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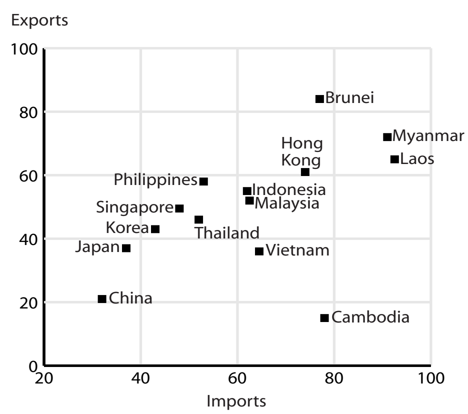
FINANCIAL CRISES AND EAST ASIA'S FINANCIAL COOPERATION

By Park Young-joon

East Asia is an area where real economic activities are closely linked. As shown in ***Figure 1,*** the brisk trade in goods and services among East Asian countries shows a well-integrated East Asian economy. Most trade by East Asian countries is cleared in U.S. dollars, however, which implies that, when foreign exchange shocks occur, countries in the region are highly vulnerable to financial crisis caused by foreign exchange market risks. Further, East Asia may also suffer from financial market collapse and economic recession.

Figure 1: **Trade Shares among East Asian Countries, 2008, percentage**



Source: Direction of Trade Statistics, International Monetary Fund.

Regional economic integration may benefit from more efficient investment of capital and financial market developments as well as from lessening the impact of external economic shocks by absorbing them in an integrated financial market structure. The strong economic linkages within the region might, however, lead to the risk of crisis contagion. One example is the Asian financial crisis of 1997: the initial crisis in Thailand triggered contagion in other neighboring countries in East Asia. Financial instability originating from crisis contagion has a significant impact when operating in a regional economy.

After Asia's foreign exchange crisis in 1997–98, East Asian countries realized the great need for regional financial cooperation as a self-protection measure against financial crisis. The recognition of common needs among the countries led to proposals for several regional financial initiatives to strengthen regional financial cooperation for their own self-protection. During the evolution of these initiatives, more integrated economic activities through globalization increased the size of intraregional trade in East Asia, and this trend has accelerated regional cooperation by giving the initiative a more concrete shape.

ASEAN Plus Three[1] countries have started making efforts to develop regional financial cooperation in collaboration with the existing global financial architecture. This effort has made progress on two representative initiatives in East Asia: the Chiang Mai Initiative (CMI) established in 2000, and the Asian Bond Market Initiative (ABMI) put in place in 2003. The recent global financial crisis has accelerated the development of the CMI toward creating a regional financial architecture. 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 more readily available to regional investments and ultimately contributes to regional economic growth.

1. The Association of Southeast Asian Nations (ASEAN), established in 1967, 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.

Two Tracks of Post-Crisis Financial Cooperation

The global economy has been suffering from financial collapse and economic recessions since the subprime mortgage crisis. The Bretton Woods system and the Group of Seven or Group of Eight processes that have dominated the global economic order are currently in transition toward a new global financial architecture. As part of reforming the global financial architecture, the governance structures of both the International Monetary Fund (IMF) and the World Bank are undergoing important institutional changes to better reflect the emerging countries' voices in the world economy.[2]

From East Asia's perspective, there are two tracks of post-crisis financial cooperation: the Group of 20 process in a global sense and the CMI in a regional dimension. Indeed, two important events have the potential to affect the course of Asian economies and the world economy after the global financial crisis.

The first was the G-20 summit meetings held in Washington, D.C., in 2008 and in London and Pittsburgh in 2009. The proposals from the G-20 summit dealt with various critical issues related to the current global crisis and financial markets, focusing on recovering from the current crisis and tackling the causes of financial crisis. G-20 leaders have granted an enlarged role to the IMF by providing it with increased available capital. Additional lending resources in the amount of $750 billion are going to be allocated to the IMF, mainly through additional equity contributions, expansion of the New Arrangements to Borrow, and Special Drawing Rights allocations.

The second event was the ASEAN Plus Three Finance Ministers' Meeting held in Bali, Indonesia, in May 2009. Those who attended this meeting took the framework of the existing CMI—a network of bilateral swap arrangements among the member countries—and moved it toward multilateralization. The Chiang Mai Initiative Multilateralization (CMIM) finally came into effect on 24 March 2010.

Regional Financial Cooperation in East Asia

Origin of East Asia's Regional Initiatives

The Asian economy was hit hard by the 1997 financial crisis, which was a severe internal shock in the East Asian region in terms of the source of the shock. The financial markets in Thailand, Korea, and the Philippines collapsed through a sequence of rapid contagion. IMF-coordinated financial support packages and lender countries' emergency liquidity support were provided to rescue the economies in crisis. For some countries, however, the packages and support programs along with the policy prescriptions made the economic conditions worse. The East Asian countries learned from the 1997–98 experience the importance of financial stability, and they realized the need for a regional financial safety net. Accordingly, the severity of the crisis and their disappointment with the IMF program to handle the crisis as well as the details of the conditionality created momentum to speed up East Asian financial cooperation.

Many regional initiatives were created, including Japan's proposal of establishing an Asian Monetary Fund (AMF) and the Manila Framework of the agreement on financial cooperation put together by 14 Asia-Pacific economies.[3] ASEAN Plus Three countries, in particular, created important initiatives such as the CMI as a regional self-protecting mechanism; the Economic Review and Policy Dialogue (ERPD) as an economic review process; the ABMI to develop regional currency bond markets; and the initiative put together at the Governors and Deputies Meeting of the Executives' Meeting of East Asia Pacific Central Banks, which established the Asian bond funds. This article restricts its scope to the CMIM and the ABMI as unique regional financial safety nets in East Asia.

2. For example, the IMF's reform to increase underrepresented countries' quotas will be finished by January 2011, and the final decision of the World Bank on enhancing voting power for developing countries by at least 3 percent will be made at the spring meetings in 2010.

3.The 14 economies are Australia, Canada, China, Hong Kong SAR, Indonesia, Japan, Korea, Malaysia, New Zealand, Brunei Darussalam, the Philippines, Singapore, Thailand, and the United States.

Birth of the Chiang Mai Initiative

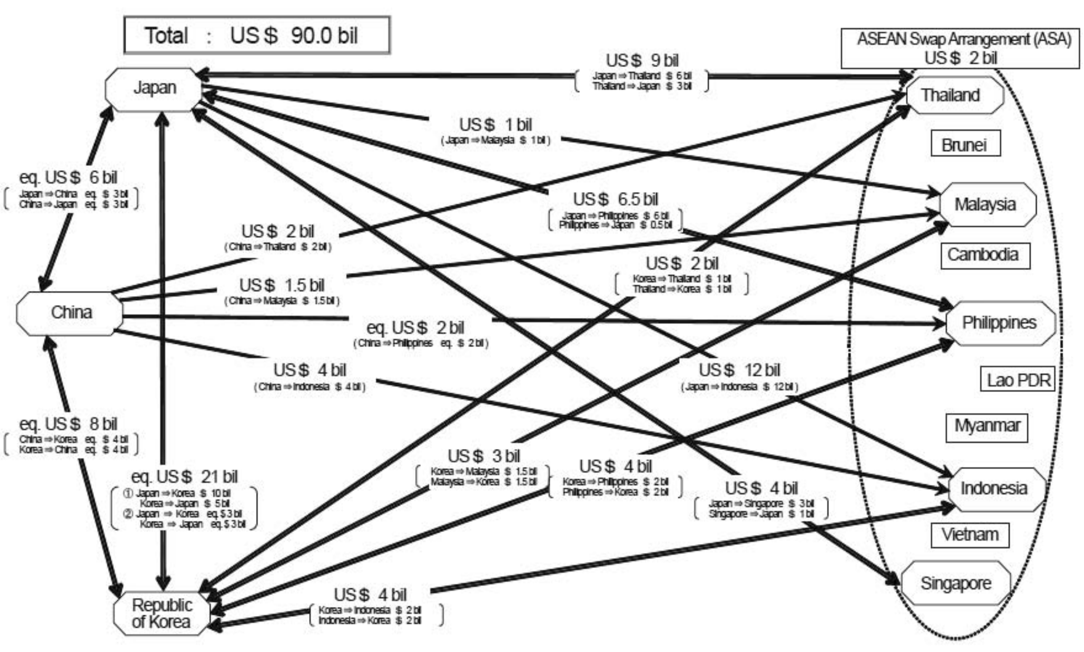
The CMI was agreed to in May 2000 in Chiang Mai, Thailand, with the objective of establishing a network of bilateral swap arrangements among ASEAN Plus Three countries to address short-term liquidity difficulties in the region and to supplement the existing international financial arrangements. The CMI was an expanded version of the previous ASEAN Swap Arrangements (ASA), which initially included the five ASEAN countries (Indonesia, Malaysia, the Philippines, Singapore, and Thailand). 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. The framework was basically a series of bilateral swap agreements between the central banks of the two countries involved in each particular swap arrangement. ***Figure 2*** shows the bilateral currency swap arrangements under the CMI as of 15 April 2009.

Member countries can request short-term financial support without the IMF's consent for the specified amount of the commitment fund, known as IMF delinked liquidity support. The IMF-linked portion has increased from 10 percent of the commitment fund during the early years of the CMI to 20 percent of fund currently (for the CMI and the CMIM). That is, 80 percent of the fund is linked to the IMF support program, resulting in IMF conditionality.

Chiang Mai Initiative Multilateralization

ASEAN Plus Three countries have agreed to multilateralize the CMI agreement in such a way that any member country can utilize liquidity support from the total fund of $120 billion. Because the fund was established in the form of promissory notes, there is no direct and immediate effect on any member country's foreign reserves. Member countries have agreed to a two-tier contribution share according to a ratio of 20 for ASEAN countries and 80 for the Plus Three countries. Specifically, ASEAN contributes $24 billion (20 percent), China (including Hong Kong) and Japan each contribute $38.4 billion (32 percent each, in other words), and Korea contributes $19.2 billion, or 16 percent). In terms of borrowing multiples, 0.5 applies to China and Japan, 1.0 to Korea, 2.5 to the large ASEAN countries (Thailand, Malaysia, Indonesia, Singapore, and the Philippines),

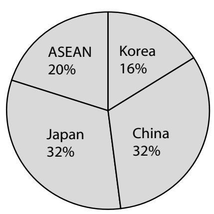
Figure 2: **Network of Bilateral Swap Arrangements under the Chiang Mai Initiative, April 2009.**



Source: "Regional Financial Cooperation among ASEAN+3: Network of BSAs under the CMI," Ministry of Finance of Japan, www.mof.go.jp/english/if/CMI_0904.pdf.

and 5.0 to the small countries of ASEAN (Vietnam, Cambodia, Laos, Myanmar, and Brunei). Thus, during a crisis ASEAN countries can draw greater amounts than their contributions. Applying larger borrowing multiples to the countries that are more vulnerable to financial risks and economic crises elevates the efficacy of the CMIM to respond to the crisis through emergency liquidity support. Despite a rather loose structure of the CMIM fund and its relatively small size compared with the IMF, its multilateralization is seen as a significant move forward to improve Asia's financial stability and East Asia's financial cooperation. The CMIM is basically a commitment to provide U.S. dollars to member countries in crisis, and, thus, it primarily helps stabilize foreign exchange markets in the region (see ***Figure 3*** and ***Table 1***).

Figure 3: **Agreed Contributions to the Chiang Mai Initiative Multilateralization (CMIM)**



Source: Ministry of Strategy and Finance, Seoul, Korea.

Asian Bond Market Initiative

An informal meeting of the Finance Ministry deputies and Central Bank deputies of the ASEAN Plus Three countries was held in Tokyo in November 2002 to discuss specific ways to develop the Asian bond markets under the ASEAN Plus Three framework. One month later, in Chiang Mai, Thailand, a comprehensive plan for the development of the regional bond market, the ABMI, was endorsed. The ABMI aims to develop efficient and liquid local currency bond markets in Asia by better utilization of Asian savings for Asian investment in the region. It is also expected to mitigate the problem of dual mismatches of both currency and maturities in Asia.

Under the ABMI, working groups address several critical issues: developing new securitized instruments, establishing a regional credit guarantee mechanism, exploring an Asian credit-rating system, and strengthening Asian credit-rating agencies. ASEAN Plus Three initially agreed to establish the Credit Guarantee Investment Mechanism (CGIM) in the form of a trust fund of $500 million under the Asian Development Bank (ADB); the CGIM was renamed the Credit Guarantee Investment Facility (CGIF), and the agreement was to establish it with an increased fund size of $700 million.

Remaining Issues

The CMIM is still an evolving agreement regarding several points to be improved in the future: establishing an ASEAN Plus Three surveillance unit, institution building of the CMIM secretariat, and some limitations of the CMIM.

Regional Surveillance Mechanism

The necessity of a regional surveillance mechanism is indicated by the existence of IMF conditionality.

Table 1: **Contributions to Chiang Mai Initiative Fund, 2010**

Country	Contribution (U.S. dollars, billions)	Borrowing multiple (%)
Brunei	0.03	5
Cambodia	0.12	5
China[1]	34.20	0.5
Hong Kong SAR	4.20	2.5
Indonesia	4.77	2.5
Japan	38.40	0.5
Korea	19.20	1
Laos	0.03	5
Malaysia	4.77	2.5
Myanmar	0.06	5
Philippines	3.68	2.5
Singapore	4.77	2.5
Thailand	4.77	2.5
Vietnam	1.00	5

Source: Ministry of Strategy and Finance, Seoul, Korea.
1. Excludes Hong Kong.

The current CMIM relies on IMF surveillance as long as the 80 percent disbursement is linked to the IMF. East Asian countries are reluctant, however, to use the IMF lending facilities because the IMF required harsh structural reforms and offered some policy advice that misled the economies in crisis in 1998. These issues led to the East Asian countries wanting to establish an independent and solid surveillance unit of their own.

The issues of surveillance and conditionality are important for the success of the CMIM. As Henning points out, the lack of development of surveillance within ASEAN Plus Three means the IMF link will be maintained for the time being.[4] Henning also stresses that if ASEAN Plus Three manages its surveillance mechanism effectively, other countries and international organizations will accept the CMIM arrangements and regional financial cooperation in East Asia.

Under the CMI, a regional surveillance mechanism was established in May 2002 by the ERPD. Objectives of the ERPD include identifying potential macroeconomic and financial risks, preventing crises, monitoring regional capital flows and currency markets, strengthening banking and financial systems, reforming international financial architecture, and enhancing self-protecting and support mechanisms in East Asia. The noninterference policy of the ERPD would affect the processes of decision making and surveillance.

A new surveillance mechanism will be required under the CMIM. The new surveillance unit should be established by designing effective peer pressure and guaranteeing independent and strong surveillance activities in such a way as to minimize moral hazard. In addition, the member countries are ready to accept external policy recommendations for financial stabilization. Using both bilateral and multilateral surveillance functions with the aid of IMF technical assistance is recommended during the period of transition. In this sense, the ASEAN Plus Three surveillance unit performs a cooperative and complementary role along with IMF surveillance. As an interim surveillance unit, the ADB publishes, in collaboration with the ASEAN secretariat, a surveillance report on individual economies as part of the bilateral surveillance process. As for multilateral surveillance activities, a consolidated report covers an overall economic assessment of ASEAN Plus Three economies in addition to the global economic environments and potential external risk factors.

Institution Building of the CMIM

ASEAN Plus Three has not yet institutionalized its arrangements, such as its secretariat, and this prevents a more frequent and quick assessment of the vulnerability of the region and the disbursement of liquidity support under the CMIM. Establishing the CMIM secretariat is important for managing its funds and operating the CMIM efficiently. When it comes to institutional building, we need to provide some functional criteria: governance should be designed to be independent and even-handed. Also the secretariat's cooperative efforts with its surveillance unit require the member countries to enforce its policy recommendations. Furthermore, the member countries should be ready to take recommendations seriously and show cooperative attitudes toward implementation and international cooperation in coordinated policies. This issue of institution building is important for the future of the CMIM and ultimately East Asia's financial cooperation.

Limits and Prospects of the CMIM

The CMIM has several limitations as it tries to be an effective regional financial cooperation mechanism, particularly in its role as a regional financial safety net. Regional financial cooperation is still evolving, as is the CMIM. The current snapshot of the CMIM as it evolves shows some limits that need to be improved for it to operate better in the future and to enhance its efficacy as a regional safety net.

First, the total amount of swap facilities available under the CMIM may not be enough to support preemptive, short-term liabilities in the region. Second, although the CMIM is a regional financial arrangement, in practice it is heavily linked to the IMF through IMF conditionality. The IMF-linked portion of 80 percent

4. C. Randall Henning, "The Future of the Chiang Mai Initiative: An Asian Monetary Fund," Policy Brief 09-5 (Washington, D.C.: Peterson Institute for International Economics, 2009).

should be decreased to enhance the effectiveness of the CMIM by reinforcing the regional surveillance mechanism.

Third, one of the most important issues for enhancing the efficacy of the CMIM is to reduce the stigma and moral hazard of requesting the emergency short-term liability. Both the stigma and moral hazard problems are commonly revealed in the emergency liquidity support programs, even in the IMF lending facilities. The future phase of the CMIM should be appropriately designed in such a way as to minimize the problems of stigma and moral hazard in the potential beneficiary countries.

During the recent global financial crisis, many East Asian countries suffered from a liquidity shortage; however, no countries have yet accessed the CMIM. South Korea, for example, was experiencing a severe liquidity problem in financial markets in late 2008, but Korea did not utilize the currency swap program under the CMI. Instead, in 2008 Korea negotiated and drew on a U.S. Federal Reserve swap line that significantly mitigated Korean financial market risks. Korea chose this route because, among other reasons, the government worried about the stigma of borrowing short-term liquidity from emerging or developing countries, which reflects the severity of economic conditions.

Fourth, the leading regional countries' leadership and cooperation through political decision making are essential and strongly required as part of multilateral cooperation. We have witnessed the importance of this type of leadership in the example of the European area. East Asia is a region with strong heterogeneity in the levels of economic development and complex historical backgrounds that lead to rather slow progress in regional financial cooperation.

Finally, the role of the CMIM should be strengthened in the frame of global-regional financial safety nets. The necessity of financial safety nets has been realized to avoid contagion of a crisis and to contribute to sustainable and balanced growth by reducing the incentive to accumulate huge international reserves in emerging economies. The CMIM can play an important role to complement the global financial safety nets, such as the IMF lending facilities, by reinforcing its linkages and appropriate division of labor between the global and the regional safety nets.

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