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**FINANCIAL AND MACROECONOMIC COOPERATION
IN ASEAN: ISSUES AND POLICY INITIATIVES**

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December 1999

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**FINANCIAL AND MACROECONOMIC COOPERATION
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Paper prepared for the ASEAN Roundtable 1999 "ASEAN BEYOND THE REGIONAL CRISIS: CHALLENGES AND INITIATIVES", 5-6 November 1999 (Singapore)

The author appreciates comments by the conference participants. The usual caveat applies.

The paper was completed while the author was a visiting scholar at the Institute of Southeast Asian Studies (ISEAS), Singapore

CIES DISCUSSION PAPER 99/29**FINANCIAL AND MACROECONOMIC COOPERATION
IN ASEAN: ISSUES AND POLICY INITIATIVES****Ramkishen Rajan****Abstract**

The focus of this paper is threefold. First, the term “regional contagion” is defined and discussed. This analytical discussion provides the context within which the scope - if not type - of regional cooperation in the financial and macroeconomic spheres may be explored. Second, the main policy initiatives in ASEAN in these areas are briefly highlighted. Third, and finally, a concrete policy initiative for regional cooperation in ASEAN and the larger East Asian region is proposed.

Key words: *ASEAN contagion, cooperation, currency crisis, East Asia, EMEAP, monetary funds*

JEL Classification: F30, F32, F34

1. Introduction

While the intellectual debate about the exact causes of the crisis in East Asia and the appropriateness of various remedies rages on, one thing that is clear is that the boom-bust cycle in East Asia was caused by foreign bank lending. Indeed, the bulk of the net US\$130 billion reversals in capital flows from the four crisis-hit ASEAN economies (Indonesia, Thailand, Philippines and Malaysia) and South Korea, between 1996 and 1998, was due to reversals in net short term lending by commercial banks. Reversals in portfolio equity investments roughly averaged only US\$10 billion during this period (Table 1). Such large-scale capital withdrawals, curtailment in lending and consequent sharp currency devaluations, inevitably create major collateral damage and dislocations to the domestic financial sectors. Indeed, the closure of troubled financial institutions was a key element of the IMF programs for the crisis-hit economies (Lane and Associates, 1999). Table 2 provides some evidence of the dominance of banks (and “near-banks”) relative to the bond and equity markets in ASEAN. It is this heavy regional dependence on bank intermediation that contributed to the breadth, depth and longevity of the regional crisis.

Insert Table 1 & 2

This being said, the aim of this paper is *not* to revisit the origin and consequences of the crisis¹. Rather, the focus here is threefold. First, the issue of “regional contagion” is briefly discussed. This provides the context within which the scope - if not type - of regional cooperation in the financial and macroeconomic spheres may be considered. Second, the main policy initiatives in ASEAN in these areas are

¹ See Corsetti et al. (1998), Radelet and Sachs (1998a,b) and Rajan (1999a) for detailed, data-intensive descriptions of the crisis.

highlighted. Third, and finally, a concrete policy initiative for regional cooperation in ASEAN and the larger East Asian region is proposed.

2. Rationale for Regional Cooperation in the Macroeconomic and Financial Spheres²

The currency crises of the 1990s, and particularly the one to hit ASEAN and the larger East Asian region in 1997-98, seem to be strongly suggestive of the relevance and pervasiveness of contagion or negative spillover effects that are largely regional in scope (thus, also referred to as “neighbourhood effects”).

Following Masson (1998), we may describe “contagion” as a situation where a currency crisis in one economy leads to a jump to a “bad” equilibrium in a “neighbouring” economy. In other words, the definition of contagion refers to the simultaneous occurrence of currency crises between economies, with a currency collapse in one economy leading to a speculative attack on another (regional) currency. While there is a need to be very precise in defining the term “currency crisis” in empirical analyses, we take it here to involve an actual break of an exchange rate peg and concomitant currency depreciation, or speculative pressure which may not lead to an exchange rate depreciation, but does lead to an international reserve depletion or an interest rate hike.

Thus, in the case of East Asia, while the crisis spread initially from Thailand (following the devaluation of the baht in July 2, 1997), to Indonesia, Malaysia and the Philippines by the end of August that year, the South Korean won depreciated in November. In turn, this had reverberations back to the rest of Southeast Asia. Singapore and Taiwan also experienced “modest” currency depreciations during September-October 1997, while Hong Kong’s currency board came under severe pressures, resulting in a sharp interest rate hike to maintain the currency peg.

² This section is based on Rajan (2000).

What is less clear, however, are the channels which cause currency crises to be contemporaneous over time. Masson (1998) makes an important distinction between transmission channels that are related to investor sentiment or psychology (which he refers to as “pure contagion”) and linkages between countries that are measurable/observable *ex-ante* (which he refers to as “spillovers” or “inter-relatedness”). He calls common external shocks that impact all regional economies “monsoonal” effects. Masson shows how it is conceptually possible for “pure contagion” to make an economy relatively more vulnerable to a currency crisis. The important point here is that there must exist a range or zone of weakness within which a currency is potentially vulnerable to a speculative attack in the first instance, with pure contagion increasing the zone of vulnerability. This is consistent with the escape clause based (ECB) second generation currency crises models pioneered by Obstfeld (1994), of which contagion models are a subset.

All ECB models stress that while speculative attacks are not inevitable (on the basis of underlying “fundamentals”)³, neither are they arbitrary, random or indiscriminating (i.e. unanchored by fundamentals). Rather, there must exist some weaknesses in the economic fundamentals of the economy for an attack to occur, as the credibility of the fixed exchange rate regime is less than perfect. If the economy’s fundamentals are either very “good” or very “bad”, it will respectively never or always be attacked. Within these two extremes - which imply unique equilibrium (i.e. an attack with close to 0 or 1 probabilities) - there is an intermediate range (grey area). Within this range, there may exist some weaknesses in the economy that are neither strong enough

³ There is no firm consensus yet as to what is meant by “fundamentals”. However, empirical analyses have found that the strength of the domestic financial/banking sector, the extent of lending booms, the degree of currency overvaluation, and the size and maturity structure of external debt are among the most important variables to be concerned about (see, for instance, Krueger et al., 1998 and Tornell, 1999). De Gregario and Valdes (1999) find that the likelihood of a contagious attack is inversely related to the average debt maturity structure.

to completely preclude a speculative attack on the currency, nor sufficiently weak to make an attack unavoidable. Rather, there are a multiplicity of equilibria such that an economy remains on what seems to be a sustainable path (“superior equilibrium”), until some trigger or evidently minor event coalesces market expectations to an ‘inferior’ equilibrium, that is realised. Thus, shifts in market sentiments could lead to jumps between one equilibria to the other, in the process introducing sharp volatility in financial markets.

Against this analytical background, it is revealing to note that, in almost all crises experiences, the economies initially and worst affected by the crises were also the ones with the worst fundamentals to begin with. This is best illustrated by the Table 3 in the case of the East Asian crisis, where Thailand had the worst fundamentals, followed by Indonesia, which was the most severely impacted by the crisis. Hong Kong and Singapore, which seem to have had the best fundamentals, were the least affected. Malaysia and the Philippines were somewhere “in between”.

Insert Table 3

An important agenda for empirical research is how relevant the various causes of contagion were in the case of the East Asian crisis. In any case, regardless of the exact transmission mechanisms and definitions (Rajan, 2000), there is an important message that emanates from the above discussion: *economic policy slippages in any one economy can and do reverberate rapidly to other economies in the region in the form of contagious currency crises, with consequent detrimental effects on the real economies*⁴. This in turn provides the analytical basis for encouraging some sort of “peer pressure”,

⁴ It is easy to show how an initial devaluation could actually prove to be contractionary in the short and medium terms, with the domestic financial and corporate sectors caught in a downward spiral, leading to a sharp discrete decline in the domestic currency following the initial breakdown of the exchange rate peg. This point is developed within a simple “bank-centred” Mundell-Fleming framework (Rajan and Sugema, 1999).

“club spirit” or broader form of economic cooperation that promotes the pursuit of sustainable and prudent macroeconomic policies in each economy in the region.

3. Financial and Macroeconomic Cooperation in ASEAN: Existing Policy Initiatives

Since the 1990s, ASEAN has gradually but increasingly been looked upon as a vehicle for deepening regional economic linkages, epitomised by the launch of the ASEAN Free Trade Area (AFTA) in 1993. Given this shifting focus of ASEAN to economic issues, one would have expected the alliance to play a leading role in regional cooperative initiatives to tackle the crisis. Indeed, in the areas of financial and macroeconomic cooperation, ASEAN has been actively promoting schemes such as the intensified use of ASEAN currencies in regional trade through the creation of a network of Bilateral Payments Arrangement (BPA) and the creation of regional bond markets (Setboonsarng, 1998). Without minimising the importance of these and other initiatives by ASEAN, undoubtedly, the single most important regional initiative was the endorsement by the ASEAN finance ministers of a regional monitoring system in Manila in November 1997 to complement and supplement the IMF’s global surveillance role.

The ASEAN Surveillance Process (ASP)

The ASEAN Surveillance Process (ASP) was initially under the purview of the Asian Development Bank (ADB) and recently transferred (at least partially) to the ASEAN Secretariat in Jakarta. The overall objectives of the ASP are broadly to: (a) assist ASEAN members in spotting a potential crisis and responding to it accordingly; (b) assess the vulnerability of ASEAN members to financial disruptions and crises; (c) improve the coordination of ASEAN members’ economic policies through the dissemination of sound practices that meet international standards; and (d) promote a

“peer monitoring” environment among ASEAN members through a review of potentially vulnerable sectors⁵ (ADB, 1998). Conceptually, the ASP was envisaged to deal not only with conventional macroeconomic indicators, but also to examine the regulatory and supervisory functions in the financial sector, corporate governance issues, and various measures of external indebtedness. While the IMF Article IV arrangements with member countries involved bilateral discussions, the ASP has taken a regional approach, somewhat akin to the OECD. The ASP is supervised by a Select Committee of ASEAN central banker governors and finance ministers.

An ASEAN Surveillance Quality Unit (ASQ) has been established in the ASEAN Secretariat in Jakarta, Indonesia⁶. The ASQ is responsible for the construction of indicators to monitor the regional economies (focussing on macro-specific areas), and the preparation of surveillance reports for the ASEAN Select Committee. The ADB is to provide the ASP with various regional technical assistance (RETA) projects. The ADB has recently established an in-house Regional Economic Monitoring Unit (REMU) to assist in its regional operations. The REMU coordinates and implements the ADB’s RETA projects to the ASP. This project assistance involves providing inputs to the ASP reports (the first report of the ASP was submitted to the Select Committee in October 1999) and generally strengthening the research and technical capacities of ASEAN officials on surveillance-related matters. The REMU has been fortified by assistance from Ausaid and has set up an Asian Recovery Information Centre (ARIC) (launched in

⁵ While the terms “peer review” and “peer monitoring” have come into vogue in ASEAN and the international financial community as a whole, they have usually been left undefined. Former Bundesbank president, Hans Tietmeyer (1998), probably provided the most succinct and effective definition, when he referred to:

the importance of assessing domestic vulnerabilities in the light of evolving global conditions, as well as of relaying such assessments to interested parties to forestall delays in correcting inadequate structures and destabilising trends.

⁶ See, “ADB Supports ASEAN Surveillance Process”, **ASEAN Press Release**, March 25.

November 1999). The ARIC consolidates all information (data and research) on the ASEAN and East Asian economies most directly impacted by the regional crisis⁷.

Potential Constraints on Effectiveness of the ASP

While the ASP has gotten off the ground, one has to be concerned about how effective it can and will really be for at least three reasons.

The first potential impediment to a well-functioning monitoring mechanism has to do with the lack of transparency in economic data and general public documentation of economic and financial activities in the region. To be sure, the authorities in the region have tended to be less than forthcoming about their economic and financial situations, and have used economic data as a strategic tool rather than a public good. The establishment of benchmarks for timely and accurate data is essential if foreign investors and lenders are to be able to make rational and economically viable decisions with reasonably accurate perceptions of risks and benefits.

The second constraint has to do with the *real-politik* of ASEAN. Substantial asymmetries in the sizes and levels and stages of economic development of member nations, on the one hand, and the ASEAN policy of strict non-intervention in one another's affairs (economic and particularly political), on the other, may make it extremely difficult to operate a regional surveillance mechanism effectively. This is so, as criticisms of an economy's - misguided and unsustainable economic policies - may be perceived as being incompatible with the "ASEAN spirit". Lastly, notwithstanding assistance from the ADB, there is a question of whether ASEAN has the institutional capacity to develop an effective surveillance mechanism on a regular basis, given its small and poorly financed secretariat in Jakarta and loose and highly decentralised organisational structure.

⁷ The website of the ARIC project is <http://www.aric.adb.org>.

The above obstacles are indeed very real. For instance, the ASEAN secretary general, Rudolfo Severino, reportedly stated in late 1998 that the ASEAN Secretariat's inability to manage and supervise the mechanism and the reluctance by some member economies to reveal "too much" information and data, have been the primary reasons for the initial slow progress (Nath 1998). It is doubtful that these issues have been adequately sorted out since then.

Manila Framework

In light of these constraints, the effectiveness of the regional surveillance process might be enhanced if this were extended to include APEC economies. This would provide greater opportunities (and resources) for developing Asia Pacific economies to benefit from the expertise of the more advanced members of APEC. From the perspective of contagion, as noted previously, during the East Asian crisis, the eventual currency crisis in South Korea was in part caused by contagion from ASEAN, the Korean crisis in turn reverberating back to Southeast Asia. Similarly, withdrawals of bank loans by Japan and South Korean banks played an important role in intensifying the crisis in ASEAN (Kaminsky and Reinhart, 1999).

Presumably, in recognition of this, ASEAN finance ministers and central bankers have significantly intensified intraregional consultations as well as those with other key economies in the larger East Asian region (such as China, Japan and Korea) since 1997. In fact, ASEAN has been among the drivers of APEC's "Manila Framework for Enhanced Asian Regional Cooperation to Promote Financial Stability", which was agreed to at the fifth APEC summit in Vancouver in November 1997. The Framework included the following initiatives⁸: (a) a cooperative financing arrangement that would supplement IMF resources; (b) enhanced economic and technical cooperation,

⁸ See the **APEC Economic Leaders' Declaration**, "Strengthening the Foundations for Growth", November 18, 1998.

particularly in strengthening domestic financial systems and regulatory capacities; and (c) a mechanism for regional surveillance to complement the IMF's global surveillance.

Little public information is available for an objective evaluation of the progress and accomplishments to date of the Manila Framework, including whether there actually exists an APEC-wide surveillance process, and, if so, its relation to the ASP. Apparently, the recent push towards maximum transparency by the IMF and World Bank and the availability of timely information on their activities for public consumption has not rubbed off onto the regional bodies in Asia⁹. At the very least, the discussion of surveillance results at the ASEAN/APEC levels ought to be made readily available along the lines of the IMF's Public Informational Notices (PINs) after the Executive Board's discussions of Policy Papers and Article IV consultations. Indeed, the IMF Executive Board has recently agreed to releasing Letters of Intent, Memoranda of Economic and Financial Policies and Policy Framework Papers that underlie Fund-supported country programs (**IMF Survey**, September 27, 1999). ASEAN, APEC and the regional organisations in East Asia should follow suit, taking the attitude that the greater the transparency and timely availability of information (not just data), the better.

All this being said, one does recognise the need to balance this push towards transparency, on the one hand, and the desire by the regional economies to preserve some degree of confidentiality, on the other¹⁰. However, as a rule, the bias in the case of ASEAN/APEC at present is clearly towards confidentiality, which is at odds with that of greater disclosure by the international community.

⁹ In search of details of both the ASP as well as substantive progress on an APEC-wide basis, I undertook a detailed search of recent articles, statements, etc on the ASP and Manila Framework on the websites of APEC (<http://www.apecsec.org.sg/>); ASEAN (<http://www.aseansec.org/>); and the ADB (<http://www.adb.org/>). The search proved almost totally unfruitful! The most informative source of regional surveillance arrangements was that available on the new ARIC website (see fn 7).

¹⁰ The latter is particularly necessary if there are to be effective and genuine discussions of concerns regarding individual countries' economic policies.

4. Towards Enhanced Regional Financial and Macroeconomic Cooperation in East Asia

Having noted the major regional initiatives that have been undertaken in the financial and macroeconomic spheres in ASEAN (and APEC), the next question that arises is what further types of cooperative arrangements ought to be undertaken in light of the regional dimension of contagion. For reasons noted above, in the areas of financial and macroeconomic cooperation, it makes more sense to think in terms of larger (East) Asia-wide cooperative initiatives, with ASEAN playing a key influencing role in the larger region¹¹.

The Executives' Meeting of East Asia-Pacific Central Banks (EMEAP)

In this regard, the East Asian and Pacific region does, in fact, already have an existing cooperative scheme in place in the form of the EMEAP or the Executives' Meeting of East Asia-Pacific Central Banks. The EMEAP is a cooperative organisation comprising central banks and monetary authorities of eleven economies: Australia, China, Hong Kong, Indonesia, Japan, South Korea, Malaysia, New Zealand, the Philippines, Singapore and Thailand. Its primary objective is to strengthen the cooperative relationship among its members. The EMEAP's activities broadly encompass three levels: (a) annual meetings of the EMEAP governors; (b) semi-annual ones involving the deputy governor; and (c) three Working Groups on "Banking Supervision", "Financial Markets", and "Payments and Settlement Systems". Specifically, while the deputy governors have been meeting since 1991, the governor's started meeting regularly only since 1996, there having been four meetings since then: the first

¹¹ This is broadly consistent with Plummer's (1998) analysis of the nexus between ASEAN and APEC. Specifically, he noted that:

APEC will continue to be "nested" in ASEAN in that the subregional organisation is playing a central role in molding the direction of APEC to be consistent with the goals of ASEAN economic cooperation. The remainder of this section focuses on a single key proposal for regional cooperation.

and third in Tokyo (July 19, 1996 and July 14, 1998), the second in Shanghai (July 25, 1997), and the fourth in Hong Kong (July 9, 1999). Each one of these meetings have had a broad theme: the first was on the “means of strengthening central bank cooperation to enhance financial stability and market development in the region”; the second was on “asset prices and (their) impact on monetary policy”; the third on the “relationship between international investment and financial stability”; and the fourth on the “International Financial Architecture”¹². It was only after the governors started their regular meetings since 1996 that the EMEAP became fairly active (and certainly took on a higher profile), with the establishment of the various Working Groups noted above.

In addition to the Working Groups, following - indeed, spurred on by - the Tequila crisis, substantive steps towards monetary cooperation have been taken by the EMEAP. For instance, a number of member economies signed a series of bilateral repurchase (repo) agreements in 1995 and 1996. Hong Kong and Singapore also reached an agreement to intervene in foreign exchange markets on behalf of the Bank of Japan (Moreno, 1997). These creditor regional economies also attempted to help defend the Thai baht for some period before the Bank of Thailand succumbed to the speculative pressures.

A useful starting point for regional macroeconomic and financial cooperation might, therefore, be to expand the scope of the EMEAP itself, rather than establishing an entirely new framework/organisation. This is so for a couple of reasons. One, the region is generally averse towards building new institutions. Two, the EMEAP have close linkages with the BIS and IMF (since the EMEAP is, after all, a body of central bankers). An appropriate and realistic charter for the EMEAP might be to focus primarily on its original goals of enhancing regional monetary and financial cooperation; exchange and

¹² Information on EMEAP is available on their website: (<http://www.emeap.org:8084/>)

pooling of information; and come to the aid of regional currencies that are susceptible to speculative pressures (Rajan, 2000).

However, in order to be a more effective deterrent against such attacks (i.e. monetary defence mechanisms), a monetary facility could be established, with “appropriate” contributions from member economies of the EMEAP, thus ensuring a large pool of available reserves. Ability to access this pool of funds and reduce moral hazard concerns (i.e. ready availability of “easy/cheap money”) ought to be conditional on/tied to member economies maintaining some pre-determined standards of macroeconomic and financial stability, and, if and when necessary, be willing to subject themselves to peer pressure to undertake necessary policy adjustments¹³. Obviously, such macro-cum-prudential oversight needs to be complemented by both peer review (as defined in fn 5) and an effective regional surveillance process-cum-early warnings system that tracks national, regional and international macroeconomic developments, and facilitates necessary policy corrections in a timely manner. Seen in this light, one could easily envisage the ASP being expanded to include the other non-ASEAN members of the EMEAP and possibly even being housed in the latter¹⁴.

¹³ There are a number of other channels and mechanisms through which regional or international support may create moral hazard concerns and the accompanying perverse incentive structures (though many do tend to be exaggerated). No attempt is made in this paper to tackle this subject systematically.

¹⁴ We have not directly tackled issues arising from Australia’s and New Zealand’s membership, i.e. is the facility purely East Asia-focussed (and, if so, which ones), or should it be expanded beyond the EMEAP members to include others in APEC or even non-APEC Asian countries such as India, for that matter (which has been included in the new G-20 forum noted in the next subsection)? The Japanese government, for instance, hosted a “Tokyo Dialogue” in December 1997 among finance ministry officials and central bankers of ASEAN, China, South Korea and India. Would this be an appropriate grouping? The chairman of the Pacific Economic Cooperation Council’s Financial Market’s Development Group (PECC-FMD), Jesus Estanislao (1999a, p.10) has noted:

(o)n a functional basis..(PECC-FMD)..(has) followed the financial markets in their judgements that in East Asia - as the financial and economic crisis has show - ten economies, have to consult more freely with each other. Indonesia, Malaysia, the Philippines, Singapore and Thailand are the original ASEAN 5. Japan, China, Hong Kong, Chinese Taipei and South Korea are APEC economies in North East Asia. These economies are the East Asian 10. They are the very core of crisis Asia.

Regional Bank for International Settlements (BIS) and Lender of Last Resort

While more contentious, a “beefed up” EMEAP could be seen as a step towards the creation of an Asian BIS. Such a body would ensure the development of region-wide banking and financial sector standards and codes (consistent with international best practices) and monitors their implementation in addition to taking on the role of a *de facto* regional lender of last resort prior to a crisis (Sasaki, 1996 and Grenville, 1998)¹⁵. With a regional body playing a major role in setting and ensuring implementation of such standards, this may engender a greater sense of “ownership” of the standards and norms may be felt by the regional member economies. This stands in sharp contrast to the current situation, where there seems to be a “top-down” approach towards such issues, with decisions being made largely by the G-7 industrialised economies with little input from the smaller, developing ones¹⁶.

The suggestion of a regional lender of last resort (RLLR) warrants some discussion. There are, of course, a number of well known difficulties with the lender of last resort (LLR) function, particularly at the international level (i.e. ILLR). These range from the usual moral hazard problem, which may lead to over borrowing and overlending, to the costs of international institution-building. In addition, there is the perennial question of whether an ILLR would have sufficient resources to create confidence that its operations will be successful¹⁷. Uncertainties over the liquidity of an

Comparing Estanislao's suggestion to membership of EMEAP, the non-East Asian economies of Australia and New Zealand are excluded (though both have been actively involved in the PECC-FMD activities), but Chinese Taipei is included.

¹⁵ The Asian BIS concept was put forward initially in 1995 by the former governor of the Reserve Bank of Australia, Bernard Fraser.

¹⁶ Admittedly, there have been some improvements in representation following the East Asian crisis, with the establishment of the G-20 and other international financial groupings that have included representatives from developing economies in the consultation process (Rajan, 2000).

¹⁷ As noted by Deputy Governor of the Bank of England, Mervyn King (1999):
(t)he current resources of the IMF – between US\$125 billion and US\$150 billion

ILLR would undoubtedly undermine its credibility and its powers of stabilisation. Unlike the ILLR, an East Asian RLLR has the capacity to raise funds when needed, and is not exposed to the same type of resource constraints. To be sure, Japan alone holds about US\$200 billion in foreign reserves (excluding gold), China, Hong Kong, Singapore, Taiwan and Korea together hold about US\$400 billion, while India, Thailand and Malaysia hold another US\$70 billion in aggregate. By comparison, the US holds US\$70 billion and the EU about US\$350 billion¹⁸. The moral hazard problem of a LLR function ought to be reduced at the regional level, where the other member economies can exercise peer pressure¹⁹.

The resources of the regional body can be further consolidated if it negotiates guaranteed lines of credit with private banks on behalf of its member economies in times of distress. This is not unlike the Argentine arrangement, in which the country has entered into an agreement in December 1996 with a group of 13 foreign banks to lend Argentina up to US\$6.1 billion against collateral at a premium over the LIBOR rate for a certain “commitment fee”. In the case of East Asia, a large part of the pre-crisis lending was by regional - mainly Japanese - banks (Table 4)²⁰. Thus, a regional body ought,

depending on how they are measured – are wholly inadequate for an ILOLR. Nor are resources on the appropriate scale likely to be forthcoming. Indeed, with the new Supplemental Reserve Facility (SRF) introduced at the end of 1997, which enables economies to far exceed the conventional quota based limits on borrowing from the IMF, the increased lending activity has created liquidity problems for the institution. For recent discussions of the IMF and the ILLR function, see Fischer (1999) and Giannini (1999).

¹⁸ Figures are as of mid 1998 from the Economist magazine and Tateishi (1998). Data for the EU excludes Finland, Greece, Ireland, Luxembourg and Portugal.

¹⁹ Following the US-assisted bailout of Mexico, some have argued that the US has been the *de facto* LOLR for Mexico.

²⁰ See Peek and Rosengren (1998) for a detailed discussion of Japanese bank lending to ASEAN during the crisis period. Also see Kaminsky and Reinhart (1999), who rightly emphasise that the sharp escalation in bank lending to East Asia just prior to the crisis was largely due to European banks.

presumably, to have greater “leverage” over the private banking community and be able to play a more effective coordinating role between them and regional members.

Insert Table 4

Common Basket Peg

A number of economists have proposed the creation of a common currency basket for East Asian economies (Kusukawa, 1999 and Williamson, 1999a,b)²¹. Invariably, such a common currency basket would require greater coordination among participating monetary authorities. Kusukawa (1999) actually goes on to recommend the establishment of a regional body to support the common basket system, possibly some kind of regional monetary facility. The argument in favour of a currency basket is far from settled. For instance, Rajan (1999c) finds that the computed weights of the yen in the optimal baskets of individual economies (using data for 1996-97) seem quite dissimilar, and suggests that individual basket pegs may be preferable for the time being. However, if all the regional economies do pursue such a currency basket regime, it may be the case that, over time, the optimal basket pegs for the regional economies may see a convergence. A common basket may then be economically justifiable and politically tenable. In such a case, the “beefed up” and expanded EMEAP (in terms of functions, membership and resources) might be the natural coordinating monetary authority to deal with such a currency basket regime.

²¹ Note, the focus is on *currency basket* not *common currency*. In light of the turbulence faced by the East Asian economies following the regional crisis, on the one hand, and the seeming successful introduction of the euro by the European Union (EU), on the other, leaders of ASEAN agreed to study the feasibility of a common ASEAN currency system (Announced as part of the latest ASEAN summit meeting in Hanoi and included in the Hanoi Plan of Action, **Business Times**, Singapore, December 15, 1998). From an economic standpoint, Eichengreen and Bayoumi (1999) have suggested that East Asia may be as close to - or rather, as far away from - being an optimum currency area (OCA) as Western Europe. However, the European experience has emphasised the need for strong political will and consensus towards such a policy goal. As they go on to note, such leadership and single-mindedness does not seem to be present in ASEAN or the larger East Asian region at the current time.

5. Concluding Observations

The first part of this paper provided the analytical basis for enhanced regional cooperation in the spheres of financial and monetary cooperation. The emphasis here was on detailing the various transmission channels leading to regional contagion or negative spillovers, with a speculative attack, and resulting devaluation-induced recession in one economy possibly infecting neighbouring economies. Broadly, a distinction was made between “pure contagion” (i.e. regional spillovers that cannot be accounted for by trade and finance linkages), on the one hand, and “interdependencies” (which can be accounted for by trade and finance linkages), on the other. It was noted that existing currency crises models of contagion - which require the existence of multiple equilibria - suggest that the regional economies must have some existing weakness in “fundamentals” to be negatively impacted by a currency crisis in a regional economy.

Available theory and evidence does suggest that *pure contagion* is not random or arbitrary. This underscores the need for the primary focus to be placed squarely on the domestic policy arena. In the ASEAN context, this broadly involves strengthening the financial systems and corporate and industrial structures. However, given the fact that regional *interdependencies* (whether real or financial) are fairly high in ASEAN, even relatively “strong” regional economies can be and have been affected by crises in the “weaker” neighbouring economies. These geographically concentrated policy externalities suggest the need for some form of regional cooperation in the financial and macroeconomic spheres.

Some might argue that *pure contagion* may be less important in the future, as investors seem to have differentiated between the regional economies following the crisis (Van Rijckeghem and Weder, 1999). This view is clearly debatable. In any case, indications are that at least regional *interdependencies* will probably rise significantly in

the future, as the stronger economies such as Singapore have sharply escalated their investments in economies such as Thailand, where asset prices remain depreciated²².

It was noted that the major initiative to date in ASEAN has been the ASEAN Surveillance Process. It has been suggested that there may be a strong case for shifting the focus from the surveillance of only ASEAN economies to the larger East Asian region. In fact, the Manila Framework, which ASEAN members played an important role in shaping, explicitly set out regional surveillance as one of the goals. However, the failure of both ASEAN and APEC to provide more timely and up-to-date information on the progress and achievements (or lack thereof) of the initiatives, has precluded a detailed evaluation of either of them. The most promising regional surveillance effort (or at least the one on which most information is currently available) seems to be the recently established Regional Economic Monitoring Unit within the ADB.

The paper then shifted focus to the issue of concrete policy proposals for future cooperation. There are no doubt a number of “soft” regional cooperative initiatives of importance that could be taken by the regional economies, in the form of human resource development and training, information gathering and dissemination, experience sharing/policy dialogue, and such. These are fairly uncontroversial and are the specific and detailed focus of Estanislao (1999a) and, therefore, were not dealt with here. Rather, the focus of this paper was on one substantive/major (and therefore, controversial?) proposal, viz. the expansion of the role of the EMEAP, so as to act as the central coordinating body for regional financial and macroeconomic cooperation. It was suggested that the EMEAP might be the appropriate body within which a regional monetary facility could be established. The primary responsibility would be to assist

²² Thus, figures from the Thai central bank show Singapore's direct investment in Thailand to have jumped to 31.7 billion baht in 1998, up from 9.9 billion baht in 1997, making Singapore the third largest investor in the country after the US and Japan (**Far Eastern Economic Review**, October 21, 1999, p.68).

member economies in times of financial market turbulence and weakness, as opposed to acting as a “substitute” to the functions of international organisations like the IMF. If anything, just the opposite is true, as such a “fortified” and expanded EMEAP-cum-regional facility could play a highly complementary role to the IMF in aiding distressed economies during the crisis management and resolution periods.

The reason for suggesting the expansion and “beefing up” of a credible existing regional body rather than proposing an entirely new standing institution in East Asia, is the recognition of the region’s concerns about developing layers of institutions. Drawing an analogy to international institutional arrangements, what has been proposed here is one organisation effectively taking on some functions of the BIS, IMF and various sector-specific international groupings or regulators, supervisors and central banks experts, as summarised by Teitmeyer (1999). If this is found infeasible (for whatever reason²³), a distinct organisation to deal with some of the above issues could be established, though the lines of functional responsibilities with the EMEAP and other regional alliances would need to be clearly worked out.

No doubt, there will be a number of sceptics to such a proposal. It is, however, insufficient to merely find fault with the proposed scheme. Rodrik (1999, p.3) has argued that:

(a)s long as capital flows remain large relative to the liquid assets held by national governments and are easily reversible, the international economy will be hostage to spectacular boom and bust cycles.

Insofar as this is true, and given the absence of substantive steps towards the reform of the monetary and financial architecture at an international level²⁴, alternative policies and

²³ For instance, there may be some who support an Asian-type BIS but may not necessarily support a regional monetary facility (though one would wonder about the rationale for the objections to the latter in light of the discussion in this paper).

²⁴ While this is an overused term, Eichengreen (1999) notes that initiatives underway under the banner of “reform of the international financial architecture” are (ought to be) organised under four

initiatives for regional financial and macroeconomic cooperation need to be put forward as “self-help” mechanisms for the small open economies in East Asia in this era of the globalisation of capital flows²⁵.

pillars: international standards, Chilean-type taxes on short term foreign borrowing; greater exchange rate flexibility; and collective action clauses in loan contracts as an alternative to IMF bailouts. As he further notes (pp.3-4) of such initiatives:

(t)he danger is that the process losing steam...(A)s time passes, the sense of urgency recedes and second thoughts inevitably develop.”

²⁵ For instance, while sharing the view of this paper that the initial emphasis must be on domestic reforms, Estanislao (1999b) has proposed the setting up of a “Regional Stability Forum” to allow for more systematic cooperation in the areas human resources development and training, information and experience sharing, and other “soft” forms of cooperation on a sustained and regular basis. He envisages that such a forum would be a first step towards a “long-term, ambitious program (of) coordination and joint actions”, including considerations of an eventual monetary union.

Table 1**Net Capital Flows to East Asia (Indonesia, Malaysia, South Korea, Thailand and Philippines) (\$ billions), 1995-99**

Type of Capital Flow	1995	1996	1997	1998 ^c	1999 ^d
Current Account Balance	-40.6	-54.8	-26.1	69.2	44.6
External Financing	83.0	99.0	28.3	-4.2	7.8
Private Flows	80.4	102.3	0.2	-27.6	0.3
Equity Investment	15.3	18.6	4.4	13.7	18.5
Direct	4.2	4.7	5.9	9.5	12.5
Portfolio	11.0	13.9	-1.5	4.3	6.0
Private Creditors	65.1	83.7	-4.2	-41.3	-18.2
Commercial Banks	53.2	62.7	-21.2	-36.1	-16.0
Nonbanks	12.0	21.0	17.1	-5.3	-2.3
Official Flows	2.6	-35.3	28.1	23.4	7.6
Resident Lending/Others ^a	-28.3	-27.3	-33.7	-22.9	-21.0
Reserves (exc. Gold) ^{a,b}	-14.1	-16.9	31.5	-42.1	-31.4

Notes: a) minus denotes increase
b) including resident net lending, monetary gold and errors and omissions
c) estimates
d) forecast

Source: IIF (1999)

Table 2**Selected Indicators of Financial Sector Development in East Asia (% of GDP), 1994-96**

	Credit of Banking System (1995)	Bank Assets (1994)	Bank Share in Financial Intermediation (1994) ^a	Stock Market Capitalisation (1996)	Bond Market Capitalisation (1996)
Indonesia	50	57	91	10	6
S. Korea	70	75	38	43	24
Malaysia	132	100	64	33	56
Philippines	63	54	n.a.	n.a.	39
Thailand	137	110	75	4	14

Notes: a) assets of banks as a percent of the assets of banks and non-bank financial institutions
Sources: Rajan (1999b)

Table 3
Summary of Economic Fundamentals of Selected East Asian Economies

Fundamentals	Country Rankings ^a						
	1	2	3	4	5	6	7
<u>External</u>							
International Reserves ^b	P	I	M	T	K	H	S
Current Account/GDP ^c	T	K	M	P	I	H	S
Debt/GDP ^d	T	P	I	M	S	H	S
Export Slowdown ^e	T	S	M	K	H	P	I
Real Exchange Rate: deviation from PPP ^f	S	K	H	M	T	I	P
<u>Banking Strength</u>							
Capital Adequacy ^g	K	T	I	M	P	H	S
Nonperforming Loans ^h	M	T	K	I	P	S	H
Bank Ratings ⁱ	I	K	T	P	H	M	S
<u>Liquidity Mismatches</u>							
Excess Credit growth ^j	P	M	T	I	S	K	H
Short-term external debt/Reserves ^k	K	I	T	P	M	H	S
Broad Money/Reserves ^l	T	I	P	K	M	S	H
Overall Average ^m	T	I	K	P	M	S	H
Overall based on Thailand Weights ⁿ	T	I	K	P	M	S	H

Notes: a) I - Indonesia, H - Hong Kong, K – South Korea, M - Malaysia, P - Philippines, S - Singapore, T - Thailand. Ordinal ranking in descending order of “bad” fundamentals; b) in SDRs, June 1997; c) 1996; d) 1997; e) change (%) in 1996 less the average change (%) previous three years; f) June 1997; g) unclear from source, but probably average of 1996 and 1997; h) 1997 estimates; i) May 1996; j) growth of credit to private sector relative to nominal GDP, 1996; k) June 1997; l) June 1997; m) equal weights to all fundamentals (including two others included in original sources); n) greater weights given to fundamentals in which Thailand is weakest

Source: Goldstein and Hawkins (1998b)

Table 4
Nationality of Banks Providing Loans (\$ billions) to Southeast Asia
as at June 1997 and Mexico as at June 1994

<u>From</u> <u>To</u>	Japan (1)	Germany (2)	France (3)	USA (4)	UK (5)	Hong Kong (6)	Total ¹ (7)	1/7 (%)	(2+3+5)/7 (%)	4/7 (%)
Indonesia	23	6	5	5	4	6	61	37.7	24.5	6.6
Thailand	38	8	5	4	3	18	99	38.3	16.1	4.0
Malaysia	10	6	2	2	2	3	33	30.3	33.3	8.5
Philippines	2	2	3	3	1	4	17	11.8	35.2	6.1
Mexico (June 1994)	4	4	20	20	16	0	71	5.6	32.4	28.2

Note: 1) Includes economies not listed in this table.

Source: Goldstein and Hawkins (1998a)

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