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# East Asian Financial and Monetary Cooperation and Its Prospect: Beyond the CMI

INTERNATIONAL  
ECONOMIC POLICY

**Young-Joon Park and Yonghyup Oh**

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Korea Institute for International Economic Policy

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## Executive Summary

This paper examines the ASEAN+3 cooperation of regional financial safety nets, and reviews the regional monetary issues of a single currency and currency competition in East Asia. We point out potential systemic risks in East Asia and the importance of regional surveillance. ASEAN+3 regional surveillance should move forward to the stronger measures of peer review and peer pressure, and make the AMRO a well-resourced professional surveillance secretariat to create capacity to apply independent conditionality. To this effective surveillance mechanism, we propose to establish the Board of Coordination to support the ASEAN+3 ERPD by confirming its decision or remitting the relevant case to the ASEAN+3 ERPD and providing possible legal consultation. The institution building of the CMIM secretariat will accelerate the establishment of a regional monetary institution, e.g. an Asian Monetary Fund. The current crisis provides sufficient incentives for East Asian economies to pursue internationalization of their currencies, and it would open the possibility towards a single currency in East Asia.

**Keywords:** Regional financial safety nets, Surveillance mechanism, CMIM, ABMI

**JEL Classification:** E61, F36, F55

## 국문요약

본 논문은 ASEAN+3 체제의 지역 금융안전망인 치앙마이 이니셔티브 다자화 (Chiang Mai Initiative Multilateralization)와 아시아채권시장 발전방안(Asian Bond Market Initiative), 그리고 글로벌 금융위기 이후 다시 활발해진 역내 단일통화에 대한 논의에 대해 살펴본다. 치앙마이 이니셔티브 다자화가 보다 실효성있는 지역 금융 안전망으로 기능하기 위해서는, 역내 경제 감시기능을 담당하기 위해 신설 예정인 경제조사국(ASEAN+3 Macroeconomic Research Office)의 감시기능은 더욱 강화 되어야 하며, 현재 운영 중인 ASEAN+3 경제동향 점검 및 정책대화(Economic Review and Policy Dialogue)와 유기적인 관계를 유지해야 한다. 이와 함께 본고에서는 조정국(Board of Coordination)을 별도로 설치하여 ASEAN+3 경제동향 점검 및 정책대화의 정책 권고안에 대한 회원국의 이의신청이나 법률적 지문 등을 제공할 것을 제안한다. 또한 현행 치앙마이 이니셔티브 다자화가 아시아통화기금과 같은 지역통화협력체로 발전하기 위해서는 CMIM 사무국의 설립이 선행되어야 한다.

**핵심용어:** 지역 금융안전망, 감시기구, 치앙마이 이니셔티브 다자화, 아시아 채권시장 발전방안

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# Contents

I. Introduction .....	9
II. East Asia's Financial Cooperation .....	12
1. East Asia's Regional Financial Safety Nets.....	12
2. Asian Bond Market Initiative .....	15
III. Regional Surveillance Mechanism in East Asia .....	18
1. ASEAN+3 Economic Review and Policy Dialogue .....	18
2. AMRO as a New Regional Surveillance Unit.....	21
IV. Way Forward for Effective ASEAN+3 Surveillance .....	22
1. Systemic Risk and Regional Surveillance .....	22
2. Looking Beyond the Current ASEAN+3 ERPDP .....	25
V. The Idea of an Asian Monetary Fund.....	33
1. CMIM as a Precursor to Asian Monetary Fund.....	33
2. East Asia vs. Euro-Zone.....	35
VI. Asian Currency Competition and Movement Toward.....	38
a Regional Currency	
VII. Concluding Remarks.....	42
References.....	45
Appendix.....	47



## Tables

Table 1. ASEAN+3 member's CMIM Contribution and Voting Power.....	14
Table 2. Average Daily NDF Turnover.....	23
Table 3. Comparison between EFSF (European Monetary Fund)..... and CMIM (Asian Monetary Fund)	36

## Figures

Figure 1. Asia's Portfolio Investment by Region.....	16
Figure 2. Portfolio Investment in Europe .....	17
Figure 3. Portfolio Investment Flows in Equity (% $\Delta$ ) .....	24
Figure 4. Modality and Development of Regional Economic Surveillance... ..	26
Figure 5. Proposed ASEAN+3 Surveillance Mechanism .....	31
Figure 6. Increased Currency Instability .....	39
Figure A. Proposed EU Supervisory Structure.....	48

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# East Asian Financial and Monetary Cooperation and Its Prospect: Beyond the CMI

Young-Joon Park and Yonghyup Oh

## I. Introduction

After a rapid contagion of the 1997-98 Asian currency crisis across East Asian countries, ASEAN+3<sup>1</sup> realized the need for a regional financial cooperation as a self-help measure against financial crisis. Their recognition of common needs for regional financial safety nets led to several initiatives to reinforce regional financial cooperation for their own protection against financial crisis. Through the evolutionary process of these initiatives, greater integration in economic activities has increased intraregional trade in East Asia, and it has accelerated regional cooperation by making the details of the initiative feasible.

Three key initiatives were undertaken to promote regional financial cooperation: (i) the Chiang Mai Initiative (CMI) comprised of a network of bilateral swap arrangements, (ii) the Asian Bond Market Initia-

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<sup>1</sup> ASEAN (Association of South East Asian Nations) has 10 member countries: Thailand, Malaysia, Singapore, Indonesia, the Philippines, Brunei, Burma, Laos, Vietnam, and Cambodia. The Plus Three countries are the republic of Korea, Japan, and the People's Republic of China.

tive (ABMI) to develop local currency bond markets in East Asia, and (iii) ASEAN+3 Economic Review and Policy Dialogue (ERPD) for a review of regional economies and policy dialogue process. The recent global financial crisis has accelerated the development of the CMI toward its multilateralization as a regional financial safety net. The ABMI was initiated to promote intraregional investment of the huge amount of foreign reserves in East Asia. Establishing integrated regional capital markets helps make regional savings available for regional investments and ultimately contributes to regional economic growth. In addition to the ASEAN+3 ERPD, ASEAN+3 finance ministers recently agreed to establish the ASEAN+3 Macroeconomic Research Office (AMRO) as a new independent regional surveillance unit by next year.

This paper focuses on several important issues on the ASEAN+3 financial and monetary cooperation: ASEAN+3 surveillance cooperation to cope with potential systemic risks in East Asia, development of the Chiang Mai Initiative Multilateralization (CMIM) towards an Asian Monetary Fund, and Asian currency competition. Under the regime of regional economic and financial cooperation, both regular exchange of information and policy recommendation through peer review process are critical to the macroeconomic and financial stability of the regional economy, including capital market and foreign exchange market. It is essential to exchange information frequently on the potential economic risk factors, such as hefty surges in short-term capital flows, and to regularly discuss macroeconomic and foreign exchange policies in order to prevent a repeat of regional financial crisis.

We also examine Asian currency competition and think ahead of a

regional currency. The global financial crisis has provoked controversial policy incentives to make national currencies used more internationally. The declining position of the US dollars as an international key currency and surging Chinese economic power may help establish a road in creating an East Asian common currency more easily than before.

The remainder of this paper is organized as follows. Section 2 briefly reviews East Asia's financial safety nets, including the CMIM and the ABMI. Section 3 discusses the regional surveillance mechanism in East Asia. Section 4 emphasizes the necessity of effective regional surveillance against potential systemic risks, and provides suggestions for enhancing the effectiveness of the ASEAN+3 surveillance mechanism. Section 5 explains the idea of an Asian Monetary Fund as the future of the CMIM. Section 6 discusses Asian currency competition and movement towards a single currency, and finally section 7 concludes.

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## II. East Asia's Financial Cooperation

### 1. East Asia's Regional Financial Safety Nets

#### 1.1. Birth of Chiang Mai Initiative

The Asian economy was hit severely by the 1997 financial crisis, which began as a regional internal shock in East Asia. The financial markets in Thailand, Korea, and the Philippines collapsed through rapid crisis contagion. IMF's liquidity-support packages and emergency liquidity support from other countries were provided to rescue the economies in crisis. For some countries, however, the packages and support programs along with policy prescriptions made the economic conditions worse. East Asian countries learned the importance of financial stability from the 1997-98 experience, and they realized the acute need for regional financial safety nets. Accordingly, the severity of the crisis and their disappointment with the IMF program based on harsh structural reforms created momentum for speeding up East Asia's financial cooperation.

The CMI was agreed to in May 2000 in Chiang Mai, Thailand, with the objective of establishing a network of bilateral swap arrangements among ASEAN+3 countries to address short-term liquidity difficulties in the region and to supplement existing international financial arrangements. The CMI was an expanded version of the previous ASEAN Swap Arrangements (ASA), which was initially established by

five major ASEAN countries.<sup>2</sup> The ASA was ineffective during the crisis in 1997-98, however, and later the CMI framework was extended to all ASEAN countries as well as the Plus Three countries of Korea, China, and Japan. The framework was basically a set of bilateral swap agreements between the central banks of the two countries involved in each swap arrangement.

Under the CMI, member countries may request short-term financial supports without the IMF's consent for the specified amount from the committed fund, known as IMF-delinked liquidity support. The IMF-delinked portion has increased from 10 percent of the commitment fund to the current level of 20 percent. That is, 80 percent of the fund is linked to the IMF support program with IMF conditionality.

### 1.2. Chiang Mai Initiative Multilateralization

ASEAN+3 countries have agreed to multilateralize the CMI in such a way that any member country can utilize liquidity support from the total fund of \$120 billion under a single agreement. Because the fund was financed in the form of promissory notes, there is no direct and immediate effect on the member country's foreign reserves. Members have agreed to a two-tier contribution scheme: 20 percent contribution by ASEAN countries and 80 percent by the Plus Three countries.

Specifically, as summarized in Table 1, ASEAN contributes \$24 billion (20 percent), China (including Hong Kong) and Japan each contributes \$38.4 billion (32 percent each), and Korea contributes \$19.2 bil-

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<sup>2</sup> Indonesia, Malaysia, the Philippines, Singapore, and Thailand.

lion (16 percent). As for borrowing multiples, 0.5 applies to China and Japan respectively, 1.0 to Korea, 2.5 to the larger ASEAN countries, and 5.0 to the small countries<sup>3</sup> of ASEAN. This implies that ASEAN countries can draw amounts larger than their contributions. Furthermore, applying larger borrowing multiples to the countries that are more vulnerable to financial risks and economic crisis elevates the efficacy of the CMIM to respond to a crisis through emergency liquidity support.

**Table 1. ASEAN+3 Member's CMIM Contribution and Voting Power**

	Contributions			Purchasing Multiple	Voting Power (%)	
	USD (Bil.)		Share (%)			
China	38.4	Exc. HK 34.2	32.0	28.5	0.5	25.43
		HK 4.2		3.5	2.5	2.98
	Japan	38.4	32.0	0.5	28.41	
Korea	19.2	16.0	1.0	14.77		
Plus 3	96.0	80.0	-	71.59		
Indonesia	4.77	3.97	2.5	4.52		
Thailand	4.77	3.97	2.5	4.52		
Malaysia	4.77	3.97	2.5	4.52		
Singapore	4.77	3.97	2.5	4.52		
Philippines	3.68	3.07	2.5	3.75		
Vietnam	1.00	0.83	5.0	1.85		
Cambodia	0.12	0.10	5.0	1.22		
Myanmar	0.06	0.05	5.0	1.18		
Brunei	0.03	0.02	5.0	1.16		
Lao PDR	0.03	0.02	5.0	1.16		
ASEAN	24.0	20.0	-	28.41		
Total	120.0	100.0	-	100.0		

Source: Ministry of Strategy and Finance, Korea.

<sup>3</sup> Vietnam, Cambodia, Laos, Myanmar, and Brunei.

The CMIM, which came into effect on March 24 in 2010, is basically a commitment to provide U.S. dollars to member countries in crisis. It ultimately helps stabilize foreign exchange markets in the region and plays a significant role as a financial safety net. Despite its loose structure and relatively small amount of the CMIM fund, its multilateralization is evaluated as a significant move towards improving East Asia's financial stability and regional cooperation.

## 2. Asian Bond Market Initiative

ASEAN+3 Finance Ministry deputies and central bank deputies were involved in discussions on how to develop the Asian bond markets under the ASEAN+3 process in 2002. A month later, in Chiang Mai, Thailand, the ABMI was endorsed in order to develop a regional bond market. The ABMI aims to develop efficient and liquid local currency bond markets in Asia through investment of huge savings of Asian countries in the region. It was also expected to mitigate the problem of both currency and maturity mismatches in East Asia.

The ABMI was the ASEAN+3 countries' reaction to the double-mismatch problem that was one of the main causes of the Asian crisis in 1998.<sup>4</sup> In the 1990s, the East Asian economies borrowed foreign currency to finance domestic investment through heavy bank financing. A large portion of these foreign currency bonds had a short maturity

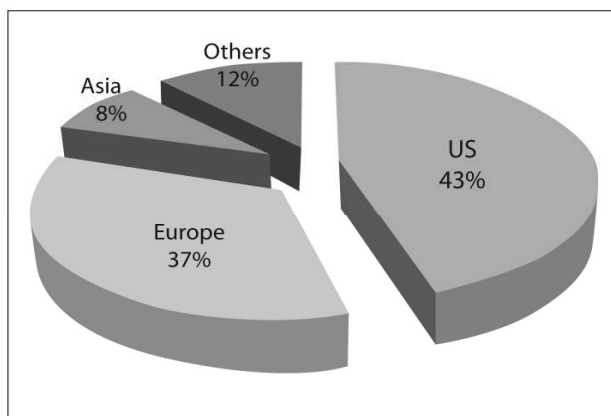
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<sup>4</sup> Brunnermeier *et al.* (2009) point out that maturity mismatch was the main source of financial instability. Particularly in emerging market economies, maturity mismatch can create serious systemic risk when being accompanied by currency mismatch.



while revenue flows for repayment were in domestic currencies over the long period, and led to currency and maturity mismatches. This came about because of an underdeveloped regional bond market, and heavy dependence on bank financing without issuing and trading local currency bonds. Thus, the aim of the ABMI is to create regional bond markets where bonds are denominated in regional currencies.<sup>5</sup>

**Figure 1. Asia's Portfolio Investment by Region**



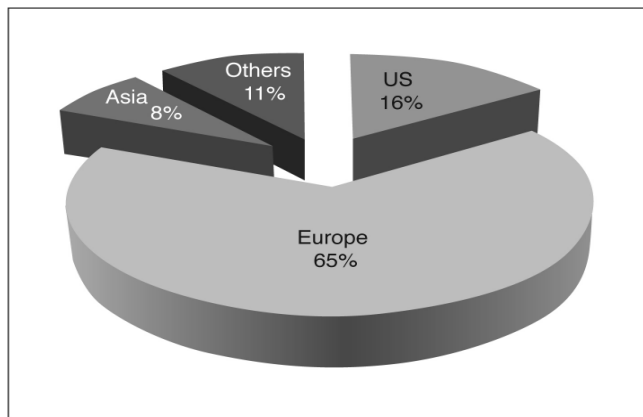
Source: Yoshino (2010).

One of the reasons for the lack of development of Asian bond market is that the reserves and capital in Asia have been largely invested in

<sup>5</sup> In line with the ABMI, two bond funds were introduced in the Executive Meetings of the East Asia and Pacific Central Banks (EMEAP) in 2003: Asia Bond Fund 1 and Asia Bond Fund 2. The ABF 1, announced in 2003, with a capitalization of US\$1 billion, is mandated to invest in dollar-denominated Asian sovereign bonds. The ABF 2, introduced in 2004, with a capital of US\$2 billion, is mandated to invest in Asian bonds denominated in local currencies. It consists of both Pan-Asian Bond Index Fund and Fund of Bond Funds or sub-funds in the eight countries.

the U.S. and Europe, and then they are re-invested in Asia through international investment institutions and hedge funds. As Figures 1 and 2 indicate, 80% of Asia's portfolio investment has went into assets in the U.S. and Europe while Europe absorbs 65% of portfolio investment in its own region. Moreover, as of March 2009, ASEAN+3 members' foreign reserve amounts to 52% of the total reserve in the world. However, most of the reserve has invested in assets outside of East Asia.<sup>6</sup>

**Figure 2. Portfolio Investment in Europe**



Source: Yoshino (2010).

<sup>6</sup> Since most central banks restrict their investment to the assets of rating AA or above, lots of firms in East Asia are excluded from their investment.

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### **III. Regional Surveillance Mechanism in East Asia**

#### **1. ASEAN+3 Economic Review and Policy Dialogue**

The transformation of the CMI into CMIM was a significant step forward in that it enhanced the efficacy of short-term emergency liquidity support among ASEAN+3 member countries. Along with multilateralization, regional surveillance is a critical and important issue that must be dealt with in order to develop the CMIM as a more effective entity for financial cooperation in the region.

The necessity of regional surveillance is also indicated by the existence of IMF conditionality. The current CMIM will continue to rely on IMF surveillance as long as the 80 percent of its disbursement is linked to the IMF. However, East Asian countries are reluctant to utilize lending from the IMF because of harsh structural reforms often demanded by the IMF and its stigma effect. These led East Asian countries to establish an independent surveillance unit of their own. As Henning (2009) points out, the lack of development of surveillance within ASEAN+3 means the IMF link will be maintained for the time being. He also stresses that if ASEAN+3 manages its surveillance mechanism effectively, other countries and international organizations will become more favorably inclined to the CMIM arrangements and regional financial cooperation in East Asia. This implies that the establishment of the AMRO, as an independent regional surveillance unit, can reduce the level of IMF conditionality in the future.

A regional surveillance mechanism was established under the CMI in 2002 by the ASEAN+3 ERPD. The objectives of the ASEAN+3 ERPD include identifying potential macroeconomic and financial risks, preventing crises, monitoring regional capital flows and currency markets, and enhancing self-help and support mechanisms in East Asia. However, as pre-existing surveillance activities are not appropriate for the multilateralized CMI, another new surveillance unit will be required.

ASEAN+3 finance and central bank deputies hold two-day ERPD meetings semiannually. Kawai and Houser (2007) describe the ASEAN+3 ERPD sessions as follows. The participants exchange their views on global, regional, and individual country reports on economic developments, various types of risks affecting the regional economies, and several policy options. The ADB and the IMF provide economic reports, thereby facilitating the deputies' policy dialogue, information sharing, and exchange of views. External experts provide their views on certain topics and issues, and engage in dialogue with the deputies. Policymakers of individual countries only provide assessment of economic conditions in their own countries. They do not formally assess economic conditions and vulnerabilities in other countries and nor do they make recommendations for policy change in other countries.

ASEAN+3 ERPD became an important information exchange mechanism on economic conditions and policies in East Asia. However, the noninterference policy of the ERPD would affect the processes of decision making and surveillance. According to Kawai and Houser (2007), the ERPD process encompasses (i) assessment of global, regional, and national economic conditions, (ii) monitoring of regional capital

flows and currency markets, (iii) analysis of macroeconomic and financial risks, (iv) improvement of conditions in banking and financial systems, and (v) provision of outlets for voices from Asia in the reform of the international financial system. Steps have been taken for cooperation in monitoring short-term capital flows and developing a regional early-warning system to assess regional financial vulnerabilities. Many ASEAN+3 members have set up official surveillance units for economic and financial monitoring and are developing their own early warning systems. Both the Group of Experts (GOE) and the Technical Working Group on Economic and Financial Monitoring (ETWG) were launched to explore ways and means for strengthening the region's economic surveillance capacity.

The ASEAN Secretariat (ASEC) provides support to the ASEAN+3 ERPDP process, and the ADB provides a statement and a paper for discussion at the meetings of finance ministers and central bank deputies. The IMF has been participating in the ASEAN+3 deputies process in the ERPDP. However, there has been no single, independent, professional organization which prepares comprehensive assessments of member countries' economic performance; including analysis of risks, vulnerabilities, and appropriate policy recommendations. The new surveillance unit under the CMIM should be established by designing effective measures for application of peer pressure, and guarantee independent surveillance activities in such a way as to minimize moral hazard. At the same time, member countries should be ready to accept external policy recommendations to achieve financial stability. Using both bilateral and multilateral surveillance functions with the aid of

IMF technical assistance would be recommended during the period of transition toward a well-functioning surveillance unit. In this regard, the ASEAN+3 surveillance unit can perform a cooperative and complementary role alongside IMF surveillance.

## **2. AMRO as a New Regional Surveillance Unit**

The 13th meeting of ASEAN+3 Finance Ministers agreed to establish a new regional surveillance unit, called the ASEAN+3 Macroeconomic Research Office, to ensure the effective operation of the CMIM. The AMRO is expected to begin operations in May 2011. The AMRO is expected to play a significant role in monitoring regional economic conditions as well as in support for provision of prompt emergency liquidity to member countries in crisis, in addition to contributing to effective regional financial safety nets.

ASEAN+3 members have reached an agreement on the basic elements of the AMRO. The AMRO will be located in Singapore to monitor and analyze regional economies, which contributes to the early detection of risks, swift implementation of remedial actions, and effective decision-making of the CMIM. After its establishment, AMRO will submit a report on the overall macroeconomic and financial assessment of the ASEAN+3 region and individual members. During the process of ERPDP, the AMRO will submit a consolidated surveillance report with overall macroeconomic and financial assessment of all member countries and the region; highlight topics for ERPDP discussion, and make a presentation during the ERPDP session.

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## IV. Way Forward for Effective ASEAN+3 Surveillance

### 1. Systemic Risk and Regional Surveillance

Realization of systemic risk<sup>7</sup> results necessarily in turmoil in the foreign exchange market, particularly in emerging economies. For example, Table 2 shows average daily non-deliverable forward (NDF) turnover for several Asian currencies between 2003-04 and 2008-09. It shows that, right after the global financial crisis, cross-border transactions increase, with rising investment flows and speculative positioning drive emerging East Asian NDF markets.

In addition to double mismatches mentioned earlier, there are certain types of risks that arise from surges in capital flows, such as macroeconomic risks or financial instability from sudden reversal of huge capital flows. In fact, during the recent global financial crisis, there have been hefty surges in capital inflows to Asia: movements of excess

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<sup>7</sup> 'Systemic risk' is frequently used after recent global financial crisis which was triggered by the US subprime mortgage problem. G10 Report (2001) defines systemic risk as follows:<sup>7</sup>

"the risk that an event will trigger a loss of economic value or confidence in, and attendant increases in uncertainty about, a substantial portion of the financial system that is serious enough to quite probably have significant adverse effects on the real economy. Systemic risk events can be sudden and unexpected, or the likelihood of their occurrence can build up through time in the absence of appropriate policy responses. The adverse real economic effects from systemic problems are generally seen as arising from disruptions to the payment system, to credit flows, and from the destruction of asset values."

global liquidity and carry trade, expected improvements in the current accounts of Emerging Asian Economies, expected opportunities of widening interest differentials that could become catalysts for excessive capital inflows.

**Table 2. Average Daily NDF Turnover**

Currency	2003-04 (USD mil.)	2008-09 (USD mil.)
CNY	50	1,000
INR	20-50	800
KRW	700-1,000	3,000
PHP	20-30	500

Source: Asia Capital Market Monitor (2009).

Sharp capital reversals or Sudden Stop<sup>8</sup> is another potential source of systemic risk in East Asia's emerging economies. Recently the ADB warned that government authorities of emerging Asian economies should be ready to respond when volatile capital flows threaten to destabilize their financial markets. Surges in short-term capital inflows could potentially leave countries vulnerable to sudden reversals in portfolio investment and to sharp currency movements. The huge investment from overseas has put significant pressure on the currencies of emerging economies. Recent surges in capital flows have been driven by portfolio equity flows, shown in Figure 3, as investors take advantage of earnings potential between emerging Asian markets and

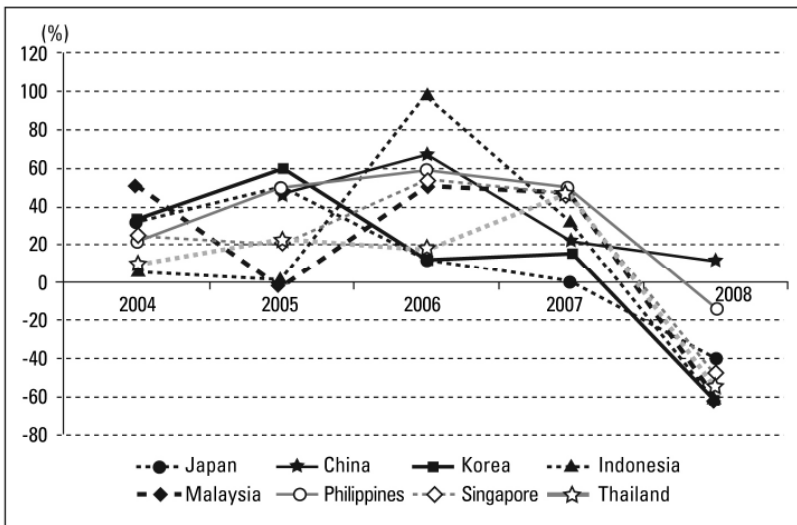
<sup>8</sup> Sudden Stop is a large and mostly unexpected shrinkage of international capital flows, and is associated with large depreciations and financial disruption.



mature markets.

The question at this point would be how to respond to volatile capital flows effectively to prevent financial instability. In addition to managing capital flows with policy measures, it is essential to strengthen regional surveillance activity and cooperation for financial supervision. Therefore, to reinforce prudential measures and create a more resilient financial system, the following objectives, among others, should be pursued: (i) reduction of currency and maturity mismatches, (ii) promotion of countercyclicality of bank lending and capital inflows, (iii) strengthening of regional supervision especially for systematically important financial institutions, and (iv) close monitoring of credit risks.

**Figure 3. Portfolio Investment Flows in Equity (%Δ)**



Source: IFS.

## 2. Looking Beyond the Current ASEAN+3 ERPD

East Asia's economic and financial system lacks experience and effective tools for macro-prudential supervision and micro-prudential regulation. In fact, shortcomings of the present system include (i) lack of adequate macro-prudential supervision, (ii) no institutionalized means for supervisors to take common decisions for the region, (iii) lack of frankness and cooperation among national supervisors, (iv) failure to challenge supervisory practices on a cross-border basis, (v) lack of economic surveillance and stronger peer pressure across member states.

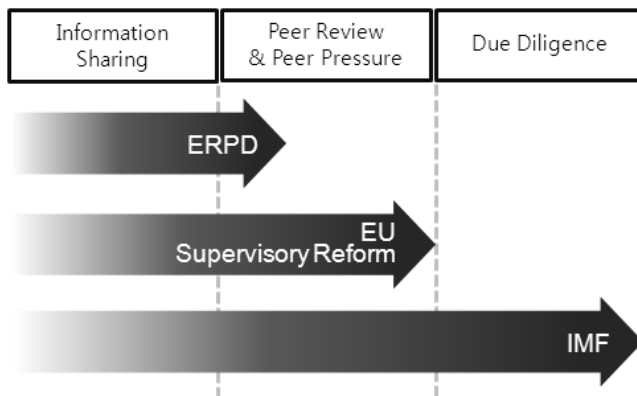
### 2.1. Stronger Peer Review and Peer Pressure

Bolstering the regional surveillance mechanism is essential to creating effective regional financial safety nets. There are three components of regional economic surveillance: (i) information sharing, (ii) peer review and peer pressure, and (iii) due diligence. Park and Kim (2010) compare the development stages of the ASEAN+3 ERPD, the European supervisory reform proposal, and the IMF surveillance in Figure 4. Currently the ASEAN+3 ERPD process is in transition from the information sharing stage to the next stage of a more rigorous scrutiny stage, which must eventually involve some form of due diligence in the future.

EU's experience with global financial crisis created the need for bet-

ter European supervision of financial institutions.<sup>9</sup> The Comply-or-Explain principle in the European case gives ASEAN+3 ERPD a benchmark for instituting more binding peer review and peer pressure. Its surveillance process should focus ultimately on providing the regional equivalent of the IMF multilateral surveillance.

**Figure 4. Modality and Development of Regional Economic Surveillance**



Source: Park and Kim (2010).

For the ASEAN+3 ERPD to become stronger, it will need enhanced capacity to conduct regional surveillance and an appropriate institutional mechanism for carrying it out. The ASEAN+3 ERPD process must move out of its current stage of information exchange and include stronger peer review and due diligence if possible. ASEAN+3 can

<sup>9</sup> European reform of supervisory system is briefly introduced in Appendix.

use peer review not only to conduct country-by-country bilateral surveillance, but also to engage in cross-country assessment or assessment of broader issues of regional cooperation. Due diligence, on the other hand, will be necessary to guide the activation of the CMIM in times of crisis. Due diligence also involves an assessment of a potential borrowing country's ability to pay back, in order to determine whether assistance should be extended, and what conditions should be attached to this assistance. At present, due diligence for the CMIM is linked to the IMF's Article IV surveillance and its program conditions. While a formal unit is still being set up, the ASEC and the ADB were asked to carry out interim surveillance activities based on existing surveillance processes.

In order to enhance regional surveillance, ASEAN+3 surveillance should (i) move forward to the peer review and pressure stage and if possible, to due diligence, (ii) make the AMRO a well-resourced professional surveillance secretariat, (iii) create capacity to apply independent conditionality, (iv) introduce an effective macro-prudential supervisory framework for financial regulation and supervision. At the same time, the regional surveillance unit should be flexible enough to respond to ASEAN+3 whenever needed, as well as leave room for national adjustments to account for specific features of local markets. As decentralized surveillance units are already in place, we need a higher degree of supervisory harmonization than ever before with enhanced ability to network the decentralized authorities to provide a more interconnected surveillance.

A better mechanism needs to be introduced to apply binding peer

pressure on each member country so that each country's policymakers may adopt appropriate policies to reduce economic and financial vulnerabilities. More importantly, an effective peer review and peer pressure mechanism built on mutual trust can facilitate the sharing of views on best practices and policies.

## 2.2. Strengthening ASEAN+3 Surveillance Mechanism

It is generally recommended that both bilateral and multilateral surveillance tools be used. For the interim surveillance, ADB publishes a surveillance report - as part of bilateral surveillance process - on individual economies in collaboration with the ASEAN Secretariat. As for multilateral surveillance activities, a consolidated report on the regional economic and financial situation should be published by the ADB and the ASEC. The consolidated report will cover an overall economic assessment of ASEAN+3 economies in addition to external economic environment.

Once the AMRO is established, the Office of Regional Economic Integration (OREI)<sup>10</sup> of the ADB and the ASEC should provide support

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<sup>10</sup> The ADB established the OREI in 2005 and significantly expanded its role on surveillance activities. These include (i) monitoring economic policies and financial architecture issues from a regional and subregional perspective and disseminating results to promote prudent economic management; (ii) strengthening the capacity for economic monitoring at the regional and subregional levels through provision of technical assistance and advisory services; and (iii) strengthening ADB's relations with other international financial institutions, as well as regional and subregional bodies, by providing monitoring inputs for various meetings and discussions. The OREI also assisted in the creation of national surveillance units in seven ASEAN countries (Indonesia, Philippines, Thailand, Cambodia, Lao PDR, Vietnam, Brunei Darussalam) and China.

for the AMRO. The ADB publishes, in collaboration with the ASEAN secretariat, a surveillance report on individual economies as part of the bilateral surveillance process. The ADB also developed and installed Early Warning System (EWS) software in several ASEAN+3 countries, and contributed to the advance detection of emerging vulnerabilities. In addition, a supporting regional database on macro-prudential indicators; along with Vulnerability Indicators and Early Warning System (VIEWS) software for economic and financial monitoring has been developed and installed in the national surveillance units of central banks and finance ministries of ASEAN+3 members. VIEWS software is routinely used by ASEAN+3 central banks and finance ministries to monitor economic and financial conditions. As for multilateral surveillance activities, a consolidated report gives an overall economic assessment of ASEAN+3 economies in addition to global economic environments and potential external risks. The AMRO may request and utilize technical assistance it would need from the IMF.

At the same time in order to reinforce peer review and peer pressure processes with relevant policy recommendations, it is suggested that a Board of Coordination be established within the ASEAN+3 ERPDP process as in Figure 5. The Board of Coordination can suspend the decisions by the surveillance unit, and the addressees may appeal to the Board concerning the prescribed policies when they seem unacceptable. The Board may confirm the decision or remit the case to the ASEAN+3 ERPDP and provide consultation on the legal issues. The surveillance unit shall be bound by the decision of the Board of Coordination, and adopt an amended decision regarding the case concerned.

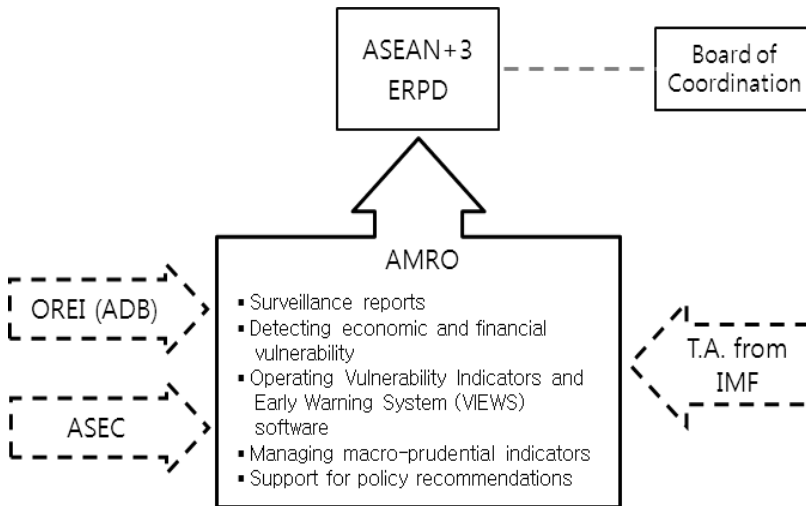
The ASEAN+3 ERPD process could be more effective in several ways that would enhance the quality of the dialogue. First, the discussions should be more open, with officials debating their own and other countries' economic problems, vulnerabilities, and policy options to ensure that good policies are made for the region. Second, the AMRO will be an independent, professional organization that prepares comprehensive reports for analyses, assessments, and discussion to support the process, while the ADB and the IMF provide their views of the global and regional economy. Third, institutions with the best knowledge and expertise on particular issues could be invited to the process on an *ad hoc* basis.<sup>11</sup>

The ERPD process needs greater emphasis on technical analysis and to create an environment for serious policy debate. This means adopting an appropriate balance between the traditional presumption of noninterference in domestic affairs of another country and the new challenge of rigorously scrutinizing economic and financial conditions, risks, and policy prescriptions of the country. The process must encourage candid and active discussions on the technical matters without being abrasive and confrontational. Member countries should also be ready to accept policy recommendations based on mutual trust.

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<sup>11</sup> For example, the Bank for International Settlements (BIS) on global capital market issues, the International Organization of Securities Commissions (IOSCO) on global security market regulation, global rating agencies on sovereign risks, the International Association of Insurance Supervisors (IAIS), and the Basel Committee on Banking Supervision (BCBS) with recommendations from the Financial Stability Board (FSB) and the IMF.

**Figure 5. Proposed ASEAN+3 Surveillance Mechanism**



The emerging East Asian economies should pay attention to international efforts for strengthening macro-prudential surveillance. The process focuses on such matters as mitigating the procyclicality of financial systems, financial supervision consistent with international financial standards, and sharing best practices or experiences.<sup>12</sup> The turmoil in the international financial markets has revealed significant weaknesses in the functioning, regulation, and oversight of financial

<sup>12</sup> For example, Korea adopted micro-prudential regulatory measures after the 1997 Asian financial crisis. The regulation was reinforced in 2009 with the aim to achieve enhanced effectiveness: (i) foreign currency liquidity ratio to reflect respective level of recoverability, (ii) minimum safety asset requirement and contingent plan enactment in case of crisis, (iii) new standards on foreign currency derivatives trading risk management established, (iv) limits on the hedging of export proceeds to 125 percent of exports. (Cho, 2010)



systems within and across international borders. Authorities in the region, both individually and collectively, need to address weaknesses in their financial systems in order to improve their functioning and integrity. Regional surveillance must emphasize the importance of surveillance on consumer credit and local banks, as well as non-bank institutions, such as hedge funds, investment banks, insurance companies which have posed systemic risks during the current global crisis. Furthermore, supervisory activities under regulation regimes should be performed in a countercyclical manner because most financial systems exhibit high degree of procyclicality. Particularly in emerging market economies, excessive risk-taking during booms - associated with large capital inflows and rapid domestic credit growth - often become the cause of financial crises. Maturity and currency mismatches on financial and nonfinancial balance sheets during booms also aggravate the economic conditions whenever symptoms of crises appear.

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## V. The Idea of an Asian Monetary Fund

### 1. CMIM as a Precursor to Asian Monetary Fund

What differentiates the CMIM from other ordinary funds is that no money is raised upfront. The CMIM member countries commit money, and when needs arise, the members agree to render. Member countries have prepared regulatory changes to make this happen in their respective countries. The CMIM has a small surveillance unit, AMRO, but for the CMIM to ensure follow-ups, additional institutional structure will need to be built; including a secretariat for administrative duties and a settlement scheme to manage the money transfers.

Should the CMIM be disposed with such an institutional structure like the above, it will effectively become an Asian Monetary Fund. Would Asia need an institution like the AMF? The answer is probably *yes*. A regional stability mechanism like this may do a better job in dealing effectively and quickly with regional problems than global institutions like the IMF. A comparable case would be the European intervention against its current sovereign debt crisis that happened in May-June 2010: the creation of a European Financial Stability Facility (EFSF) effectively helped calm the market anxiety and prevent international transmission of the problem. The IMF also contributed to the facility, but this was expected given the role of the IMF and European representation within the IMF. Therefore the credit goes to the Euro-

peans themselves.

East Asia is an area where real economic activities are strongly linked. It is well integrated in real economic activities, but not as well in the financial area. However these countries do not have a common currency of their own in clearing trade. It is cleared mainly in US dollars. When this is the case, gains from real economic integration – low production costs, higher production levels and competitive advantages for consumers, etc. – can easily be lost by losses in the values of the currencies of these economies vis-à-vis the US dollar. Therefore, whatever shocks that affect the exchange rates offset the gains from trade in goods and services.

Limited exposure to developed markets for most Asian financial firms has helped Asian countries. It was foreign exchange markets that have been hit especially hard as foreign investors retrieved their portfolio investments from these markets. That is why for East Asia the last crisis was rather an exchange rate crisis rather than a financial crisis.

The CMIM is more significant than the old CMI scheme since not only the size of the money pooled is larger, but the process is institutionalized by multilateralization. This is a significant building block for the future Asian regional economic architecture.

What would be the CMIM's position with respect to the IMF? The CMIM is too small to be comparable with the IMF, and the CMIM will co-exist with the IMF. One important issue is the IMF conditionality. The fact that there is no money provided by the IMF for the CMIM makes the enforcement of IMF conditionality difficult to comprehend. It is a weak argument to claim that the lack of surveillance expertise

represented by the AMRO would necessitate IMF conditionality. It is not very clear what the IMF conditionality program actually signifies presently, as the IMF had used as the basis of its conditionality such as the Washington consensus no longer look valid. For these reasons, limiting the amount of the withdrawal within the CMIM because of IMF conditionality does not make much sense. We propose that the CMIM work without IMF conditionality and that the IMF be invited to provide independent funding with conditionality that it would like to impose. The CMIM and the IMF are complementary in this regard.

## **2. East Asia vs. Euro-Zone**

An Asian monetary fund is an institution that will help bridge differences among East Asian economies. East Asia is much more heterogeneous than the euro-zone, with their differing degrees of growth, development and wealth. The region needs strong institutions to turn these differences into an advantage and make possible efficient allocation of resources and growth.

The euro-zone did not create this type of institution until recently with the agreement on the European Financial Stability Facility in early May 2010: the EMU did not have a European monetary fund up to that point, but it has a European Central Bank. The EFSF has a total funding of close to one trillion USD and aims to overcome the euro-zone's sovereign debt problems, the epicenter of which is Greece, Italy, Ireland, Portugal and Spain.

**Table 3. Comparison between EFSF (European Monetary Fund) and CMIM (Asian Monetary Fund)**

	<b>European Monetary Fund</b>	<b>Asian Monetary Fund</b>
Function	- Sovereign fund to bail out countries in short-term liquidity crisis	- Expected to assume role as a regional monetary stabilizer. There is no regional currency and thus exchange risks are present at all times. A high level of foreign reserves in the region makes the role of this fund somewhat ambiguous
Link with regional economic integration	- Not a strong symbol of European monetary integration. The euro-zone has the euro as a single currency, ECB as European central bank, and other institutions like the European commission and parliaments	- Has the symbolic significance of representing the advancement of East Asian financial integration
Enforcement	- Little competition toward larger contribution shares - Create an SPV to issue government-guaranteed bonds at pre-committed amounts - No IMF conditionality for the European contribution not coming through the IMF	- Competition toward a higher share, as quotas within the CMIM will likely impact the politics of future Asian regional institutions - Commitment of money in pre-determined amounts - IMF conditionality

Notes: Revised from Oh (2010). IMF provides its own share of extra funding to the EFSF, and the IMF is entitled to impose conditionality for the part of its contribution.

The EFSF was created in time of economic crisis to rapidly cope with the current problem, whereas the CMIM is created in peace time. The latter is therefore not a popular recourse for its members. The EFSF is similar to the CMIM in that it is based on commitments, not actual submissions of money. As the EFSF is a much needed facility, we will soon see money flow out of the EFSF, while we might have to wait to see if the same would happen for the CMIM. But despite the likelihood that the CMIM will not likely be utilized immediately, it does represent an important step for deeper financial integration for the region.

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## **VI. Asian Currency Competition and Movement Toward a Regional Currency**

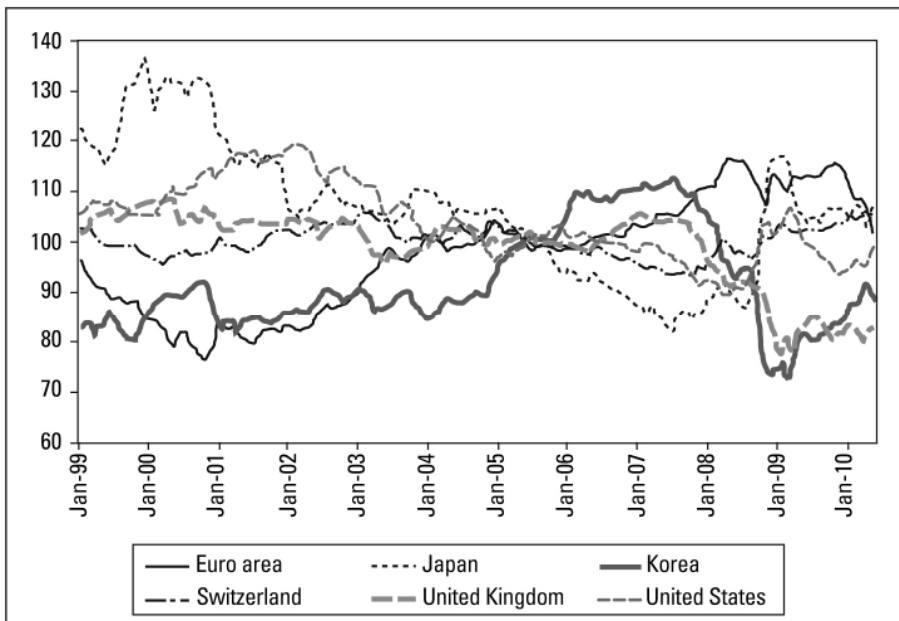
The CMIM aims at stabilizing the regional economies against regional financial stress. The CMIM should be regarded as a birth to form one polar of the system that ensures regional sovereign solvency and financial market stability. The rest of the system would include deepening of regional financial markets, a stable regional currency system, and sound government fiscal conditions, etc. This section briefly discusses the regional currency system, as this issue has been left out for a quite some time. Whereas the current problems of the euro-zone cast doubts in the merits of a single currency, we believe that a single currency is still a very attractive policy option for East Asia against times of crisis for following reasons:

- To reiterate, external shocks caused by the crisis via exchange rate fluctuations affect both real and financial performance of national economies.
- A large economy with a heavily managed exchange rate regime like that of China incurs huge financial costs, in the form of hoarding foreign reserves.
- A large open economy with moderate openness in trade and finance like Japan witnesses a strong yen, but at a cost of corporate competitiveness at the international level, which leads to an

abrupt fall of exports and investments when an international crisis happens.

- Crisis makes a small open economy like Korea suffer from huge devaluations, prone to inflation pressure and reduction in the relative gains from exports.

**Figure 6. Increased Currency Instability**



Notes: CPI-adjusted real effective exchange rates from BIS (Monthly averages, 2005=100).

The twin deficits in the U.S. will persist, given the US economic stimulus packages. This would increase the downward pressure in the value of the US dollar. As a result the currency competition will be-



come fiercer at the anchor currency level among US dollars, euro, renminbi, or yen. Smaller economies will also strive to internationalize their currencies to minimize the impact of external shocks to their respective currencies. These developments should facilitate debates on a more stable East Asian regional currency system, be it in the form of a dominant currency, a basket or a single currency. Note that a single currency in East Asia is likely to lead to a state similar to one in which East Asian currencies are all internationalized. To agree on a single currency may take less time and possibly lower cost than each country trying to internationalize its currency. It would be incorrect to conclude that the present euro-zone crisis is a sign that a single currency may not be a good thing and thus not the best choice for East Asia. We would like to argue that the seemingly worst scenario for the euro-zone, a break-down of the euro-zone, could be turned out to be good for the recovery of the European economy.

It is certainly a very difficult task for East Asia to have a more stable regional currency system whether they are based on a creation on a basket or a common currency. Unfortunately there is little movement in this direction.<sup>13</sup> On the other hand some countries in East Asia, e.g. China, Thailand, Korea, Malaysia and Indonesia, have already reviewed during the crisis period how to make their currency more internationally usable. The previous literature has identified that for a currency to become an international currency involves profound improvements in the size of the economy, exchange rate stability, financial

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<sup>13</sup> A notable exception is the efforts of Japanese scholars headed by Dr. Ogawa.

market development – foreign exchange market, financial markets, and capital markets – and political stability.<sup>14</sup> Moreover, there does not seem to be any currency in the Asia-Pacific region that can compete against the US dollar.<sup>15</sup> Given these limitations, we find it hard to believe that country-specific policy implementations for currency internationalization are in fact pareto-improving against coordinated efforts on creating a sound regional currency system.

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<sup>14</sup> Iwami and Sato (1996), Chinn and Frankel (2008), and Tavlas (1997).

<sup>15</sup> See Baek and Oh (2009) for an evaluation of the Asia-Pacific national currencies.

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## VII. Concluding Remarks

We have discussed several important issues concerning East Asia's financial and monetary cooperation, including summarization of three key initiatives of (i) the CMIM, (ii) the ABMI, and (iii) ASEAN+3 ERPD. Furthermore, this paper emphasizes some aspects of regional financial safety nets by way of strengthening regional economic surveillance activities, and future development of the CMIM towards an Asian monetary fund, as well as Asian currency competition.

However, the CMIM currently has several limits to becoming an effective regional financial safety net. First, the total amount of swap facilities available under the CMIM may not be sufficient for supporting preemptive short-term liability in the region. Second, although the CMIM is a regional financial arrangement, in practice it is closely linked to the IMF by IMF conditionality. 80% of the CMIM that is linked to the IMF should be reduced, to enhance effectiveness of the CMIM by reinforcing regional surveillance mechanisms.

One of the most important issues for enhancing the efficacy of the CMIM is to reduce the stigma effect and moral hazard for requesting the emergency short-term liability. Both the stigma effect and moral hazard problem are commonly revealed in the emergency liquidity support programs even in IMF lending facilities. The future phase of the CMIM should be appropriately designed in such a way to minimize its stigma effect and moral hazard problem among potential benefi-

ciary countries.

The role of the CMIM should be strengthened within the framework of global-regional financial safety nets. The necessity of financial safety nets has been emphasized to avoid contagion from crises and to contribute to sustainable and balanced growth by reducing incentives to accumulate huge international reserves in emerging economies. The CMIM can play an important role in complementing global financial safety nets, such as IMF lending facilities, by reinforcing its linkages and appropriate division of labor between the global and regional safety nets.

East Asia's economic and financial systems lack experience and effective tools in macro-prudential surveillance. In fact, shortcomings of the present system include (i) lack of adequate macro-prudential supervision, (ii) no institutionalized means for supervisors to take common decisions for the region, (iii) lack of openness and cooperation among national supervisors, (iv) failure to challenge supervisory practices on a cross-border basis, (v) lack of economic sanctions across member states. Therefore, the ASEAN+3 surveillance mechanism should bolster peer review and peer pressure by strengthening AMRO's surveillance functions.

The ASEAN+3 ERPDP process could be more effective in several ways that would enhance the quality of the dialogue. First, discussions should be more open and thus allow officials to exchange their views on other countries' economic problems, vulnerabilities, and policy options. Second, the AMRO will be an independent, professional surveillance institution that prepares comprehensive surveillance reports for

economic analyses and assessments to support the process, while the third party, like the ADB and the IMF, provide their views on the global and regional economies. Third, the ASEAN+3 ERPD can maintain close relationships with international institutions with best knowledge and expertise on specific issues. Developing more efficient early warning systems and its effective utilization are also important as part of regional surveillance.

The current crisis provides sufficient incentives for East Asian economies to pursue internationalization of their currencies, although the lack of financial and foreign exchange market competitiveness is hindering its progress. Some East Asian economies would be ready to accept other East Asian currencies for clearing their trade, if it is less costly than using USD, and the shortage of USD liquidity is a favorable factor among those East Asian countries with liquidity problem opting for the former. Therefore, it would open the possibility towards a single currency in East Asia. However, further study will make it clear that there are potential conflicts between the heterogeneity among East Asian economies and a movement toward a single regional currency.

Further study will also monitor closely what is happening in the euro-zone. Much of the discussion on economic integration in East Asia has its roots in the European experience. East Asia is certainly different in many respects from Europe, but additional and interesting policy implications may be drawn from the imminent European developments for the CMIM.

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# Appendix

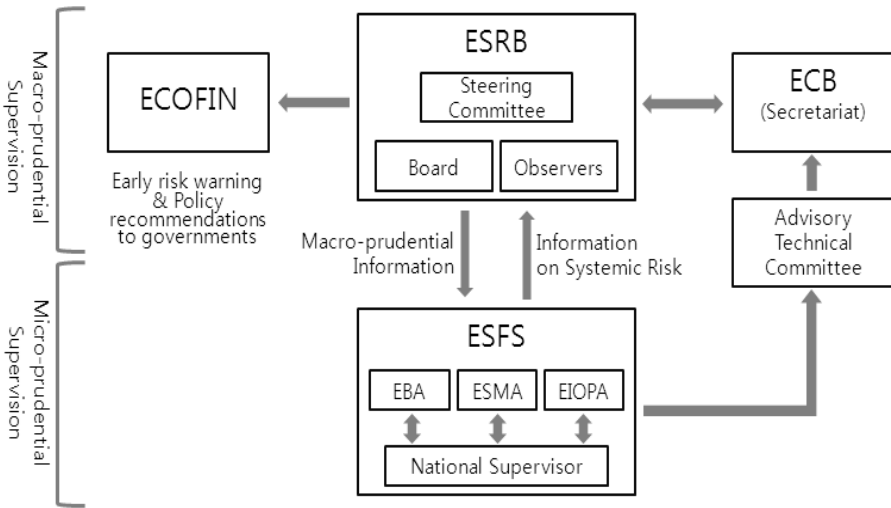
## Reform of EU Regional Supervisory System

According to the proposal of the European Commission, the new European supervisory system will be set up in 2010. As illustrated in Figure A, the proposal for a new European supervisory architecture aims to perform both macro-prudential and micro-prudential supervision by establishing two new institutions.

The European Systemic Risk Board (ESRB) will monitor and assess systemic risk to the financial system as a whole: i.e., macro-prudential supervision. The ESRB is to provide a system for early warning of system-wide risks and issue recommendations for action to deal with these risks. The ESRB will be established under the support of the European Central Bank (ECB), with the participation of EU central banks and supervisory authorities, among others. The ESRB will not have its own direct intervention instruments to forestall identified macro-prudential risks. Instead, it will draw attention to potential risks and it will put forward specific proposals, as required, to the Economic and Financial Affairs Council (ECOFIN), the member states or supervisory authorities for the mitigation of those risks. These proposals will not be legally binding, but the addressees are supposed to provide explanations if they choose not to implement the proposed actions: so-called Comply-or-Explain principle.



**Figure A. Proposed EU Supervisory Structure**



Source: European Commission.

The European System of Financial Supervisors (ESFS) is to undertake micro-prudential supervision. It consists of a network of national financial supervisors working with new European Supervisory Authorities (ESA), created by transforming the existing supervisory committees in areas such as banking, insurance and securities markets into the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pensions Authority (EIOPA). In the field of micro-prudential supervision, the ESFS will be established with a mandate to provide a framework for closer cooperation among national supervisions. The existing European supervisory committees, whose role is currently li-

mitted to consultation and coordination, will become the ESA, and will be primarily responsible for the standardization of member states' regulations and supervisory practices, as well as for facilitating cooperation among national supervisions. However, supervision of financial markets and individual institutions will basically remain a national responsibility.



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## East Asian Financial and Monetary Cooperation and Its Prospect: Beyond the CMI

Young-Joon Park and Yonghyup Oh

This paper examines the ASEAN+3 cooperation of regional financial safety nets, and reviews the regional monetary issues of a single currency and currency competition in East Asia. We point out potential systemic risks in East Asia and the importance of regional surveillance. ASEAN+3 regional surveillance should move forward to the stronger measures of peer review and peer pressure, and make the AMRO a well-resourced professional surveillance secretariat to create capacity to apply independent conditionality. To this effective surveillance mechanism, we propose to establish the Board of Coordination to support the ASEAN+3 ERPD by confirming its decision or remitting the relevant case to the ASEAN+3 ERPD and providing possible legal consultation. The institution building of the CMIM secretariat will accelerate the establishment of a regional monetary institution, e.g. an Asian Monetary Fund. The current crisis provides sufficient incentives for East Asian economies to pursue internationalization of their currencies, and it would open the possibility towards a single currency in East Asia.

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