

**Monetary and Financial Cooperation in East Asia:  
Future Directions for Institutional Arrangements of  
Monitoring and Surveillance \***

Yunjong Wang  
Senior Research Fellow  
Korea Institute for International Economic Policy  
300-4 Yomgok-Dong, Seocho-Gu  
Seoul, Korea 137-747  
yjwang@kiep.go.kr

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## 1. Introduction

The case for effective global economic institutions is now stronger than ever. The establishment of the World Trade Organization in 1995 is just a case in point. The original Bretton Woods blueprint for global economic infrastructure had called for a third international economic organization, the International Trade Organization (ITO), to be created simultaneously with the International Monetary Fund (IMF) and the World Bank (WB). When the U.S. Senate refused to ratify ITO out of concerns about yielding U.S. sovereignty to an international bureaucracy, the General Agreement on Trade and Tariffs (GATT) emerged in 1948 as an *ad hoc* body to provide the global public goods required by the impending expansion of international trade. GATT was not only in exile in Geneva, far from its two sister organizations in Washington D.C., it was also not recognized as a legal organization by international law.

The explosive growth of world trade since 1948 has brought unparalleled prosperity to many countries, particularly to East Asian countries. However, even though the expansion of trade yielded positive net benefits to virtually all participants, it also constantly created political tensions among countries because of the suffering wrought by the required structural adjustments. The transformation of GATT into WTO in 1995 represented the triumph of intelligent collective action to prevent the equivalent of "birth pangs" from killing the goose when it is laying the golden egg.

The creation of WTO was an example of responding appropriately to changing international circumstances. Globalization has accelerated the flow of goods and the operations of the international product cycle, and a new strengthened global institution was badly needed to coordinate individual national efforts to cope with the continual structural adjustments. It is unfortunate, however, that the WTO story is actually a rare example of successful collective action.

Globalization will require more than just the WTO to address the many challenges that it has thrown up for economic management. Globalization has also quickened the pace of international capital flows and the relocation of production platforms, and the international community has yet not, however, responded either in a timely manner or in a creative way to the equally serious economic adjustments generated by the increased mobility of capital. There have been numerous destructive speculative attacks on currencies in the last decade of the 20th century: the European exchange rate mechanism crisis in 1992-93, the Tequila crisis in 1994-95, the Asian financial crisis in 1997-98, the ruble-to-ruble conversion in August 1998, and the crash of the Brazilian real in January 1999.

The general lesson is that new circumstances require new forms of collective actions. For the particular case of global financial instability, there was a short burst of serious creative thinking after Robert Rubin identified in 1998 the need for a new international financial architecture. But with the quick strong recovery of most East Asian economies in 1999-2000, the wind has gone out of the efforts to reform the international financial institutions.

The attention is clearly gone from the reformulation of the international financial architecture, but the problems that had aroused the attention are still with us. Although East Asian economies have taken numerous measures (e.g. improving bank supervision, allowing greater exchange rate flexibility) to inoculate themselves against future capital account shocks, most of them are still vulnerable to very large negative capital account shocks. The national strategy of having a very large stock of foreign reserves to deal with the infrequent large capital flight may work but it is an extremely expensive strategy. Naturally, it has occurred to many astute economists in East Asia that a regional pooling of foreign exchange reserves may be a cost-effective response to the problem of big but infrequent capital flight. Building upon this insight, and from the monetary experience of Western Europe, a growing number of East Asian economists are realizing that although meaningful changes to the international financial architecture are out of reach, changes to the regional financial architecture are not only attainable but also have a receptive constituency.

At present, the East Asian countries share a broad sense of financial cooperation. In 1999, the leaders of ASEAN invited China, Japan and South Korea to join them in Manila to discuss economic cooperation in the region. The ASEAN+3 summit in November 1999 declared a "Joint Statement on East Asian Cooperation" that covers a wide range of possible areas for regional cooperation. Recognizing the need to establish regional financial arrangements to supplement the existing international facilities, the finance ministers of ASEAN+3 at their meeting in Chiang Mai, Thailand, in May 2000 agreed to strengthen the existing cooperative frameworks in the region through the "Chiang Mai Initiative (CMI)." This Initiative involves an expanded ASEAN Swap Arrangement (ASA) that included all ASEAN members and a network of bilateral swap and repurchase agreement facilities among ASEAN countries, China, Japan and South Korea.

Significant progress has been made in implementing the CMI to further strengthen the self-help and support mechanisms in East Asia, e.g. the ASA facility was increased to US\$1 billion on November 17, 2000. Regarding the network of bilateral swap arrangements (NBSA) and repurchase agreements under the CMI, substantial

agreement on the BSA has been reached between Korea-Japan, Malaysia-Japan, and Thailand-Japan. Government officials of ASEAN+3 countries will continue to work towards establishing a network of bilateral swap and repurchase agreement facilities among ASEAN+3 countries.

The goal of this study is to contribute to the effort to construct regional financial arrangements that would reduce the occurrences of financial crisis, and lower their costs. This study will confine itself to the issues related to crisis prevention through regional financial arrangements and mutual surveillance. In particular, in relation to the current development of the Chiang Mai Initiative (CMI), the analysis will focus on how to strengthen mutual surveillance processes through regional policy dialogue. As the degree of financial cooperation changes, mechanisms and institutions will evolve along with the other pillars of financial cooperation – liquidity assistance mechanisms and exchange rate coordination. Under the ASEAN+3 framework, progress has only been made in implementing the CMI. A discussion has just recently started to the setting up of an effective policy dialogue mechanism to support the operation of the CMI. Since different institutional settings will require different mechanisms for effective monitoring and surveillance, it is only natural that one should expect other initiatives such as exchange rate coordination to emerge as the CMI process works itself out in response to the needs for more regional public goods.

This paper is organized as follows. Section 2 begins with a discussion of the objectives and modality of monitoring and surveillance. Section 3 reviews and assesses existing regional or sub-regional initiatives in terms of information exchange, surveillance systems and other policy dialogue mechanisms among the ASEAN+3 countries. Section 4 makes a proposal for constructing a surveillance mechanism under the ASEAN+3 framework. Section 5 concludes the study with some final observations.

## **2. Objectives and Modalities of Monitoring and Surveillance**

The Asian crisis and historical experience have demonstrated that the growing interdependence in the world through financial integration has heightened the need to engage in international economic and financial cooperation. A broad definition of contagion implies the transmission of shocks from one country to another through various channels. In particular, with integrated markets, financial instability is unlikely to remain within national borders. Indeed, cooperative efforts at both regional and global levels are needed to counter the negative spillovers or externalities. For example, the IMF's surveillance activities amount to the provision of global public goods.

As Glick and Rose (1999) point out, crises have a regional component so that neighboring countries have a strong incentive to engage in mutual surveillance and to extend one another assistance in the face of potentially contagious threats to stability. Whether or not the primary source of the Asian financial crisis was the sudden shifts in market expectations and confidence, foreign lenders were so alarmed by the Thai crisis that they abruptly pulled their investments out of the other countries in the region, making the crisis contagious. The geographical proximity and economic similarity (or similar structural problems) of these Asian countries prompted the withdrawal of foreign lending and portfolio investment, whereas differences in economic fundamentals are often overlooked. If the channels of contagion cannot be blocked off through multilateral cooperation at the early stage of a crisis, countries without their own deep pockets of foreign reserves could not survive independently. Hence, neighbors have an interest in helping put out a fire (a financial crisis) before it spreads to them (Ito, Ogawa and Sasaki, 1999). As long as a crisis remains country-specific or regional, there is no urgent political need for unaffected countries to pay the significant costs associated with playing the role of a fire fighter.

As mentioned above, the formation of a regional financial arrangement in East Asia also reflects frustration with the slow reform of the international financial system. The urgency of architectural reform in the G7 countries has receded considerably. The slow progress has been further complicated by the perception that the current international architecture is defective. As long as the structural problems on the supply side of international capital such as volatile capital movements and G3 exchange rate gyrations, the East Asian countries will remain as vulnerable to future crises as they were before. Instead of waiting for the G-7 to create a new architecture, whose effectiveness is at best questionable, it would be in the interest of East Asians to work together to create their own self-help arrangements. The CMI of ASEAN+3 is one such available option (Park and Wang, 2001).

Monitoring and surveillance is the bedrock on which coherent policy formation under the regional financial arrangements rests. A joint effort is being explored within the ASEAN+3 framework to serve that purpose. A regional monitoring and surveillance process would provide prompt and relevant information for assessing the situation of countries in trouble and potential contagious effects of a crisis to neighboring countries. Furthermore, a joint exercise based on a region-wide early warning system would facilitate closer examination of financial vulnerabilities in the region. In addition, the regional monitoring and surveillance process would contribute to ensuring effective implementation of high-quality accounting and auditing standards, strong disclosure

requirements, credible rating agencies and appropriate corporate governance (Eichengreen, 2001). As the OECD is not a superfluous organization to its member countries, the regional monitoring and policy surveillance along with regional facilities would greatly contribute to the further development of financial markets and institutions in the region.

Although the CMI does not need to design its own conditionality at this point, because it is tightly related to the IMF, it does not mean that the CMI should not put its own surveillance function in place. First, under the CMI framework, 10 percent of the swap arrangements can be disbursed without Fund involvement.<sup>1</sup> When swap-providing countries jointly decide to disburse the 10 percent, they need their own surveillance over a swap-requesting country. The 10 percent is not automatically disbursed, but by the consent of swap-providing countries. In this regard, a regular monitoring and surveillance process should provide information for assessing the situation of the country in trouble. At present, the current practices under the ASEAN+3 process cannot effectively capture emerging problems. In this regard, the CMI will need to develop its own regional surveillance mechanism for preventing potential crises in East Asia. As the CMI moves forward beyond the current framework, a more comprehensive surveillance mechanism should be developed with deeper economic and monetary integration.

The current structure of the CMI does not require a new institution like the Asian Monetary Fund (AMF) because it is tightly linked to IMF facilities and conditionalities. In this regard, regional surveillance under the CMI will not serve as a structural adjustment program attached to liquidity assistance. However, for preventive purposes, a regional surveillance mechanism will enhance the collective efforts to strengthen the financial systems in the region.

If the CMI goes beyond the supplementary role to the IMF and seeks independent conditionality by establishing a regional fund (AMF), then the CMI should have its own strong surveillance process to diagnose economic problems in the region and prescribe appropriate policy recommendations (or conditionalities). Eichengreen (2001) finds it useful to distinguish between technical assistance and financial assistance. True enough, there is no reason to discourage competition in the market for technical assistance. Governments should be free to choose the source of technical assistance with the best track record. However, Eichengreen's concern is that if multiple monetary funds were available, East Asian governments would have an incentive to shop around for the most

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<sup>1</sup> The bilateral swap arrangements under the CMI are premised on the condition that 90 percent of the committed currency swaps would be activated along with the financial support of the IMF.

generous assistance and the least onerous terms. He believes that AMF conditionalities would be much softer than those of the IMF. His concern should be seriously addressed if there is development beyond the CMI.

The three pillars of liquidity assistance, monitoring and surveillance, and exchange rate coordination are essential elements for regional financial and monetary cooperation. However, the development of regional financial cooperation and its related surveillance systems will be evolutionary as shown in the case of European monetary integration (see Wang and Yoon, 2002 for details). Although a full-fledged form of monetary integration is not viable at this stage, East Asia may begin to examine the possibilities and desirability of cooperation and coordination in exchange rate policies – creation of a regional exchange rate mechanism and eventually an East Asian common currency. In this regard, the CMI could be regarded as a significant step, providing a basis upon which further regional financial and monetary cooperation can evolve (Henning, 2001).

As a supporting instrument and mechanism, regional monitoring and surveillance will also vary, depending upon the stage of regional financial and monetary integration. As the region becomes more institutionally integrated, more comprehensive and binding policy coordination will be required. In this regard, regional monitoring and surveillance ranges along a spectrum from simple information exchange and informal consultation forums to a supranational entity like the EMU. At one extreme point of the spectrum lies policy independence, in which governments simply take the policies of other governments as given, attempting neither to influence them nor be influenced by them. They merely exchange information and consult multilaterally without any formal pressure. Between independence and integration lies coordination which involves joint problem identification and pursuit of mutually beneficial policy objectives. Informal consultation, peer pressure, and rule-based penalties may be used for encouraging and enforcing certain common policies (UN ESCAP, 2000).

Under a loose and informal policy dialogue framework, formal enforcement mechanisms to impose sanctions and fines on countries that do not comply with agreed policy guidelines and recommendations may not be needed. In keeping with the ASEAN policy of non-interference, the regional surveillance process in East Asia is built on the basis of consensus and informality. East Asia in contrast to Europe lacks the tradition of integrationist thinking and the web of interlocking agreements that encourage monetary and financial cooperation. In this sense, East Asians may not be prepared to negotiate international agreements which include provisions for sanctions and fines for countries that do not adjust their domestic policies as needed for common policy objectives (Park

and Wang, 2000a). This unwillingness would make it difficult for a regional surveillance process to impose politically unpopular policies on the member countries and, hence, may pose a serious moral hazard problem.

It is worthwhile to distinguish conceptually two different types of moral hazards in conjunction with regional financial arrangements and related surveillance processes. One is related to liquidity assistance, while the other is related to collective actions required for common policy objectives. The former is tantamount to the IMF's bilateral surveillance and its conditionality attached to the liquidity provision. If the CMI develops into more or less an independent financial arrangement from the IMF, then the regional financial arrangement should be designed so as not to undermine the Bagehot rules (Kim, Ryou and Wang, 2000).<sup>2</sup> The proper conditionalities or pre-qualifications should discipline the borrowers to adhere to sound macroeconomic and financial policies. Otherwise, the Asian financial arrangement will go bankrupt.

Assume that there exist the IMF and a regional fund. The IMF will play the role of an insurance firm that has its own monitoring and surveillance device. However, the presence of a regional fund as a cooperative partnership fund will complicate the welfare consequences, depending on whether the regional fund is in a better position to monitor the effort than the insurance firm. If the regional fund cannot effectively harness its monitoring capabilities to reduce the moral hazard problem, countries may become less cautious; the IMF will tend to provide less insurance. The regional fund may crowd out the more effective insurance provided by the IMF, thus becoming completely dysfunctional. In this regard, peer monitoring is essential for controlling the moral hazard involved in the partnership, and may even improve social welfare by enhancing the countries' risk-sharing capabilities.

The latter type of moral hazard is not necessarily related to liquidity assistance. When common policy objectives are set, joint policy coordination is required to achieve a desirable outcome. Peer pressure is likely to work better when observable policy parameters are rather subjective and policy impact on neighboring countries is rather neutral. A broad category of recently proposed international standards and codes may belong to this category. East Asian countries should be encouraged to adopt the best international practices but a degree of variation and flexibility should be permitted. The OECD type of economic surveillance is feasible for the regional process. If East Asian countries pursue some form of exchange rate coordination, a set of policy parameters

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<sup>2</sup> A regional lender of last resort can address moral hazard problems by adhering to the classic Bagehot rules of lending (a) freely to solvent borrowers, (b) against good collateral, and (c) at a penalty rate.



should be closely watched to effectively coordinate the policy actions. Otherwise, in the absence of an incentive-compatible mechanism, countries may have an incentive to make less effort.

Without an institutional setup to make the team incentive problem more manageable, mere peer pressure or a peer review process cannot provide an effective incentive to commit member countries to perform the required collective activities for common policy objectives. To ensure that peer pressure is effective as a motivational device, a set of policy objectives should be clearly defined. Furthermore, it is essential that policy recommendations agreed upon by member countries should be made public, thereby reinforcing peer pressure through monitoring in the marketplace. To prevent free-rider problems, effective monitoring is essential to identify which parties do not comply with particular policy efforts. However, policy efforts are not always observable so that moral hazard prevails in this kind of uncertainty.

Kandel and Lazear (1992) note the usefulness of classifying peer pressure as either internal or external. Internal pressure exists when an individual gets disutility from hurting others, even if others cannot identify the offender. External pressure exists when the disutility depends specifically on identification by others. The internal pressures are the equivalent of guilt, whereas the external pressures are like shame. In the context of surveillance, the important issue is observability. A country feels shame when others can observe its actions. Without observability, only guilt can be an effective form of pressure. A surveillance and monitoring unit should exert peer pressure to motivate member countries to perform the required activities. Key observable policy parameters (expected policy efforts) should be developed in order to give a clear message to the offenders. Otherwise, some offenders may feel guilty, but not make the maximum efforts required for common policy objectives.

Team spirit and partnership should be based on mutual trust and a sense of responsibility. Those psychological components may be more important than institutional settings or rule-based norms. However, both internal and external pressure will fail when there is neither self-imposed guilt nor a feeling of shame. Then, a group of participants should devise a credible punishment mechanism. That punishment should not be random, but should be deliberately designed, specifying under what conditions penalties or sanctions will be imposed. As long as the enforcement mechanism works as a credible threat, the common policy objectives can be achieved through maximum collective efforts.

### **3. Regional or Sub-regional Initiatives among the ASEAN+3 Countries**

Before the Asian financial crisis broke out in 1997, few would have argued for the creation of a regional financial arrangement in East Asia. Only a market-led integration process was taking place in East Asia. Accordingly, there were few monitoring and surveillance activities at the regional level prior to the crisis. However, the financial crisis that erupted in 1997 was a major financial breakdown that gave East Asians a strong impetus to search for a regional mechanism that could forestall future crises. This search is now gathering momentum, opening the door to possibly significant policy-led integration in East Asia.

This section will review and evaluate the existing regional surveillance processes: the Manila Framework Group Meeting, and the ASEAN+3 Surveillance Process. I will assess these regional or sub-regional surveillance-related initiatives according to three criteria:

1. the precise content of information exchange—information sets, priorities, targets, models, and rules.
2. the conduct and methods of surveillance, the substance of surveillance recommendations in the peer review process, and the implementation of surveillance recommendations,
3. the role of these surveillance initiatives in improving the regulation, supervision, and integration of financial services markets (banking, investment funds, brokerage and asset management) within the ASEAN+3 countries.

#### ***Manila Framework Group (MFG)***

On 18-19 November 1997, a conference of deputy finance ministers and central bank governors from 14 countries, mainly in the Asia-Pacific region, was held in Manila, and “A New Framework for Enhanced Asian Regional Cooperation to Promote Financial Stability” (the so-called Manila Framework) was agreed upon. The Manila Framework Group (MFG) centers around four initiatives: (1) regional surveillance; (2) technical assistance geared towards strengthening the financial sector; (3) bolstering of the IMF’s ability to deal with financial crises; and (4) a contingent financing arrangement (CFA) for Asian currency stabilization.

Although the MFG has no formal status, there are now biannual meetings among 14 countries/areas plus the IMF, World Bank, and Asian Development Bank.<sup>3</sup> The MFG

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<sup>3</sup> The 14 member economies are Australia, Brunei Darussalam, Canada, China, Hong Kong SAR, Indonesia,

is seen by some observers as the preeminent forum for regional surveillance and peer pressure (e.g. Grenville, 2001). The IMF's Regional Office for Asia and the Pacific provides the Technical Secretariat for the Group. The position of Chair is occupied alternately by an ASEAN and non-ASEAN member. However, the MFG involves only a limited number of the economies in the region (not covering all ASEAN plus three) and its inputs and outputs are not made public, apart from an agreed press release after the meeting.

The MFG has shown only limited success as one of the surveillance mechanisms for the region. Regional surveillance was conducted by the three international financial institutions — the IMF, the World Bank, and the Asian Development Bank. According to the agenda discussed during the Manila Framework Group meeting in New Zealand, 45 December 2001, the IMF focused on global economic outlook and financial sector reforms. The World Bank and the Asian Development Bank presented the issues of structural reforms in the Asia-Pacific region and regional economic outlook and development issues respectively. The three presentations and follow-up discussions took only three hours including tea break. The reality is that the participation of the IMF and two multilateral development banks did not make any value-added contribution to region-specific surveillance because their analyses were already easily available from other sources.

The performance of MFG as a mechanism for regional financial cooperation and regional financial surveillance has not been very successful by the three criteria outlined above. Specifically,

1. because MFG has not yet clearly specify the objectives of information exchange and surveillance, no priorities, targets, and rules have been set for the process of information exchange;
2. because there is no actual peer review process in the MFG the surveillance process is simply a general discussion of the global and regional economic outlook, with no attempt to formulate any country-specific or region-wide recommendations for policy actions; and
3. because the issues related to financial sector reforms are only discussed cursorily, the MFG process has not led to improvements in the regulation, supervision, and integration of the financial markets of East Asia.

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Japan, South Korea, Malaysia, New Zealand, the Philippines, Singapore, Thailand, and the United States.

### ***ASEAN Surveillance Process and ASEAN+3 Surveillance Process***

In October 1998 the ASEAN finance ministers signed a Term of Understanding that established the ASEAN Surveillance Process (ASP). In addition to the usual monitoring of exchange rates and macroeconomic aggregates, the ASP also monitors sectoral and social policies. The responsibilities of ASP include capacity building, institutional strengthening, and sharing of information. The ASEAN Finance Ministers meet twice a year for policy coordination under the ASP.

The Asian Development Bank (ADB) supports ASP by preparing the *ASEAN Economic Outlook* reports and special issue studies. ADB established the Regional Economic Monitoring Unit (REMU) in early 1999 to provide support to the ASEAN and ASEAN+3 surveillance process, and to house the Asia Recovery Information Center (ARIC). REMU also supply monitoring information to the meetings of the Manila Framework Group and the Asia-Europe Finance Minister. ADB has also programmed a number of regional technical assistance projects implemented via REMU, e.g. training of officials from ASEAN central banks and finance ministries in methods of economic monitoring and surveillance, technical support to the ASEAN Surveillance Coordination Unit (ASCU) located in the ASEAN Secretariat in Jakarta; and helping in the establishment of Surveillance Units in the ministries of finance (so far in Cambodia, Indonesia, Lao PDR, the Philippines, Thailand, and Vietnam).

The ASEAN Surveillance Process does not send fact-finding missions to member states like the IMF's Article IV consultation mission. Instead, finance and central bank officials who are the focal points for the ASEAN Surveillance Process directly provide information on their latest economic and financial situations to the ASEAN Surveillance Coordinating Unit (ASCU) at the ASEAN Secretariat. ASCU uses these inputs to analyse the economic and financial developments in ASEAN (while taking into account global developments that could affect ASEAN), and presents its conclusions in a report, currently called the ASEAN Surveillance Report. The ASEAN finance and central bank deputies review and finalise this report before it is tabled for discussion by the ASEAN finance ministers during their peer review.

The ASEAN+3 group was formalized in Manila in November 1999. Monitoring exercises performed under the ASEAN Surveillance Process have been expanded to involve China, Japan and South Korea. The first peer review meeting under the ASEAN+3 Surveillance Process was held in May 2000 on the sidelines of the ADB's annual meeting. Currently, the ASEAN+3 Surveillance Process is similar to the ASEAN Surveillance Process. However, as the CMI develops into a source of financial facilities that are more independent from the IMF, the ASEAN+3 Surveillance Process needs to be

strengthened beyond the peer review process. While this may seem to depart from the traditional policy of non-interference in domestic affairs, the fact is that ASEAN+3 policy makers are now increasingly confronted with the necessity of constructive engagement.

The ASEAN+3 finance ministers made the decision to establish an ASEAN+3 Study Group at their meeting in Honolulu on 9 May 2001. The task of the Study Group is to examine ways of enhancing the effectiveness of ASEAN+3 economic reviews and policy dialogues to complement the bilateral swap arrangements under the CMI. It was agreed that Japan and Malaysia would co-chair the Study Group and that its membership, which is on a voluntary basis, would consist of finance and central bank officials from the ASEAN+3 countries.

The first meeting of the ASEAN+3 Study Group was held in Kuala Lumpur on 22 November 2001. The main purpose of the meeting was to discuss a joint paper prepared by Bank Negara Malaysia and the Ministry of Finance, Japan, entitled "Possible Modalities to Enhance the Effectiveness of Economic Reviews and Policy Dialogues among the ASEAN+3 Countries." The paper recommended an action agenda to be implemented in two phases. The first phase enhances the existing process of economic reviews and policy dialogues among the ASEAN+3 countries, and the second phase constructs a new strengthened policy dialogue mechanism.

Using proposed three criteria to evaluate the ASEAN+3 Surveillance Process, there exists substantial room for improvements. First, the ASEAN+3 surveillance process needs to specify the precise content of the information to be exchanged. Right now, the countries have such wide discretion over the contents of their reports that easy comparison of situations across economies is difficult for many important issues. The ASEAN+3 surveillance process should specify clearly the minimum set of information that should be included in each report. By allowing the participants to conduct comparative analysis easily, the probability of a mutually useful exchange of views and experiences should be much higher.

Second, the current practices under the ASEAN+3 process cannot effectively signal the early warning of potential risks to facilitate the required individual or collective policy responses. The issues of concern and emerging problems are not sufficiently addressed mainly due to the fact that the discussion at the ASEAN+3 meetings currently tends to focus on recent economic developments of member countries on a voluntary basis. The substance of surveillance recommendations in the peer review process and the actual implementation of surveillance recommendations remain yet to be developed.

Third, in light of the inadequacies in information exchange and in peer review, it is not surprising that the ASEAN+3 surveillance process has not contributed to the

improvements in the regulation, supervision, and integration of the financial markets of the member countries.

#### **4. Construction of a Surveillance Mechanism: A Proposal**

The structure of necessary surveillance mechanisms depends on the objectives of the policy dialogue group concerned. A higher degree of economic and monetary integration generally requires a more intensive surveillance mechanism. In this regard, it should be understood that the policy dialogue process is evolutionary, as European experiences have vividly shown. Clearly, enthusiasm in cooperation will exist only if the expected benefits are deemed sufficient enough to justify the effort. For this reason, an effective surveillance mechanism should presuppose well-defined objectives and ensure sufficient benefits for cooperation. Without a concrete agenda for action and visible outcomes, only rhetoric would prevail in a policy dialogue.

Although regional surveillance initiatives provide a potentially meaningful and substantive value-added contribution to existing multilateral and other mechanisms, East Asian countries do not yet have other specified common policy objectives. Crisis prevention is rather ambiguous as a policy objective for surveillance. Surveillance mechanisms should come along with other pillars of monetary and financial cooperation. As the CMI further develops and other initiatives such as exchange rate coordination emerge, the objectives of concomitant surveillance mechanisms will be more clearly spelled out. The policy dialogue process through peer review would be a good starting point, but it cannot sustain itself unless CMI maintains forward momentum by expanding its scope of actions.

An enhanced surveillance mechanism in East Asia could be constructed in the following three phases:

Phase I: Building a regular policy dialogue framework. Member countries should introduce a system for information sharing to enhance the transparency of domestic economic policies through a peer review process. No independent surveillance unit is required to serve as a secretariat. Existing multilateral and other regional initiatives mutually reinforce the surveillance function, but common policy objectives need not be specified in detail. Advanced countries in the region or the ADB can provide technical assistance for capacity building.

Phase II: Introduction of an integrated policy dialogue mechanism. An independent surveillance unit is established to serve as a secretariat to lead the policy dialogue mechanism in the region. Regional surveillance should focus on more region-specific

purposes such as developing a region-wide early warning system, and a plan for regional pooling of foreign exchange reserves. However, this kind of more structured surveillance mechanism also needs to clearly specify the enforcement mechanism to be used in the event of a conflict between individual interests and the common interests of the group. Peer pressure or moral suasion may not work when political constraints prevent an early warning from being expressed or from being heeded.

Phase III: Monetary integration and strengthened surveillance process. East Asians presently appear to pursue financial cooperation in the absence of exchange rate coordination. It is not yet clear whether East Asia will emulate the European experience by adopting some form of monetary integration. However, if East Asia starts monetary integration some time in the future, the regional surveillance mechanism should be structured and managed in order to support the coordinated exchange rate mechanism.

The ASEAN+3 Surveillance Process does not involve sending fact-finding missions to member countries like the IMF's Article IV consultation mission. As a means of enhancing the effectiveness of ASEAN+3 economic reviews and policy dialogue, the aforementioned ASEAN+3 Study Group has sought to develop a common template for the economic report currently prepared by each participating member on the voluntary basis. In order to complement the CMI and the macroeconomic analyses information from the Fund's Article IV consultations, the ASEAN+3 countries should maybe supply data on social variables that would give additional indications of the resilience of their economies, e.g. absolute poverty rate, labor strikes, and political developments (general and presidential elections).

The ASEAN+3 Study Group has proposed that the economic reports not only include assessments made by the IMF, WB and ADB but also the countries' responses to these assessment, and the various reports from the private sectors such as international credit rating agencies and global investment companies. The inclusion of the last two items, it was felt, would facilitate a candid exchange of views and increase the "comfort level" among officials. In the envisaged Phase I, members would merely share the information. Peer review would not reach a consensus to coordinate the actions required for resolving the problems. Because of the inherent ineffectiveness of regional surveillance under Phase I, it is necessary to boost "comfort level" quickly so that the more useful Phase II could be ushered in.

In Phase II, an independent surveillance unit will serve as a warehouse of information and a generator of warning signals for both individual countries and the group as a whole. Following the ASEAN tradition of non-interference into domestic policies, the report should focus on the provision of warning signals. This ASEAN+3

surveillance unit will expand in scale if the CMI were to evolve increasingly toward being an independent regional monetary fund.

In Phase II, the independent surveillance unit is expected to submit its own surveillance report to the ASEAN+3 policy dialogue meetings. The ASEAN+3 policy dialogue process should discuss the issues identified by the surveillance report and make necessary policy recommendations to member countries, individually or collectively. Those policy recommendations are not necessarily binding, but only encouraged through peer pressure. In order to facilitate the implementation of surveillance recommendations agreed by the members, the surveillance report should also include the progress of the implementation in a separate chapter.

The ASEAN+3 policy dialogue process should also initiate collective efforts to improve the regulation, supervision, and integration of the financial services markets of the ASEAN+3 countries. The best practices both within and outside the Group should be identified. Taking into account the economic diversity of the region, the unit should design an appropriately paced phasing in of these best practices. Progress on this harmonization of standards should be a regular feature in the unit's surveillance report.

One concern is that peer pressure or moral suasion may not work due to political constraints that prevent the agreed recommendations from being fully implemented. As in the case of the European integration process, the surveillance and policy coordination had a double-decker structure in policy formation and implementation. Only specific common policies such as monetary and exchange rate policies were binding at the Community level, while economic policies such as budgetary and structural policies remained under the national sovereignty of member states. However, to make peer pressure more effective, there is a need for using both a structured process as well as market pressures. In the European Community, the framework of broad economic policy guidelines (BEPGs) provides a basis for policy coordination.<sup>4</sup> This structured surveillance process has contributed to assessing the consistency of each member state's economic policies.

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<sup>4</sup> The Broad Economic Policy Guidelines (BEPGs) adopted in December 1993 under the Maastricht Treaty provided the framework for economic policy coordination among member states. BEPGs were adopted annually since then, becoming more specific and concrete over time. Although no country specific guidelines were formulated, member states were encouraged to implement the recommendations included in the BEPGs. The implementation of the guidelines was monitored in accordance with the procedure laid down in the Treaty. The Council also assessed the implementation of those guidelines in their assessment of member states' convergence programs. The Luxembourg European Council of 13 December 1997 adopted a resolution on economic policy coordination, which became the cornerstone of multilateral surveillance and policy coordination in the euro area. The resolution emphasized that the BEPGs should provide more concrete and country-specific guidelines, and that the Ecofin Council as the central decision making body for economic coordination should pay attention to giving early warning and be ready to make recommendations in case a member state's policies are inconsistent with the BEPGs.



The ASEAN+3 countries at the current stage do not seem well prepared for establishing a policy coordination mechanism in the surveillance process. In the case of Europe, a more effective and structured surveillance process started only when the European countries sought monetary integration in the 1990s. Thus, it will take more time for the ASEAN+3 countries to agree to establish more comprehensive and structured surveillance systems like the EMU.

Currently, the existing ASEAN+3 policy dialogue process takes place primarily at the ASEAN+3 Finance and Central Bank Deputies' Meeting (AFDM+3) and ASEAN+3 Finance Ministers' Meeting (AFMM+3). The frequency of the regular meetings is very low and the rank of the officials participating in the meetings is high. To increase the frequency of the meetings, Japan proposed an informal AFDM+3 meeting to be held back-to-back with the International Monetary Fund/World Bank Annual Meetings. However, some member countries were of the view that holding the informal AFDM+3 back-to-back with the IMF/World Bank Annual Meetings might not be practical as countries would not be able to devote sufficient resources to the informal AFDM+3 meeting given their preoccupation with the Annual Meetings. Also, it should be noted that low frequency of meetings under the ASEAN+3 process means less intensive economic reviews and policy dialogues among the members. The fact is that without urgent issues to be discussed, many members are sensibly reluctant to have more meetings.

Under Phase II, a group or an institution will be charged with the responsibility to undertake quality and in-depth reviews and assessments of the regional economies. There are following three options.

*Option 1: Building up an existing institution to the tasks*

There are two obvious candidates: (a) the ASEAN Surveillance Coordinating Unit (ASCU) at the ASEAN Secretariat in Jakarta, and (b) the Asian Development Bank Institute (ADBI) in Tokyo. Both of these candidates do not presently have the capacity to undertake the required analyses of the ASEAN+3 economies, and regional trends. Both candidates will need substantial technical assistance from the Asian Development Bank (ADB) to build up their analytical expertise. ASCU has a slight edge over ADBI because it is already managing and coordinating surveillance activities under the ASEAN Surveillance Process.

*Option 2: Using an Existing Institution*

The obvious candidate in Asia under this option is the Regional Economic Monitoring Unit (REMU) within ADB. This is the easiest option because it already has the technical expertise and a surveillance mechanism in place.

### Option 3: Operating through a Working Group

A group, such as an “eminent persons group” or “experts group” could provide economic reviews and assessments to be used as input to the AFMM+3 and AFDM+3. The group would comprise outstanding economists from academia, think tanks, and the private sector. The composition of membership of the Working Group (WG) is most important to ensuring its effectiveness because the right mix in membership could increase the “comfort level” of officials to provide information and exchange views with the WG.

Option 3 is the least workable. The constantly changing composition of "outside experts" would mean a lack of institutional memory and could also lead to a lack of commitment to the job. Option 2 seems the most practical in terms of operating costs and managerial capacity. Furthermore, the choice of REMU as the regional surveillance unit will help in the needed transformation of the ADB from a bank focused on infrastructure lending to a monetary fund geared toward short-term adjustment loans. The rise of the private capital markets has made the traditional bricks-and-mortar focus of ADB and WB relevant only for the poorest countries. As most of East Asia should have been graduated from the loan programs of the WB and ADB in the mid-1990s, these development banks should already be in the process of being phased out. However, because there is no Asian Monetary Fund (AMF), we should entertain seriously the thought of transforming ADB into AMF. The operating principle is that new circumstances require new forms of collective action, and the re-optimized configuration should not have obsolete international organisations.

If ADB is deemed to have too much excess burdens that will prevent it from being successfully transformed into an effective monetary fund, then we should choose Option 1 -- whereby we build up ASCU to be the unit for regional surveillance under Phase II.

## **5. Concluding Remarks**

Historically, international economic integration had been led by both economic motives and political motives. Charles Wyplosz (2000), in fact, concludes that the number one lesson offered by the European experience is that what matters most in seeking economic and financial integration is the political will to do so rather than the economic incentives to do so. Eichengreen (1997, 2000) notes that the European countries had worked very hard for over a half century to develop a wider web of political and diplomatic agreements that encourage their cooperation on monetary and financial matters, and since such a web does not exist in East Asia, the political

preconditions for monetary unification in East Asia are not in place.

However, because East Asia has just suffered a painful and costly financial crisis, the East Asian countries may now be prepared to set aside their differences and work together to develop a region-wide self-help system against future crises. But, even then, East Asian governments still hold divergent preferences with respect to the pace, extent and direction of regional financial cooperation. This is understandable because East Asian economic systems, patterns of trade, and levels of economic development are far more diverse than those in the European Community. Clearly, even if the present interest in economic integration holds or expands, East Asia still has a long way to go before putting into effect the Chiang Mai Initiative and launching other types of regional financial arrangements.

The ASEAN+3 countries presently appear to pursue financial cooperation without any commitment to an exchange rate arrangement under which the exchange rates of the participating countries are pegged to each other. In the absence of exchange rate coordination, incentives for mutual surveillance will be limited because a member country facing a speculative currency attack may be free to float its exchange rate vis-à-vis those of other neighboring countries. Under the current ASEAN+3 policy dialogue framework, the purpose of the CMI and mutual surveillance system is to prevent the occurrence of financial crises and contagion in the region, but such an elaborate institutional arrangement for mutual surveillance and policy coordination will realistically not emerge in the near future.

The immediate task now is to establish an independent surveillance unit as a standing secretariat to support the ASEAN+3 policy dialogue process. This unit should start on a modest scale, and we recommend enlarging either the Regional Economic Monetary Unit (REMU) within Asian Development Bank or the ASEAN Surveillance Coordination Unit (ASCU) within the ASEAN Secretariat for this task. The former appears to be the natural choice provided that, as the CMI progresses further such that national economic policies (like individual exchange rate regimes) require regional coordination, ADB would evolve into a regional monetary fund to provide the regional public goods to prevent financial crises, and reduce their costs.

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