally planned with better care than the 1997 proposal.

As a result, in its complementarity with multilateral institutions, the CMI compares favorably not only to the 1997 AMF proposal but also to other plurilateral and regional financial facilities.

Present debates over the merits of Asian financial cooperation would usefully focus on the desirability of enlarging the current arrangements and developing regional surveillance and policy dialogues. Chapters 2 and 4 reviewed the normative arguments over this scenario. Weighing the points made there, this author takes a strongly, though conditionally, supportive posture toward regional cooperation. The region and the international community can benefit from the additional resources, speed of response, economizing of reserves, stimulus to broader economic cooperation (including support for domestic financial restructuring), and even amelioration of political conflict potentially provided by East Asian financial agreements.

It bears emphasizing that multilateral approaches to financial stabilization that are centered in the IMF remain first-best for the time being and the foreseeable future. Regional financial agreements can nonetheless serve as useful adjuncts to the multilateral framework and as second-best, fallback arrangements when the multilateral system proves cumbersome or fails. The reluctance of Asian governments to leave all of their financial stabilization eggs in the IMF basket is understandable. The organization is dominated by the United States and European governments, and it demonstrated its fallibility during the 1997-98 crisis.[1] The evolution of the international financial architecture, moreover, is uncertain.

A further argument in favor of Asian financial regionalism centers on uncertain political support within the United States—Congress in particular—for multilateral finance. Although the US Treasury and the Federal Reserve might have supportive intentions, the history of IMF quota increases and the ESF demonstrate that these competent bureaucracies do not set US policy by themselves. Just as East Asian trade regionalism was boosted by the long delay in securing trade-promotion authority by the Clinton and Bush administrations, Asian financial cooperation follows declining political support in Congress for the IMF.

What of the possibility that ASEAN+3 could sever ties to the IMF and develop financial arrangements that compete with and undermine the multilateral institutions? There is no consensus within ASEAN+3 in favor of declaring the independence of regional arrangements from the IMF, and the group is not about to do so. The interests of creditors and an aversion to taking the political heat for applying tough conditionality to one's neighbors, among other reasons, argue for retaining the IMF link for the foreseeable future. Fears of this scenario should not determine the posture of the international community, which should instead support surveillance and enlargement and work to ensure that

1. Lane et al. (1999).

Asian regionalism steers a constructive course (which is elaborated on below).

These considerations make regional cooperation combined with continued multilateral cooperation a compelling course for East Asia. The objections raised by critics, though not decisive, arise from valid concerns for the long-term health of the IMF and multilateral cooperation. Their critiques flag important caveats and qualifications and suggest a need for a more systematic analysis of the complementarity between the two levels.

The International Monetary Fund

The IMF can protect financial multilateralism and advance East Asian regional cooperation through action in four areas: codifying principles of legitimate financial regionalism, IMF quotas, surveillance, and financial-sector restructuring.

Principles of Regionalism

The history of the IMF's relations with regional arrangements, ranging from the European Payments Union to the G-10 swaps and NAFA, shows that there are no standards or criteria for evaluating regional arrangements that are agreed to or codified multilaterally. Although officials have welcomed East Asian arrangements that are complementary with the IMF (Fischer 2001), they have yet to define "complementarity." Ambiguity about what constitutes a legitimate regional arrangement opens the door to proposals, such as that for the AMF in 1997, that can undermine the IMF and delay economic adjustment.

Moreover, the international community has reviewed the consistency of regional financial facilities with countries' multilateral commitments in a completely ad hoc fashion or failed to review them at all. There is no process or procedure through which such arrangements are evaluated formally. Some have been discussed by the IMF's Executive Board, whereas others have not. If the East Asian case serves as a guide, furthermore, the number of regional financial arrangements is likely to rise.

The multilateral trade regime, by contrast, possesses a set of criteria that define the compatibility of regional trade arrangements with countries' commitments in the General Agreement on Tariffs and Trade (GATT) and World Trade Organization (WTO). These are established in Article XXIV of the GATT and Article 5 of the General Agreement on Trade in Services.[2] There is dissatisfaction with the interpretation of the criteria

2. In the case of Article XXIV, a regional free trade area or customs union must liberalize "substantially all" trade internally; countries concluding FTAs (free trade areas) must not

and the process by which they are applied.[3] Despite violation of the criteria in some of them, in no case has the GATT blocked or nullified a regional trade agreement. But the authors of the GATT and founders of the WTO perceived the need for such criteria correctly, and we can learn from experience with Article XXIV when defining the place of regional arrangements in the international financial system.

The member states of the IMF should create the financial equivalent of GATT Article XXIV as a formal set of principles. At an opportune moment, the members of the IMF could introduce them as a new article into the IMF's Articles of Agreement.[4] The new principles should define the features of regional financial arrangements that are compatible and incompatible with countries' commitments under the articles. Such arrangements should also be at least as transparent to the public as the facilities and operations of the IMF. They should observe basic rules of emergency finance, standing ready to lend into liquidity crises but at premium interest rates and with assurance of repayment.

The new, explicit rules should continue the permissiveness of the status quo with respect to regional and plurilateral financial arrangements. But they should establish an obligation to formally notify the IMF of agreements on such arrangements, substantial changes in them, and the accession of new members. *The authority to review such arrangements should be vested in the IMF Executive Board.* These principles and the rationales for introducing them are presented in box 7.1.

As members of the IMF, national governments already have a number of obligations. The most important of these relate to the maintenance of convertibility on current account transactions (Article VIII, Section 2), avoidance of discriminatory currency practices (Article VIII, Section 3), exchange arrangements and surveillance of economic policies (Article IV), quotas and subscriptions (Article III), operations and transactions

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raise tariffs against third parties, while customs unions must introduce common external tariffs that are on average no higher than previous tariffs of the individual members. These requirements can be met gradually in the cases of "interim agreements" that lead eventually to an FTA or customs union. Preferential trade agreements involving developing countries are held to somewhat less demanding standards. The requirements of Article 5, introduced with the Uruguay Round, are also somewhat more lenient. See, e.g., Dam (1963); Jackson (1969, 1997); Lawrence (1996); Frankel (1997); and Jackson and Davey (1986).

3. Although countries are obliged to notify the GATT of regional arrangements and to provide information requested of them, the rigor of the subsequent review is variable and usually no explicit decision is rendered by the working group or, now, the WTO Committee on Regional Trade Agreements.

4. Because amending the Articles of Agreement is a long process and consumes considerable political energy, these principles would be better gathered with other possible changes into a single amendment. Changes facilitating private-sector involvement in crisis stabilization, were the Board of Governors to agree on them during the next several years, might present one such opportunity.

Box 7.1 Principles of regionalism for the International Monetary Fund

Preamble

Whereas multilateral cooperation is essential for fostering international financial stability and adjustment;
But regions often have distinctive financial challenges (such as regionally differentiated contagion, disruption of regional trade and investment relations, regionally-specific adjustment problems);
And regional cooperation may be more expeditious than multilateral cooperation;
We, the members of the International Monetary Fund, hereby agree to abide by these principles for regional financial initiatives to ensure that they are both regionally beneficial and consistent with our multilateral obligations.

Criteria

Regional financial and monetary arrangements are to be deemed consistent with the multilateral system when they:

- create *no substantial conflict* with members' obligations under the Articles of Agreement of the IMF;
- are at least as *transparent* as the financial and monetary rules and operations of the IMF;
- adopt and pursue *sound rules of emergency finance*, to be understood as lending into liquidity shortfalls (as distinguished from insolvency) at premium interest rates and with assurance of repayment; and
- lend on *sound conditionality*, understood to mean policy adjustments that eliminate the financing gap in the medium term, or link lending to IMF conditionality directly.

Principles and Procedures

Member states shall report and disclose the details of their regional cooperative arrangements to the Executive Board of the IMF.

Regions shall thereby submit their arrangements to the purview and assessment of the Executive Board. In the case of inconsistencies between such arrangements and the criteria or principles established here, the Executive Board shall enumerate them in a report to the member governments, which shall be issued publicly, and ask that the arrangement be brought into conformity.

Accession of new members to regional arrangements is subject to the same review by the Executive Board.

The Executive Board may review an arrangement every three to five years, and can cite a regional arrangement in violation of these criteria or principles.

Regional surveillance is desirable, especially when it transcends IMF surveillance, but is no substitute for IMF surveillance. The IMF may assist in regional surveillance, if requested to do so by the members of the region.

Regional financial facilities shall not undercut IMF conditionality. When IMF financing is involved, the negotiation of lending programs and the disbursement of funds should be either linked to IMF programs or closely coordinated

(*Box 7.1 continues next page*)

Box 7.1 Principles of regionalism for the International Monetary Fund (*continued*)

with the IMF. This does not preclude a region that develops high-quality conditionality from substituting it for IMF conditionality when appropriate.

Regional policies with respect to financial regulation and private-sector involvement must be consistent with stabilization efforts on the part of the IMF.

When financial cooperation is accompanied by monetary integration, and such cooperation extends to the introduction of a common monetary policy, then IMF membership of the region as a whole should be considered.

(Article V), and participation in the Special Drawing Rights (SDR) department (Articles XV through XXV). Not infringing on the obligations that its members have to the IMF should be the first requirement for regional financial arrangements. Regional exchange controls and discriminatory capital controls, for example, must be specifically disallowed.

These principles would establish some new obligations that reflect the lessons of experience with regional arrangements over the last several decades and some contemporary concerns. Although regional surveillance and policy dialogue are constructive, for example, regional financial arrangements should not impinge on IMF surveillance. While multilateral surveillance continues, regional surveillance would ideally build upon and transcend the review by the IMF. The IMF should assist in regional surveillance exercises to the extent that regional partners desire such assistance and IMF staff resources can accommodate such requests.

Policy conditionality is a critical question in the relationship between the IMF and regional financial arrangements. When grappling with crises, the IMF and regional facilities must not compete by relaxing the policy adjustments required of borrowers. Despite its acknowledged mistakes, the IMF holds a comparative advantage over other regional and multilateral organizations in the specification of conditionality. It holds this position by virtue of its analytic resources, the experience and expertise of its staff, and its global perspective, which confers a unique ability to draw lessons across countries and regions. Thus, at this time, regional financial arrangements are wise to "import" or "borrow" the IMF's conditionality.[5]

However, the present supremacy of the IMF should not be interpreted as a monopoly that has been conferred for all time.[6] If a regional arrange-

5. To ensure respect for these principles, and protect itself from misguided regionalism, the IMF has an additional useful tool up its sleeve. Recall the discussion of the worst-case scenario in chapter 4, which suggested that the IMF could utilize its authority under Article VI to prevent its loans from being used to redeem outstanding swaps.

6. Note, e.g., that the Organization for Economic Cooperation and Development's Working Party No. 3 was probably more influential than the IMF with respect to surveillance

ment develops analytically sound, high-quality conditionality, it ought to be able to substitute it for IMF conditionality.[7] The critical considerations are the quality of the program, not the institutional origin, and the operational coordination of the work of the region with that of the IMF. In contrast to competition in crisis lending, moreover, intellectual competition in the analysis and setting of policy conditionality among international organizations would be useful. The international community would benefit from having a more complete "market," so to speak, in the analysis of surveillance and conditionality.

Recognizing a predominant concern in the resolution of recent and current financial crises, regional groups must avoid guidance and policies with respect to the private sector that could undercut the IMF's (and their own) efforts for stabilize countries. For example, regional arrangements must not encourage banks to reduce their exposures to countries that have borrowed from the IMF. Regional arrangements must not undercut arrangements that might be agreed upon within the IMF in the future regarding private-sector involvement, such as a bankruptcy-style orderly workout mechanism.

Were the members of the IMF to agree on this set of principles, they could consider granting the Executive Board the authority to disallow regional arrangements that it finds to be inconsistent with the principles. In the absence of a vote of disapproval, which would be taken on the initiative of an executive director, regional arrangements would be accepted. A decision to disapprove should be made by a super majority of the votes of the executive directors and could be enforced by the ability to declare offending members ineligible to draw IMF resources. Article V, section 5, provides for a declaration of ineligibility when existing obligations are not met. An amendment to the articles would probably be required to enforce new obligations with respect to surveillance, conditionality and private-sector involvement.

Any prospective mechanism of (dis)approval of a regional arrangement should be balanced fairly, however, which suggests several caveats. First, any vote in the Executive Board would have to be on the consistency of the regional arrangement with members' obligations in the IMF as defined by the Articles of Agreement and principles of regionalism. Members would have to defend their votes on the basis of the criteria and defend their interpretation of those criteria. They could not legitimately vote to disapprove because they simply did not favor the arrangements.

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of industrial countries through at least the mid-1980s and continues to cooperate on surveillance with that organization.

7. The defining characteristics of "high-quality conditionality" are naturally the subject of debate. This debate cannot be definitively settled here, but some elaboration can be found in the section below on ASEAN+3 financial arrangements.

Second, the threshold of disapproval would have to be set appropriately. A simple majority would be too low, giving a relatively small group of countries virtual veto power.[8] An eighty-five percent majority would be too high, because the region whose arrangement is under consideration might well be able to block disapproval even without outside support.[9] A threshold of about two-thirds would require the relatively small block of advanced countries and most prospective regional groupings to secure outside support and would thus seem to be more equitable.

Finally, the appropriate threshold—as well as the feasibility of introducing an amendment to the articles—is linked to the fundamental question of the redistribution of quotas (discussed in chapter 6 and addressed below).

These principles avoid several pitfalls that have become apparent with the multilateral trade regime's treatment of regional trade arrangements. First, they provide no loophole for "interim agreements," through which many dubious trade agreements have slipped. Second, they require the disclosure and transparency that is necessary to conduct a rigorous review, which was insufficient in the case of the GATT. Third, reviews can be conducted not just at the time of the creation of a regional financial arrangement, but also when new members accede to existing arrangements and as such arrangements evolve over time. By applying these lessons from the GATT, we can expect the principles of financial regionalism to operate more satisfactorily than have the principles of trade regionalism.

Skeptics might point to the experience of the GATT as evidence that a "mutual nonaggression" might prevail with respect to regional financial arrangements, with deleterious consequences for the integrity of financial regionalism and multilateralism. Whereas the WTO has a one-country-one-vote system and is governed largely by consensus, the IMF has a weighted-voting system in which consensus is not strictly necessary. Moreover, procedures that allow countries to object to regional financial arrangements strengthen such governments relative to present procedures. These principles would thus be less prone to mutual nonaggression than the status quo.

The purpose of these principles is not to give effective jurisdiction to

8. The executive directors from the United States and members of the European Union currently wield 53.9 percent of the votes in the IMF, including the votes of non-European countries that are in the constituencies of European executive directors.

9. The four Asian executive directors wield 15.8 percent of total votes, again including the votes of non-ASEAN+3 countries that are in the constituencies led by Indonesia and Australia. After the prospective enlargement, EU members' combined voting power will fall just short of one-third of total votes, while their seven executive directors will control 34.1 percent. The three members of NAFA control 21.6 percent of IMF votes; the executive directors from the United States, Canada, and Spain, in whose constituency Mexico sits, cast 26.2 percent.

the IMF over all balance of payments lending. Chapters 5 and 6 discussed the numerous departures from exclusive reliance on the IMF since its creation. Nor do these principles seek principally to protect the IMF as an institution, although well-functioning international institutions deserve support. Conflicts with the bureaucratic interests of the IMF—which should be distinguished from conflicts over the terms on which funds are lent to resolve a crisis—will be acceptable when larger goals are at stake. If a regional group wishes to fully displace the IMF with a more ambitious regional arrangement and is willing to commit the resources to do so effectively, as Europe has done, then the IMF and other member governments have few legitimate objections.

However, coordination and jurisdictional problems arise when regional finance is mixed with multilateral finance. These principles are designed to prevent the misuse of IMF funds and facilitate coordination between multilateral and regional arrangements in situations of mixed finance. Because governments have an interest as shareholders in the health of the IMF and an interest in fostering timely economic adjustment on the part of neighbors, these principles are intended primarily to safeguard the interests of IMF member countries.

One might ask how these principles, had they been adopted several decades ago, would have affected the emergence of regional monetary and financial integration in Europe. The second amendment to the articles of agreement was drafted specifically to permit EMS-type arrangements and countries are thus free to choose their own exchange arrangements.[10] The short-term facilities that financed foreign exchange intervention within the EMS (discussed in chapter 5) raised no serious conflicts with IMF obligations or the principles proposed here. Depending on whether EC conditionality was weak or strong, however, the medium-term facility could have undercut the bargaining position of the IMF with borrowing countries.[11] European officials nonetheless administered their medium-term facility in ways that avoided undercutting the IMF and even employed the IMF as the “bad cop” when strict conditionality was required in an EC member state. The EMS, the movement toward the single currency, and the medium-term facility displaced the IMF from lending

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10. With European currency stabilization in mind, members’ rights to create regional exchange rate arrangements were protected by the second amendment to the Articles in 1978. Article IV, Section 2(b), reads, “Under an international monetary system of the kind prevailing on January 1, 1976, exchange arrangements may include (i) the maintenance by a member of a value for its currency in terms of the special drawing right or another denominator, other than gold, selected by the member, or (ii) cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members, or (iii) other exchange arrangements of a member’s choice.”

11. The Italian programs of 1974 and 1977, for example, contained the potential for such conflict.

operations in Western Europe. But, these measures were part of a larger European project and the principles proposed here would not have elevated the bureaucratic interests of the IMF above that project. In sum, these principles might have hastened Europe's development of strong conditionality in the use of the medium-term facility but would not have impeded either exchange-rate stabilization or the creation of the monetary union.

Similarly, the Chiang Mai Initiative appears to substantially pass the test posed by these principles. The principles would require further disclosure of the features of the bilateral swap agreements, which would be necessary to render a definitive judgment on their compatibility with the principles. China and Japan would also have to clarify how any activation of their agreement, hypothetical as that might be, would be coordinated with the IMF. Nonetheless, under most of the bilateral swap agreements, ninety percent of borrowings must be tied to an IMF program. The 10 percent that can be disbursed without such a program is small and restricted to six months or less. The non-IMF-linked portion is thus shorter term than the US credits to Mexico under the NAFA in early 1995, for example, and thus would probably not carry policy-adjustment conditions. If a borrower drew on the 10 percent but subsequently realized that it would need medium-term money, it would have to submit to IMF conditionality.

By contrast, these principles would have blocked the 1997 proposal to create an Asian Monetary Fund. Under that proposal, the AMF could have undercut IMF conditionality and weakened the impetus for economic adjustment in the region. By clarifying which arrangements would be complementary and in conflict, these principles, had they been part of the IMF legal structure in 1997, would have almost certainly dissuaded Japanese officials from this proposal, saving the members of the system a fruitless and embittering debate. The introduction of such an article could referee such debates in the future, providing legal cover for legitimate regional regimes, such as the CMI, and protection against illegitimate ones, such as those that might lead to the worst-case scenario discussed above.

Quotas

The IMF should increase the size of the Asian country quotas, and their voting strength in the organization, during the current Twelfth General Review of Quotas. Quotas are reviewed at least every 5 years but have not been readily adjusted to reflect changes in the economic circumstances of IMF members. Because of the outward orientation on trade and finance of many countries in East Asia, in particular, increases in their quotas have not kept pace with their growth and with increases in their vulnerability to crises. In redistributing quotas, European IMF members should clearly surrender the largest share. The members of the euro area in particular should accept a consolidation and reduction in their quota shares as a logical consequence of their Maastricht Treaty commitment to a common external monetary policy.[12] The responsibility for implementing these recommendations rests not with the IMF's staff but rather primarily with its member countries.[13]

Surveillance

The IMF can support the regional surveillance mechanism that is being developed by ASEAN+3. It currently provides country-specific information, as contained in Article IV consultations and staff reports, and *World Economic Outlook* forecasts. The IMF is expected to continue to do so and can entertain requests from ASEAN+3 for further support.[14] The group would benefit not only from updating the forecasts for individual countries, which the IMF staff currently provides, but also from more extensive examination of the spillovers among them. In its analysis and reports to the Executive Board, the IMF staff should also conduct surveillance of the region as a whole.[15] This could include analysis of any regional monetary and exchange rate arrangements and the adequacy of regional institutions for making external policies. Such exercises could be disclosed to the public at the discretion of the region.

Financial-Sector Restructuring

Finally, the IMF might have a special role to play arising from the weakness of the financial and banking sectors in a number of Asian countries.

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12. See references in chapter 6, footnote 27. Several events during the next few years could well open a window of opportunity for Europe to confront these issues: The convention that is presently examining proposals for institutional reform in the European Union, the intergovernmental conference that will follow, and a British referendum on joining Economic and Monetary Union. Once the British referendum has been held, the politics of consolidation of representation and quotas might be more opportune. A related issue is that any reduction in European quotas in favor of other members would reduce the IMF's usable resources. It would be desirable to offset this effect by an increase in overall quotas and/or an increase in the usability of the currencies of the members receiving the larger quotas.

13. An increase in Asian quotas in the IMF might reduce support among Asian governments for further regional financial cooperation. For this reason, those who fear Asian financial regionalism would want to make redressing the underrepresentation of Asia a top priority.

14. The IMF supports the surveillance activities of the Asia-Pacific Economic Cooperation forum and the Manila Framework Group as well.

15. Recommendations made in the external evaluation of IMF surveillance (IMF 1999, 27-28, 60-62). On the evolution of surveillance, see Pauly (1992, 1997).

The IMF has strengthened its role in this area through Financial Sector Assessment Programs (FSAPs), the development of financial codes and standards, and the creation of a new department devoted to capital and financial markets. Peter Kenen (2001) recommends that the IMF and World Bank should conclude 5-year agreements with countries in support of home-grown financial-sector reform that addresses needs identified in an FSAP. The Bretton Woods institutions arguably have a comparative advantage with respect to these issues.

The United States

Although regional financial arrangements that do not include the United States limit American influence, maintaining such influence also carries costs, including an obligation to commit attention and resources to the region. East Asian financial cooperation can benefit the United States through greater burden sharing on financial rescues. Such cooperation could reduce the need for US mediation of disputes within the region when they threaten to become severe, particularly if the East Asian policy dialogue and surveillance mechanism were strengthened. To the extent that such arrangements contribute to financial stability in the region, furthermore, American firms and investors also benefit directly.

Accepting regional initiatives removes the United States from criticism for taking a blocking position and forces regional players to take full responsibility for the successes and failures of their initiatives. US acceptance, in particular, forces creditors within the area to "come clean" with respect to their willingness to support regional initiatives. Finally, because regional financial cooperation employs less of "other people's money" (specifically, that of the IMF) and more of their own, such arrangements will strengthen incentives to facilitate economic adjustment, head off crises, and when they occur, manage crises responsibly.

US officials have been right to make their acceptance of the CMI conditional on its complementarity with the IMF. One might argue that as long as financial regionalism in Asia reinforces the multilateral regime and genuinely stabilizes international financial relations, however, *US policy should be "conditionally supportive" rather that merely (perhaps grudgingly) "nonobjecting*."

US officials would do well to acknowledge the basic rationale for East Asian financial cooperation and the potential benefits to the international community (which were reviewed above). They should also state clearly the circumstances and conditions under which they would regard an enhancement of such cooperation to be desirable and under which they would regard it to be undesirable. This statement should draw upon the basic principles laid out above.

The United States must not oppose Asian regional arrangements that take *pains to complement the multilateral system of financial stabilization*, for at least three historical and political reasons. First, and fundamentally, the United States created its own set of bilateral swap arrangements during the 1960s. Although those were retired in 1999, the United States also created NAFA in 1994 and maintains that agreement. The United States has also laid down the principles under which a financial facility could be opened in the future under the auspices of the Manila Framework Group.

Second, the United States has acquiesced in several other regional "carve outs" from multilateral monetary and financial regimes, beginning with the Marshall Plan and European Payments Union and continuing with the European Monetary System and Economic and Monetary Union. Third, and most compelling, the United States has been less forthcoming with bilateral assistance through the ESF to East Asia than to Latin America and was itself largely responsible for delays in the ratification of the New Arrangements to Borrow and approval of the IMF quota increase during the 1997-98 Asian crisis. With some adjustment for regional circumstances, many of these points also apply to European governments, whose collective voting power in the IMF is larger than that of the United States and which thus share responsibility with the United States for managing the institution.[16]

With such policies and actions in the past, the United States has effectively (though unintentionally) encouraged Asian governments to seek alternatives to relying on it and on institutions led by it. Regional arrangements are thus the result, among other factors, of US and IMF policies. Asian governments, for their part, have had to overcome substantial differences among themselves. US policymakers have noted the prior inability or unwillingness of Asians to organize on a regional basis and taken some comfort in entreaties by Asian governments to remain involved in the region. But US officials should not be surprised if the incentives to cooperate reach a threshold above which intraregional differences can be overcome.

ASEAN plus Three

Recommendations to ASEAN+3 fall under three categories. The group is discussing the enhancement of regional surveillance on economic policy, and action on this front should indeed be a priority. During the medium term, ASEAN+3 will review financial arrangements, and it should consider enhancements in this area as well. At the same time, the group should continue to reassure the international community that it supports multilateral arrangements.

16. The posture of the Group of Seven toward the IMF is discussed in Bergsten and Henning (1996, 91-92). It needs to be noted, at the same time, that European governments actively encourage East Asian cooperation through the Asia-Europe Meeting process.

Surveillance

Since its Honolulu ministerial meeting in May 2001, ASEAN+3 has focused on the enhancement of surveillance, or "policy dialogue," as the members refer to the process. Owing to differences within the group over the disclosure of information and the intrusiveness of peer review, among other issues, progress on this front has been modest. *To develop a robust surveillance process, ASEAN+3 will need to come to agreement on a set of basic points*:

- What information will be disclosed?
- Who will collect and analyze the information?
- What range of issues will their analysis cover?
- What information and analysis will be reported to the group as a whole?
- Will errant governments be confronted by their peers?
- Will the exercise be effectively connected to planning for emergency contingencies?

The multiplicity of regional and subregional organizations both assists and constrains the development of regional surveillance. ASEAN, ASEAN+3, the Asian Development Bank, the South East Asian Central Bank forum, the Asia-Pacific Economic Cooperation forum, the MFG, the Executives' Meeting of East Asia-Pacific Central Banks, and other bodies all have some role in reviewing the economic policies of the region's countries.[17] This redundancy carries several important benefits.[18] But the number and overlap of East Asian institutions and processes has arguably reached a point of diminishing returns.

Streamlining these institutions would help to conserve and better allocate scarce financial and human resources, including the time of national officials who must attend multiple forums. *The task of supporting regional surveillance should be clearly assigned to a single organization with a mandate to collect information from national governments and central banks, organize and analyze this information, disseminate it to group members, and lead peer-review sessions at ministerial and deputies' meetings.*

Building upon the IMF process, rather than duplicating it, would be an economical way to launch a new regional surveillance process.[19] Each

17. Eichengreen (2001); Ito and Narita (2002).

18. Grenville (2002).

19. The European Community kept the IMF out of the surveillance of the Europewide institutions and management of the European Monetary System. It might nonetheless have benefited from subjecting the management of this system to direct IMF scrutiny at some key points, such as prior to the 1992-93 currency crises. Similarly, in relying on the IMF for surveillance as well as conditionality, Asian governments would be doing themselves a favor.

Asian country conducts a round of Article IV consultations with the IMF and has access to the reports on its regional partners through their IMF executive directors. Those consultations and reports could be the basis for enhanced surveillance at the regional level, which could then supplement the IMF process and staff analysis by bringing additional information (e.g., on banking fragility) to bear and serving as the basis for more candid discussion among a smaller group than regional officials might have in the IMF.

To conduct regional surveillance effectively, however, would require that Asian governments overcome a predisposition against scrutiny of the "internal affairs" of partners and occasional confrontation over policy. Once such a process is in place, if the region's governments wish to reduce their dependence on the IMF and its staff for analysis, they could later decide to assign a greater share of the work to a regional body. Whether regional surveillance builds upon or parallels IMF surveillance, though, it should not replace IMF surveillance.

The aspect of surveillance that probably deserves the highest priority is the introduction of a serious dialogue on exchange rate policy. Since the crisis, most governments have shifted toward a flexible exchange rate regime. But they continue to manage their currencies such that the 2001-02 depreciation of the yen against the dollar was partly matched by depreciation of other currencies (see figure 4.1). In contrast, China, Hong Kong, and Malaysia continue to maintain pegs to the US dollar. Conflicts among national exchange rate policies have thus arisen and must be discussed candidly among governments in the region.

The relationship between the Chinese renminbi and the Japanese yen is particularly important. Recall that China threatened to reconsider its peg when the Japanese yen weakened into the mid-140s during the middle of 1998, after which the United States and Japan intervened to support it. During 2001 and 2002, Chinese and South Korean officials on the one hand and Japanese officials on the other issued diametrically opposed pronouncements on the desirability of the yen's depreciation from the 120s. At a minimum, Japanese officials should want to know the limits of Chinese tolerance for yen depreciation, and Chinese officials should want to signal that limit to Japanese partners. Avoiding outright currency conflicts is a de minimus test of the seriousness of regional monetary cooperation.

Financial Arrangements

ASEAN+3 can usefully build on present financial arrangements by modifying the link between the bilateral swap agreements and the Contingent Credit Line, by introducing greater transparency, and by considering an expansion of their geography and functions.

Contingent Credit Line

ASEAN+3 should further enhance the complementarity between the CMI and the IMF through greater reliance on the IMF's Contingent Credit Line. The CCL was created after the Asian crisis to expedite the disbursements of funds for countries that "prequalify" and are then subject to contagion. Countries would be eligible on the basis of, among other things, (1) a positive assessment of economic policies, as judged quarterly by the Executive Board; (2) progress toward international standards; (3) constructive relations with private creditors and limitations on external vulnerability;[20] and (4) no expectation of a need for additional IMF resources. Under procedures modified in 2000, a prequalifying country would receive "the strong benefit of the doubt" when petitioning the Executive Board for activation.[21] That review would be conducted on an expedited basis, releasing probably one-third of the total borrowing. Another "post-activation" review would set the phasing and conditionality of subsequent disbursements.[22]

Under the present CMI arrangements, prequalification is not sufficient for the disbursement of funds through the bilateral swaps; the IMF would have to disburse its own funds before intra-Asian swaps could be activated. *This restriction could be usefully removed; CCL prequalification should instead be a sufficient basis for disbursement under the CMI.* A country that has prequalified under the CCL should be deemed to have sound policies and to have satisfied the "IMF link."

When a long period of time intervenes between prequalification and a request for disbursement, concerns could arise that the policies of the borrower have changed and that qualification is obsolete. These concerns are addressed in part by the IMF Executive Board's quarterly review of macroeconomic policies. The concerns could be further addressed by subjecting activation of BSAs to a quick determination by the ministers of ASEAN+3—or of the three regional creditors—that the policies of the borrower have not worsened, coupled with a strong presumption in favor of disbursement, as under the CCL.

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20. The third criterion includes efforts to put in place arrangements that involve the private sector, from which East Asian countries would surely benefit. In assessing a country's external vulnerability, the Fund asks, among other things, whether a country has a system for monitoring private external liabilities, which would be enhanced by the short-term capital flow monitoring mechanism of the CMI (IMF 2000).

21. Funds would be available for up to 1 year for prequalifying countries. There is no general access limit, though disbursements are expected to be in the range of 300-500 percent of the member's quota. Interest charges are levied at 150 basis points over regular borrowings, rising to 350 basis points for borrowing at longer durations—equal to financing under the BSAs of the CMI but less than the rates that apply to borrowings under the SRF. CCL loans are to be repaid within 1 year to 18 months (IMF 2000, 2001b).

22. IMF (2001b); Fischer (2001). For a discussion, see Council on Foreign Relations, Independent Task Force (1999, 83-87, 110-15); and Kenen (2001, 114-17).

One might wonder what could happen if Japan, China, and/or South Korea disbursed to a Southeast Asian partner on the basis of CCL prequalification but the IMF Executive Board denied activation. The risk posed by this scenario appears to be minimal for the IMF. The East Asian creditors, conversely, should be quite concerned that the IMF will activate shortly after they disburse. For that reason, East Asian officials will want to consult with IMF officials to ensure that the latter have identified no deterioration in the borrower's policies since the last Executive Board review.

Such concerns are abstract, however, until a government decides to apply for prequalification under the CCL. Not only has no government chosen to do so as of this writing, but apparently none is even seriously considering an application.[23] Countries can shield themselves from contagion through precautionary borrowing under the IMF's regular facilities as well as the Supplemental Reserve Facility. The prospect of being dequalified has been a further deterrent to seeking CCL prequalification. Owing to the lack of interest, the IMF Executive Board eased the terms of prequalification in November 2000.[24] By tying regional financial facilities to the new facility, however, East Asia and the IMF could well raise interest in, attract applicants to, and breathe life into the CCL.

Linking disbursements under the BSAs to CCL prequalification would serve four purposes, in sum. First, it would accelerate disbursement of CMI funds in crises driven by contagion through the capital account. Second, it would harness CMI disbursements to IMF policy standards and more broadly enhance cooperation between the regional and multilateral levels. Third, it would bring additional resources to the system as a whole, addressing a central criticism made of the CCL.[25] Fourth, it would enhance the attractiveness of the CCL for East Asian countries.

Transparency

Separately, but relating to the financial arrangements, the details of the BSAs should be released in the spirit of transparency. The ASEAN+3 finance ministers decided not to announce any details at their press conference in May 2001. Governments and central banks have disclosed some of the important details, but only on an ad hoc basis. Reluctance to disclose material specifics will not bolster the credibility of their cooperation.

The international community, and the markets in particular, should know no less about the BSAs than about IMF loans and programs. ASEAN+3 should also agree in advance to notify the public about any BSA activations.

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23. Mexico had been widely reported as considering applying for the CCL but has apparently dropped the idea for now.

24. IMF (2000).

25. Council on Foreign Relations, Independent Task Force (1999).

Such disclosures would eliminate any temptation to use the BSAs as "window dressing," which would probably be self-defeating, and facilitate verification of their appropriate use. *ASEAN+3 finance ministers should therefore reverse their previous decision and agree to disclose the details of the framework of principles and bilateral swap agreements and to disclose swap operations on a timely basis.*

Expansion

The ASEAN+3 ministers are committed to reviewing the swap arrangements after three years. In addition to examining the specific terms of the agreements, they will want to consider extending BSAs to those members of the group that do not yet have them. *More controversially, they should consider expanding the geographic domain of their financial arrangements.* Australia and New Zealand are closely tied to ASEAN+3 through trade and investment.[26] Although the prospect of their candidacy raises political issues with Beijing, Hong Kong and Taiwan are also natural candidates on economic and financial grounds.[27]

Whether ASEAN+3 should expand the financial arrangement further, during the 2004 review or a subsequent review, depends on progress on the development of regional surveillance and, of course, on the record of use of the facilities. *If substantial progress on surveillance has been achieved, the ministers would be well advised to consider a doubling or tripling of the size of the BSAs and the ASEAN Swap Arrangement.* They could consider making the CMI more of an authentic "network" by, for example, pooling reserves or enhancing the degree to which decisions on activation are made jointly.

ASEAN+3 ministers will also undoubtedly review the IMF link. It is far too early to decide whether East Asia can or should abandon the IMF link at some indefinite point in the future.[28] However, one can usefully specify the test that the region should meet before any prospective move in this direction. Modification of the link must depend on progress in developing high-quality regional surveillance and conditionality. "High-quality," in this context, should be taken to mean accurately differentiating among three different types of crises—pure creditor panic, fundamentals-driven crises, and capital account crises that require adjustments in underlying economic policies—and attaching appropriate conditions to financing.[29]

26. Dobson (2001).

27. Yoshitomi and Shirai (2000).

28. It is doubtful that the region could develop the necessary infrastructure to consider this question seriously during the 2004 review.

29. The debate over conditionality is considerably more extensive than can be resolved here. Lane et al. (1999) review IMF conditionality during the 1997-98 crisis. Goldstein (2001) argues against most structural conditions in recent IMF programs, favoring only adjustments in macroeconomic policy and financial structures. Kenen (2001) argues that

Monitoring capital flows within the region, as ASEAN+3 has pledged to do, would help to differentiate among the types of crises.

Several Asian governments criticized the IMF for applying a one-size-fits-all package of conditions during the 1997-98 crisis. The essential challenge for ASEAN+3 will thus be to demonstrate that it can do a better job of tailoring conditions to specific crises than has the IMF.[30] If it could better diagnose crises and tailor conditionality, repeal of the IMF link would be justified.

It is also useful to consider the circumstances under which the creation of an Asian Monetary Fund would be desirable, however distant that prospect might be.[31] Success in the development of surveillance, strengthening of financial arrangements, and specification of high-quality conditionality would help to pave the way for a regional monetary fund. The governments in the region would need to enter a political agreement on strengthening regional economic institutions, give substantial discretion to a secretariat, and demonstrate a capacity for joint decision making.[32]

The institutional and political prerequisites for such an enterprise are formidable and cannot be minimized. A serious failure, such as a default on the swaps, would cast grave doubts on the wisdom of further movement along this path. But if these prerequisites were met, and the design of the AMF respected the principles of financial regionalism identified above, the international community would have few grounds on which to object.

Under these conditions, demanding as they might be, the formation of an Asian Monetary Fund could well be desirable as a contribution to international economic stability. The case for the AMF would be particularly strong if, owing perhaps to inadequate reform of the international

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crises are not opportune for exacting fundamental adjustment in financial-sector policies and regulatory regimes. A shorter list of important measures might well be superior to a longer list of requirements that appears to be "stricter"; but this will depend on the nature of the crisis and must be determined in each particular case.

30. The institutional and political requirements for such conditionality are formidable. IMF conditionality is determined in the first instance primarily by the staff; the Executive Board becomes involved relatively late in the process. Considerably more discretion has thus been devolved to the IMF staff than is now envisaged for any regional secretariat in East Asia.

31. Obviously, political and economic conditions in the region do not favor the striking of an agreement on such an institution now or in the immediate future. But, depending on the nature of future political change and realignment in East Asia, the prospects for such agreements over the long term are sufficient to warrant specifying these circumstances.

32. Such an agreement might also foster integration in trade, rules on direct investment, and other economic areas. Though political agreement on economic cooperation would be essential, it needs to be noted, agreement on forming a political union or other strong forms of political integration is not strictly necessary. On the latter, see Henning (2002).

financial architecture, the multilateral system failed to prevent crises and stabilize economies in the region.

Relations with Multilateral Institutions

During the development of the CMI, and in contrast to the AMF proposal of 1997, the members of the region have been adept at reassuring the international community of their commitment to multilateral rules and institutions. As ASEAN+3 reconsiders current arrangements and perhaps builds upon them over the long term, ministers and their governments should undertake four initiatives. *First, ministers should continue to discuss their regional arrangements openly with officials and institutions from outside the region*. As their experience with the AMF demonstrates, failure to consult those outside the region generates suspicion and undermines external support unnecessarily. *Second, while developing regional financial arrangements, East Asian governments should of course continue to support the multilateral institutions, including their evolution and reform*. Achieving greater influence in these organizations is, after all, one motive in developing the regional East Asian option.

Third, ministers should continue to build regional cooperation upon multilateral institutions, and the IMF in particular, where possible. A division of labor whereby ASEAN+3 supplements financing while the IMF supports surveillance and provides conditionality is attractive from the standpoint of conservation of staff resources and energy. Because such a division of labor also enables Asian officials to avoid specifying policy adjustments required of their regional partners, it is attractive to them for political reasons as well. Although East Asian governments might rely on the IMF in this way, however, they should not make a scapegoat of the IMF when adjustment causes political pain. Such scapegoating, which has been frequently invoked, would undermine the position of the IMF in domestic politics in member countries.

Fourth, ASEAN+3 and its member governments should take pains to demonstrate that swap arrangements and financial facilities are not and will not be used to indulge permissive financial supervision or regulation or government guarantees to their private sectors. They should explicitly foreswear, in other words, the worst-case scenario described above. They can maintain the IMF link until such time as East Asia has developed sophisticated regional surveillance and high-quality conditionality. Most fundamentally, they can pursue financial-sector restructuring in those countries to address fragility where present. Moreover, although multilateral codes and standards for financial-sector regulation and supervision require judicious application in the case of developing countries,[33] officials of the region's

33. Eichengreen (2001) discusses the ramifications for East Asian regionalism.

countries can endeavor to meet those standards over time and invite the multilateral institutions to conduct FSAPs as part of the financial restructuring process.

A Final Note

The multilateral trading system long ago accepted regionalism on certain conditions. Although a number of dubious agreements went unchallenged, the regional trade agreements that proliferated during the past five decades have by and large proven to be “building blocks” rather than “stumbling blocks” for global liberalization.[34] This book has argued that financial regionalism can similarly support openness, stability, and growth. The international community can do better than offering only grudging support (or less) to financial cooperation in East Asia. Instead, it should articulate criteria that will reconcile financial regionalism with multilateralism, as have been outlined above. And it should actively encourage the development of East Asian arrangements that are consistent with the interests of both Asian and non-Asian communities.

34. Park (2001a) borrows these phrases from Lawrence (1996).