Moving Forward on the Establishment of an Effective Surveillance System and an Improved Financial Architecture for East Asia

Yunjong Wang and Wing Thye Woo
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Yunjong Wang and Wing Thye Woo
Executive Summary

The goal of this study is to contribute to the efforts 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 mutual surveillance. This study will review and assess existing regional or sub-regional arrangements covering information exchange, surveillance systems, and institutions. In particular, in relation to the current development of the Chiang Mai Initiative (CMI), our analysis will focus on how to strengthen mutual surveillance processes through regional policy dialogue.

Key words: Chiang Mai Initiative (CMI), financial crisis, mutual surveillance process, regional policy dialogue, regional financial arrangement.
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Yunjong Wang** and Wing Thye Woo***

I. Introduction

The case for effective global economic institutions is now stronger than ever. The establishment of the World Trade Organization (WTO) 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 United States (US) Senate

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refused to ratify ITO out of concerns about yielding US sovereignty to an unelected international bureaucracy, the General Agreement on Tariffs and Trade (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 DC.; it was also not recognized as a legal organization by international law.¹)

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

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¹) In the official WTO website, one of the web pages that describe the organization contains a section entitled “A word of caution: the fine print.” The section cautions the reader that: “While every effort has been made to ensure the accuracy of the texts in this introductory section, they cannot be taken as an official legal interpretation of the agreements.... In some parts of the text, GATT is described as an "international organization". The phrase reflects GATT’s de facto role before the WTO was created, and it is used simplistically here to help readers understand that role. As the text points out, this role was always ad hoc, without a proper legal foundation. International law did not recognize GATT as an organization.” See http://www.wto.org/english/thewto_e/whatis_e/whatis_e.htm.
to changed circumstances. Globalization had 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. Just as Paul Samuelson warned us almost half a century ago, the undersupply of public goods is the norm.

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 not yet, 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 1992-1993, the Tequila crisis in 1994-1995, the Asian financial crisis in 1997-1998, the ruble-to-ruble conversion in August 1998, and the crash of the Brazilian real in January 1999. In the case of the Asian financial crisis, the performance of IMF, the international financial firefighter, was particularly wanting. Instead of recognizing the Asian financial crisis as the manifestation of the inherent instability of financial markets, IMF (possibly, out of bureaucratic inertia) diagnosed it as individual cases of overexpansionary macroeconomic policies, and hence exacerbated the collapse in these economies with deflationary “rescue” packages (Woo 2000, and Sachs and Woo 2000b).
The general lesson is that new circumstances require new forms of collective actions, which include both the founding of new economic organizations and the closure of obsolete ones. While we will not take a position in this study on the recommendations of the Meltzer Commission to implement root-and-branch reform of IMF and World Bank, we regard recommendations like these as a long overdue sensible call to the global community to redesign its global economic institutions to bring them in line with the emerging economic trends of the 21st century. Simply put, the world deserves better international infrastructural institutions.

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. In 2002, the most tangible changes at IMF since 1998 were personnel changes. The institution has not only maintained its unchallenged status as the monopoly international monetary institution; it has also widened its portfolio of activities, including poverty reduction, the traditional turf of WB. (Of course, to be fair, WB violated the division of labor first when it began extending short-term structural adjustment loans in the 1980s.)

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\(^2\) (e.g., improving bank supervision, allowing

\(^2\) See Sachs and Woo (2000a) for a list of the recommended measures.
greater exchange rate flexibility) to protect 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 on 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.

The goal of this study is to contribute to the effort to construct regional financial arrangements that would reduce the occurrences of financial crises and lower their costs. This study will confine itself to the issues related to crisis prevention through mutual surveillance. This study will review and assess existing regional or subregional arrangements covering information exchange, surveillance systems, and institutions. In particular, in relation to the current development of the Chiang Mai Initiative (CMI), our 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 Association of Southeast Asian Nations (ASEAN) +3 framework, progress has been made only in implementing the
CMI. A discussion has just recently started on 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 to 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.

Policy dialogue, along with a regular information exchange and surveillance process, is essential for the prevention of crises. The collected information will help detect and identify the characteristics of the looming crisis at an early stage so that proper remedial actions can be taken in a timely manner, and a joint exercise based on a region-wide early warning system will facilitate closer examination of financial vulnerabilities in the region. In addition, the regional policy dialogue process will contribute to ensuring effective implementation of individual or collective policy targets through peer pressure or rule-based enforcement mechanisms. Many issues involved in developing a regional policy dialogue framework will be examined and developed in this paper.

This paper is organized as follows. Section 2 begins with a discussion of the conceptual framework for information exchange and surveillance systems, and then considers the rationale and the various forms of regional surveillance and monitoring. Section 3 reviews and assesses existing regional or subregional initiatives in terms of information exchange, surveillance systems, and other policy dialogue mechanisms (i.e., the regulation, supervision, and integration of financial services markets) among the ASEAN+3 countries. Section 4 identifies the scope for strengthening the process and mechanisms of
regional information exchange, economic surveillance, and regulation of financial services markets among the ASEAN+3 countries. Section 5 considers the nature and type of institutions that are required to support the regional policy dialogue, and Section 6 concludes the study with some final observations.
II. Conceptual Framework

1. The Rationale for Information Exchange and Surveillance

The Asian crisis and historical experience have demonstrated that growing interdependence in the world through financial integration has heightened the need to engage in international economic and financial cooperation. The reality is that the close articulation of national financial markets inevitably means that financial instability is unlikely to remain within the national borders of the country of origin. Cooperative efforts at both regional and global levels are therefore needed to counter the negative spillovers. IMF’s surveillance activities is just such an example of the provision of global public goods. By the common sense logic of “two heads are better than one,” regional initiatives could complement the IMF surveillance process. The wisdom of having a second opinion on important matters clearly argues in favor of the case for regional monitoring and surveillance.

As pointed out earlier, the large exchange rate crises in the last decade have been regional in nature. Clearly, neighboring countries have a strong incentive to engage in mutual surveillance and to extend assistance to one another 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 geographic 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 (Dornbusch et al. 2000). 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 et al. 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 firefighter.

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 Group of Seven (G-7) countries has receded considerably. The slow progress has been further complicated by the perception that the current international architecture is defective. As long as there are structural problems on the supply side of international capital, such as volatile capital movements and Group of Three (G-3) (the United States, Europe, and Japan) exchange rate gyrations, the East Asian countries will remain as vulnerable to future crises as they were before.3)

3) It is equally important that East Asians continue to undertake financial sector restructuring. Without sound financial institutions and adequate regulatory regimes, Asian financial markets will remain vulnerable to external shocks. Regional monitoring and surveillance should also contribute to strengthen the efforts to restructure the financial markets in East Asia.
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 form the bedrock on which coherent regional policymaking rests. A regional monitoring and surveillance process would provide prompt and relevant information for assessing the situation of countries in trouble and the 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, a regional monitoring and surveillance process that is set up more broadly could also help ensure effective implementation of high-quality accounting and auditing standards, strong disclosure requirements, credible rating agencies, and appropriate corporate governance.

Economic surveillance is not merely an observation of economic indicators, but also an assessment of macroeconomic, financial, and structural policies of member countries. The practical fact is that only after the creditworthiness of borrowers has been established objectively prior to the ignition of regional contagion could there be quick disbursements of funds in times of crises. If an assessment process for financial assistance is begun only after receiving a request for aid, then disbursement will be inevitably delayed however deserving the case may be. Just as the Organisation for Economic Co-operation and Development (OECD) is not a superfluous organization to its member countries despite its absence of operational functions,
Asian monitoring and policy surveillance along with Asian financial facilities, when implemented correctly, could also contribute greatly to the resilience of Asian economies and further development of their financial markets.

2. Spectrum of Regional Financial Cooperation

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 2002).

The form of regional monitoring and surveillance depends on the stage of the region’s financial and monetary integration. The more institutionally integrated the region is, the more comprehensive and binding would be the nature of policy coordination. In principle, regional monitoring and surveillance ranges along a spectrum from simple information exchange and informal consultation forums to a supranational entity like the Economic and Monetary Union (EMU)—
the exact form is a function of the degree of integration.

At the most elementary stage of zero institutional integration, when governments simply take the policies of other governments as given and do not attempt to influence, the existence of policy spillovers means that it would still be useful that the governments exchange information and consult each other in a setting free of any formal pressure. When regional cooperation moves to the level of mutual liquidity provision, then moral hazard creates a strong case for monitoring and surveillance, and a clear need for specific enforcement mechanisms. An appropriate reference point for such regional activities would be the IMF consultations and conditionality. Finally, when the regional grouping agrees on deepening regional integration through exchange rate coordination, monetary policy coordination then becomes as crucial as mutual economic surveillance. The appropriate reference point in this case would be the process through which Europe progressed from the Common Market to the European Union.

3. Peer Review Process

A simple peer review process without a specific enforcement mechanism may be found among various policy dialogue groups. The G-7 process is an obvious point of reference. Informal peer pressure is the only mechanism to encourage members to implement the recommended policies. A regular monitoring process is essential for the prevention of crises. Information collected through monitoring will help detect and identify the characteristics of economic and financial vulnerabilities at an early stage so that a proper menu of
policy actions can be taken in a timely manner. Economic and financial sector monitoring will keep a close watch over (i) macroeconomic trends and policy changes; (ii) financial market developments, including cross-border capital flows; and (iii) institutional and legal changes. This rather broad coverage of economic monitoring will be useful for a better understanding of the economic situations. However, a selection of quantitative indicators would be more convenient though it might entail the risk of omitting important information.

Since the Asian financial crisis, attention has been increasingly directed to preventing the outbreak of crises by devising a warning system that can diagnose early symptoms of crises to allow administering timely policy responses. The methodology applied to developing an early warning system largely draws on the leading indicator approach commonly found in business cycle literature.\(^4\) Thus, an early warning system consists of leading indicators that signal in advance the onset of a crisis. Selected leading indicators considered in recent studies are given in Table 1. The development of leading indicators presupposes that an economy exhibits consistent and regular patterns of behavior prior to a crisis. Hence, selecting reliable indicators is the crucial step in formulating the early warning system. However, not all crises are alike, and consequently one would not expect the same indicator to be a good signal for each type of crisis. Furthermore, one observation is that banking and currency crises in

\(^4\) Most recent empirical studies on early warning systems follow one of the three approaches: the signals approach, the probit or logit models, and regression models. See UN ESCAP (2000) for a summary of the models.
<Table 1> Selected Leading Indicators of Banking and Currency Crises

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Transformation</th>
<th>Data frequency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real output</td>
<td>12-month growth rate</td>
<td>Monthly</td>
</tr>
<tr>
<td>Equity prices</td>
<td>12-month growth rate</td>
<td>Monthly</td>
</tr>
<tr>
<td>International reserves</td>
<td>12-month growth rate</td>
<td>Monthly</td>
</tr>
<tr>
<td>Domestic/foreign real interest rate differential</td>
<td>Level</td>
<td>Monthly</td>
</tr>
<tr>
<td>Excess real M1 balances</td>
<td>Level</td>
<td>Monthly</td>
</tr>
<tr>
<td>M2/international reserves</td>
<td>12-month growth rate</td>
<td>Monthly</td>
</tr>
<tr>
<td>Bank deposits</td>
<td>12-month growth rate</td>
<td>Monthly</td>
</tr>
<tr>
<td>M2 multiplier</td>
<td>12-month growth rate</td>
<td>Monthly</td>
</tr>
<tr>
<td>Domestic credit/Gross domestic product</td>
<td>12-month growth rate</td>
<td>Monthly</td>
</tr>
<tr>
<td>Real interest rate on deposits</td>
<td>Level</td>
<td>Monthly</td>
</tr>
<tr>
<td>Ratio of lending interest rate to deposit interest rate</td>
<td>Level</td>
<td>Monthly</td>
</tr>
<tr>
<td>Real exchange rate</td>
<td>Deviation from trend</td>
<td>Monthly</td>
</tr>
<tr>
<td>Exports</td>
<td>12-month growth rate</td>
<td>Monthly</td>
</tr>
<tr>
<td>Imports</td>
<td>12-month growth rate</td>
<td>Monthly</td>
</tr>
<tr>
<td>Terms of trade</td>
<td>12-month growth rate</td>
<td>Monthly</td>
</tr>
<tr>
<td>Moody’s sovereign credit ratings</td>
<td>1-month change</td>
<td>Monthly</td>
</tr>
<tr>
<td>Institutional investor sovereign credit rating</td>
<td>Semiannual change</td>
<td>Semiannual</td>
</tr>
<tr>
<td>General government consumption/GDP</td>
<td>Annual growth rate</td>
<td>Annual</td>
</tr>
<tr>
<td>Overall budget deficit/GDP</td>
<td>Level</td>
<td>Annual</td>
</tr>
<tr>
<td>Net credit to the public sector/GDP</td>
<td>Level</td>
<td>Annual</td>
</tr>
<tr>
<td>Central bank credit to public sector/GDP</td>
<td>Level</td>
<td>Annual</td>
</tr>
<tr>
<td>Short-term capital inflows/GDP</td>
<td>Level</td>
<td>Annual</td>
</tr>
<tr>
<td>Foreign direct investment/GDP</td>
<td>Level</td>
<td>Annual</td>
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<tr>
<td>Current account imbalance/GDP</td>
<td>Level</td>
<td>Annual</td>
</tr>
<tr>
<td>Current account imbalance/investment</td>
<td>Level</td>
<td>Annual</td>
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</tbody>
</table>

Source: Goldstein et al. (2000).
emerging markets do not typically occur without any warning (Goldstein et al. 2000).

In our view, the early warning system itself may lack credibility from the perspective of investors in the sense that it is just a statistical exercise with no credible content, especially when attention is given to the quality and availability of the published data. In fact, the difficulty with constructing an early warning system for developing countries arises from the lack of reliable statistics; currently these statistics are largely distorted or superimposed with other non-economic factors. This is an old problem. The international community has repeatedly stressed that provision of comprehensive, timely, and accurate economic data by member countries is essential for effective fund surveillance.5)

In addition to data problems, precisely because crises and economies can vary in nature, “one size may not fit all” when it comes to leading indicators. As also pointed out in Goldstein et al. (2000), a broader set of indicators should be considered. For example, the share of short-term debt in total external debt, as well as proxy for capital flight, does quite well in anticipating currency and banking crises.6) Political and institutional variables also have some

5) Admittedly, better information is no panacea for avoiding financial crises: in some cases, faulty economic analyses and/or unexpected developments were the driving force. Even with better information, private financial markets will still sometimes be subject to misguided self-fulfilling expectations (Goldstein and Calvo 1996, p. 258).
6) Furman and Stiglitz (1998) make a good case for including the ratio of short-term external debt to international reserves as an indicator in future early warning exercises (Goldstein et al. 2000).
predictive power in anticipating a currency crisis, but one usually cannot get high-frequency measurements on them. The sad situation is that the accurate forecasting of the timing of a crisis is likely to remain an elusive goal for academics and policy makers alike (Woo et al. 2000).

4. Mutual Liquidity Provision and Enforcement Mechanism

Under a loose and informal policy dialogue framework, formal enforcement mechanisms to impose sanctions and fines on countries that do not comply with agreed upon policy guidelines and recommendations may not be needed. In keeping with the ASEAN policy of noninterference, the regional surveillance process in East Asia is built on the basis of consensus and informality (Manzano 2001). 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 (Eichengreen and Bayoumi 1999). This unwillingness

7) Eichengreen and Bayoumi (1999) stress that East Asia does not meet the necessary intellectual preconditions for regional integration. For this reason, they conclude that it is unrealistic to speak of pooling national sovereignties, which do not exist. If the European experience is any guide, East Asia may take many years to develop effective cooperative arrangements and institutions. However, some observers also note that East Asia may be on the brink of a historical evolution, as Europe was
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 types of moral hazards in conjunction with regional financial arrangements and related surveillance processes. One is related to liquidity assistance, and 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 IMF, then the regional financial arrangement should be designed so as not to undermine the Bagehot rules (Kim et al. 2000). The proper prequalifications should discipline the borrowers to adhere to sound macroeconomic and financial policies. Otherwise, the Asian financial arrangement will go bankrupt.

Assume that there exist IMF and a regional fund. 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

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half a century ago (Bergsten 2000; Dieter 2000). While there is no doubt that considerable work needs to be done in strengthening policy dialogue and cooperation in the region, it is wrong to say that it cannot be done in East Asia (de Brouwer 2002).

8) A regional lender of last resort can address moral hazard problems by adhering to the classic Bagehot rules of lending (i) freely to solvent borrowers, (ii) against good collateral, and (iii) at a penalty rate.
fund cannot effectively harness its monitoring capabilities to reduce the moral hazard problem, countries may become less cautious; IMF will tend to provide less insurance. The regional fund may crowd out the more effective insurance provided by 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.

Without an institutional setup to make the problem of team incentive 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, and so 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 receives 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.

5. Exchange Rate Coordination and Enhanced Surveillance Process

If East Asian countries pursue some form of exchange rate coordination, a set of policy parameters should be watched closely to ensure that policy actions are coordinated effectively. The basic point is that incentive-compatible mechanisms have to be in place so that no country may have the incentive to shirk.

An examination of the arrangements that underline the EMU reveals that an array of enforcement mechanisms, ranging from “soft” to “hard,” is in place to coordinate the economic policies of members. The soft mechanism is peer pressure. One of the hard mechanisms is the Stability and Growth Pact that specifies the imposition of pecuniary sanctions based on the results of budgetary policy surveillance. A set of medium-hard mechanisms are the Broad Economic Policy Guidelines (BEPGs) that were adopted in December 1993 under the Maastricht Treaty.9) This highly structured

9) 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 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
surveillance process is necessary because of the double-decker structure of policy formation and implementation in the EMU. Only monetary and exchange rate policies are binding at the EMU level, and other economic policies such as budgetary and structural policies remain under the national sovereignty of member states.

The relevant point of all of these for ASEAN+3 is that these mechanisms for more effective and structured surveillance process were established only when Europe embarked upon monetary integration in the 1990s. Since ASEAN+3 do not seem well prepared for establishing a policy coordination mechanism at this stage, it is premature to bicker over the design of comprehensive and structured surveillance systems like those of the EMU.

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.
III. Regional or Subregional Initiatives among the ASEAN+3 Countries

Before the Asian financial crisis broke out in 1997, few would have argued for the creation of another regional economic facility 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.

Information exchange and surveillance mechanisms can be carried out at different levels (national, regional, and global) and focus on different aspects (macroeconomic, financial, and institutional). Specific structures and objectives of different types of surveillance activities need to be duly considered. For instance, it is widely agreed that international standards for sound practices at the national level are an obvious vehicle for addressing challenges to collective stability in a world of sovereign states (Eichengreen 2001a). However, the scope and enforcement mechanisms related to harmonization of standards would vary to the extent that different groups and institutions have different targets. IMF, Bank for International Settlements (BIS), OECD, Manila Framework Group (MFG), and ASEAN surveillance process all have different perspectives on how to achieve common objectives through different instruments such as peer pressure, conditionality,
and market discipline.

In this section, we review and evaluate the existing regional surveillance processes: the MFG Meeting, the ASEAN/ASEAN+3 surveillance process, and CMI-related surveillance process. We will assess these regional or subregional surveillance-related initiatives according to three criteria:

(i) the precise content of information exchange—information sets, priorities, targets, models, and rules;

(ii) the conduct and methods of surveillance, the substance of surveillance recommendations in the peer review process, and the implementation of surveillance recommendations; and

(iii) 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.

1. Manila Framework Group

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, Philippines and “A New Framework for Enhanced Asian Regional Cooperation to Promote Financial Stability” (the so-called Manila Framework) was agreed upon. The Manila Framework centers around four initiatives:

(i) regional surveillance,

(ii) technical assistance geared toward strengthening the financial sector,

(iii) bolstering of IMF’s ability to deal with financial crises, and
(iv) a contingent financing arrangement for Asian currency stabilization.

Although the MFG has no formal status, it now holds biannual meetings for 14 countries/areas plus IMF, World Bank, and Asian Development Bank (ADB).\textsuperscript{10} Some observers see the MFG as the preeminent forum for regional surveillance and peer pressure (e.g., Grenville 2001). IMF’s Regional Office for Asia and the Pacific provides the Technical Secretariat for the MFG. The position of chair is occupied alternately by an ASEAN and a non-ASEAN member. However, the MFG involves only a limited number of economies in the region (not covering all ASEAN+3) and its inputs and outputs are not made public, apart from an agreed upon 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—IMF, World Bank, and ADB. According to the agenda discussed during the MFG meeting in New Zealand, 4-5 December 2001, the IMF focused on global economic outlook and financial sector reforms. WB presented the issues of structural reforms in the Asia-Pacific region, and ADB the regional economic outlook and development issues. The three presentations and follow-up discussions took only 3 hours including tea break. The reality is that the participation of IMF and

\textsuperscript{10} The 14 member economies are Australia; Brunei Darussalam; Canada; People’s Republic of China; Hong Kong, China; Indonesia; Japan; Republic of Korea; Malaysia; New Zealand; Philippines; Singapore; Thailand; and United States.
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. Furthermore, many participants of the MFG felt that the discussion is one-sided, in the sense that they were subject to scrutiny by the US and IMF, but not the other way round (de Brouwer 2002).

The MFG also takes an interest in international financial reforms. Grenville (2001) has proposed that it could be the forum for developing regional positions that would then be presented at other meetings like International Monetary and Financial Committee (IMFC) and the Group of 20 (G20) Finance Ministers’ meeting.11) However, the MFG has not yet developed the formal status to deliver its own position to the world forums. While inputs from Australia, Canada, Hong Kong SAR (China), New Zealand, and the US could be valuable in shaping up East Asian economic arrangements, MFG has not yet made any concrete contribution to the ASEAN+3 process.

The performance of the MFG as a mechanism for regional

11) The IMFC was established on September 1999, by a resolution of the IMF Board of Governors, to replace the Interim Committee of the Board of Governors on the International Monetary System, which had been established in 1974. The G20, which was formally launched in September 1999, consists of 19 member countries and the European Union plus the Bretton Woods Institutions represented by the Managing Director of the Fund and the President of the Bank. The country members of the G20 are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the UK and the USA. The EU is the twentieth member.
financial cooperation and regional financial surveillance has not been very successful according to the three criteria we outlined earlier. Specifically,

(i) because MFG has not yet clearly specified the objectives of information exchange and surveillance, no priorities, targets, and rules have been set for the process of information exchange;

(ii) 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

(iii) because the issues related to financial sector reforms are discussed only cursorily, the MFG process has not led to improvements in regulating, supervising, and integrating of the financial markets of East Asia.

2. 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.
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 supplies monitoring information to the meetings of the MFG and the Asia-Europe finance ministers. 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 People’s Democratic Republic, Philippines, Thailand, and Viet Nam).

The ASP does not send fact-finding missions to member states like 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 ASCU at the ASEAN Secretariat. ASCU uses these inputs to analyze 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 finalize this report before it is tabled for discussion by the ASEAN finance ministers during their peer review.

In 1999, the leaders of ASEAN invited PRC, Japan, and Republic
of Korea (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. The monitoring exercises performed under the ASP were expanded to involve PRC, Japan, and Korea. The first peer review meeting under the ASEAN+3 surveillance process was held in May 2000 on the sidelines of ADB’s annual meeting. Currently, the ASEAN+3 surveillance process is similar to the ASP. However, as the CMI develops into a source of financial facilities that are more independent of 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 noninterference in domestic affairs, the fact is that ASEAN+3 policy makers are now increasingly confronted with the necessity of constructive engagement.

Using our three criteria to evaluate the ASEAN+3 surveillance process, we see substantial room for improvement. 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 for many important issues is difficult. 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 because the discussion at the ASEAN+3 meetings currently tends to focus only on recent economic developments within member countries, and (as emphasized earlier) to rely only on the information that the countries under discussion elect to provide. The substance of surveillance recommendations in the peer review process and their actual implementation remain 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 improvements in the regulation, supervision, and integration of the financial markets of the member countries.

3. Chiang Mai Initiative and Enhanced ASEAN+3 Surveillance Process

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 framework in the region through the CMI. This initiative involves an expanded ASEAN swap arrangement (ASA) that includes all ASEAN members and a network of bilateral swap agreements among ASEAN countries plus PRC, Japan, and Korea.

Significant progress has been made in implementing the CMI to further strengthen the self-help and support mechanism in East Asia. The ASA, one of the main components of the CMI, was increased to
$1 billion, effective 17 November 2000. Regarding the network of bilateral swap arrangements (BSAs) under the CMI, a substantial number of bilateral agreements have been reached, two are currently under negotiation, and one is under consideration (Table 2). Japan has been the most active: it has concluded six agreements with China, South Korea, Indonesia, Malaysia, the Philippines and Thailand, and is currently negotiating an agreement with Singapore. Korea has concluded four agreements with China, Malaysia, the Philippines and Thailand in addition to the Japan-Korea BSA. China has concluded three agreements with Malaysia, the Philippines and Thailand in addition to its agreements with Japan and Korea.

At present, the total amount of BSAs is estimated to be around $32 billion. The maximum amount any individual country can draw varies a great deal, e.g. $6 billion in the case of Thailand. Given such a small amount of liquidity available through the CMI mechanism, it is highly unlikely that the BSA system could truly be a credible and effective system of defense against future speculative attacks. Participants of international financial markets are most probably discounting the CMI as irrelevant.

Under the CMI framework, 10% of the swap arrangements can be disbursed without IMF involvement.12) But because this 10% swap can be disbursed only with the consent of swap-providing countries, these countries need to formulate their own assessments of the swap-requesting country to determine whether the balance of payments crisis is caused by domestic mismanagement or by the

12) The bilateral swap arrangements (BSAs) under the CMI are premised on the condition that 90% of the committed currency swaps would be activated along with the financial support of IMF.
### <Table 2> Progress on the Chiang Mai Initiative
(as of August 31, 2003)

<table>
<thead>
<tr>
<th>BSA</th>
<th>Currencies</th>
<th>Conclusion Dates</th>
<th>Size</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan-Korea</td>
<td>$/Won</td>
<td>4 July 2001</td>
<td>$7 billion(^a)</td>
</tr>
<tr>
<td>Japan-Thailand</td>
<td>$/Baht</td>
<td>30 July 2001</td>
<td>$3 billion</td>
</tr>
<tr>
<td>Japan-Philippines</td>
<td>$/Peso</td>
<td>27 August 2001</td>
<td>$3 billion</td>
</tr>
<tr>
<td>Japan-Malaysia</td>
<td>$/Ringgit</td>
<td>5 October 2001</td>
<td>$3.5 billion(^a)</td>
</tr>
<tr>
<td>Japan-PRC</td>
<td>Yen/Renminbi</td>
<td>28 March 2002</td>
<td>$3 billion</td>
</tr>
<tr>
<td>Japan-Indonesia</td>
<td>$/Rupiah</td>
<td>17 February 2003</td>
<td>$3 billion</td>
</tr>
<tr>
<td>Korea-PRC</td>
<td>Won/Renminbi</td>
<td>24 June 2002</td>
<td>$2 billion</td>
</tr>
<tr>
<td>Korea-Thailand</td>
<td>$/local currency</td>
<td>25 June 2002</td>
<td>$1 billion</td>
</tr>
<tr>
<td>Korea-Malaysia</td>
<td>$/local currency</td>
<td>26 July 2002</td>
<td>$1 billion</td>
</tr>
<tr>
<td>Korea-Philippines</td>
<td>$/local currency</td>
<td>9 August 2002</td>
<td>$1 billion</td>
</tr>
<tr>
<td>PRC-Thailand</td>
<td>$/Baht</td>
<td>6 December 2001</td>
<td>$2 billion</td>
</tr>
<tr>
<td>PRC-Malaysia</td>
<td>$/Ringgit</td>
<td>9 October 2002</td>
<td>$2 billion</td>
</tr>
<tr>
<td>PRC-Philippines</td>
<td>$/Peso</td>
<td>Negotiation completed</td>
<td>$2 billion</td>
</tr>
<tr>
<td>Japan-Singapore</td>
<td></td>
<td>Under negotiation</td>
<td></td>
</tr>
<tr>
<td>PRC-Indonesia</td>
<td></td>
<td>Under negotiation</td>
<td></td>
</tr>
<tr>
<td>Korea-Indonesia</td>
<td></td>
<td>Under consideration</td>
<td></td>
</tr>
</tbody>
</table>

BSA = Bilateral Swap Arrangement, PRC = People’s Republic of China, Korea = Republic of Korea

\(^a\) The US dollar amounts include the amounts committed under the New Miyazawa Initiative: $5 billion for Korea and $2.5 billion for Malaysia.

instability of the international financial markets. Because the current practices under the ASEAN+3 process cannot effectively capture emerging problems, the CMI will need to develop its own regional surveillance mechanism for its operations. It should be noted that the
existence of this regional surveillance mechanism will enhance the collective efforts to strengthen the financial systems in the region.

Ever since late 1997, there have been repeated calls for a new regional financial institution, e.g. the Asian Monetary Fund (AMF), both to serve as a surveillance mechanism to enable timely liquidity assistance, and to formulate efficient structural adjustment programs when necessary. Such proposals have met with many reservations, of which Eichengreen (2001a) is amongst the most well-argued. He distinguishes between technical assistance and financial assistance, and agrees that there is no reason to discourage competition in the market for technical assistance. Governments would thence have the option of choosing the source of technical assistance with the most cost-effective conditionality package (and, possibly also, with the best track record). However, Eichengreen points out that if multiple monetary funds were available, then East Asian governments would have an incentive to shop around for the most generous assistance and the least onerous terms. His presumption is that AMF conditionalities would be much softer than those of IMF.

Eichengreen’s (2001a) concern is a valid and realistic one, and must be seriously addressed if there is development beyond the limited frameowrk the CMI. The solution to the moral hazard problem created by the establishment of the AMF is to have built-in incentives within the governance of AMF:

• to deter loan-pushing behavior that would enable self-aggrandizement by the AMF, and
• to encourage the achievement of the highest technical competence in diagnosis and prescription.
III. Regional or Subregional Initiatives among the ASEAN+3 Countries

At the minimum, the AMF should be subject to a hard budget constraint and to the accountability of its actions so that there would not be a race to the bottom in its competition with the IMF over conditionality packages. As long as the AMF administrators face substantial penalties for reckless lending, the moral hazard problem stressed by critics of the AMF proposal would not be a major one, and would not help to incubate future crises instead of preventing them.

The ASEAN+3 finance ministers made the decision to establish an ASEAN+3 Study Group at their meeting in Honolulu, Hawaii 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 BSAs 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, Malaysia on 22 November 2001. The main purpose was to discuss a joint paper prepared by Bank Negara Malaysia and the Ministry of Finance of 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. Phase 1 enhances the existing process of economic reviews and policy dialogues among the ASEAN+3 countries, and phase 2 constructs a new strengthened policy dialogue mechanism.

The second meeting of the ASEAN+3 Study Group was held in Myanmar on 2 April 2002. There was more intensive discussion of
the possible specific modalities for phase 2 proposed by Malaysia. Although there was no consensus, the main issue is now clearly defined to be the establishment of a support unit to carry out the surveillance activities and the functions of an expert group.
IV. How to Enhance the ASEAN+3 Surveillance Process

In this section, we will draw upon our review and evaluation of existing surveillance processes to identify the scope for strengthening the process and mechanisms of regional information exchange, economic surveillance, and regulation of financial services markets among the ASEAN+3 countries.

1. Clear Specification of the Objectives

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 the CMI maintains forward momentum by expanding its scope of actions.

We propose that the explicitly stated objectives of the surveillance mechanism in East Asia be:

(i) the maintenance of financial market stability, and
(ii) the promotion of economic integration in East Asia.

At present, the ASEAN+3 countries have chosen to rely on IMF for imposing and enforcing policy conditionalities for those countries drawing from the BSAs. The regional initiative should complement the IMF surveillance process by having more regular policy dialogue meetings. However, the peer policy review process cannot operate in a vacuum; we need to identify the appropriate modalities and to design the necessary instruments, techniques, and institutions for a system of effective monitoring and surveillance.

2. Construction of an Enhanced Surveillance Mechanism

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

Phase 1: 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 ADB can provide technical assistance for capacity building. Under the ASEAN+3 framework, it would be desirable to institutionalize the ASEAN+3 meetings for policy review by requiring all CMI countries to participate in the informal monitoring process, and by increasing the frequency of informal meetings at the deputy minister level. The policy dialogue will include the review of IMF Article IV consultation staff reports on all member countries, self-assessments, and conditionalities of the program countries.

Phase 2: 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 (beyond the CMI, if necessary). By conducting extensive early warning exercises at the national and regional levels, this surveillance unit identifies the problems and presents independence surveillance reports to the policy dialogue group of the ASEAN+3. Following the ASEAN tradition of noninterference into domestic policies, the report in phase 2 should focus primarily on the provision of warning signals. Beside surveillance responsibilities, this unit should be mandated to conduct
research on future cooperative issues such as exchange rate policy coordination and financial market integration. At the same time, in order to promote broad participation of the member countries in preparing for phase 3, a network of research institutions, both private and public, should be established, and the surveillance unit could serve as the coordinating agency.

Phase 3. 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 desires monetary integration at some point in the future, the regional surveillance mechanism would have to be restructured to support the coordinated exchange rate mechanism.

3. Scope and Content of Monitoring and Surveillance

The current 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 a voluntary basis. To complement the CMI and the macroeconomic analyses information from the IMF’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 1997-1998 economic crisis in East Asia occurred largely because of the vulnerability of the financial systems there. The East Asian financial system in general suffers from inadequate economic and legal infrastructure, a condition that results in the inefficient allocation of savings, as exemplified by inordinately extensive short-term debt markets, and general absence of arm’s-length transactions. The ASEAN+3 policy dialogue process should therefore pay particular attention to the root problems in East Asia’s weak financial systems. Besides strengthening prudential supervision, risk management, and corporate governance, the financial authorities in the region must also actively promote the long-term capital markets. This is a case for financial cooperation to deepen and enhance regional financial markets. It is therefore the conditions of the financial sectors in the region that must be closely monitored.

The following set of information could be shared among the members:

- External accounts - current and capital account balance, total outstanding external debts, composition of external debts, international reserves, exchange market pressures, and short-term capital flows.
- Monetary and financial accounts - M1, M2 balances and multipliers; bank deposits; domestic credit; real and nominal interest rates (lending and deposit); balance sheets of the different financial intermediaries; nonperforming loan ratios, level of corporate debt denominated in foreign currencies; and equity prices.
• Fiscal position - budget of the central government; consolidated fiscal balance of governments at all levels; details of public sector debt (including contingent liabilities) and government-guaranteed debt; and income statements of state-owned companies.

• Real sector resilience - domestic output (according to demand component and sector of origin); terms of trade; amount, composition, and destination of exports; amount and composition of imports; relative growth of tradeable and nontradeable sectors.

• Social factors - unemployment rates, absolute poverty, trade union strikes, and political developments (general and presidential elections).

• Important changes in institutions and laws - changes in regulatory and supervisory systems, and corporate governance-related laws.

The ASEAN+3 Study Group has proposed that the economic reports include not only assessments made by IMF, WB, and ADB but also the countries' responses to the assessments, 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 1, 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 1, it is necessary to boost “comfort
level” quickly so that the more useful phase 2 could be ushered in.

In phase 2, 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 noninterference in domestic policies, the report should focus on the provision of warning signals. However, a key concern is whether the regional surveillance unit has sufficient technical expertise and financial and human resources to conduct quality and in-depth analysis of the economic problems in East Asia. As long as the CMI is largely linked to IMF conditionality, regional surveillance would play a secondary role to IMF surveillance. The ASEAN+3 surveillance unit will expand in scale as the CMI evolves toward being an independent regional monetary fund. Various issues about the institutional arrangements for this new surveillance unit will be discussed in section 5.

4. Conduct and Methods of Surveillance and Peer Review

In phase 2, 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. The policy recommendations are not necessarily binding, but only encouraged, through peer pressure. To facilitate the implementation of surveillance recommendations agreed by the members, the surveillance report should also have in a separate chapter, progress in implementing recommended policy changes.
As mentioned in section 2, it is essential that policy recommendations agreed upon by member countries be made public, thereby reinforcing peer pressure through monitoring in the marketplace. After the surveillance report is examined at the ASEAN+3 policy dialogue meetings, surveillance recommendations adopted at the meetings should be made public. The countries that do not comply with these recommendations would be pressured by the market discipline. Furthermore, non-compliant members should be disqualified from receiving the potential benefits of the CMI.

As emphasized earlier, the ASEAN+3 policy dialogue group should also initiate collective efforts to improve the regulation, supervision, development, and integration of the financial services markets of the ASEAN+3 countries. The best financial sector 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 financial sector practices. The surveillance unit would also provide technical assistance to national financial sector agencies along with ADB and other international organizations. Progress in harmonizing standards in the financial sector, and the growth of the long-term capital markets of every country should be a regular feature in the report of the surveillance unit.
V. Building Institutional Arrangements for Policy Dialogue

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 IMF/WB annual meetings. However, some member countries were of the view that doing so may not be practical as the 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 the 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.

In phase 2, a group or an institution will be charged with responsibility to undertake in-depth analytical assessments of the regional economies and of the conditions in their financial markets, and we present the following three options.

Option 1: Build up an existing institution to the tasks - We see two obvious candidates: (I) the ASCU at the ASEAN Secretariat in Jakarta, and (ii) the Asian Development Bank Institute (ADBI) in Tokyo. Both
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 ADB to build up their analytical expertise. We see ASCU as having a slight edge over ADBI because it is already managing and coordinating surveillance activities under the ASP.

*Option 2: Using an Existing Institution* - The obvious candidate in Asia for this option is the REMU within ADB. This is the easiest option because it already has the technical expertise and a surveillance mechanism in place. However, the choice of REMU as the regional surveillance unit should not mean a mere expansion in its size. For REMU to be qualified for the identified tasks, its capabilities in evaluating financial market resilience and in promoting financial sector growth need to be enhanced.

*Option 3: Operate 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 AFMM+3 and AFDM+3. The group would comprise outstanding economists from academia, think tanks, and the private sector. The composition of the working group is most important to ensure its effectiveness because the right mix in membership could increase the “comfort level” of officials to provide information and exchange views with the working group.

We think that option 3 is the least workable. The constantly changing composition of “outside expert” would mean lack of
institutional memory and could also lead to 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 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 to 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, 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 organizations.

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 2.
VI. Conclusion

Historically, international economic integration had been led by both economic motives and political motives. Charles Wyplosz (2001), 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 half a 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 CMI 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 the 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 REMU within ADB or the ASCU within the ASEAN Secretariat for this task. REMU 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.

The Asian economic crisis has revealed that the weakest links in East Asian economic management were inappropriate exchange rate management and fragile financial systems. It therefore cannot be overemphasized that the regional surveillance unit must not only be a watchdog of national macroeconomic and exchange rate policies, but also an overseer of the national financial markets, and the linkages between them and the rest of the world. We find it most unfortunate that, 5 years after the economic crisis, neither REMU nor
ASCU are sufficiently equipped to supervise the operations of the fast-evolving financial markets, and, at the same time, to promote financial market development and integration. If REMU is selected to be the regional surveillance unit to support the ASEAN+3 policy dialogue, one of its first tasks has to be strengthening its technical expertise in financial sector regulation and financial market development.\textsuperscript{13)}

\textsuperscript{13)} In two recent papers, Eichengreen (2001b, 2002) advocates the establishment of an Asian Financial Institute to promote financial cooperation as the appropriate regional response to the 1997-1998 crisis. In terms of our proposal for the regional surveillance unit, the key functions of Eichengreen’s Asian Financial Institute would be undertaken by the new financial sector department within REMU.


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