

**Hanging Together?
On Monetary and Financial Cooperation in Asia¹**

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In Asia, the idea of wider monetary and financial cooperation has been in the air since the crisis of 1997-8. The spread of monetary instability following the devaluation of the Thai baht highlighted the extent to which one country's problems could have destabilizing repercussions for its neighbors. There was the perception that the events of 1997-8 had been compounded by the large positions of highly-leveraged institutions in New York and the less-than-generous assistance and conditionality of multilateral financial institutions in Washington, D.C. More than a few observers were led to conclude that Asian governments should take steps to create a zone of monetary and financial stability better insulated from these influences.

The response has been schemes of varying scope and ambition for cooperation in the region. Least ambitious are plans to build on already extant arrangements such as the APEC Finance Ministers Process (a venue for sharing information on regional financial developments and pursuing cooperative programs to promote financial-sector development and liberalization), the Executives Meeting of East Asia and Pacific Central Banks (which is designed to encourage regional surveillance and financial market development), and the Six Markets Group or G-4 + 2 (a venue for the exchange of views among the vice ministers of finance and deputy central bank

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governors of the regional financial centers).² These arrangements for extending technical assistance and strengthening monetary policies and financial markets will, it is hoped, allow Asian countries to achieve more collectively than they could individually. The 1997-8 crisis having highlighted the urgency of upgrading prudential supervision, financial-market regulation, and corporate governance, there is an obvious argument for devoting more time, effort and financial resources to their activities.

A second set of proposals recommends the creation of a common basket peg for exchange rates, perhaps as a way station on the road to the creation of a single Asian currency (Dieter 2000). The motivations here are several. There is, to start, the role of currency pegs in the East Asian miracle. Their historical role as an anchor for wage and price expectations and a facilitator of export growth creates understandable skepticism that floating rates are compatible with the Asian development model. There is the role of yen-dollar fluctuations in setting the stage for the crisis. And there is the tendency, prominent in 1997-1998, for currency depreciation in one Asian country to spread instability to its neighbors. Observations like these provide the motivation for proposals for a system of collective currency pegs to the yen (Kwan 2001), the dollar (McKinnon 2001) or a basket of major currencies (Williamson 1999). These proposals -- particularly the last -- have been given prominence by a discussion paper prepared by French and Japanese officials for the Third Asia-Europe Finance Ministers' Meeting in Kobe in January 2001.³

²The United States has also been invited to attend recent meetings of the Six Markets Group.

³See Government of Japan (2001).

Similarly, the idea of an Asian monetary fund to provide crisis countries with financial assistance subject to more appropriate conditions continues to be discussed. This idea was originally floated by the Japanese government at a meeting in Bangkok in September of 1997.⁴ It was torpedoed, however, by the opposition of the Clinton Administration and the International Monetary Fund, which feared that a regional fund would undermine the effectiveness of IMF conditionality, and by the less than enthusiastic reaction of the Chinese government, which worried the arrangement would unduly enhance Japanese influence in the region.⁵

The next major initiative emanated from the Association of South East Asian Nations (ASEAN) or, more precisely, from ASEAN plus China, Japan and South Korea.⁶ This is the Chiang Mai Initiative (CMI) of central bank swap arrangements. Drawings through this arrangement, other than small swaps for limited periods, can only be used to supplement existing IMF arrangements and are subject to the latter's conditionality. The CMI is thus embedded in the IMF system. This new willingness of Asian policy makers to link -- some would say subordinate -- their regional initiative to global financial arrangements has helped to mollify opposition in

⁴ See Lin and Rajan (2001).

⁵See Bergsten (2000c). This experience prompted the formation of the Manila Framework Group by APEC finance ministers at a meeting in November 1997. Since the Manila Framework Group (a 14-country subset of APEC members) includes not only the crisis countries and Japan but also Australia, New Zealand and the United States, this can be seen as an attempt is to strengthen surveillance on a regional basis but in a manner consistent with existing IMF/World Bank arrangements. In the event, the discussions of the Manila Framework Group produced few concrete results.

⁶The members of ASEAN are Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam.

Beijing and Washington, D.C.⁷

What all this bodes for the future is unclear. Is it realistic to attempt to create a zone of financial stability by building self-standing institutions of Asian monetary and financial cooperation? Or is this infeasible in today's world of seamless globalization? Must regional initiatives instead be embedded in the global system of multilateral institutions and arrangements, much as Asia's economy and financial markets are embedded in the global economy and global financial system? Is it possible for Asia to square this circle as Europe has done, by creating regional economic and financial institutions that are at the same autonomous and linked to their global counterparts?

This paper addresses these issues and draws out their implications. Section 1 summarizes the development of currency- and financial-market conditions since the crisis. It documents the persistence of tensions in foreign exchange markets -- on the one hand the de jure transition toward greater exchange rate flexibility, on the other the de facto tendency to manage exchange rates and limit their fluctuation -- and sharp differences in the response of different countries. It also documents the pronounced decline in cross-border bank lending and persistent obstacles to securities-market development. These observations underscore the desirability of a cooperative response to the region's monetary and financial problems.

Section 2 considers possibilities for a cooperative monetary response, reaching generally

⁷The shift in Beijing's attitude is apparent in China's participation in the Chiang Mai Initiative. The shift in Washington's is evident in the supportive remarks made by IMF Managing Director Horst Koehler during his most latest trip to the region and in the recent comments of U.S. Deputy Secretary of State Richard Armitage that the idea of an Asian Monetary Fund to deal with events like the 1997-8 meltdown "doesn't seem to me to be a bad idea." See Koehler (2001) and Christie (2001).

negative conclusions. It argues that while pegged exchange rates played an important role in the development model pursued by East Asian countries in the second half of the 20th century, they will be less essential to the development model of the 21st. Moreover, Asian policy makers possess no solution for the intrinsic fragility currency pegs in a world of high capital mobility and democratic politics.⁸ I conclude that not even the vastly expanded system of swap arrangements growing out of the Chiang Mai Initiative will necessarily enable Asian countries to sustain a system of collective pegs. At worst the attempt to establish one could be a costly mistake. At best it will constitute a diversion from the key task at hand.

That task is to strengthen financial institutions and promote the development of financial markets. Creating a zone of financial stability means cooperating on initiatives to upgrade prudential supervision and regulation and to enhance financial transparency and creditor rights. Section 3 evaluates possibilities for fostering financial cooperation in this light. I argue that Asian policy makers should devote their scarce political capital to establishing an Asian Financial Institute with the power to set standards for financial market regulation, to identify policies for promoting financial market development, to coordinate national initiatives along these lines, to monitor the compliance of countries with its recommendations, and to apply the appropriate diplomatic and perhaps pecuniary sanctions to violators. ASEAN, or more precisely ASEAN+3 (including China, South Korea and Japan), is the logical entity to pursue this initiative.

⁸In this context I devote special attention to the experience of Singapore, which is frequently mentioned as a country that has succeeded in pegging its exchange rate while at the same time maintaining open capital markets. I show that its success in doing so reflects special circumstances not present in other Asian countries.

Section 4, in concluding, offers various questions and caveats about the feasibility of this form of Asian monetary and financial cooperation.

1. Recent Trends

External developments have contributed little to the development of financial markets and the stabilization of financial conditions since the outbreak of the crisis. Capital flows to emerging markets and to Asia in particular have declined markedly since 1997.⁹ The change in the net cross-border loans of BIS-member reporting banks to Asia-Pacific developing countries moved into negative territory in the third quarter of 1997 before falling to very significant negative levels (on the order of negative \$30 billion of net new commitments per quarter). The total net claims of BIS reporting banks on Asia-Pacific developing countries fell by more than 25 per cent from their calendar-year 1997 peak.¹⁰ Even now, new net exposures by BIS-reporting international banks are evident for a select few Latin American and Eastern European countries, but not for East Asian countries. BIS reports for 2001 show that the change in the net loans of BIS-reporting banks to Asia remains negative, reflecting doubts about the economic prospects of the region, heightened awareness of the risks of bank lending to emerging markets, and the problems of the Japanese financial system.

This decline in cross-border bank lending has not been offset by the growth of securities markets. Hedge funds and proprietary trading desks curtailed their involvement in developing-

⁹This and the next paragraph draw on BIS (2001).

¹⁰Meanwhile they stagnated, neither rising or falling significantly, in the case of emerging Europe and Latin America.

country debt and equities following the crisis, diminishing the liquidity of these markets. Emerging market equity issuance fell sharply between 1997 and 1998 and showed little tendency to recover subsequently, apart from a spurt in 1999 reflecting several large privatization transactions.¹¹ Net issuance by developing countries of international debt securities (a category that includes international money market instruments, bonds and notes), which had been running at \$20 billion a quarter (roughly a third of which had been attributable to Asia and Pacific issuers), fell almost as sharply as the previously-mentioned bank credits. By the fourth quarter of 1997, net issuance of debt securities had declined to very low levels, where it has remained subsequently (with the exception of abortive recoveries in 1998-QII and 1999-Q4).¹² Asian borrowers have come to the market to refinance maturing international bonds, but they have secured little new financing.¹³ Much of that refinancing has been at shorter maturities than maturing obligations, reflecting the limited liquidity of the primary markets.

Associated with these changes quantities have been sharp changes in prices. Spreads on emerging market debt securities have become increasingly volatile and decoupled from spreads on issues of comparably-rated borrowers in the industrial countries.¹⁴ Launch spreads have risen

¹¹Portfolio equity flows to East Asia in particular fell to \$8 billion in 1998 from more than twice that rate in the four years preceding the crisis.

¹²Negligible in this context means less than \$1 billion. In many of the subsequent quarters, net issuance was negative.

¹³The vast majority of the new financing extended to emerging market borrowers in this period went to just four countries -- Argentina, Brazil, Mexico and Turkey -- outside the Asia-Pacific region.

¹⁴This decoupling resulted as much from the Russian crisis of August 1998 as from the Asian crisis that preceded it. (Both events reduced the correlation between the two sets of spreads, although the Russian crisis arguably had a greater impact.) In any case, the earlier

significantly compared to the pre-crisis period. The post-1998 recovery of Asian stock markets has been disappointing (aside from significant gains in 1999), reflecting first uncertain prospects for recovery, then the global technology slowdown, and most recently worries of U.S. recession.

Exchange rate volatility rose sharply following the crisis, as most of the countries of the region (aside from Hong Kong, China, and Malaysia) moved from fixed or tightly managed exchange rates to freer floating. This, at least, is what the official IMF categorization shows. A number of authors (e.g. McKinnon 2001) argue that, official labels notwithstanding, rates remain tightly managed and are as stable now as before the crisis.¹⁵ Tables 1-4 shed some light on this issue.¹⁶ Table 1 shows that the exchange rates of six of the Asian countries considered (Indonesia, Korea, Malaysia, Philippines, Singapore and Thailand) were unusually stable before the crisis, whether measured by the range of average monthly percentage exchange rate changes or their standard deviations. Since the crisis, exchange rate variability against the dollar has increased sharply in many of these countries, the principle exceptions being Malaysia, Hong Kong, and Taiwan. (In constructing this and subsequent tables, I have omitted the crisis period itself, defined as the second half of 1997 and calendar year 1998.) The picture, in other words, may be more complex than suggested by McKinnon.

Table 2 measures whether intervention in foreign exchange markets has risen or declined following the crisis, displaying the mean absolute monthly percentage change in international reserves and the standard deviation of monthly reserve percentage changes. The relatively high

correlation has shown little tendency to reassert itself.

¹⁵Kawai and Akiyama (2001) make the same argument, albeit less strongly.

¹⁶Here I extend some work by Hernandez and Montiel (2001).

pre-crisis figures for the Asian countries, compared to the U.S. and Japan, confirms that their exchange rates were highly managed. Following the crisis, reserve volatility fell in Korea and Thailand while rising in Malaysia, Hong Kong and Indonesia. Malaysia and Hong Kong, it is clear, have continued to intervene heavily in order to stabilize their currencies. Indonesia, while attempting to limit fluctuations, has clearly failed to accomplish that goal.¹⁷ Be this as it may, the striking fall in reserve volatility in countries like Korea and Thailand, despite the increasing volatility of the macroeconomic and financial environment, is again suggestive of a willingness to accept a freer float.

Countries can also lean against market pressures by adjusting interest rates. Table 3 therefore reports the range, mean absolute change, and standard deviation of monthly interest rates (money market rates where possible). Consistent with the results for reserves, monthly interest rate volatility has fallen in Korea and Thailand (and more modestly in Taiwan), indicative of a commitment to greater exchange-rate flexibility. It has risen in Hong Kong, reflecting the Monetary Authority's commitment to its peg.¹⁸ Not surprisingly, interest rate volatility has also risen in Indonesia, again pointing to continued efforts, not generally successful, to limit exchange rate fluctuations in a more volatile environment.

Table 4 summarizes the preceding, presenting the ratio of exchange rate volatility to

¹⁷This serves as a reminder that statistics like these can reflect the effects of shocks as well as policies, an issue to which I return below. The evidence for Taiwan is ambiguous, since the two measures move in different directions. But neither change is large in comparison with the other countries. In the case of Singapore, reserve volatility appears to have increased very significantly, which points in the opposite direction from the statistics in Table 1. Singapore, however, is a special case (as I describe in Section 3 below).

¹⁸Malaysia is a different case: interest rate volatility fell noticeably following the crisis, reflecting the imposition of capital controls.

interest rate volatility and the ratio of exchange rate volatility to reserve volatility. Rising ratios indicate freer floating -- that shocks to currency markets are being absorbed to a greater extent by the exchange rate and to a lesser extent by monetary policy adjustments and intervention.¹⁹ They confirm the existence in Hong Kong and Malaysia of a continued commitment to pegging in the face of an increasingly volatile macroeconomic and financial environment. Singapore and Taiwan show little change. But for Thailand and Korea, the evidence is that governments and central banks have moved to a regime where exchange rates are allowed to move more freely in response to shocks. For Indonesia, the evidence again suggests that despite the increasing volatility of reserves and interest rates, reflecting unsettled financial and political conditions, exchange rate movements have been relied upon more heavily to accommodate shocks. The same is again true, albeit to a lesser extent, of the Philippines. So much for the “resurrected dollar standard.”

This evidence of growing volatility hardly makes for a happy picture. The question is what to do about it, and whether solutions can be found on a regional basis.

2. Currency Options

Prominent scholars have argued that Asia should explore collective solutions to its monetary problems. In this section I present their arguments and critique their proposals.

The Problem. The openness of Asian economies, not just to trade but also to capital flows, creates a presumption that exchange rate volatility and risk may be even more disruptive

¹⁹These measures go at least part way to addressing the concern that changes in the components, presented in Tables 1-3, reflect shocks rather than policies.

to growth there than in other times and places. Asia may suffer more damaging consequences from exchange-rate instability, the implication follows, than other less trade- and investment-oriented parts of the world. Recent empirical work has lent support to the argument that stable exchange rates encourage trade.²⁰ Asian history is also invoked in this connection. Thus, Ronald McKinnon has argued that Japan's policy of pegging the yen to the dollar from the late 1940s until the early 1970s contributed to its economic dynamism and emergence as an export powerhouse. Jeffrey Sachs (1985) has ascribed the East Asian economic miracle (in part) to the commitment of Asian governments to peg their exchange rates at competitive levels, providing a nominal anchor for wages whose stability in turn ensured the profitability of exports and stimulated the early growth of low-wage manufacturing. The common implication is that exchange-rate stability was integral to the success of the East Asian miracle. Without it export-led growth would have been more difficult. The rapid growth of labor-intensive manufacturing would not have occurred. No Asian country, it is sometimes said, has successfully developed on the basis of a floating rate.

Without disputing this interpretation of Asia's post-World War II economic history, it is not clear that these arguments will have the same force in the future as in the past. Exports have grown much faster than output in countries like Korea and Taiwan; as a simple matter of accounting, this cannot continue forever.²¹ Abundant cheap labor is no longer essential to

²⁰See for example Eichengreen and Irwin (1995). The work of Frankel and Rose (2000) is frequently cited in this connection, but their evidence is mainly on the trade-promoting effects of a common currency as opposed to stable exchange rates.

²¹So long as the term exports as used in this sentence does not include reexports, which presumably can grow faster than gross domestic product indefinitely.

industrial development in middle- and high-income Asian countries; the key, rather, is rising productivity.²² And labor productivity, as opposed to the level of nominal wages, is not something on which monetary and exchange rate policies operate directly. Moreover, the high levels of investment that were encouraged historically by stable real exchange rates and a high profits share in national income have lost their luster in the wake of the Asian crisis.

To be sure, there remain reasons why competitive real exchange rates and stable nominal exchange rates are conducive to growth. Realistically-valued real rates are important for commercially open Asian economies that continue to rely on export markets. Stable nominal rates encourage inward foreign investment and outsourcing from Japan, which in turn facilitate technology transfer and productivity growth.²³ It has been argued that the instability of Asian currencies against the yen, which were effectively pegged to the U.S. dollar until recently, damaged the growth prospects of the East Asian economies in the mid-1990s and set the stage for the subsequent crisis. More recently there have been warnings that the prospective decline of the yen against the dollar, which will occur if the Bank of Japan engages in large-scale purchases of domestic securities as a way of freeing the Japanese economy from its deflationary spiral, will

²²Although in China and other late developers abundant cheap labor clearly continues to play a role.

²³More generally, whether fixed or flexible exchange rates are more conducive to direct foreign investment is ambiguous both theoretically and empirically. In industries where firms produce the same products in a variety of markets, exchange rate flexibility presumably makes foreign investment more attractive, since exchange rate variations are one more source of risk against which producers can hedge by diversifying production internationally. (That is, they can shift production from higher- to lower-cost sites in response to currency fluctuations when they have engaged in FDI.) But when foreign firms and subsidiaries produce components rather than final products, currency fluctuations can aggravate cost fluctuations rather than providing insulation from them. This second case -- the outsourcing variant -- is presumably the one that is more applicable to Asia.

damage the prospects for recovery elsewhere in Asia by making it harder for other countries in the region to export to Japan.²⁴

At the same time, systematic analyses suggest that exchange rates have come to play a less important role over time. Moreno (2001) shows that although growth may appear to be faster, even recently, in Asian countries that peg their exchange rates, this pattern is an artifact of survivor bias.²⁵ The growth effects of stable rates, properly measured, are actually smaller in East Asia than elsewhere. Crosby and Otto (2001) similarly conclude that the connection between growth and real exchange rates is more complex and contingent now than in the past.

Related to the above is the argument that the newly industrializing economies of East Asia (ex-Japan) must be concerned with the stability of exchange rates vis-a-vis one another and not just with respect to the G-3 currencies. These concerns were pointed up by the Asian crisis, when currency instability in Thailand and Indonesia quickly infected the entire region. It remains unclear, however, why intra-regional currency fluctuations had such devastating effects, making it unclear whether (and, if so, when) they might have them again. While frequent reference is made to the competitive devaluation channel (that the initial devaluations undermined the actual and prospective export competitiveness of other countries in the region), the fact is that trade

²⁴As Kwan (2001, p.39) puts the general case, “every time the yen appreciates against the dollar, the economic growth rate in Asia (outside Japan) picks up, as happened between 1986 and 1988 and again between 1991 and 1995...”

²⁵It can also be interpreted in terms of reverse causation -- that is, countries that grow quickly for independent reasons find it less costly to subordinate their macroeconomic policies to the imperatives of maintaining a stable rate.

among the crisis countries is not large.²⁶ More important, surely, were two other effects. First, since the countries of the region all exported into the same North American, Japanese and European markets, depreciation by one could erode the market shares of the others. Although there is some sign of this effect, most of the evidence (e.g. Harrigan 2000) suggests that it was small, since exports from the crisis countries stagnated in the short run as financial distress led to declining output (rather than rising sharply as this market-share-erosion argument requires).

More important, most observers agree, was what Goldstein (1998) refers to as the wake-up call: that the outbreak of financial instability -- signaled by the collapse of the exchange rate -- in a country where market participants naively believed that no such thing was possible awakened investors to the possibility of similar problems elsewhere. Once the devaluation of the baht revealed that something was rotten in the Kingdom of Thailand, they suddenly realized that all was not well in the neighboring East Asian countries. Currency instability thus served as the starting gun for capital flight by panicked investors.

This interpretation has many adherents. But one can question whether this channel for the spread of instability will be as important in the future as the past. There is no question that once somnolent investors are now awake. They are acutely aware of (some would say excessively preoccupied by) the problems and weaknesses of the Asian economies. They now carefully grade economies according to the strength of their institutions and the pace of their reforms. All of this renders it less likely that a financial event in one country could again transform attitudes toward the entire region. And so long as countries' entire macroeconomic

²⁶Admittedly, it is growing over time (Kwan 2001), which may give this argument more force in the future than in the past.

and financial policy strategies are no longer organized around the level of the exchange rate (as was true of a number of Asian countries so long as their currencies were pegged), it is unlikely that a sudden change in the level of the exchange rate could again have such discrediting effects.

Nonetheless, the conviction that currency devaluation was the principal channel for the contagious spread of the 1997-8 crisis and that exchange-rate fluctuations, if allowed to persist, could again have equally devastating effects has prompted calls for the reestablishment of fixed parities, for agreement on the nature and composition of these pegs, and for an expanded system of currency swaps and even an international lender of last resort to provide emergency financing to countries that might otherwise be forced to abandon their pegs. Rose (1998) was perhaps the first to invoke the evidence that contagion spreads primarily within regions in support of the idea of an Asian Monetary Fund to pool the reserves of the participating countries and support those whose pegs were threatened by market pressures. Bergsten (2000c) has similarly argued that a rationale for monetary cooperation in Asia is that contagion is heavily regional.²⁷

The Solution. These arguments have led various observers to propose that Asian economies should resurrect their currency pegs and that governments should agree on the currencies to which to peg in order to limit intra-regional fluctuations. Ito et al. (1998),

²⁷Actually, this is an argument for regional surveillance and peer pressure to prevent the development of policy inconsistencies, not for an Asian fund to provide support for currencies jeopardized by inconsistent policies. To be sure, the observation that contagion has a regional component points up the possibility that a number of Asian countries could come under pressure from the currency markets simultaneously. But, if they did, reserve pooling would be of little practical help, since the countries in question would need to draw on their reserves at the same time. Indeed, having the relatively strong ones lend their reserves to the weaker neighbors may actually weaken confidence in the stronger-currency countries. In fact, these are precisely the concerns that have been raised in the context of the Chiang Mai Initiative, by Standard & Poor's among others. See the appendix below.

Williamson (1999), and a team of French and Japanese officials (Government of Japan 2001) have advanced variants of the argument that East Asian governments should agree on a system of collective basket pegs with weights on the dollar, the yen and the euro. Pegging to a basket will avoid disruptions to export competitiveness due to G3 exchange-rate fluctuations. And agreement on the weights will limit intra-regional currency swings.

While the architects of this proposal are sensitive to its weaknesses, they advance it on the grounds that the alternatives are worse. Asia's recent history, they insist, demonstrates that floating rates are volatile and damaging to the real economy. A policy of benign neglect of the exchange rate, they observe, is not feasible for countries with fragile financial systems, high levels of liability dollarization, and heavy trade dependence. Thus, a number of emerging markets that are officially classified by the IMF as having moved to independent floating (and more generally as adopting policies of greater exchange rate flexibility) continue to strictly limit the fluctuation of their currencies; they evince "fear of floating," in the widely-adopted terminology of Calvo and Reinhart (2000). They display high ratios international reserve variability and interest-rate volatility to exchange rate variability, as if they habitually intervene in domestic and international money markets to limit currency movements.²⁸

But pretending to float while really continuing to peg (or even strictly limiting the currency's fluctuation) is not credibility enhancing when the authorities have no stated

²⁸Hausmann, Panizza and Stein (2000) show that of countries officially classified as having floating exchange rate systems or very wide bands, those with high levels of liability dollarization have the greatest tendency to limit exchange rate variability (they have the highest ratios of reserve volatility and interest-rate volatility to exchange rate volatility). There is also weaker evidence that countries with the highest rate of passthrough from exchange rates to domestic prices resist exchange-rate movements.

commitment to the regime. Indeed, to the extent that there is an inconsistency between the de jure and de facto regimes, credibility will be damaged rather than enhanced.²⁹ The alternatives are a monetary policy operating strategy that articulates an explicit role for foreign-exchange-market intervention but not a target for the exchange rate -- inflation targeting is one such strategy (see below) -- and a hard peg (under which the de jure and de facto regimes are the same). A hard peg is likely to be most attractive to very small, very open economies, of which the region has several. Hong Kong's experience demonstrates that such an arrangement can be compatible with openness, financial and otherwise. But a hard peg like Hong Kong's dollar-based currency board is undesirable insofar as it will subject the economies of the region, with geographically diversified trade, to the vagaries of dollar-yen fluctuations. Argentina's recent experience provides a graphic illustration of the potential for difficulties.³⁰

Williamson's is the most fully developed of these proposals for a common currency peg.³¹ He would have countries each declare a fluctuation band with a width probably not less than plus-or-minus 5 or more than plus-or-minus 15 per cent. While exchange rates would be allowed to float within the band, the authorities would intervene to keep them from straying further. The knowledge that they stand ready to do so would create "bias in the band" (stabilizing speculation,

²⁹If the authorities make a point of denying that they are ready to intervene whenever the rate moves by a certain amount, there will be less "bias in the band" (stabilizing speculation by market participants when the edge of the range of permissible fluctuations is reached).

³⁰An Argentine-style currency board with weights on more than one anchor currency is a possibility, although Argentina's early experience with the arrangement is not exactly a sterling advertisement of its merits. In addition, there is the fact that many of the economies of the region, jealous of their sovereignty, would be reluctant to give over their monetary autonomy to outside powers. (Think, for example, of Malaysia.)

³¹Here I summarize the particulars of Williamson (1998).

also known as the “honeymoon effect”). But to avoid having to defend indefensible positions, Williamson advises governments to adjust the band whenever there is a significant change in the equilibrium rate. These realignments should occur before speculative pressure builds up in anticipation of such adjustments. To avoid speculative attacks and costly reserve losses, jump changes in the exchange rate should be avoided; the new and old band should overlap, allowing the current rate to be contained in the interior of both. While there is a presumption that the authorities will intervene to prevent the rate from straying beyond the band, if they decide that market pressures are overwhelming then they can allow the rate to go outside the band. This should avoid forcing the authorities to commit their scarce reserves to a battle with international markets that they cannot win. If those market pressures are not justified by fundamentals, then the rate will in any case move back into the band once the speculative flurry has passed.

This scheme for “monitoring bands” has obvious attractions. The commitment to intervene should encourage stabilizing market behavior, while the soft margins and allowance for them to realign relieves the authorities of the need to engage in a futile battle with the markets. The common weights in the national currency baskets will limit intra-regional currency fluctuations. And the knowledge that governments have negotiated an international agreement obliging each of them to behave in this way should enhance the credibility of their commitment to do so and therefore the extent of stabilizing speculation.

The problems with Williamson’s blueprint are indicative of the limitations of all of the associated proposals. The author suggests that the weights on the dollar, the yen and the euro

should be proportional to Asia's trade with the U.S., Japan and Europe.³² This privileges the destination of merchandise exports relative to the currency denomination of those exports, which is not obviously warranted on economic grounds.³³ It privileges trade relative to financial flows, which is not obviously warranted given that the Asian economies are buffeted as much by financial as trade flows.³⁴

Second, there is the chronic reluctance of governments and central banks to adjust the exchange rate when its equilibrium level has changed. To induce stabilizing market behavior, they must reassure the markets that they attach priority to the preservation of the peg. This in turn means that their credibility is tarnished when they renege on that promise and change the rate, which deters them from adjusting the latter before significant market pressures build up.

³²Actually, he refers to Asian countries' effective exchange rate, but this is how I interpret his meaning.

³³A point emphasized by McKinnon (2001). Even ignoring the preceding point, there is the fact that the appropriate trade weights differ across countries because of differences in the destination of their exports. This means that either governments will have to compromise on the appropriate country-specific weights, or they will have to sacrifice the objective of eliminating intra-regional currency fluctuations. McKinnon (2001) suggests that this problem can be solved if East Asian countries -- including Japan -- peg to the dollar instead of a basket. But for many of us, the idea that the yen-dollar rate could be repegged and that Japan would turn over effectively monetary-policy-making authority to the Fed is pie in the sky. The alternative of having other Asian countries peg to the yen solves neither of the problems raised in this paragraph, unless one assumes, following Kwan (2001), that other Asian countries will rapidly reorient their trade and finance so that the vast majority is conducted with Japan. More precisely, Kwan proposes that Asian countries first peg their currencies to basket. The weight assigned to the yen would then be increased gradually as Japan took steps to deregulate and upgrade the Tokyo market as an international financial center to make it attractive to nonresidents and as it opened its markets to Asian products, thereby depend he interdependence between Japan and these countries.

³⁴While there is widespread agreement in principle that optimal currency pegs should reflect the sources of finance as well as the direction of trade, there is no agreement in practice on the model or the weights.

Moreover, if the authorities reassure the markets that they are prepared to effectively minimize the extent of exchange risk, they will encourage capital to flow in beyond the point where its social return equals its social cost and set the stage for serious financial difficulties when the peg collapses (Dooley 1997, McKinnon and Pill 1999, Wilson 2000). The authors of collective band proposals tend to assume that these problems can be solved if governments somehow recognize the merits of early exchange rate adjustments (which would solve the “exit problem”) and if they commit to restoring depreciated rates to their previous level following each episode of financial pressures (which would limit the financial distress due to unexpected depreciations), but this simply assumes convenient answers to difficult political questions.

Third (and related to the preceding), there is a tradeoff between the credibility and flexibility of the band. If the authorities regularly shift the band before the rate reaches the margins in order to prevent the build-up of speculative pressure, then the monitoring-band regime will in practice differ little from floating. In particular, if the authorities regularly adjust the margins before they are reached, there will be no reason for bias in the band. If, on the other hand, they attempt to keep the rate from violating the edges of the band when the latter are approached, they will have to butt heads with currency speculators. This will provide a harsh reminder that their foreign reserves are limited, as is their capacity to put the economy through the wringer of high interest rates. All this limits the likelihood that they will emerge victorious from this contest with the markets.

A network of credit lines and swaps that pools the reserves of the participating countries is an obvious response to this problem. The European Monetary System (EMS) provides a precedent, and the recently-negotiated Chiang Mai Initiative provides the requisite mechanism.

Currency speculators attempting to force an unwarranted devaluation would then have to contend with the reserves of not just the targeted country but of its partners in the regional currency stabilization agreement as well.³⁵

The problems with this solution are well known: above all, there is the question of whether strong-currency countries would really be willing to commit a significant fraction of their reserves to supporting weak partner currencies. In Europe, the commitment to collective currency pegs was exceptionally strong and credible because intra-European trade is so extensive. Intra-Asian trade remains less important by comparison, as Williamson (1999) acknowledges. Moreover, even in Europe the strong currency country, Germany, obtained an opt out from the provision of the EMS Articles of Agreement obliging it to intervene without limit in support of its EMS partners, reflecting fears of the costs of unlimited interventions and what unlimited support might imply for its creditworthiness. It is noteworthy in this context that participants in the Asian Swap Arrangement, the precursor of the Chiang Mai Initiative, can also opt out of that arrangement.³⁶ Asia's situation is if anything even more difficult than Europe's. Throughout its existence, the EMS was supported either by capital controls (before 1992) or by a fixed timetable for completing the transition to monetary union (after 1992). Capital controls

³⁵Note, however, that while the collective reserves of the countries participating in the Chiang Mai Initiative are very large, they have committed only a share of these under the swap lines of the initiative. And the lines available to the individual participating countries are only a fraction of the collective swap lines, and in some cases these amount to less than a couple of billion dollars, a drop in the bucket relative to the liquidity of international financial markets. See also Section 3 and the appendix below.

³⁶Opting out under "exceptional financial circumstances" was permitted from the inception of the ASA, and in 1992 the right to opt out became effectively unlimited (Henning 2001).

limited speculative pressures and thus the need for intervention, while the commitment to complete the transition to monetary union by 1999, thereby anchoring exchange-rate expectations, induced stabilizing speculation more powerful than that which can be provided by a simple commitment to pegged rates.

Above all, the EMS was buttressed by the set of interlocking political, economic and financial commitments that comprise what we now call the European Union. Europe had already established a customs union when the EMS was established. And the European project was undergirded by a commitment to political integration, driven by the continent's two largest economies, France and Germany. Against this background, there was good reason to believe that member states would be prepared to support the currencies of their EMS partners.

It is clear that the same preconditions are not present in Asia. ASEAN is still struggling to establish a free trade area, much less a customs union. Its capital markets are open, like it or not. Countries remain jealous of their sovereignty; there is no appetite for political integration. There is no Beijing-Tokyo axis analogous to the axis between Paris and Bonn to push the process forward. As a result Asia lacks the nexus of contracts that makes for credible currency commitments. If Japan moves away, Xie and Yam (1999) suggest, from basing its security arrangements on the U.S. and creates an Asian security system, this problem will be solved, but it is clear that this is at best a long-term project. All this suggests that a system of collective currency pegs would be fragile. Those with a preference for more graphic metaphors (and clichés) might call it an “engine of crisis” (or a “recipe for disaster”).

But doesn't Asia's history suggest otherwise? In particular, hasn't Singapore succeeded in operating a currency band that successfully limits the fluctuation of its currency despite a

commitment to open capital markets (Rajan and Siregar 2000)?³⁷ It has operated an undisclosed (“quiet”) band system since 1975. It has limited the fluctuation of the Sing dollar against a basket of currencies to within a narrow band.³⁸ One potential explanation for this success is that Singapore has come closest to adopting Williamson’s recommendations for how to run an intermediate regime. It operates a “basket, band and crawl” (BBC) regime, creating a presumption that the authorities will normally intervene to keep the exchange rate straying far from the band, but keeping open the option of letting the rate take the strain by going outside the band if they decide that market pressures are overwhelming. The band is wide, which allows the rate to fluctuate in response to cyclical conditions. Singapore has avoided the mistake of targeting a single currency -- in 2000-1, for example, it did not have to follow the dollar up against the euro and the yen. It has adjusted its band periodically in response to changing domestic and international conditions. The implication is that other countries can match this success if they adopt the same formula.

Others would put the emphasis elsewhere, not on the design of the currency band but on other characteristics of the economy. Singapore has been able to credibly commit to adjusting its monetary policy instruments to limit exchange rate fluctuations because it has had an impeccably strong banking and financial system. It has not had a large stock of nonperforming short-term

³⁷Other counterexamples to the hypothesis could be cited such as China and Malaysia. But both countries have been aided in their efforts to peg their currencies by limits on capital inflows and outflows, something that is unlikely to be regarded as feasible and desirable elsewhere in the region.

³⁸On this history, see Monetary Authority of Singapore (2000). Patterson, Chong and Eschweiler (2000) estimate that the width of the band is plus-or-minus 2 per cent. The U.S. dollar, they estimate, has a weight in the basket of 52 per cent, although the weight attached to other Asian currencies has been rising with time.

debts in the corporate sector. It has run fiscal and current account surpluses every year since 1989. It holds large reserves, equivalent to 6 to 9 months of its imports. Its combination of strong growth and flexible labor markets (achieved through a system of variable bonuses) means that monetary policy adjustments designed to stabilize the exchange rate have not put undue strain on the economy. Its political stability means that the commitment to hit those exchange rate targets has political support and therefore credibility. And the government's reluctance to internationalize the Sing dollar has made it harder for currency speculators to get in and out of the market, insulating the currency from attack.

How many other countries can satisfy these prerequisites for the credibility and viability of a monitoring band? Few countries have equally strong banking and financial systems. Few have equally able bank supervisors. Few have equally flexible economies. Few have comparable records of political stability. All this suggests that the answer to the preceding question is “not many.”³⁹

Then what alternatives remain? Currency-board pegs to the dollar, the yen, or a dollar-yen-euro basket would minimize the fragility of the exchange rate (without necessarily eliminating it -- see above) but expose the region to G-3 currency fluctuations, unless countries based their currency boards on common a basket of major currencies (which is problematic, since different countries have very different commercial and financial links with Japan, Europe and the United States). It would expose them intra-regional currency fluctuations unless all of the

³⁹This points to the question of whether Singapore itself can realistically expect to satisfy the demanding prerequisites for operating this regime in the future. The country may face an even more volatile economic environment in the future than the past. Its politics may grow more contested. Authors like Patterson, Chong and Eschweiler (2000) have already suggested that these trends may force it to move to a more flexible rate.

countries of the region moved to currency boards, a solution that is unattractive to the larger economies. Monetary union, which would eliminate intra-Asian exchange rate instability by eliminating intra-Asian exchange rates, remains in the realm of social science fiction for the foreseeable future.⁴⁰ While capital controls would greatly simplify the defense of a regional system of currency pegs, there is little appetite in the region for the reimposition of controls, China and Malaysia to the contrary notwithstanding. Rather, governments see the liberalization of financial markets and the internationalization of banking systems as the best way of solving their financial problems.⁴¹ These are all reasons for thinking that controls may become more difficult to operate in the future.⁴²

Having ruled out all other options *ad seriatum*, the unavoidable conclusion is that most Asian countries will move toward freer floating. But floating is not a monetary policy operating strategy -- as one economist has put it, it is the absence of a monetary policy operating strategy. What then should be put in its place? While there are many possible alternatives to an exchange-

⁴⁰Importantly, the Chinese appear reluctant to move to deep integration. As the Chinese Minister of Finance, Xiang Huaicheng, recently put it, “given diversified background in history, culture and level of economic development, the East Asian countries must pursue regional cooperation in a gradual and orderly manner, taking into account their unique characteristics.”

⁴¹Thus, Malaysia’s controls were criticized as providing the authorities with leeway to ease regulations on lending to “non-productive” sectors, to weaken the definition of nonperforming loans, and reducing capital requirements, which hardly encouraged them to put their financial problems behind them. Moreover, the controls prevented capital inflows that were needed to recapitalize the banking system. See Spencer (1999).

⁴²Not just financial liberalization but also changes in financial technology (computerized trading, the proliferation of derivative financial instruments) will make capital controls more difficult to operate in the future. To be effective, such controls will have to be encompassing and draconian. And this is not something that residents, jealous of their financial freedom and increasingly able to make that preference known through the medium of democratic politics, are likely to tolerate.

rate based monetary policy strategy, the currently fashionable one is inflation targeting. Inflation targeting is a monetary policy operating strategy with four elements: an institutionalized commitment to price stability as the primary goal of monetary policy; mechanisms rendering the central bank accountable for attaining its monetary policy goals; the public announcement of targets for inflation; and a policy of communicating to the public and the markets the rationale for the decisions taken by the central bank. Institutionalizing the commitment to price stability lends credibility to that objective and gives the central bank the independence needed to pursue it. Mechanisms for accountability make this pursuit politically acceptable and impose costs on central banks that are incompetent or opportunistic. Announcing a target for inflation and articulating the basis for the central bank's decisions allows these mechanisms to operate.⁴³

What is the role of the exchange rate in inflation targeting? Exchange rate movements convey information about future inflation and unemployment. Thus, a central bank concerned to minimize deviations in inflation and unemployment from their targets will respond by adjusting policy when the exchange rate moves. But it will not follow a rigid rule for altering policy when the exchange rate moves to the edge of a preannounced band. How it will respond to exchange rate movements will depend on why the exchange rate moved and on what that movement implies for future output and inflation. Without going into details, an inflation-targeting central

⁴³I should emphasize that the regime that I am describing is *flexible* inflation targeting as opposed to *strict* inflation targeting. Strict inflation targeting is when only inflation enters the central bank's objective function, flexible inflation targeting when there is also a positive weight on other variables, output for example. Under flexible inflation targeting the central bank does not attempt to return the actual inflation rate to its target immediately under all circumstances, for doing so would create undue volatility in interest rates and output. Rather, it eliminates discrepancies between actual and target inflation gradually over time, since it is adverse to sharp fluctuations in output.

bank will respond differently to exchange rate fluctuations depending on the source and nature of the shock that causes the exchange rate to move.⁴⁴ Thus, inflation targeting does not mean benign neglect of the exchange rate, although it means no longer organizing the country's entire monetary policy operating strategy around a target level or range for the rate.

Finally, what is the role of international cooperation in the operation of this regime? Agreeing on a common inflation target would be a small step in the direction of a common monetary standard (although it is no guarantee of exchange rate stability).⁴⁵ The availability of foreign credits and swaps could enhance the credibility of open-economy inflation targeting. When inflation rises temporarily but output falls, the central bank may be reluctant to raise interest rates to defend its inflation target at the cost of aggravating the recession: the availability of foreign credits may resolve this dilemma by financing foreign exchange market intervention that strengthens the exchange rate, facilitating pursuit of the inflation target, without requiring higher interest rates that are counterproductive from the point of view of the full employment

⁴⁴This raises the question of whether inflation targeting is really any different from a Williamsonian basket, band, and crawl (BBC) system. A central bank operating a basket, band and crawl regime will respond in some cases when the currency approaches the edge of its band to prevent it from straying further, but not in other cases. In particular, when the authorities see pressures on the rate as temporary but overwhelming, they can let it move further, in the expectation that it will eventually come back on its own. Permanent shocks to the competitive position of the economy justify changes in the level of the band or the rate of crawl, where temporary shocks do not. Thus, a central bank operating a Williamson-style band will also respond differently to different shocks to the foreign exchange market, depending on their source and on the circumstances. Clearly, then, there are some similarities between IT and BBC.

⁴⁵This is because exchange rates, being asset prices, are more volatile than commodity prices, because different economies will experience different shocks, leading the authorities to accept different amounts of inflation and hence different exchange rate movements, and because different central banks will attach different weights to the various arguments in their objective functions.

target. In reality, of course, the effectiveness of sterilized foreign exchange market intervention is limited in most emerging markets, where the bond markets in which intervention takes place are underdeveloped.

This last observation points to the main respect in which international cooperation can facilitate the operation of this monetary regime. Asian countries can cooperate in the development of the relevant financial markets. Not only will this facilitate sterilized intervention, but it will limit the disruptions caused by the active use of interest rates and the greater flexibility of exchange rates implied by inflation targeting. If countries develop long-term bond markets, the maturity mismatches and short-term exposures that cause financial distress when the interest rate changes will no longer be such a problem. If they strengthen the management and supervision of domestic banks, the currency mismatches that cause exchange rate changes to provoke widespread bank failures will be less disruptive. Financial stability and development are needed, in other words, for the successful operation of any monetary regime. It is to the implications of this observation that I now turn.

3. Financial Options

More than exchange-rate stabilization per se, Asian prospects would be enhanced by steps to promote financial stability and financial development.

The Problem. The 1997-8 crisis underscored the need for progress on both fronts. It was arguably problems in the finance-company sector that rendered the Thai crisis so disruptive and the run on Indonesia's banks that transformed the depreciation of the rupiah into a full-blown financial panic. Had banks been better supervised and financial markets better regulated, the

fallout from these currency adjustments would have been less. The literature on the effects of currency crises suggests that the output losses are smaller when depreciation is not accompanied by major financial-sector problems.⁴⁶ Output losses are two to three times as large when currency crises are allowed to become twin crises (Kaminsky and Reinhart 1999). In the presence of stronger banks and better regulated financial markets, it follows, the effects of currency adjustments that eliminate misalignments are more likely to be positive.

Similarly, the underdevelopment of securities markets (in particular, the bond markets that are the closest substitutes for bank-generated credit) can be blamed for the exaggerated importance of bank finance that turned out to be the gap in the region's financial armor (Goldstein 1998). Securities markets are less conducive than banks to connected lending (securities exchanges being more anonymous) and to the use of finance as an instrument of industrial policy (securities markets being more decentralized and therefore difficult to guide). It follows that the development of decentralized, competitive, anonymous financial markets -- especially the bond markets that are the most direct substitutes for bank finance -- will strengthen market discipline and discourage governments from using finance to further nonfinancial ends, a practice that is incompatible with financial opening and liberalization.

In addition, banks tend to be too big and well connected to be allowed to fail, a source of moral hazard of which investors are acutely aware. In the first half of the 1990s this awareness encouraged them to engage in indiscriminate bank-to-bank lending which financed the accumulation in banking systems of dubious real-estate loans (as in the case of Thailand) and

⁴⁶See for example Gupta, Mishra and Sahay (2000) and Bordo, Eichengreen, Klingebiel and Martinez-Peria (2001).

industrial commitments (as in the case of South Korea). Much of this foreign finance was short term, reflecting the absence of liquid markets in long-term debt instruments and the artificial incentives of the Basle Capital Accord for short-term bank-to-bank lending.⁴⁷ And when a shock to confidence caused this capital flow to reverse direction, the stability of entire national banking systems was placed at risk.

Had this money instead been mediated by the bond market, the result would have been different. In response to the shock to confidence, the prices of these assets and liabilities and not merely their quantities could have adjusted. Modest adjustments on several margins are easier to accommodate than major adjustment on one. While the fall in bond and equity prices would not have been painless, it would not have produced as profound a threat to the stability of banking systems and financial markets generally as did the liquidation of bank-to-bank loans.

To contain these threats to stability, prosperity and growth, Asian countries must secure financial stability and promote the development of securities markets. A large literature points to the most important measures needed to achieve these ends.⁴⁸ Buttressing financial stability involves applying market discipline to financial institutions and strengthening prudential supervision. Intensifying market discipline in turn means removing implicit guarantees and opening banking to foreign competition, while upgrading prudential supervision means establishing independent supervisory and regulatory agencies, giving them dedicated budgets, ensuring that their employees are adequately trained and compensated, and empowering to

⁴⁷The latter reflected the assumption of the framers of the accord, which proved erroneous, that short-term loans were less risky because they were more liquid, justifying the application of lower capital charges.

⁴⁸For a recent synthesis, see Caprio and Honohan (2001).

intervene when problems are detected, including if necessary the power to reorganize or liquidate distressed intermediaries. There is little controversy about the ingredients of this recipe, although the best way of blending them remains a matter of some controversy.

Similarly, how to effectively promote the development of deep and liquid financial markets is understood in principle if not in practice. Doing so presupposes the creation of a framework that facilitates transparency and strengthens creditor rights. Mandating the prompt and effective dissemination of financial information by those issuing debt securities, something that can be facilitated by adopting securities-market regulations requiring disclosure, will attenuate information asymmetries. In turn this will limit the adverse selection and moral hazard that might otherwise stunt the growth of markets in these assets. But information in the absence of contract enforcement is not enough. In addition, effective creditor rights (in the form of restrictions on going into reorganization, laws mandating that secured creditors be paid first in the event of reorganization, and rules for whether management can stay in place following a reorganization) are needed to contain principal-agent problems that might otherwise discourage the development of deep and liquid bond and equity markets (LaPorta et al. 1998). Again, while there is controversy about how to best implement these measures, there is little disagreement about their desirability.

In the present context, two questions follow. First, does international cooperation have a role to play in advancing these policies? And, second, is there a role for cooperation at the regional level, in Asia in particular?

The arguments for international cooperation are familiar but no less compelling for that fact. To the extent that financial crises spill across borders, financial stability has the character of

an international public good (Wyplosz 1999). Governments will therefore under-invest in its provision in the absence of international cooperation. Regulators will be reluctant to hold their banks to expensive capital and liquidity requirements in the absence of international cooperation, since those banks would then lose market share to more laxly regulated foreign competitors able to provide the same services for less. They will be reluctant to require strict disclosure of financial information as a prerequisite for listing an issuer's securities on the local exchange, since the latter will then stand to lose business to exchanges with less stringent requirements. The Basel Capital Accord can be seen as an international response to the first of these problems, while the international standards of the International Organization of Securities Commissions (IOSCO), promulgated in cooperation with the IMF and the Financial Stability Forum, can be seen as an international response to the second.

Since the spread of financial instability and competition for market share do not respect regional borders, it is not obvious that such cooperation should be organized at the regional as opposed to the global level. If the externality is global, in other words, the response should be global as well. Additional rationales are thus needed to justify cooperation at the regional level. Two suggest themselves. First, the transactions costs that must be surmounted in order to arrange a cooperative response may be lower at the regional level because the number of participating governments is smaller and the countries involved are more cohesive (reflecting similar historical experiences, long-standing diplomatic relationships, or pre-existing non-financial agreements). Thus, Fratianni and Pattison (2000) attribute the success of the BIS to the fact that, historically, it has been made up of a small number of members at similar stages of economic and financial development.

Second, regional governments may share common problems, facilitating agreement. Asian countries all share, to one extent or another, problems of security market underdevelopment, inadequate financial transparency, and bank-dominated financial markets, which in turn reflect the close historical connections between government and finance and the historical tendency for governments to use financial markets as an instrument of industrial policy.⁴⁹ To the extent that Asian governments are aware of these common problems and have especially strong incentives to devise an effective policy response, a regional arrangement is the obvious basis for organizing training programs and technical assistance and for promulgating internationally-agreed standards for supervision and regulation.

The Solution. One way of doing so would be to establish an “Asian Financial Institute,” or AFI. The AFI would have an explicit mandate to coordinate initiatives for promoting financial stability and development in the region. It would provide technical assistance to national agencies seeking to strengthen prudential supervision and regulation. It would run training programs for bank inspectors, securities and exchange commissioners, and accountants, enlisting students from all of its members, exploiting economies of scale and scope and encouraging the efficient pooling of knowledge and expertise. It would provide central banking services, such as reserve management, clearing and settlement, to member central banks, not unlike the central banking services that the Bank for International Settlements provides to its members. Many financial market participants in Asia clear, net and settle their transactions using U.S. and European payments systems; liquidity and technical support for a pan-Asian payments and

⁴⁹Given the profound differences between the structure of the economies of China and South Korea, or Singapore and Vietnam, it is clear that this argument should not be pushed to far.

settlements system would obviate the need for traders and investors to go through these third markets. The AFI could be a venue for the negotiation of common agreements on capital and liquidity requirements and regulatory processes intended to promote the stability of banking systems, and of standards for information disclosure, securities listing and corporate governance designed to promote the development of regional financial markets. To be sure, such standards and codes are already being promulgated at the global level, by inter alia the Basel Committee of Banking Supervisors (in the case of capital adequacy for international banks), the Financial Stability Forum (in the case of prudential supervision and regulation), the IMF (in the case of data dissemination, transparency, and codes of conduct for monetary and fiscal policies), and the OECD (in the case of corporate governance). But having the AFI organize negotiations on the design of a distinct set of regional financial standards appropriate to Asia's circumstances would address concerns that global standard-setting initiatives are not sensitive to the special features of the Asian model.

What might this distinct set of Asian financial standards, sensitive to the economic structure, history and traditions of the region, look like? How might a set of Asian financial standards differ from the analogous global standards? These are large questions, too large to be definitively answered here. Let me, however, offer an example. First, Asian standards might have fewer and looser restrictions on portfolio concentrations. In many Asian countries, industrial development involves a prominent role for large conglomerates and industrial groups, which draw their external financing from a small number of closely allied banks. This development model implies that portfolio concentrations that are relatively large by international standards may be a necessary corollary of economic development. But allowing claims on

individual borrowers to comprise a larger share of individual bank portfolios in turn implies greater financial risk and the need for capital requirements higher than those required by the Basle Committee.

I have chosen this example to illustrate that a distinctive Asian approach to prudential supervision and regulation need not be laxer than that mandated by global financial standards. Looser restrictions in one area, portfolio concentrations, could be offset by tighter restrictions in other, capital requirements. With the appropriate combination of measures, there is no reason why the Asian approach would necessarily be incompatible with the relevant global standards. Clearly, a regional approach to coordinating prudential supervision and regulation will serve no purpose if it simply amounts to setting looser standards than those promulgated globally; the argument for a distinctive Asian approach is not that Asia can afford worse financial regulation than the rest of the world, but that it may wish to attain the same standards of safety, stability and efficiency in different ways. Thus, a regional approach to financial standard setting must be consistent with its global analog, while still possibly differing in its particulars in ways that speak to Asia's special needs.

How would the AFI advance this Asian approach? First, it would take input from the national regulators and other authorities of the participating countries. It would of course be those same national authorities who would be responsible in the first instance for implementing and monitoring compliance with those standards. In addition, however, the AFI would monitor the compliance of its members and use public announcements and perhaps, ultimately, financial penalties to discipline violators (not unlike the non-interest-bearing deposits and fines that can be levied on European Union member states that violate the Growth and Stability Pact).

In addition, the AFI could provide central banking services. It could serve as a mechanism for coordinating monetary, fiscal, financial and regulatory policies to promote the development of financial markets in the region, while discouraging governments from pursuing “beggar-thy-neighbor” strategies that promised to grow their financial markets at the expense of the markets of their neighbors. (It would prevent any race to the bottom, in other words.) And under exceptional circumstances it might provide emergency assistance, in the form of credits and swaps, to countries with financial difficulties that threaten to undermine financial stability and development in the affected country and its neighbors.⁵⁰

This is not the first time that such an entity has been proposed. In 1995 Bernie Fraser, the then Governor of the Reserve Bank of Australia, suggested establishing an Asian version of the Bank for International Settlements to carry out some of these functions.⁵¹ The institution envisaged by Fraser would have been responsible for exchanging information regarding international financial and monetary policies and developing contingency plans for dealing with financial crises. It was also expected to offer a venue for sharing information and experience regarding supervision and surveillance of financial systems and to provide central banking services to member central banks. Still, Fraser’s vision was more modest than that described here. In particular, the promulgation and enforcement of standards, regulations and policies for promoting financial stability and development, which would be among the key functions of the

⁵⁰Although one could also imagine establishing an AFI that did not possess a lending capacity.

⁵¹His initiative can be understood as a response to the instability that followed the Mexico crisis of December 1994. It lost steam when the BIS responded preemptively by expanding into Asia.

AFI, were not among the responsibilities of the Asian BIS enumerated by Fraser.

More recently, C. Fred Bergsten (2000a,b) proposed the creation of an APEC Financial Institute. Bergsten advocated the creation of an institution to “provide training to bankers, auditors and accountants, lawyers and credit raters, and supervisors and regulators throughout the region.”⁵² But while Bergsten’s motivation is similar, the responsibilities of the institution he envisages would again be more limited than those of the institute proposed here. Bergsten’s institute would provide training, not lending. It would not coordinate regulatory functions. It would not promulgate and monitor compliance with standards. The contrast is not surprising: APEC’s heterogeneous membership (including the U.S., Canada, Australia, and New Zealand, among others) is not obviously compatible with standard setting, monitoring and lending functions expressly tailored to Asia’s needs.

ASEAN -- or, more precisely, ASEAN+3 -- is a logical organizational basis for the institute envisaged here.⁵³ ASEAN is an organization of Asian countries. It already is in the business of providing technical assistance: at the Fourth ASEAN Finance Ministers Meeting (in March 2000), ASEAN+3 finance ministry and central bank deputies agreed to establish a network of research and training institutions. Since 1998 the association has conducted regional surveillance exercises in the context of the ASEAN Surveillance Process, the purpose of which is to facilitate cooperation in the formulation of monetary, fiscal and financial policies through

⁵²These are realistic ambitions, Bergsten argues, because the new Asian regionalism is proceeding more rapidly on finance than on trade, which is the opposite of the European model. This sequencing is logical, it can be argued, because the Asian crisis was a financial crisis. See also Bergsten (2000b).

⁵³The appendix provides a more detailed review of ASEAN and the alternatives.

information exchange, peer review, and recommendations for action at the regional and national levels. That surveillance process is informed by all members providing the ASEAN Surveillance Coordinating Unit (SCU), based in the ASEAN Secretariat in Jakarta, with the same data provided to the IMF in conjunction with its Article IV consultations and program negotiations. While financial assistance (under the provisions of the Chiang Mai Initiative) may be provided in response to the conclusions of this regional surveillance exercise, this is contingent, as noted elsewhere in this paper, on the recipient government meeting the conditions set down by the IMF. Thus, folding the Chiang Mai Initiative and the ASEAN Surveillance Process into the AFI would help to ensure that the activities of the new institute were coordinated and compatible with those of the Bretton Woods institutions.

Creating an AFI and housing within it the subscriptions and swap lines of the Chiang Mai Initiative would have the corollary benefit of removing ambiguity about the purposes of the CMI. The purposes of the Chiang Mai Initiative would be clearly defined as furthering the aims of the AFI, namely fostering financial stability and development, not stabilizing exchange rates. Whether fixed or flexible exchange rates were more conducive to financial stability and development would then be recognized as a separate question.

To be sure, ASEAN has weaknesses that militate against using it as a platform for an Asian Financial Institute. Japan, China and South Korea are not members, a problem that has hampered its efforts to move toward regional free trade. ASEAN is heterogeneous; is it realistic to expect such a diverse group of countries, ranging from Singapore to Myanmar (and, in the case of ASEAN+3, China to Japan), to agree on a set of prudential standards and financial-development policies with coherence and economic bite? Perhaps most importantly, the

effectiveness of the ASEAN Surveillance Process is weakened by the presumption of nonintervention in national affairs that is ASEAN's distinguishing feature. As Manzano (2001, p.96) puts, "In keeping with the 'ASEAN way,' the surveillance process will be undertaken on the basis of consensus and informality." This emphasis on "consensus and informality" is not obviously compatible with effective pressure for coordinated action. It made for a delay of more than a year in setting up the surveillance process, since participants could not agree on how much sensitive economic data should be shared with their neighbors. Few details about the peer reviews have been published, aside from their mention in official meeting statements.

These are problems that would have to be remedied if any serious initiative to promote regional financial cooperation is to succeed. The negotiation of the Chiang Mai Initiative has shown that ASEAN can function as ASEAN+3; its members can coordinate their initiatives with China, Japan and South Korea.⁵⁴ Other standard-setting bodies such as the International Accounting Standards Committee operate subcommittees to deal with the particular problems of advanced-industrial countries and emerging markets; there is no reason why an ASEAN-based AFI could not similarly differentiate the advice it gives to its different members. The most difficult problem would be the need to abandon ASEAN's consensual approach to surveillance and the presumption of nonintervention in national affairs for a more forceful approach. Asia's institutions of economic and political cooperation lack the tradition of blunt speaking and constructive criticism that is characteristic of the IMF and OECD. Adopting a more forceful, interventionist approach to surveillance would be a sea-change in intergovernmental relations in

⁵⁴If doing so is possible in the case of the Chiang Mai Initiative, in other words, it is not obviously impossible in the case of an Asian Financial Institute.

Asia. But while the significance and therefore the difficulty of such a change should not be underestimated, without it a meaningful regional arrangement to promote financial stability and development -- that is to say, one with the ability to apply effective peer pressure for compliance with its decisions -- would not be possible. There is no finessing this point.

The fact of these problems leads one to ask whether some other regional grouping might not provide a better basis for this initiative. To the contrary, most of the alternatives are less attractive. The APEC finance ministers process is not suitable, since it involves a larger and even more heterogeneous group of countries, and its concrete achievements have so far been limited to the creation of training programs and seminars on topics like financial regulation, risk management and credit analysis. The same is true of the Manila Framework Group, which does not even possess a permanent secretariat, permanent staff or dedicated funding. While EMEAP, the Executives' Meeting of East Asia-Pacific Central Banks, has among its objectives regional surveillance, the exchange of information, and the promotion financial market development, its meeting schedule is irregular, and those meetings have lacked coherence and continuity. Firm surveillance, peer pressure and constructive criticism feature no more prominently in its discussions than in those of ASEAN. The SEANZA Group of central banks has many of the same limitations from the present point of view.

An alternative to building an Asian Financial Institute on the foundation of the ASEAN Surveillance Process and the Chiang Mai Initiative is to expand the responsibilities of the ADB. The ADB is already in the business of providing advice on, inter alia, policies for promoting financial development. It already provides technical assistance to governments participating in the ASEAN Surveillance Process and publishes an *Asian Development Outlook* that resembles

the *World Economic Outlook* that is integral to the IMF surveillance process. In the same manner that the IMF and the World Bank have organized financial stability reviews, might it not be logical for Asian countries to encourage the ADB to carry out similar functions?

But the ADB has not demonstrated the capacity to efficiently carry out an expanded set of functions. In addition, the United States, all of the larger European countries, a number of Central Asian Republics, and some of the micro-states of the Pacific are members of the Bank, which would complicate using it as a platform for Asian coordination.⁵⁵ Moreover, the Bank's charter explicitly states that it shall give preference to the smaller countries of the region, a mandate which is not obviously consistent with these other functions.

Alternatively, it might be argued that the AFI should be established by an entirely new grouping of Asian countries, separate from ASEAN, APEC, SEANZA, EMEAP and the others. This group could be made up of countries committed to financial openness (leaving out any that prefer to opt for capital controls) and to market-based banking systems (leaving out those that are reluctant to privatize state banks), and at comparable levels of financial development (leaving out the poorest countries with the least developed financial systems). Asian countries initially left out could opt in once they met these preconditions. The greater homogeneity of economic structures would allow the development of more detailed standards for prudential supervision and more effective policies for financial development. But this would do less to apply effective peer pressure to those countries that were furthest from best practice to upgrade their arrangements. It would do least to address the special needs of the poorest countries and to create a zone of financial stability encompassing all of Asia.

⁵⁵The U.S. is not only a member but the largest shareholder, along with Japan.

Moreover, creating yet another regional grouping would not address the alphabet-soup problem -- the proliferation of overlapping arrangements that robs regional initiatives in Asia of their coherence. Folding the AFI into an existing institution does not solve this problem, but resisting the temptation to create yet another self-standing grouping can at least avoid making it worse. It will prevent adding another regional surveillance round, for example, to already-existing ASEAN and APEC surveillance exercises. In addition, there are reasons to think that folding the AFI into an existing regional organization such as ASEAN will enhance the effectiveness of the new institution, since the commitments made by AFI members will then become intertwined with the other commitments of ASEAN members. Countries will hesitate to violate one, the argument goes, for fear of jeopardizing the others.

Alternatively, might these duties not be better discharged by a global institution like the Bank for International Settlements, which has extensive experience relevant to cooperative agreements on the supervision of financial institutions and the regulation of financial markets? The BIS has recently taken on some new Asian members, indicating that it recognizes the existence of this market niche. But many Asian policy makers will regard this response as inadequate for the same reasons that they see the IMF as failing to fully meet regional needs. The BIS is dominated by the large Western economies. Its decisions are unlikely to be tailored to the imperatives of the Asian model. Because it is a club of high income countries, its standards and services are not well suited to the needs of Laos, Myanmar, the Philippines, or Vietnam. It is in the business of coordinating the supervision of well-developed banking systems and the regulation of well-developed financial markets, not of designing policies to facilitate the development of those markets where they do not exist.

4. Conclusions and Caveats

This paper has considered the case for more systematic and far-reaching economic policy cooperation in Asia. It has attempted to push the debate forward by drawing a sharp distinction between monetary cooperation on the one hand and financial cooperation on the other. Its argument is that the case for financial cooperation to strengthen the supervision of banking systems and the development of financial markets is stronger than the case for monetary cooperation to stabilize intra-Asian exchange rates. Exchange rate fluctuations in and of themselves are not the principal threat to financial stability. The more clear and pressing danger is the inadequate supervision of banking systems and the chronic underdevelopment of equity and, especially, bond markets. Cooperation to stabilize exchange rates would be a diversion at best and a costly mistake at worst. Cooperation in strengthening banking systems and promoting the development of bond markets, on the other hand, would go a long way toward creating a zone of economic and financial stability.

This has led me to propose the creation of an Asian Financial Institute on the platform of ASEAN+3. This institute would develop guidelines for the prudential supervision of banking systems and for policies of financial development -- guidelines and policies that would be consonant with the Asian model. Its regional surveillance would monitor the compliance of members with those standards and policy guidelines. It would pressure governments that failed to meet its standards and comply with its guidelines. It would provide technical assistance for countries that found it difficult to meet these standards on their own. And in the event of financial difficulties that threatened to derail financial development in a country and destabilize

its neighbors, it could provide emergency swaps and credits through the Chiang Mai Initiative.

Creating an Asian Financial Institute on the platform of ASEAN+3 would require answering a series of difficult questions. Some of these were already posed above. And still others that require positive answers before it makes sense to go ahead with this form of Asian monetary and financial cooperation.

First, there is the question of what would permit cooperation in developing and monitoring a distinct set of Asian financial standards from leading to overly permissive supervision and regulation. One could imagine a result in which the AFI simply gave aid and comfort to those working to defer rather than force adjustment, provisioning for nonperforming loans, bank recapitalization, and so forth.⁵⁶ It would be particularly important to address this danger were the Chiang Mai Initiative's swap lines folded into the AFI and used to assist countries experiencing temporary financial difficulties. In part, this problem can be contained by making clear that the development of a separate set of regional guidelines for prudential supervision and regulation does not relieve the participating countries from their obligations to global standards, but only helps them meet these in different ways better attuned to their particular circumstances. The "Asian financial standards" promulgated by the AFI would serve no purpose -- indeed they would be counterproductive -- if they were simply looser than the analogous global standards, in other words. But they could serve a useful role if they gave member countries guidance on how to most efficiently meet those standards in ways consistent with their economic and financial structures. In addition, the fact that the vast majority of the

⁵⁶This issue is obviously related to the question, raised above, of whether ASEAN's relatively ineffectual surveillance process can be strengthened.

credits available to participating countries under the Chiang Mai Initiative can be drawn only when a country has an agreement with the IMF provides some reassurance that this finance could not be used simply to avoid adjustment.⁵⁷

This brings us to the next question, of how and whether the AFI be fit into the global framework. The preceding discussion suggests that the mandate of the AFI should make clear that any financial standards it promulgates and financial-development strategies it promotes should not conflict with those promulgated and promoted at the global level. The AFI would have to be seen by its members as helping them meet those standards in a fashion consistent with their own special circumstances, not as helping members evade those standards. Coordination is needed not only on targets but also on assessments of compliance. Unlike the Manila Framework Group, where the presence of the IMF as technical secretariat encourages the compatibility of regional surveillance activities with those of the Fund, there is no comparable arrangement in the case of the ASEAN Surveillance Process. ASEAN possesses its own Surveillance Coordinating Unit, as noted above. But the understanding that members will provide the SCU with the same information they provide the IMF in conjunction with Article IV surveillance and program negotiations is no guarantee that the Fund and the SCU will draw the same conclusions. The two institutions might offer inconsistent, incompatible assessments of performance and recommendations for action, undermining the credibility of one another's advice. This suggests a need to build bridges between the SCU and the Fund and to involve the

⁵⁷This suggests further the desirability of not changing this arrangement, as has been suggested by some of the participating governments (see below).

latter in the AFI's surveillance exercises.⁵⁸

A final question -- raised above but worth repeating -- is whether separate regional standards and strategies for prudential supervision and financial development would have significant value added. Is there really a case for distinct Asian financial standards and development strategies, or at least for a distinctive Asian approach to implementing them? Or would such efforts at the regional level simply duplicate initiatives and strategies already being developed globally? Above I have suggested some respects in which prudential regulation and financial development strategies might be tailored to Asia's tastes and needs. But are these and other differences between the "Asian way" and ongoing global efforts in these areas substantial enough to justify a major investment in building new institutions of Asian financial cooperation? This is the question to which advocates of broader Asian financial cooperation must provide a detailed and convincing answer before the ambitious efforts at regional cooperation they envisage deserve to go ahead.

⁵⁸The same issues arise in connection with the capital-adequacy standards of the Basel Committee of Banking Supervisors, the broader standard-setting agenda spearheaded by the IMF, and the financial-development advice and activities of the World Bank. In each case there is the danger that the AFI's initiatives could be inconsistent with those of its global counterparts, undermining the credibility of all involved. It is essential therefore to build in mechanisms for the exchange of views between the AFI and these global bodies.

Appendix. Existing Institutional Arrangements

In this appendix I review existing arrangements for monetary and financial cooperation in the Asia-Pacific region.

ASEAN

The goal of ASEAN is the promotion of trade and investment flows in the region. The experience of Europe, where the establishment of a customs union led eventually to the creation of a common currency, has encouraged the idea that ASEAN might similarly become a platform for monetary and financial integration. Unfortunately, ASEAN's efforts to create a regional free trade area have been halting. Some members remain reluctant to subordinate their industrial policies to the goal of regional free trade.⁵⁹ In part this reluctance to put free trade above other goals is indicative the fact that the benefits of regional free trade are less than compelling so long as the free-trade area does not encompass the three large economies of Japan, South Korea, and China, not to mention Australia and New Zealand. Reflecting this realization, in November 2000 the leaders of the ten ASEAN nations commissioned a study of the feasibility of linking their economies with those of China, Japan and South Korea. But expanding ASEAN to encompass China, Japan and South Korea would make achieving across-the-board free trade even more difficult, since Japan and Korea remain strongly opposed to opening their protected agricultural markets.

⁵⁹Malaysia, for example, has been reluctant to cut its prohibitive tariffs on vehicle imports for fear of jeopardizing its national car project.

The Association's first foray into issues of financial development and regulation took place at a meeting of ASEAN finance ministers in Thailand in March 1997, producing an Understanding on ASEAN Cooperation in Finance. (Calling this its "first foray" is perhaps a bit strong. Two decades earlier there was the first Asian Swap Arrangement, a \$100 million facility agreed to in 1977 by the five founding ASEAN members -- Indonesia, Malaysia, Philippines, Thailand and Singapore -- and increased to \$200 million in 1978.⁶⁰) In any case, the goals of the Understanding on Cooperation in Finance were limited: they included facilitating further meetings and encouraging the sharing of expertise on issues of financial sector regulation and development.

The next step was the establishment of the ASEAN surveillance process in October 1998. The purpose of the surveillance process is to facilitate cooperation in the formulation of monetary, fiscal and financial policies through information exchange, peer review, and recommendations for action at the regional and national levels. All ASEAN members are to provide the ASEAN Surveillance Coordinating Unit, based in the ASEAN Secretariat in Jakarta, with the same data provided to the IMF in conjunction with its Article IV consultations. Technical assistance for the surveillance process is provided by the ADB (Manzano 2001).

The idea of issuing recommendations for national action is a departure for ASEAN, an association based on the principle of nonintervention in national affairs (Soesastro 1998). Thailand and Philippines have argued that ASEAN surveillance should become more proactive and interventionist (Kozmin 2001). There was an attempt at the July 1998 Ministers' Meeting to come up with ways of strengthening the application of peer pressure for policy adjustments, but it

⁶⁰For more on this, see below.

yielded no concrete result.

Finally, at the Fourth ASEAN Finance Ministers Meeting (held in Brunei on 25-6 March 2000) ASEAN+3 finance and central bank deputies agreed to establish a network of research and training institutions. The goal of this initiative was to strengthen human resource development in East Asian financial cooperation, to establish a network of contact persons to facilitate regional surveillance, and to conduct a study of the modalities and mechanisms for a regional financing arrangement to supplement the existing international facilities. The latter can be seen as setting the stage for the subsequent Chiang Mai Agreement.

Chiang Mai Initiative

The Chang Mai Initiative is a descendant of the Asian Swap Arrangement, the facility established in 1977 by the five original ASEAN members and extended to the five other ASEAN members at the Darussalam ASEAN Finance Ministers Meeting in March 2000. That arrangement was then transformed, in May of 2000, into the Chiang Mai Initiative encompassing not just the ten ASEAN countries but also Japan, China and South Korea. After being publicly announced at the ASEAN meeting in Chiang Mai, Thailand, the agreement was finalized in December 2000.

Dedicated support lines under the Chiang Mai Agreement are \$1 billion. The prior members are to contribute \$150 million each, while each of the new ASEAN members will contribute \$50 million. Countries will be eligible to borrow up to twice their maximum contribution. Swaps can be drawn for up to six months, with one six month extension possible (Henning 2001).

This Asian Swap Arrangement will be supplemented by a network of bilateral swap agreements among the 13 participating countries (some of which are in place and others of which are still in the negotiation stage). In principle, there could be 30 bilateral agreements between China, Japan and South Korea, on the one hand, and the 10 ASEAN members on the other, plus three additional agreements among the three non-ASEAN participants. In practice, the main agreements under negotiation are between Japan and the relatively high-income members of ASEAN. (Grants are viewed as a more appropriate form of assistance for the low-income countries than the temporary provision of resources through swap agreements.)

Technically, the key difference between these bilateral swap lines and the Asian Swap Agreement that preceded them is that under the provisions of the Chiang Mai Arrangement, countries can borrow reserves collateralized only by local currencies instead of having to offer U.S. treasury bonds as collateral. While these lines are bilateral, the provision of funds via them will presumably be coordinated by the participating creditor countries. Up to ten percent of the drawings available to a country can be provided for a limited period without it having entered into an IMF agreement, but subsequent disbursements will be linked to an IMF program and therefore to the government's success in meeting IMF conditions, thus meeting U.S. and IMF insistence that a regional support arrangement should not undercut the effectiveness of IMF conditionality.⁶¹

A number of limitations of this agreement have been noted. First, while the combined reserves of the participating countries are large, the liquidity that will be available to each

⁶¹The Malaysian government objected to this provision, and in response the participating governments agreed to review it three years following the establishment of the agreement.

participating country is not. The \$1 billion of dedicated funds is small relative to the liquidity of regional financial markets. The swap lines made available to each individual country are only a fraction of the widely-advertized total, and in many cases amount to just \$1-3 billion, which is a miniscule amount compared to the resources of international financial markets.

Japan's existing bilateral swap arrangements with Malaysia and South Korea, provided in response to the Miyazawa Initiative in order to promote financial restructuring and recovery from the 1997-8 crisis, do not come with conditionality attached. (Note that these facilities are separate from those that Japan would extend to these countries under the provisions of the Chiang Mai Initiative, although they raise some of the same issues.) This creates concern that the availability of weakly-conditioned support will create borrower moral hazard and encourage the adoption or retention of fragile currency pegs. In addition, this kind of collective arrangement creates credit risk for the lenders, who may suffer credit downgrades if they commit too many of their own reserves to supporting partners in need of balance-of-payments support. Linking disbursements after the first ten per cent to IMF conditionality is designed to address this fear, but it is no guarantee since it is not clear that a country's Chiang Mai partners will be paid back with the same speed as the Fund. Indicative of this concern, Standard & Poor's has warned that the expanded swaps of the Chiang Mai Agreement could in principle threaten the credit ratings of the strong currency countries (Sakakibara 2001). This danger is compounded by the fact that two of the three currencies against which the participating countries will presumably seek to stabilize (the dollar and the euro, where the yen is the third of the three) are not in the arrangement. The participating central banks, in other words, cannot print those currencies; to prevent weak regional currencies from depreciating against them, they will be forced to deplete their reserves.

This is in contrast to the European Monetary System, where the parity grid was defined exclusively in terms of participating currencies (Wyplosz 2001).

APEC

The objective of Asia-Pacific Economic Cooperation is trade and investment liberalization among the countries bordering on the Pacific. This goal can be traced back to the declaration of national leaders at the Bogor Summit in 1994 to achieve free and open trade in the region by 2010 or 2020. Unfortunately, progress in achieving this goal is hindered by the composition of APEC's membership, which is even more heterogeneous than in the case of ASEAN.

On matters of finance, the main forum for the exchange of views and information among members is the finance ministers' process, whose objective is to promote financial sector development and liberalization. But action has been limited to the use of training programs and seminars on topics such as financial regulation, risk management and credit analysis, which take place under the umbrella of the Financial Regulators' Training Initiative. That initiative has been criticized, moreover, for providing an inadequate supply of training services, for lacking clarity of purpose (there is no agreement on priorities and course agendas), for the uneven quality of the training provided, and for inadequate coordination of its various programs (Bergsten 2000b).

APEC's main achievement on the exchange-rate/financial front is the Manila Framework Agreement, to which I turn next.

Manila Framework Group

Agreement on the Manila Framework for regional cooperation in the pursuit of financial stability was reached at the APEC's Vancouver Summit in November 1997. The Manila Framework was a response to the objections registered by the U.S. government and the IMF to the idea of an Asia Fund, in that it was designed to be complementary to and embedded in the IMF system rather than to compete against it.⁶² The principal components of the framework are a mechanism for regional surveillance that would complement the IMF's Article IV surveillance, technical assistance to strengthen financial systems and financial regulation, and a facility designed to augment IMF financial resources.

The Manila Framework Group (MFG) consists of a 14-country subset of APEC members (Australia, Brunei, Canada, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore, Thailand and the United States). Participants are deputy ministers of finance and deputy central bank governors. Recent meetings have been attended by representatives of the BIS and IMF; the latter provides the technical secretariat. The role of the Fund can be thought of as honest broker; in addition, its presence helps to embed MFG surveillance into the global surveillance process.

As other observers have noted the MFG "does not appear to be strongly influential in the region" (Sakakibara 2001). It has no permanent secretariat or funding of its own. With 14 countries and IFI representatives all present, it has been unable to reach decisions quickly and functions mainly as a forum for the exchange of views.

EMEAP

⁶²On the Asia-Fund idea, see below.

EMEAP, the Executives' Meeting of East Asia-Pacific Central Banks, was organized in the early 1990s with leadership from Japan and Australia. Its members are the South East Asian and Australasian members of SEANZA: Australia, China, Hong Kong, Indonesia, Japan, South Korea, Malaysia, New Zealand, the Philippines, Singapore and Thailand. Its objectives include regional surveillance, the exchange of information and views, and the promotion financial market development. There are annual meetings of EMEAP central bank governors, semi-annual meetings of the deputy governors, and three working groups concerned with banking supervision, financial markets, and payments and settlement systems.

EMEAP's weaknesses are its irregular schedule of meetings and their lack of continuity: each meeting has a different theme, and themes have ranged over everything from social safety nets to capital flows. Like the MFG, EMEAP has no secretariat; instead, responsibility for organizational matters, along with the meetings themselves, is rotated among the participating central banks.

SEANZA

The SEANZA Group originally grew out of a 1956 meeting of central bank governors from the Asia-Pacific region. The governors agreed that the central banks of the region should pool their resources in order to provide training courses for promising central bank staff (the first of which was held in 1957). An offshoot, SEACEN (South East Asian Central Banks), was then established in the 1980s as a training and research organization. The SEANZA Forum of Banking Supervisors was established in 1984 as an additional subsidiary of the main SEANZA Group, to provide a forum for the exchange of information on issues and problems of common

interest. More recently, special-purpose regulatory agencies have joined the central banks in this forum. However, the inclusion of a number of smaller Asia-Pacific countries makes it unwieldy for regional cooperation.

Asian Monetary Fund

The idea of an Asian Monetary Fund was originally tabled by the Japanese Government at a meeting in Bangkok in September 1997. Pledges of contributions were reportedly received from Hong Kong, Taiwan and Singapore, bringing the total resources that would have been available under this arrangement to more than \$100 billion (Asian Development Bank 1999). The idea was that this pool of funds could be disbursed quickly in order to provide emergency balance-of-payments support to crisis countries. Not only would this financing be more generous and be disbursed more quickly than in the case with IMF standby arrangements, but the expectation was that it would come with less demanding conditionality, given Asian countries' tradition of non-intervention in one another's affairs (Lin and Rajan 2001).

The initiative was allowed to die in the face of U.S. government and IMF opposition and the less-than-enthusiastic reaction of the Chinese authorities. Malaysian Prime Minister Mahathir Mohamad attempted to resuscitate it at a 1999 Asian Summit in Singapore, and Philippine President Joseph Estrada renewed the proposal in his opening remarks at an informal ASEAN summit in Manila that same year, but again to no avail.

Some of the early criticisms of the Asia Fund proposal have considerable force.⁶³ An

⁶³See DeGregorio, Eichengreen, Ito and Wyplosz (1999) for further analysis along these lines.

Asia Fund that lent generously subject to few conditions would create moral hazard for the governments on the receiving end. The effectiveness of IMF conditionality, which is designed to address this moral hazard problem, would be undercut by the availability of an alternative source of official finance that was subject to fewer conditions. It can be argued that an Asia Fund that lent too generously subject to too few conditions would soon find itself out of funds and therefore out of the crisis-management business (Rose 1999), but that experience would surely be regarded as an expensive setback to efforts to encourage wider monetary and financial cooperation in the region. In response, it can be argued that IMF-style conditionality is inappropriate and irrelevant when the crisis in question has elements of a self-fulfilling creditor panic -- it is a "liquidity crisis" rather than a "solvency crisis" -- and that Asian crises, like that of 1997-8, are typically of this sort. But many observers would question the notion that the financial problems Asia has faced and will face are primarily of the "pure liquidity crisis" variety.

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Table 1. Monthly Nominal Exchange Rate Volatility

	Period	Range	Standard deviation
U.S. \$/DM	Pre-crisis	0.09	0.03
	Post-crisis	0.12	0.03
U.S. \$/Yen	Pre-crisis	0.18	0.03
	Post-crisis	0.16	0.03
Chile	Pre-crisis	0.05	0.01
	Post-crisis	0.09	0.08
Mexico	Pre-crisis	0.16	0.03
	Post-crisis	0.09	0.02
Indonesia	Pre-crisis	0.02	0.01
	Post-crisis	0.28	0.07
Korea	Pre-crisis	0.05	0.01
	Post-crisis	0.10	0.03
Malaysia	Pre-crisis	0.03	0.01
	Post-crisis	0.00	0.00
Philippine	Pre-crisis	0.02	0.00
	Post-crisis	0.14	0.03
Thailand	Pre-crisis	0.02	0.00
	Post-crisis	0.07	0.02
Australia	Pre-crisis	0.08	0.02
	Post-crisis	0.16	0.04
Hong Kong	Pre-crisis	0.00	0.00
	Post-crisis	0.00	0.00
New Zealand	Pre-crisis	0.06	0.01
	Post-crisis	0.15	0.04
Singapore	Pre-crisis	0.03	0.01
	Post-crisis	0.06	0.01
Taiwan	Pre-crisis	0.06	0.01
	Post-crisis	0.06	0.01

Notes : Pre-crisis period is 1995-7 to 1997-6.

Post-crisis period is 1999-1 through 2001-7

All exchange rates except the first two are against the U.S. dollar.

Source : See text.

Table 2. Monthly Reserve Volatility

	Period	Mean Absolute	Standard deviation
Germany	Pre-crisis	1.09	1.35
	Post-crisis	3.36	4.76
Japan	Pre-crisis	1.61	2.57
	Post-crisis	1.99	2.95
Chile	Pre-crisis	2.20	2.88
	Post-crisis	1.96	2.91
Mexico	Pre-crisis	6.58	8.76
	Post-crisis	2.38	3.39
Indonesia	Pre-crisis	2.15	2.92
	Post-crisis	6.25	19.23
Korea	Pre-crisis	3.36	4.15
	Post-crisis	2.28	2.06
Malaysia	Pre-crisis	2.08	2.81
	Post-crisis	2.75	3.34
Philippine	Pre-crisis	4.34	5.12
	Post-crisis	6.72	19.27
Thailand	Pre-crisis	1.87	2.92
	Post-crisis	1.48	2.16
Australia	Pre-crisis	5.43	8.88
	Post-crisis	6.98	10.42
Hong Kong	Pre-crisis	2.26	2.82
	Post-crisis	4.68	18.79
New Zealand	Pre-crisis	6.11	8.55
	Post-crisis	9.84	20.12
Singapore	Pre-crisis	0.97	0.76
	Post-crisis	4.82	18.67
Taiwan	Pre-crisis	1.09	1.93
	Post-crisis	1.29	1.42

Notes : Pre-crisis period is from 1995-7 to 1997-6.

Post-crisis period is from 1999-1 through 2001-4, 2001-5, or 2001-6, depending on data available.

All exchange rates are against the U.S. dollar.

Source : See text

Table 3. Monthly Interest Rate Volatility

	Period	Range	Mean Absolute Change	Standard deviation
Germany	Pre-crisis	1.56	0.02	0.03
	Post-crisis	2.62	0.04	0.06
Japan	Pre-crisis	0.84	0.06	0.10
	Post-crisis	0.23	0.43	1.35
Chile	Pre-crisis	13.36	0.17	0.20
	Post-crisis	10.70	0.27	0.44
Mexico	Pre-crisis	36.78	0.12	0.14
	Post-crisis	24.68	0.07	0.08
Indonesia	Pre-crisis	4.51	0.07	0.10
	Post-crisis	32.59	0.12	0.22
Korea	Pre-crisis	6.02	0.07	0.09
	Post-crisis	1.61	0.02	0.04
Malaysia	Pre-crisis	4.41	0.07	0.12
	Post-crisis	2.78	0.04	0.07
Philippine	Pre-crisis	4.25	0.09	0.11
	Post-crisis	7.58	0.13	0.20
Thailand	Pre-crisis	8.98	0.21	0.24
	Post-crisis	1.86	0.15	0.18
Australia	Pre-crisis	1.95	0.01	0.02
	Post-crisis	1.52	0.02	0.03
Hong Kong	Pre-crisis	1.38	0.07	0.08
	Post-crisis	3.19	0.11	0.15
New Zealand	Pre-crisis	2.28	0.03	0.04
	Post-crisis	2.54	0.02	0.03
Singapore	Pre-crisis	1.82	0.10	0.13
	Post-crisis	1.81	0.13	0.20
Taiwan	Pre-crisis	1.95	0.05	0.07
	Post-crisis	1.60	0.03	0.05

Notes: Pre-crisis period is 1995-7 through 1997-6.

Post-crisis period is 1999-1 through 2001-7, except in a few cases where the period ends earlier because of limited data availability.

Source : See text

Table 4. Volatility Ratios

	Period	Exchange rate changes	Exchange rate changes relative
Germany	Pre-crisis	0.82	1.87
	Post-crisis	0.50	0.58
Japan	Pre-crisis	0.34	1.30
	Post-crisis	0.03	1.15
Chile	Pre-crisis	0.07	0.46
	Post-crisis	0.05	0.75
Mexico	Pre-crisis	0.23	0.36
	Post-crisis	0.27	0.61
Indonesia	Pre-crisis	0.06	0.19
	Post-crisis	0.30	1.29
Korea	Pre-crisis	0.14	0.29
	Post-crisis	0.75	1.32
Malaysia	Pre-crisis	0.07	0.30
	Post-crisis	0.01	0.01
Philippine	Pre-crisis	0.04	0.08
	Post-crisis	0.13	0.60
Thailand	Pre-crisis	0.02	0.13
	Post-crisis	0.10	0.82
Australia	Pre-crisis	0.93	0.24
	Post-crisis	1.07	0.35
Hong Kong	Pre-crisis	0.01	0.02
	Post-crisis	0.00	0.00
New Zealand	Pre-crisis	0.38	0.16
	Post-crisis	1.25	0.48
Singapore	Pre-crisis	0.05	0.89
	Post-crisis	0.07	0.73
Taiwan	Pre-crisis	0.32	0.59
	Post-crisis	0.30	0.97

Notes: Pre-crisis period is 1995-7 through 1997-6.

Post-crisis period is 1999-1 through 2001-7, except in a few cases where the period ends earlier because of limited data availability.

Source: see text.