From the Chiang Mai Initiative to an Asian Monetary Fund

By

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Abstract: In the aftermath of the Asian financial crisis of 1997-98, East Asian finance ministers launched several new initiatives for regional financial cooperation including: (i) regional economic surveillance; (ii) a regional liquidity support arrangement; and (iii) Asian bond markets initiative. This paper evaluates the progress of such initiatives—particularly the Chiang Mai Initiative Multilateralization (CMIM)—and explores the possible evolution of the CMIM toward an Asian Monetary Fund (AMF). The paper argues that for an AMF to emerge, East Asian authorities need to strengthen regional surveillance and upgrade their capacity to formulate independent conditionality in the event of crisis lending so that the CMIM can be delinked from IMF programs. The paper also makes a case for more flexible use of CMIM when the type of external shock that affected the Republic of Korea in the fall of 2008 following the Lehman collapse hits Asia once again in the future. Given capital inflow risks, the paper suggests the authorities to prepare for exchange rate policy coordination—through intensive policy dialogue—to better manage macroeconomic and financial conditions while keeping intraregional exchange rate stability. An Asian Currency Unit should be developed to facilitate such policy dialogue for exchange rate policy coordination.

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1. Introduction: Key Issues

The Asian financial crisis of 1997-98 devastated not only the currency values and the financial systems of Indonesia, the Republic of Korea (Korea), Malaysia, and Thailand, but also their overall economic activity, social conditions and, in some countries, political systems. The financial crisis and its spread across the region revealed several important points: financial systems and economic conditions were closely inter-connected across East Asia; reliance on the International Monetary Fund (IMF) alone for crisis management is not the best option; and there is a need to create a regional self-help mechanism for effective prevention and management of financial crises.

Recognizing this, East Asian governments and central banks embarked on several new initiatives for regional financial cooperation including: (i) regional economic surveillance; (ii) a regional liquidity support arrangement; and (iii) Asian bond market development. This paper evaluates the progress of recent financial cooperation initiatives in the region—particularly the Chiang Mai Initiative (CMI) and its multilateralization—and explores the possible evolution of the CMI toward an Asian Monetary Fund (AMF). The paper also discusses the importance of regional exchange rate policy coordination due to rising risks of volatile capital flows.

2. Launch of the Chiang Mai Initiative

Several factors led to the launch of the CMI.

Asian Monetary Fund (AMF) proposal

Soon after the outbreak of the Thai financial crisis following baht devaluation in July 1997, the Japanese government hosted a meeting in August to generate an agreement among the "Friends of Thailand" on a much-needed financial support package for crisis-affected Thailand.[1] Following this success, Japan, with support from Korea and several major ASEAN countries that participated in the Thai support package, proposed in September to establish an AMF, which was designed to supplement IMF resources for crisis prevention, management, and resolution. The aim was to pool foreign exchange reserves held by the East Asian authorities, both to deter currency speculation, and to contain a currency crisis and contagion in a member economy. It was said then that as much as US$100 billion would be mobilized.

The United States (US) and the IMF opposed this proposition on the grounds of moral hazard and duplication. They argued that an East Asian country hit by a currency crisis

[1] The so-called "Friends of Thailand" were economies which extended financial assistance to Thailand in 1997 and included Australia, Brunei Darussalam, the People's Republic of China, Indonesia, Japan, the Republic of Korea, Malaysia, and Singapore.

would bypass the tough conditionality of the IMF and receive easy money from the AMF, thereby creating the potential for moral hazard; they also reasoned that an AMF would be redundant in terms of its expected businesses and operations in the presence of an effective global crisis manager, the IMF. Without the People's Republic of China's (PRC) clear support, the idea was eventually shelved.[2]

ASEAN+3 initiatives.

Leaders of the ten ASEAN member countries, PRC, Japan and Korea initiated the ASEAN+3 process in 1997, which focused on macroeconomic and financial issues initially but was later expanded to include many other ministerial processes—for foreign affairs; economy and trade; environment; energy; health; labor; science and technology; and social welfare, among others. The group's finance ministers have been particularly active on regional financial cooperation, including the launch of the Chiang Mai Initiative as the region's liquidity support arrangement, the Economic Review and Policy Dialogue (ERPD) process as the region's economic surveillance mechanism, both in May 2000, and the Asian Bond Markets Initiative (ABMI) as the region's project for local-currency bond market development in August 2003.[3]

The ASEAN+3 leaders in 2004 agreed that the establishment of an "East Asian Community" was a long-term objective and affirmed the role of ASEAN+3 as the "main vehicle" for this eventual establishment. The idea of creating such a community had been proposed by the East Asia Vision Group (2001) and the Vision Group's wide-ranging proposals were considered by the official East Asia Study Group (2002).[4] The ASEAN+3 leaders in 2002 received the Study Group's Final Report, which identified 17 concrete short-term measures and 9 medium- to long-term measures to move East Asian cooperation forward. The leaders endorsed in 2003 the implementation strategy of these short-term measures—to be implemented by 2007—and in 2004 encouraged a speedier implementation of the short-term measures as well as the implementation of the medium- and long-term measures.

Key medium- and long-term recommendations on regional financial cooperation included the establishment of a regional financing facility and the pursuit of a more closely coordinated exchange rate mechanism (see Box 1). The CMI was considered as an initial step toward the establishment of a regional self-help financing facility.

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[2] PRC did not express clear views over Japan's proposal; it did not support nor reject it. In my conversation with Eisuke Sakakibara, then vice minister of finance for international affairs of Japan's Ministry of Finance, he said that if PRC had supported Japan's proposal then he would have gone all the way to create an AMF despite the US and IMF opposition. He also acknowledged that the lines of communication between the finance ministries of Japan and PRC were not well-established then and the lack of intensive information exchange prevented PRC's clear support of the Japanese proposal from being obtained. Taking this as an important lesson, the lines of communication between the two ministries, and those among wider ASEAN+3 countries, have deepened since then.

[3] See Kuroda and Kawai (2002), Rajan and Siregar (2004), Kawai (2005) and ADB (2008).

[4] The East Asia Vision Group (EAVG) was established in 1999 under the leadership of Korean President Kim Dae Jung. The East Asia Study Group (EASG), composed of government officials, was set up in 2000 essentially to respond to the Vision Group's recommendations.

Box 1: Recommendations on East Asia's regional financial cooperation by EAVG and EASG

East Asia Vision Group (EAVG) recommendations:

- Establish a self-help regional facility for financial cooperation;
- Adopt a better exchange rate coordination mechanism consistent with both financial stability and economic development; and
- Strengthen the regional monitoring and surveillance process within East Asia to supplement IMF global surveillance and Article VI consultation measures.

East Asia Study Group (EASG) recommendations on medium-term and long-term measures that require further studies:

- Establish a regional financing facility, with the recognition that the Chiang Mai Initiative is an initial step toward the establishment of a regional self-help financing facility;
- Pursue a more closely coordinated regional exchange rate mechanism consistent with both financial stability and economic development, with the recognition that a coordinated exchange rate mechanism becomes important for regional financial stability with the growing interdependence among East Asian countries; and
- Establish an East Asian regional surveillance process as a long-term mechanism to help enhance financial stability in the region.

Source: East Asia Vision Group (2000) and East Asia Study Group (2002).

3. Recent Progress on the Chiang Mai Initiative

ASEAN+3 finance ministers have pursued regional financial cooperation in three areas. This section focuses on the ERPD and the CMI, without discussing the ABMI, which is designed to help develop and integrate regional local-currency bond markets.

Economic Review and Policy Dialogue process

The ERPD is a regional economic surveillance process, designed to contribute to the prevention of financial crises through the early detection of irregularities and vulnerabilities and the swift implementation of remedial policy actions. Its modality is information exchange, policy discussions, and peer reviews, which are the basis for enhancing regional monetary and financial cooperation. The ERPD was intended to facilitate analyzing economic and financial conditions of the global, regional, and individual national economies; monitoring of regional capital flows and financial market developments; assessing and managing vulnerabilities and risks; and undertaking joint actions on issues affecting the region. The expectation was that countries would implement better macroeconomic policy, financial sector policy and institutional reforms due to peer pressure.

Without strong supporting mechanisms for such surveillance, however, the ERPD process has not been as successful as initially expected, though gradual improvements have been made over time. One of the problems has been the lack of a competent secretariat in charge of the process, and another is the absence of central bank governors in the process, although central bank deputies have been participating in ASEAN+3 Finance Deputies' meetings.[5]

Chiang Mai Initiative

The CMI is a landmark liquidity support facility in East Asia, which is intended to reduce the risk of currency crises and manage such crises or crisis contagion. It comprises (i) a network of bilateral swap agreements (BSAs) among PRC, Japan, and Korea, and between one of these Plus-3 countries and a select ASEAN member and (ii) the ASEAN Swap Arrangement (ASA). The total amount under the bilateral swap agreements reached US$90 billion—with 16 BSAs—and the total ASA stood at US$2 billion as of April 2009 (Table 1).

Table 1. Progess on BSAs under the Chiang Mai Initiative (as of April 2009), US$ billion

To: / From:	PRC	Japan	Korea, Rep. of	Indo-nesia	Malay-sia	Philip-pines	Singa-pore	Thai-land	Total
PRC	--	3.0[a]	4.0[a]	4.0	1.5	2.0[a]		2.0	16.5
Japan	3.0[a]	--	13.0[b]	12.0	1.0[c]	6.0	3.0	6.0	44.0
Korea, Rep. of	4.0[a]	8.0[b]	--	2.0	1.5	2.0		1.0	18.5
Indonesia			2.0	--					2.0
Malaysia			1.5		--				1.5
Philippines		0.5	2.0			--			2.5
Singapore		1.0					--		1.0
Thailand		3.0	1.0					--	4.0
Total	7.0	15.5	23.5	18.0	4.0	10.0	3.0	9.0	90.0

Notes: (a) The agreements are in local currencies, and the amounts are US dollar equivalents.

(b) Japan-Korea BSA includes both US dollar swaps (US$10 billion from Japan to the Republic of Korea and $5 billion from Korea to Japan) and local currency swaps (US$3 billion equivalent each from Japan to Korea and from Korea to Japan). The yen-won BSA was raised from US$3 billion to US$20 billion equivalent in December 2008 until end-April 2009, which was later extended to end-October 2009.

(c) There is also a US$2.5 billion commitment (made on August 18, 1999) under the New Miyazawa Initiative.

(d) The table does not include the ASEAN Swap Arrangement (ASA), which totals US$2 billion.

[5] Central bank governors in the region have formed the Executives' Meeting of Asia-Pacific Central Banks (EMEAP) as a completely separate forum from the ASEAN+3 finance ministers' process. Its activities include annual meetings of EMEAP central bank governors, semi-annual meetings of the deputy governors, and three working groups concerned with bank supervision, financial markets, and payments and settlement systems. While this forum is considered the most influential for regional central banks, it seems to have its own weaknesses, such as irregularity of meeting schedules and lack of continuity.

Source: Data from Japanese Ministry of Finance website.

An important feature of the CMI is that crisis-affected members requesting short-term liquidity support can immediately obtain financial assistance for the first 20% of the BSA,[6] and that the remaining 80% is provided to the requesting member under an IMF program. Linking the CMI to an IMF program and its conditionality was designed to address the concern that the liquidity shortage of a requesting country may be due to fundamental policy problems, rather than a mere panic (i.e., herd behavior) of investors or genuinely external shocks, and that the potential moral hazard problem could be non-negligible in the absence of rigorous conditionality. Essentially the CMI is intended for crisis lending and hence requires conditionality.[7] The potential creditors of the CMI, including Japan in particular, seem to believe that the lack of the region's capacity to formulate and enforce effective adjustment programs in times of crisis should require the CMI to be linked to IMF programs.[8]

Another important feature of the CMI is that the BSAs do not seem to bind potential lender countries to actually lend because of the "opt-out" arrangement. Essentially the BSAs are contractual agreement between central banks, and potential lenders may opt not to lend.[9] In the event of a currency crisis in a member country, some potential lenders may provide liquidity while some may not. This creates a degree of uncertainty as to whether the needed liquidity is fully provided to a potential borrower country in the event of a currency crisis. The multilateralization of the CMI was considered to alleviate part of such uncertainty.

CMI multilateralization

Since May 2006, the finance ministers have been working to improve the functioning of ERPD and CMI and to multilateralize the CMI (see Box 2). The ERPD has been considered as an integral part of CMI. A "self-managed reserve pooling" arrangement, governed by a single contractual agreement, has been introduced as a form of CMI multilateralization (CMIM). Its total size has been set at US$120 billion. Member contributions and borrowing limits have been decided; Japan and the PRC would contribute 32% each, Korea 16% and ASEAN 20% (Table 2). A decision has been made to establish an independent "surveillance unit" to "monitor and analyze regional economies and support CMIM decision-making" as well as an "advisory panel of experts" to "work closely with the Asian Development Bank (ADB) and the ASEAN Secretariat to enhance the current surveillance mechanism in order to lay the surveillance groundwork for the CMIM" (Joint Media Statement of the 12th ASEAN+3 Finance Ministers' Meeting, May 2009).[10] In a sense, the CMIM will be heading toward a more institutionalized structure

[6] Initially the IMF-delink portion was 10% and it was raised to 20% in May 2005.

[7] On the other hand, bilateral local-currency swap arrangements between central banks—such as the yen-won swap between the Bank of Japan and the Bank of Korea—which are part of the CMI, are not intended for crisis lending and, hence, not subject to conditionality.

[8] Some ASEAN+3 members, such as Malaysia, believe that the CMI should not be linked to IMF programs.

[9] This is based on assessments by the finance ministry officials as the BSAs between countries are not publicly disclosed.

[10] The surveillance unit function will likely be handled for the time being by the ADB and the ASEAN Secretariat. This reflects the established practice so far where both institutions have supported the ERPD process. For example, the ASEAN+3 Finance Ministers Meeting is always convened with the support of the

with the support of a surveillance unit and under the guidance of an advisory panel of experts.

Box 2: Progress on ERPD and CMI

Continuous progress has been made to strengthen ERPD and CMI since its launch and more recently to multilateralize the CMI. Some of the major developments over the last few years include:

- Integration and enhancement of ERPD into the CMI framework (May 2005);
- Raising the ceiling for withdrawal without an IMF program in place from 10% to 20% of the total (May 2005);
- Adoption of the collective decision-making procedure for CMI swap activation, as a step toward multilateralizing the CMI (May 2006);
- Agreement in principle on a self-managed reserve pooling arrangement governed by a single contractual agreement as an appropriate form of CMIM (May 2007);
- Agreement on the total size of the CMIM to be at least US$80 billion and on the proportion of contribution coming from ASEAN countries and the Plus-3 countries to be 20:80 (May 2008);
- Agreement on an increase in the total size of CMIM from US$80 billion to US$120 billion, establishment of an independent surveillance unit, and a possible increase in the IMF de-linked portion above the current limit of 20 percent (February 2009); and
- Agreement on all the main components of CMIM—including the individual country's contribution, borrowing accessibility, and the surveillance mechanism—and the implementation of the CMIM before the end of 2009, including the establishment of an advisory panel of experts in addition to an independent surveillance unit (May 2009).

Source: ASEAN+3 Finance Ministers Meeting Statements, various years.

Obviously the agreement on country contributions, particularly among the Plus-3 countries, was a significant achievement (see Box 3). A few points are noteworthy. First, the CMIM is now designed as a US dollar liquidity support arrangement, thereby excluding the local-currency swaps that are in place in the CMI BSAs, under the same IMF-link arrangement. Second, the CMIM has included all ASEAN+3 members, although Brunei and low-income ASEAN members (Cambodia, Lao People's Democratic Republic, Myanmar and Viet Nam) were not included in the CMI BSAs. Hong Kong, China has also joined the CMIM without becoming a formal member of the ASEAN+3 finance ministers' meeting.[11] So it is now a more inclusive arrangement, and this opens up a possibility of other countries' participation. Third, Indonesia is now eligible to borrow a smaller amount (US$11.9 billion) than that provided by CMI BSAs (US$18 billion). This may require some additional

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ASEAN Secretary General and the participation of the ADB President in policy dialogue with the ministers. The deputies' meeting has been attended by the ASEAN Secretariat, ADB, and other expert institutions (including more recently the IMF). The ADB has been providing a confidential report to the deputies.

[11] Hong Kong, China has been a regular participant in ASEAN+3 finance and central bank deputies' meetings and other initiatives such as the ABMI, but always as part of the PRC team.

mechanism to cope with possible currency turmoil and crisis in Indonesia. Finally, voting powers of member countries largely reflect their financial contributions, but are adjusted in a way to increase the voice of smaller countries, like ASEAN members, by giving equal basic votes (except for Hong Kong, China which did not get any basic votes).

Table 2. CMIM Financial Contributions, Borrowing Agreements, and Voting Power

Members	Financial Contributions		Borrowing Agreements			Voting power			
	$Billion	Share (%)	Multi-plier	Maximum Swap Amount ($Billion)	IMF De-linked Portion ($Billion)	No. of Basic Votes	No. of Votes Based on Contribu t-ions	Total No. of Votes	Share (%)
Plus Three Countries	**96.00**	**(80.00)**	**0.69***	**57.6**	**13.20**	**4.8**	**96.0**	**100.8**	**(71.59)**
PRC and HKG	38.40	(32.00)	0.72*	19.2	5.52	1.6	38.4	40.0	(28.41)
PRC	*34.20*	*(28.50)*	0.50	17.1	3.42	1.6	34.2	35.8	(25.43)
Hong Kong, China	*4.20*	*(3.50)*	2.50*	2.1	2.10	0.0	4.2	4.2	(2.98)
Japan	38.40	(32.00)	0.50	19.2	3.84	1.6	38.4	40.0	(28.41)
Republic of Korea	19.20	(16.00)	1.00	19.2	3.84	1.6	19.2	20.8	(14.77)
ASEAN	**24.00**	**(20.00)**	**2.63**	**63.1**	**12.62**	**16.0**	**24.0**	**40.0**	**(28.41)**
Brunei Darussalam	0.03	(0.03)	5.00	0.2	0.03	1.6	0.0	1.6	(1.16)
Cambodia	0.12	(0.10)	5.00	0.6	0.12	1.6	0.1	1.7	(1.22)
Indonesia	4.77	(3.98)	2.50	11.9	2.39	1.6	4.8	6.4	(4.52)
Lao PDR	0.03	(0.03)	5.00	0.2	0.03	1.6	0.0	1.6	(1.16)
Malaysia	4.77	(3.98)	2.50	11.9	2.39	1.6	4.8	6.4	(4.52)
Myanmar	0.06	(0.05)	5.00	0.3	0.06	1.6	0.1	1.7	(1.18)
Philippines	3.68	(3.07)	2.50	9.2	1.84	1.6	3.7	5.3	(3.75)
Singapore	4.77	(3.98)	2.50	11.9	2.39	1.6	4.8	6.4	(4.52)
Thailand	4.77	(3.98)	2.50	11.9	2.39	1.6	4.8	6.4	(4.52)
Viet Nam	1.00	(0.83)	5.00	5.0	1.00	1.6	1.0	2.6	(1.85)
ASEAN+3	**120.00**	**(100.00)**	**1.16***	**120.7**	**25.82**	**20.8**	**120.0**	**140.8**	**(100.00)**

Note: *Hong Kong, China's borrowing is limited to the IMF de-linked portion because Hong Kong, China is not a member of the IMF.
Source: The Joint Media Statement of the 12th ASEAN+3 Finance Ministers' Meeting, 3 May 2009, Bali, Indonesia.

Box 3: Status-driven Negotiations of CMIM contribution among the PRC, Japan and the Republic of Korea

- Japan, the PRC and Korea each wanted to have such a large share of the CMIM contributions that the sum exceeded 100%, leading to difficult and protracted negotiations. Japan wanted to have the largest contribution share as it was both the largest economy in Asia and the largest contributor under the CMI BSA (totaling US$44 billion compared with Korea's US$18.5 billion and the PRC's US$16.5 billion). On the other hand, the PRC wanted to have a share as large as Japan's given that it was the largest holder of foreign exchange reserves in the world (totaling $2 trillion compared with Japan's $1 trillion and Korea's $250 billion). Korea wanted to have a share as large as the PRC's, given the high degree of development its development, the depth of Korean capital markets, and its large contribution under the CMI BSA.
- ASEAN, having earlier agreed on their own individual shares among themselves, apparently urged the Plus-3 countries to agree on shares so that significant progress could be made on CMIM.
- The final decision was an extremely effective compromise. First, the PRC agreed to a share of 28.5% for itself, but was able to convince other ASEAN+3 members that Hong Kong, China should be a new CMIM member and that Hong Kong, China get a share of 3.5%. So, the PRC's overall share of $32%, including both Hong Kong, China and the mainland, was the same as Japan's. Second, Japan's share of 32% was larger than the share provided by the PRC, maintaining Japan's status. Finally, Korea's share of 16% was a half of Japan's and the PRC's, but was much larger than its relative economic and financial weight in ASEAN+3, which was approximately 11-12%. So all the Plus-3 countries could enjoy prestige and satisfaction.

Source: Author's assessment.

Partly to respond to the Indonesian dilemma, the Japanese Finance Ministry announced in May 2009 that it would begin to arrange yen-based bilateral currency swap lines with other Asian economies, up to a total of 6 trillion yen (US$60 billion equivalent). These arrangements are quite unusual in the sense that they are subject to the same conditionality as the CMIM and IMF link, and that the Japan Ministry of Finance will raise the needed funds by using the Foreign Exchange Special Account; essentially it will borrow from the market by issuing yen-denominated bills. It is reported that Japan and Indonesia will set up a swap line of 1.5 trillion yen (US$15 billion equivalent), and that the Japanese government is preparing similar arrangements with the Philippines and Thailand.

Although Indonesia did not face a currency crisis in the aftermath of the global financial crisis, it had some funding difficulty for fiscal purposes and the rupiah depreciated sharply. The country was able to secure US$5.5 billion in "standby loan facility"—or "deferred drawdown options—from Japan ($1 billion), Australia ($1 billion), the ADB ($1.5 billion) and the World Bank ($2 billion) in 2009. This facility enabled the Indonesian government to secure financial resources for budgetary support in coping with the global financial crisis.

The Japan Ministry of Finance introduced a mechanism to enable emerging Asian economies to issue Samurai bonds—by providing sovereign guarantees through the Japan Bank for International Cooperation's "Market Access Support Facility"—with a maximum amount of 500 billion yen (US$5 billion equivalent). In this framework, a maximum of $US1.5 billion equivalent of yen was committed to Indonesia, which would issue Samurai bonds in the amount of 35 billion yen (US$350 million equivalent) with JBIC's full guarantee of the principle and partial guarantee of interest payments.[12] This type of support would enable other emerging Asian governments to raise foreign currency funds at the time of market turbulence.

The PRC has also arranged yuan-based currency swap lines with six central banks, i.e., Hong Kong, China (200 billion yuan), Korea (180 billion yuan), Indonesia (100 billion yuan), Malaysia (80 billion yuan), Argentina (70 billion yuan) and Belarus (20 billion yuan). These swap lines are said to be intended more for trade settlement than for emergency situations, such as currency speculation and balance of payments difficulties, given the yuan's lack of capital account convertibility.

4. Lessons from Korea in the Global Financial Crisis for the CMI

The global financial crisis has provided important lessons for the Chiang Mai Initiative, as no country wished to use it even when hit hard by currency speculation and capital flow reversals. A good case is found with Korea.

Impacts of the global financial crisis on the Korean economy

The Korean economy had enjoyed relatively stable economic growth in the early 2000s, with a growth rate averaging 5% of GDP and strong fundamentals. The banking system was well-capitalized, nonperforming loans remained low, and large firms' balance sheets were generally healthy. However, there were some concerns over the high levels of foreign debt ($210 billion in June 2008) and loan-deposit ratios (127%) in the banking sector. The Korean financial market was hit hard by the external shock following the collapse of Lehman Brothers in September 2008.

During October and November 2008, both domestic currency and foreign exchange liquidity tightened for domestic banks with large wholesale financing requirements, and foreign investors withdrew from Korea. As the global financial crisis deepened, funds flowed out of the country due to deleveraging by foreign financial institutions in response to heightened concerns about credit risk. Korean financial institutions faced shrinking foreign currency supply and a severe liquidity crunch even though they had not been exposed to large sub-prime mortgage related instruments.

The real economy also slipped into a recession, as Korean exports shrank rapidly, owing to the contraction of import demand in the developed markets of the US and Europe. Korean stock prices had been falling since May 2008 reflecting global weakening in liquidity. Moreover, the Bank of Korea had lost large amounts of foreign exchange reserves since March 2008; the reserves declined from US$264 billion in March to just below US$200 billion in November. The spread of credit default swap in

[12] In the event Indonesia cannot issue bonds, it was agreed that JBIC would participate in the joint lending arrangement for Indonesia organized by the World Bank and the ADB. Indonesia was able to issue Samurai bonds

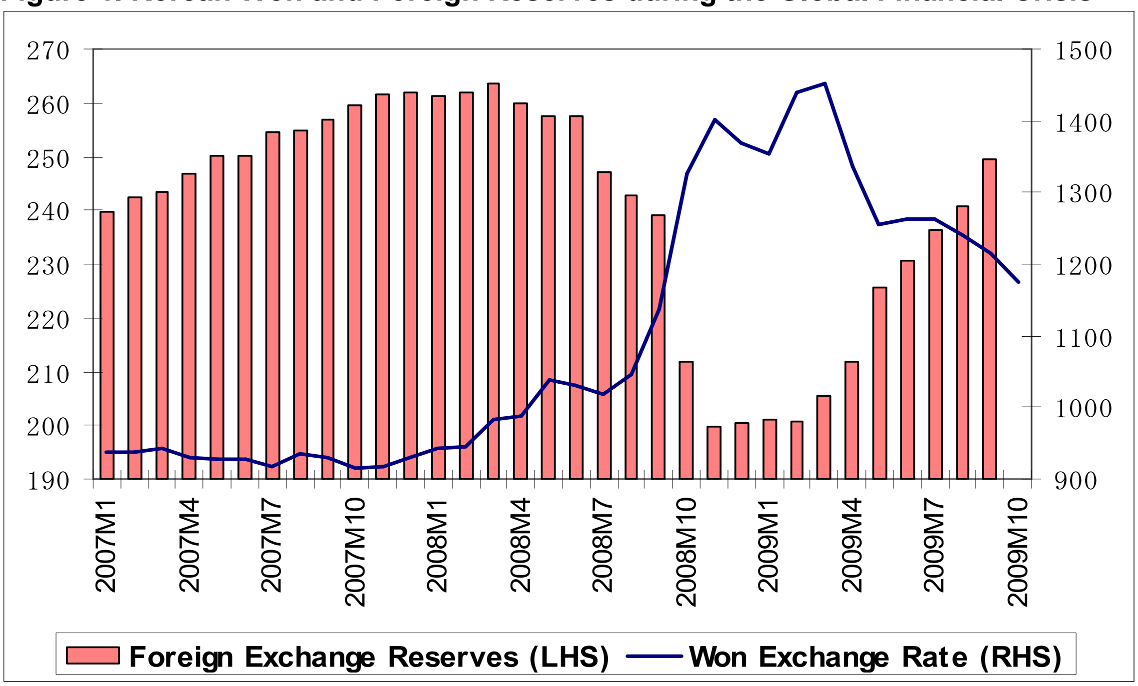
Korea had started to rise in late 2007, reaching a peak of 700 basis points in late October 2008, just days before a currency swap arrangement with the US Federal Reserve (Fed) was arranged. The won started to depreciate rapidly, from a strong 907 won per US dollar recorded in October 2007 to 1,483 won per US dollar in November 2008.[13]

Policy responses

The authorities in Korea responded swiftly to the impacts of the global financial crisis. The Bank of Korea eased its monetary policy aggressively, to soothe the financial market unrest and ward off a sharp contraction of the real economy. It brought its Base Rate down by a total of 3.25 percentage points, to its lowest level of 2% in six steps from October 2008 until February 2009. Along with this, it expanded liquidity in those sectors badly affected by the credit crunch through its open market operations and lending facilities. At the same time, it actively provided foreign-currency liquidity to domestic financial institutions through, for example, the swap market, in order to stabilize the foreign exchange market that was directly hit by the impact of the global financial crisis. The government also guaranteed all foreign debts in the banking sector until 2011. Unwilling to go to the IMF or CMI (which is tightly linked with IMF), the Korean authority entered into a US$30 billion currency swap arrangement with the US Fed in October 2008 and with the Bank of Japan and the People's Bank of China in December 2008.

The currency swap arrangement with the Fed had an immediate, significant stabilizing impact on the market. In 2009, the low won helped export recovery and reserve accumulation to 249 billion in September. The won began to restore its value gradually (see Figure 1).

Figure 1. Korean Won and Foreign Reserves during the Global Financial Crisis



[13] The value of the won recovered afterwards but then reached the weakest level of 1,516 won per dollar in February 2009. Since then the won has strengthened.

The Korean government also announced a fiscal expansion as soon as the global financial crisis began to affect the economy.

Lessons from Korea

The most important and significant measure to calm any panic in the Korean financial market was the currency swap arrangement with the US Fed. There were several success factors: First, it was a pre-emptive measure in the sense that the US dollar liquidity support was implemented in the middle of the market turmoil but before the currency crisis took place. It had an important calming effect on the financial market. Second, the size was large enough to contain currency speculation. Third, it was done through the US Fed's arrangements with multiple counties (Korea, Singapore, Brazil, and Mexico) and Korea was not the only country that received a commitment of liquidity support from the Fed.

An important fact is that Korea did not choose to go to its ASEAN+3 peers for liquidity support under the CMI, from which it could have obtained a maximum of US$23.5 billion. There were three reasons. First, if Korea had done so, it would have had to go to the IMF because of the CMI requirement of a link with an IMF program as the amount of borrowing would have exceeded 20% of the CMI BSA. This would have posed a significant political problem for the Korean government, given the stigma associated with the "IMF crisis" in 1997-98. Second, opting for bilateral local-currency swap lines with the Bank of Japan or the People's Bank would not have been attractive because of their limited size (US$3 billion equivalent with the BOJ and US$4 billion equivalent with the PBOC) and non-convertibility of the yuan. These bilateral swap lines could be drawn without the usual conditionality or link to IMF programs as they can be used for precautionary purposes, but not for crisis lending, which would require larger amounts.

There are several lessons to be learned from the Korean experience. In a fundamental sense, the effectiveness of the ERPD should be strengthened so that the CMIM could be used without IMF links. But this may take some time. During this transition period—under turbulent circumstances as in the case of Korea in the fall of 2008—CMIM support should be provided flexibly by (i) enabling precautionary lending rather than just crisis lending; (ii) delinking CMIM from IMF programs or requiring that no conditionality be imposed, in a way comparable to the IMF's recently introduced Flexible Credit Line; and (iii) supplementing CMIM by additional bilateral contributions, involving sufficiently large amounts, from economies inside and outside the region to make ample resources available for potential needs in the region. These considerations would help those countries which cannot arrange currency swaps with the US Fed, such as Indonesia, Malaysia, the Philippines and Thailand.

5. Policy Challenges: From CMIM to an AMF

There are several key policy challenges for CMIM.

Transform CMIM into an Asian Monetary Fund

The ongoing multilateralization process of the CMI could eventually lead to the creation of an AMF once a strong, independent professional secretariat is set up and the CMIM's IMF linkage is removed. So the key is to create conditions for further IMF-delinking. Institutionalizing the management of CMIM is necessary for this purpose. A proposed surveillance unit for regional economic surveillance and CMIM decision-making could become a permanent secretariat to deal with financial and currency crises as well as normal regional surveillance. A proposed advisory panel of experts would have the potential to function as a *de facto* board of executive directors, making day-to-day decisions, discussing surveillance reports produced by the secretariat, and approving the amount and conditions of crisis lending.

To transform CMIM into an AMF, the quality of economic surveillance (ERPD) needs to improve so that lending conditionality, independent of IMF programs, can be formulated in the event of CMIM activation. For this purpose, the following recommendations may be made:

- Clarify rules for activating CMIM lending;
- Establish a joint forum for finance ministers and central bank governors to intensify policy dialogue among them;
- Set up a strong professional secretariat, with the required analytical expertise and policy experience, to enable it to support regional economic surveillance (ERPD), CMIM activation, and independent conditionality formulation; and
- Move beyond the simple "information sharing" stage to a more rigorous "peer review and peer pressure" stage, and eventually to a "due diligence" stage, to improve the quality of economic surveillance.[14]

Once these conditions are met, a new AMF would emerge capable of conducting effective surveillance, providing international liquidity in the event of a crisis, and formulating and monitoring policy conditionality.

A new AMF would also be important from another perspective. It would encourage many Asian economies to embark on the rebalancing of sources of growth toward domestic and regional demand and correcting payments imbalances. After the Asian financial crisis of 1997-1998, many economies in the region saw the high value of building foreign exchange reserves as self-insurance to avoid currency crises. For them going to the IMF could be political suicide because of the stigma associated with IMF interventions in the public at large. So these governments have had every incentive to accumulate reserves by running large current account surpluses and intervening in the currency markets. The region's emerging economies would welcome the rebalancing if an AMF could reduce financial turbulence and act as the region's lender of last resort.

Exchange rate policy coordination

Currently no consensus exists, even within ASEAN or ASEAN+3, on a regional exchange rate arrangement, despite the rising economic and financial interdependence within East Asia (Moon and Rhee, 2009). But, looking beyond the current global financial crisis and economic difficulties and considering the rising degree of economic interdependence among East Asian economies through trade and investment, these economies need to undertake greater exchange rate policy coordination with each other. Once global financial stability is restored and these economies register early recovery and move to monetary policy exit, one can expect the resumption of large capital inflows into Asia. To manage such capital inflows and maintain macroeconomic and financial sector stability, it will be important for these economies to allow greater rate flexibility vis-à-vis outside currencies—such as the US dollar and the euro—but this may damage a

[14] "Due diligence" involves a rigorous scrutiny of a potential debtor economy and policy from a potential creditor's perspective (Kawai and Houser 2008).

country's international price competitiveness when its neighbors resist currency appreciation. Hence, the best policy option for the region is to allow collective currency appreciation vis-à-vis the US dollar and the euro, while keeping relative stability of intraregional rates, which does not significantly damage each country's international price competitiveness and spreads adjustment costs across countries (Kawai 2008). Such collective exchange rate appreciation of the East Asian currencies will require a significantly coordinated approach to exchange rate regimes.

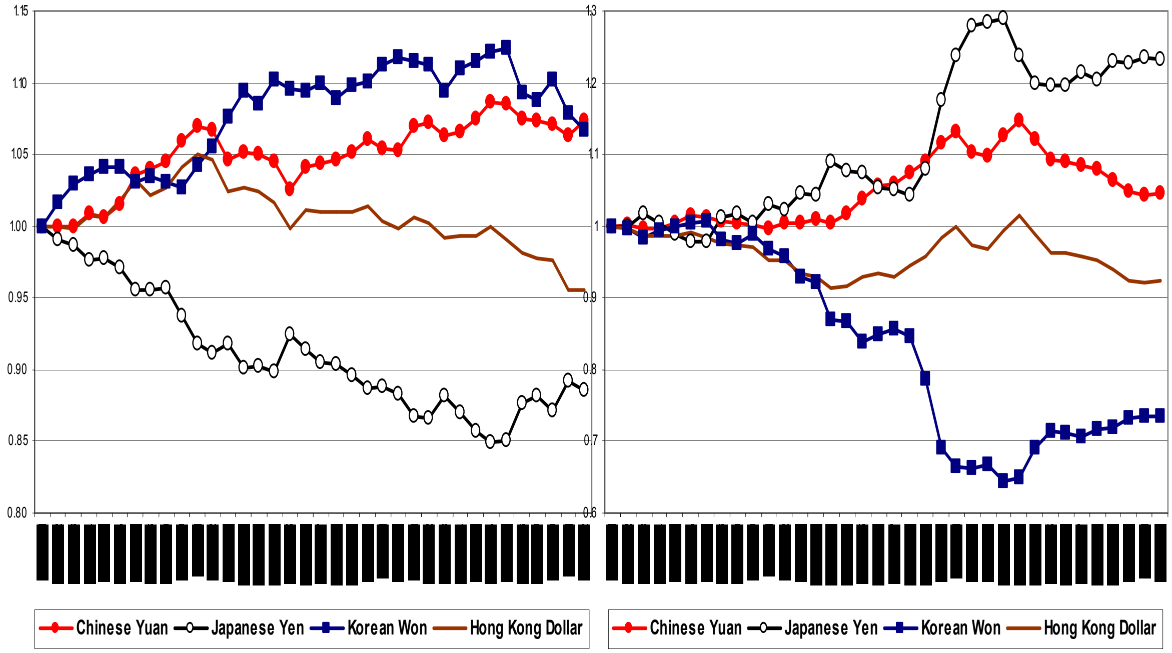
To prepare for this type of policy coordination, emerging East Asian economies may consider adopting policies to stabilize their exchange rates against a common basket of external and internal currencies—called the SDR-plus, comprising the US dollar, the euro, the pound sterling, the Japanese yen, and emerging Asian currencies—in order to achieve relative stability of their effective exchange rates and intra-regional exchange rates. An appropriately weighted basket of the yen and emerging Asian currencies can be defined as an Asian Currency Unit (ACU); it is a currency basket of ASEAN+3 currencies (and possibly including the Hong Kong dollar).[15] An ACU index can measure the degree of joint movement of East Asian currencies and the divergence of individual component currencies from the regional average given by the ACU rate. Figure 2 illustrates the point that the won and yen were moving in divergent directions between the pre- and post-global financial crisis periods. Once the PRC moves to adopt a more flexible exchange rate regime, ACU movements and divergence indicators would provide more meaningful information.

These efforts can help further strengthen Asian monetary cooperation. Collective appreciation requires at least informal policy coordination—through more effective policy dialogue and communication among ASEAN+3 authorities—in terms of their choice of exchange rate regimes. Use of an ACU index will be useful in facilitating policy dialogue and currency-market surveillance. This could be followed by more formal coordination of exchange rate policy with clearly defined rules for exchange rate parities, which could be defined in terms of an SDR-plus or even an ACU basket and exchange market interventions.

[15] So the SDR-plus is a basket of the US dollar, the euro, the pound and the ACU. The ADB-led initiative of creating an ACU index in 2006 was suspended by the Plus-3 country position that currency weights in an ACU index should not be decided by ADB, and that at least those among the Plus-3 countries should be decided by the countries concerned. Now that all ASEAN+3 countries and Hong Kong decided their contributions to CMIM and their voting powers, these shares could be used as weights for the construction of an ACU index. These weights are not too far from those constructed based on GDP, trade and capital account transactions. See Chai and Yoon (2009) and Kawai (2009) for the concept of ACU and its possible roles. Eichengreen (2006) provides a parallel currency approach to ACU.

Figure 2. Deviations from ACU Exchange Rates in 2005-07 and 2007-09

2005-2007 **2007-2009**



Views of the US Treasury

The US opposed the creation of an AMF when it was first proposed in 1997. Given the important role the US plays in the Asia-Pacific region, it is important to understand the current view of the US, particularly the US Treasury.

Interesting remarks were made by Adams (2006), Under Secretary for International Affairs of the US Treasury at the time. He stated: “With respect to an Asian Currency Unit (ACU), there has been some confusion about the US position on this topic...We do not see the ACU as a competitor to the dollar…We believe that greater exchange rate flexibility is desirable for the region, but are open-minded as to whether that involves currency cooperation within the region.” On broader regional financial cooperation, while he wanted to see more “clarity on the CMI” with regard to the amounts available absent IMF programs and the conditions imposed by CMI creditors, he stated “we…support regional cooperation that is consistent with multilateral frameworks.” It seems that the US views have been changing.

6. Conclusion

East Asia can contribute to the stability of global finance by achieving sustainable economic growth and financial stability (and by not repeating financial crises) through (i) establishing resilient national and regional financial systems; (ii) rebalancing sources of growth towards regional demand; (iii) strengthening regional liquidity (CMIM) and surveillance (ERPD) arrangements and eventually moving to create an Asian Monetary Fund (AMF); and (iv) adopting formal or informal exchange rate policy coordination.

The objectives of CMIM are: (i) to address short-term liquidity problems in the region; and (ii) to supplement the existing international financial arrangements. A new AMF will clearly inherit these objectives.

To transform the current CMIM into an AMF, much more significant progress needs to be made in the area of surveillance. The ERPD process which is currently in transition from the "information sharing" stage to the "peer review" stage, will have to aim to achieve the next stage of "due diligence"—a more rigorous scrutiny of a potential debtor economy. As this evolution takes place, the ERPD will be more closely linked to CMIM. In addition, ASEAN+3 finance ministers and central bank governors need to work closely to strengthen their policy dialogue and cooperation. A regional forum for financial stability—called an Asian Financial Stability Dialogue, involving finance ministries and central banks as well as financial sector supervisors and regulators—should also be established to facilitate information exchange, policy dialogue, and mutual cooperation among them.

A new AMF should establish itself as a complementary organization, a building-block of the global financial architecture provided by the IMF. This implies that an AMF should work closely with the IMF, exchanging information on a routine basis, often conducting joint analysis—as for the Financial Sector Assessment Program—and intervening in crisis countries together if needed. However, this means that the IMF should also clarify its roles and focus. The IMF as a key global institution has a clear role of ensuring global consistency, but this should not imply that the IMF sets all the key agendas and that regional institutions—such as a new AMF—simply follow.

In addition, the IMF should re-establish itself as an effective, credible and trustworthy institution. Otherwise the IMF would not be accepted in Asia as a true partner for the region. The IMF needs significant reforms on its operations and governance. On the operational side, the IMF must focus on the surveillance of systemically important economies (like the US and the European Union) and multilateral consultation (focusing on such issues as the global payment imbalance) to ensure global macroeconomic and financial stability. On governance reform, three major changes will have to be made, at least from the Asian perspective. They are: substantial reduction of Europe's voting power and representation; disallowance of any single member country—including the US—to have a veto power; and selecting the next managing director from Asia. With such fundamental changes, emerging Asian members would be likely to provide the IMF with an opportunity to regain trust and ownership among them and be regarded as their partner for macroeconomic and financial stability in Asia.

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