

## ADB Working Paper Series on Regional Economic Integration



### Regional Surveillance for East Asia: How Can It Be Designed to Complement Global Surveillance?

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## **Abstract**

This paper discusses conceptual and operational issues related to regional surveillance for East Asia, which is a topic that has assumed considerable prominence in recent months. The need for regional surveillance is both immediate and evolving. For the immediate need, a surveillance mechanism must cover the operational requirements of the Chiang Mai Initiative Multilateralization (CMIM) as a conditional lending facility. At the same time, it must also respond to East Asia's evolving need for a formal framework of policy dialogue and cooperation as economic integration deepens and macroeconomic interdependence strengthens. The paper discusses six principles that can help guide the design of an effective regional surveillance mechanism for East Asia: (i) avoid duplication with other organizations, (ii) clearly define the purpose of surveillance, (iii) centralize surveillance activities in a single organizational unit, (iv) use objective indicators to inform analysis, (v) design the governance structure to ensure independence, and (vi) provide analysis and recommendations directly to senior policymakers.

*Keywords:* Surveillance; Global and regional surveillance; surveillance design mechanism; East Asia

*JEL Classification:* E02, F3

## 1. Introduction

This paper discusses conceptual and operational issues related to regional surveillance for East Asia, which is a topic that has assumed considerable prominence in recent months. In May 2009, the ASEAN+3 Finance Ministers agreed that “an independent surveillance unit will be established as soon as possible to monitor and analyze regional economies and support...decision-making” in the Chiang Mai Initiative Multilateralization (CMIM).<sup>1</sup> On the global scene, however, the Group of Twenty (G-20) Leaders’ Summit in September 2009 charged the International Monetary Fund (IMF) to develop “a forward-looking analysis of whether policies pursued by individual G-20 countries are collectively consistent with more sustainable and balanced trajectories for the global economy...building on the IMF’s existing bilateral and multilateral surveillance analysis.”<sup>2</sup> How does the agenda to create a new regional surveillance mechanism in East Asia square with the global agenda to strengthen IMF surveillance? Will surveillance conducted by a regional body duplicate or complement IMF surveillance? These are some of the questions addressed in this paper.

The concept and practice of regional surveillance is not new in East Asia. In fact, immediately after the 1997/98 Asian financial crisis the ASEAN Surveillance Process (ASP) was established among ASEAN member states. The process was meant to strengthen policy dialogue and policymaking capacity in the monetary, fiscal, and financial areas through information exchanges, peer reviews, and policy recommendations. ASP brings together ASEAN’s finance ministers twice a year for this purpose. In addition, the ASEAN Surveillance Coordinating Unit (ASCU) was established within the ASEAN Secretariat in order to coordinate the surveillance process. The ASCU, with inputs from respective national units, prepares semi-annual ASEAN Surveillance Reports, which analyze recent global and national developments, identify emerging vulnerabilities, and raise relevant policy issues for the consideration of the ASEAN finance ministers. A key feature of the ASP has been the use of peer review and peer pressure in order to bring about desirable policy changes among the member countries, though its effectiveness may be limited by the uneven provision of data by national authorities in terms of availability, timeliness, and quality. Such discrepancies in data provision reflect both different stages of development and the unwillingness of some member governments to fully cooperate in the surveillance process (Manupipatpong, 2002).

In May 2002, the ASEAN+3 finance ministers introduced the ASEAN+3 Economic Review and Policy Dialogue (ERPD) process to apply to a larger set of East Asian countries. At the same time, they agreed to establish “a regional financing arrangement to supplement the existing international facilities.”<sup>3</sup> The purposes of the ERPD process include (i) assessing global, regional, and national economic conditions; (ii) monitoring

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<sup>1</sup> The Joint Media Statement of the 12th ASEAN+3 Finance Ministers’ Meeting in Bali, Indonesia on 3 May 2009. ASEAN+3 comprises the ten member countries of the Association of Southeast Asian Nations (ASEAN) plus the People’s Republic of China (PRC), Japan, and the Republic of Korea.

<sup>2</sup> Leaders’ Statement: The Pittsburgh Summit held 24–25 September 2009.

<sup>3</sup> The Joint Ministerial Statement of the ASEAN+3 Finance Ministers’ Meeting in Chiang Mai, Thailand on 6 May 2000.

regional capital flows and currency markets; and (iii) analyzing macroeconomic and financial risks. Steps have been taken to strengthen cooperation in these areas, including the establishment of expert groups. ASEAN finance and central bank deputies hold an ERPD session twice a year to exchange their views, but the lack of a permanent secretariat has limited the usefulness of the dialogue. The deputies present the assessment of their own economies, but refrain from assessing the economic developments and policies of other countries, and recommending policy adjustments (Kawai and Houser, 2008).

The recent decision by the ASEAN+3 finance ministers to establish an independent surveillance unit within East Asia reflects the leaders' recognition that existing processes need to be strengthened further, especially in view of the prospective needs of the CMIM. Surveillance is a necessary component of any mutual financial assistance facility. Unconditional financing when there is a need for policy correction can create moral hazard, both for potential borrowers and for international investors, even when it does not adversely affect the prospect for timely repayment. It is only through surveillance that the appropriate combination of financing and adjustment can be identified in a lending program. This is the idea of conditional lending, which goes back not only to the early days of the IMF, but also to the work of the European Payments Union in the 1950s (Kawai and Takagi, 2005).

The need for effective regional surveillance is both immediate and evolving. Up to this point, the Chiang Mai Initiative (CMI), lacking an effective surveillance mechanism, has required that financing beyond 20% of the bilateral swap facility be provided only to a country under an IMF-supported program. With effective surveillance, the multilateralized CMI could rely more on its own judgment to make a lending decision, including both the amount and any conditionality, without creating moral hazard or raising concerns that the problems leading to balance of payments difficulties may be fundamental in nature. As the region's economic integration continues to deepen further, surveillance can assume an added dimension. With strengthening interdependence, East Asia is faced with an increasing need for a cooperative mechanism to prevent a crisis from occurring in the first place. It will also need a more effective framework of regional policy dialogue and cooperation to deal with policy spillovers, both to mitigate political tensions and find scope for collective action. Surveillance is the foundation upon which such cooperative schemes can be built.

The rest of the paper considers aspects of regional surveillance for East Asia in the following sequence. Section 2 discusses the definition of surveillance, including the distinctions among bilateral, multilateral, and regional surveillance. Section 3 explores the scope for surveillance by a regional body—in a world where global institutions, notably the IMF, are already involved in conducting surveillance—by identifying areas where the existing global mechanisms can be strengthened. Section 4 addresses the issue of how best to design an effective surveillance mechanism for East Asia that minimizes duplication with and complements surveillance conducted at the global level. Finally, Section 5 presents concluding remarks.

## 2. What is Surveillance?

Surveillance is one of those words that most people seem to know, but for which there is no universally agreed-upon definition. The first instance of what is commonly regarded as surveillance of the international monetary system occurred within the context of analytical work conducted by the League of Nations. However, the word surveillance—in the sense that it is used today—only appeared for the first time in the internal documents of the IMF in the early 1970s. Surveillance became part of the lexicon of international economics in connection with the Second Amendment of the IMF Articles of Agreement, which came into force in 1978. Article IV of the amended Articles of Agreement established obligations for the IMF to “oversee the international monetary system in order to ensure its effective operation” and “oversee the compliance of each member with its obligations” specified therein (Section 3[a]) as well as to “exercise firm surveillance over the exchange rate policies of its members” (Section 3[b]). The Surveillance Decision of 1977, which has been superseded by the subsequent Surveillance Decision of 2007, holds that the surveillance of exchange rate policies encompasses all macroeconomic and macro-critical structural policies that may influence a member country’s exchange rate or balance of payments (i.e., “external stability” in the language of the 2007 Decision).

The definition of surveillance offered by Crow et al. (1999) is as useful as any for the purposes of this paper: “analysis of, scrutiny over, and advice concerning...countries’ economic situations, policies, and prospects.” In terms of making surveillance effective in practice, however, defining the purpose of surveillance is far more important than agreeing on the precise definition. Crow et al. (1999), followed by Boughton (2001), identified the following possible purposes of surveillance: (i) policy advice, (ii) policy coordination and cooperation, (iii) information gathering and dissemination, (iv) technical assistance, and (v) identification of vulnerabilities. These multiple purposes highlight the roles that IMF surveillance is understood to have assumed over time but are not explicitly spelled out in the Articles of Agreement. The IMF’s Independent Evaluation Office (IEO) concluded in 2007 that the lack of clarity over the purpose of surveillance had rendered IMF surveillance less than fully effective. In the context of East Asia, therefore, it is critically important from the outset to agree upon the primary purpose of surveillance.

In IMF terminology, it is customary to use the terms bilateral and multilateral to characterize the two broad categories of surveillance activities. Bilateral surveillance refers to the surveillance of the policies of individual countries. Within the IMF, it is typically conducted through periodic Article IV consultations with all member countries.<sup>4</sup> Multilateral surveillance refers to the surveillance of economic linkages and policy spillovers among countries as well as international or regional economic and market developments. It can complement bilateral surveillance by bringing into the analysis global and cross-country perspectives. Within the IMF, multilateral surveillance is most visibly conducted through the semi-annual World Economic Outlook (WEO) and Global

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<sup>4</sup> The Organisation for Economic Co-operation and Development’s (OECD) equivalent of bilateral surveillance is conducted through the Economic Development Review Committee, which produces Economic Surveys (Thygesen, 2004 and 2008; Koromzay, 2008).

Financial Stability Report (GFSR) exercises. Multilateral surveillance was first developed at the Organisation for Economic Co-operation and Development (OECD) in the 1960s, when the IMF was preoccupied almost exclusively with bilateral surveillance.<sup>5</sup>

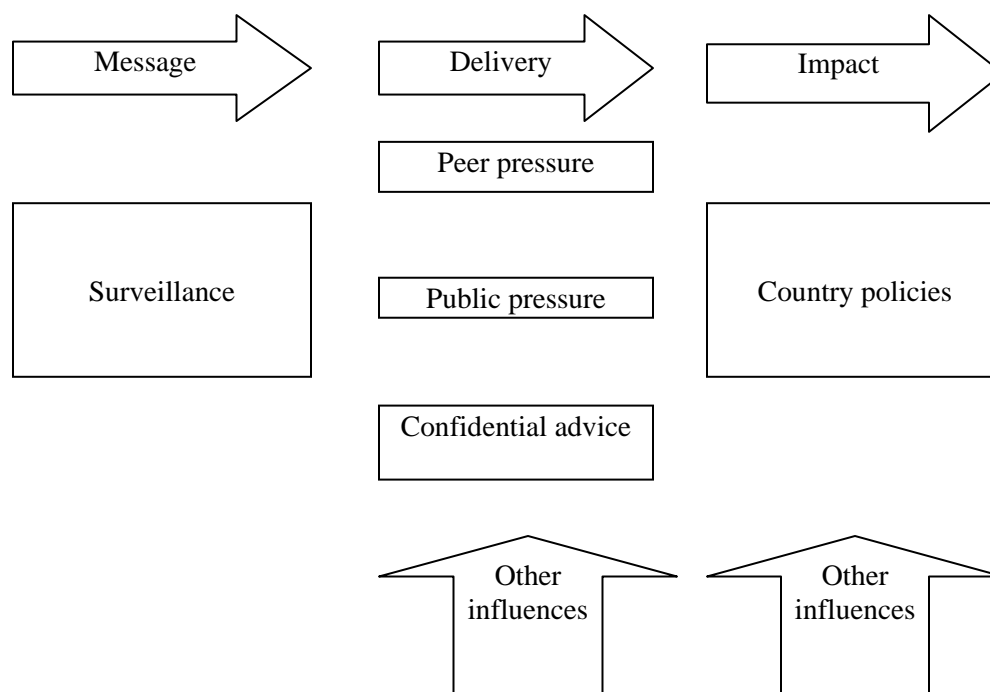
Somewhat confusingly, the term regional surveillance now appears in various IMF documents. For example, the IMF's official statement, in summarizing the Executive Board review of surveillance in 2008, states that one of its core activities is "to monitor global, regional, and national economies...through bilateral, regional, and multilateral surveillance."<sup>6</sup> The IMF's area departments are currently producing regional economic outlooks twice a year as part of what they regard as regional surveillance activities. In this definition, regional surveillance covers a geographically defined group of countries or a regional monetary union, while multilateral surveillance applies to the world economy as a whole. But this is not the only sense in which the term regional surveillance can be used in the context of East Asia. Regional surveillance could also mean surveillance conducted by a regional body, whether it is bilateral, multilateral, or even regional. In fact, this is the sense in which the term regional surveillance is used in this paper. Likewise, the term global surveillance can be used to mean surveillance conducted by a global body irrespective of the orientation of its content.

A discussion of surveillance is made easier if it is viewed in terms of a results chain consisting of three stages (Figure 1). In the first stage, surveillance produces a message, such as the assessment of crisis vulnerability in a particular country or the need for a particular country to make a policy correction. In the second stage, the conductor of surveillance delivers the message to the relevant audience by utilizing one or more of three available channels: (i) peer pressure through the officials of other countries, (ii) public pressure through the markets or the general public (e.g., the electorate in a democracy), and (iii) quiet persuasion as confidential advisor to the government. Though IMF surveillance has historically relied on the confidential advisor role, it has increasingly utilized the public pressure channel by publishing more and more of its surveillance documents. In contrast, OECD surveillance has relied on the peer pressure channel by organizing its surveillance activities as a peer review process (Thygesen, 2008). Finally, in the third stage, the message may have an impact on policymaking in the country concerned if the right message is delivered appropriately. This framework is used as needed in this paper's discussion of how to design an effective surveillance mechanism for East Asia.

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<sup>5</sup> Multilateral surveillance is conducted at the OECD through its Working Party 3.

<sup>6</sup> IMF. October 2008. IMF Executive Board Reviews the Fund's Surveillance. Public Information Notice No. 08/133. Washington DC, US: IMF. This particular terminology is not consistent with the language of the Articles of Agreement, where bilateral and multilateral ostensibly correspond to member countries and the international monetary system, respectively. There is no counterpart to regional.

**Figure 1: The Results Chain of Surveillance**

Source: IEO (2006).

### 3. Exploring the Scope for Regional Surveillance

It would be a daunting task for any organization to match the resources that the IMF devotes to surveillance activities. In terms of human resources alone, the IMF devoted over 1,100 staff years to surveillance activities in fiscal year (FY) 2005, which is the last year for which such numbers are publicly available (IEO, 2006). The IMF has since downsized somewhat. However, given the additional expenditures associated with surveillance, the total financial cost of IMF surveillance activities is likely hundreds of millions of US dollars per year. There is no institution in the world that can effectively compete with the IMF in terms of the volume of bilateral and multilateral surveillance activity. From this standpoint, it is indeed legitimate to ask why East Asia would need its own surveillance mechanism.

A compelling case for East Asia having its own mechanism is that the region has a different objective for conducting surveillance than the IMF. East Asian authorities want to be able to make their own independent decisions with respect to the use of reserves pooled under the CMIM. Over time, the region's officials are seeking to use such a mechanism to catalyze deeper economic integration by having an East Asian framework

of policy dialogue and cooperation. But the fact that there is a logical case for regional surveillance does not mean that it should duplicate the efforts made at the global level. The content of regional surveillance should include areas in which it can complement global surveillance. Identifying such areas requires an understanding of the strengths and weaknesses of IMF surveillance.

IMF surveillance arguably has strengths in two broad areas, which are related in each case to the quality of analysis and information processing that comes from the amount of resources the institution devotes to surveillance (even when it does not have privileged access to information). First, by far the IMF's greatest strength is the data-intensive and internationally comparable content of its bilateral surveillance. The IMF's *self-assessment* of bilateral surveillance, for example, considers its analysis of fiscal policy as "a top area of value-added," owing to its "exceptional skill at placing fiscal policy in an integrated macroeconomic framework." The same self-assessment also notes that the IMF's analyses of monetary policy, the short-term outlook, and recent developments are highly valued by financial market participants. The IMF's bilateral surveillance adds the greatest value in its analysis of developing countries and small emerging markets, for which the IMF is "one of the few...sources of independent and integrated macro-analysis and advice" (IMF, 2008a).

Second, the IMF's multilateral surveillance has also been successful in the timely identification and analysis of relevant issues and risks facing the global economy. IEO (2006) notes that, based on evidence gathered during 2000–05, multilateral surveillance exploits the IMF's comparative advantage in exploring linkage-related and cross-country issues, and its analysis has frequently influenced policy debate at the global level, including the G-7 and G-20 processes. As an indication of their quality and impact, the IMF's multilateral surveillance products, especially the WEO forecasts, regularly receive a wide public reception. In the fall of 2005, for example, there were almost 600 press references to the WEO throughout the world over a 12-day period following its release (IEO, 2006). Although the OECD and the Bank for International Settlements (BIS), among other global institutions, also produce high-quality multilateral surveillance outputs, the IMF draws its strengths both from the large amount of resources at its disposal and from exploiting the near universal coverage of countries.

Against these possible strengths, a number of external and internal reviews have identified at least four aspects of IMF surveillance that could benefit from improvement. First, the IMF's multilateral surveillance is not well integrated with bilateral surveillance. Owing in part to the historical origin of IMF surveillance as a bilateral surveillance activity, multilateral surveillance still has a strong bottom-up element. Integration is hampered by the organizational structure of IMF surveillance in which different departments are charged with different aspects of surveillance (e.g., area departments for bilateral surveillance and the Research Department for multilateral macroeconomic surveillance). Crow et al. (1999) noted that "knowledge transfer across departments [was] deficient," which manifested "itself in an inadequate cross-fertilization between multilateral and bilateral surveillance." Progress has since been made to integrate multilateral and bilateral surveillance by strengthening the top-down element, among other adjustments, but IMF (2008a) still notes that bilateral surveillance "on average pay[s] too little attention to placing explicitly the country in the global context."

Second, the IMF's macroeconomic surveillance is not well integrated with financial surveillance, reflecting the inherent complexities of the matter (McDonough et al., 2006). In the past, IMF surveillance was mainly macroeconomic as most of its economists on staff have been macroeconomists. It was only after the 1994 Mexican financial crisis (and especially the 1997/98 Asian financial crisis) that the IMF began to recruit people with financial sector and market experience on any serious scale. Despite considerable progress in recent years, the G-20 Summit in November 2008 still noted that the IMF should give "greater attention to...financial sectors" and better integrate "the reviews with the joint IMF/World Bank financial sector assessment programs," with a view to strengthening "the role of the IMF in providing macro-financial policy advice."<sup>7</sup> IMF (2008a) underscores the need to build financial expertise and use it more strategically, noting the "analysis of transmission channels from financial to real sectors [as] a key area for improvement."

Third, the IMF's surveillance outputs often lack candor and evenhandedness. The primary reason for the lack of candor comes from the desire of IMF staff to maintain good relations with national authorities and therefore avoid offending them.<sup>8</sup> Crow et al. (1999) used the term "a culture of clientism" to explain the "tendency of the Fund, particularly staff in area departments, to be insufficiently frank and direct in its assessment of a country's policies or economic situation."<sup>9</sup> This same incentive explains the lack of evenhandedness. Larger countries tend to have more influence in the organization so that the IMF staff's desire to be diplomatic is heightened when dealing with large industrial and emerging market economies. It is difficult to substantiate such a claim (IMF, 2008b), but this perception persists, especially with respect to the IMF's interactions with its largest shareholders. The lack of candor diminishes the clarity of a message and the perceived lack of evenhandedness undermines the credibility of surveillance. All three G-20 Summits from November 2008 to September 2009 recognized the weaknesses inherent in IMF surveillance and charged the IMF to provide "even-handed, candid and independent surveillance of the risks facing the global economy and the international financial system."<sup>10</sup>

Finally, IMF surveillance, except in a program context, does not fully exploit the available channels of influence outlined in Figure 1. At least as a routine exercise, the outputs of surveillance are generally discussed in the narrow circle of country representatives at the Executive Board or with the IMF staff's counterparts in finance ministries and central banks. But these officials are for the most part technical experts who may not have sufficient access to their respective ministers and governors, not to mention prime

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<sup>7</sup> G-20 Summit Declaration on Financial Markets and the World Economy. Washington DC, US. 15 November 2008.

<sup>8</sup> Another reason relates to the role of the IMF as confidential advisor to whom privileged information may be provided. There is also the concern that given the perception that the IMF has an information advantage, its remarks about market-sensitive issues can actually impact the markets. However, the reality is that with the exception of program countries the information advantage that the IMF may have once possessed has all but disappeared.

<sup>9</sup> According to IMF (2008b), about 30% of the mission chiefs surveyed indicated that they had delivered a candid message, while about 50% acknowledged that they had been constrained and were less than candid.

<sup>10</sup> G-20 Summit Leaders' Statement in Pittsburgh, US on 24–25 September 2009.

ministers and presidents. Rarely does the IMF interact with the real decision makers of economic policies in large industrial and emerging market economies. The IMF's confidential advice often does not receive the attention of sufficiently senior officials. In addition, the Executive Board, where surveillance discussions take place, does not have sufficient seniority to serve as an effective peer pressure group. The IMF has tried to project its influence by participating in global forums of senior policymakers, such as the G-7 and G-20 processes, but its involvement has largely been limited to providing technical inputs.

#### 4. An Effective Regional Surveillance Mechanism

Going beyond the existing ASP and ASEAN+3 ERP, the blueprint for an effective regional surveillance mechanism in East Asia must be based on the proper understanding of where it can best complement global surveillance. The preceding discussion of IMF surveillance has identified two key strengths as well as four broad areas that could benefit from improvement. These identified strengths and needs can form the basis for designing a regional surveillance mechanism to effectively complement global surveillance. At least six principles present themselves with regard to establishing a regional surveillance mechanism, as indicated below. The first is the self-evident idea that duplicating the activities of other organizations should be minimized. The next three principles deal with organizational and technical requirements designed to create a high-quality message, which is the first stage of the results chain (Figure 1). The last two principles deal with the second stage of the results chain, namely, how message delivery can be made more effective.

- ***Avoid duplication with other organizations.*** If surveillance is only meant to deliver policy advice, gather and disseminate information, and provide technical assistance as its primary objective, then there are already a variety of competing institutions. A new East Asian unit would be unlikely to possess a clear comparative advantage in producing surveillance outputs intended for these purposes. To duplicate the efforts being made at other global and regional institutions would not be an efficient way of using the world's scarce public resources, and also imposes an unwelcome, additional administrative burden on the member countries. As noted, the IMF produces high-quality bilateral and multilateral surveillance outputs by drawing upon resources that no other institution can realistically match; country authorities, on their part, already expend considerable resources to assist the surveillance activities of the IMF and other agencies by supplying statistical information, engaging in policy discussions, and participating in a peer review process. East Asian policymakers are well aware of these facts, which is why the existing ASP and ASEAN+3 ERP are designed to receive technical surveillance inputs from the IMF as well as the Asian Development Bank (ADB), both of which are regularly invited to present their analyses at high-level

meetings.<sup>11</sup> There is no reason to believe that the new East Asian surveillance unit would be designed to operate differently.<sup>12</sup>

Avoiding duplication does not mean that the new surveillance unit (or any regional surveillance activity) should shy away from conducting its own analysis of global and national economic developments. As the regional custodian of pooled reserves and arranger of financial packages, the surveillance unit must be aware of the economic policy challenges in each country and the global environment in which member countries operate. It must also have the technical expertise to form its own judgment of crisis vulnerability, identify regional policy spillovers, and suggest scope for collective action. To perform its tasks effectively, it is critical that the surveillance unit be granted complete access to all surveillance outputs produced on the region's economies by the IMF and other institutions. Avoiding duplication suggests that the unit would not have to prepare elaborate reports on the assessment of developments, economic policies, and prospect at the global level or in individual countries. The institutional setup for the surveillance of global and national economic developments can be kept relatively lean.

Financial surveillance, though critical in assessing crisis vulnerability, is another area where duplication with global surveillance should be carefully avoided. This is especially the case because financial surveillance is a highly labor-intensive activity. There are at least three aspects to this. First, the right kind of financial expertise is scarce; linking financial analysis to the real sector is an art that is only beginning to develop.<sup>13</sup> It is unrealistic to expect that the regional surveillance unit will quickly develop expertise in this area. Second, a financial crisis is a relatively rare event and developing crisis-relevant expertise requires global exposure. This expertise can best be fostered at a global institution and shared globally. Third, financial flows are global phenomena and the activities of large financial firms cut across national and regional boundaries. At the same time, supervision of individual institutions can only take place at the national level. Financial surveillance is, therefore, one area in which the regional approach makes little sense.

Although these and other reasons argue for concentrating surveillance resources within global institutions, such as the IMF and the Financial Stability Board, this is only true of surveillance designed to identify crisis vulnerability. If surveillance were assigned an additional purpose, the regional approach can still play a role. For example, the regional surveillance unit could assume the role of promoting the development of local currency bond markets under the Asian Bond Markets Initiative (ABMI).<sup>14</sup> If the purposes of surveillance include this or other similar types of policy cooperation in pursuit of a

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<sup>11</sup> ADB's technical inputs to the process are included in its review of emerging East Asia's growth and policy issues published semiannually as the Asia Economic Monitor.

<sup>12</sup> Currently, the IMF is involved only at the deputies' level. In seeking expert assessments from other global and regional institutions in the future, the new surveillance unit has no reason to favor one institution over the other.

<sup>13</sup> The IMF is in the process of refocusing on financial sector surveillance and real-financial linkages as a priority area (IMF, 2009).

<sup>14</sup> The ABMI is currently one of the three regional financial cooperation initiatives of ASEAN+3, along with the CMIM and ERPD.

common regional goal, then the quantitative and regulatory monitoring of financial developments in the region becomes a relevant exercise for the regional surveillance unit. Even so, the resource requirements for financial surveillance at the regional level can be kept lean because regional surveillance, out of necessity, must rely heavily on information provided by global and national agencies.

- **Clearly define the purpose of surveillance.** The discussion above has made clear that the purpose largely determines the content of surveillance. Moreover, unless the purpose is clearly defined, a focused message cannot be produced from any surveillance activity. Among the possible purposes of surveillance noted above, the most immediate for East Asia is the identification of vulnerabilities, which should also be understood to include the due diligence task of a crisis lender in assessing the capacity of a potential borrowing country to repay and the conditions that should be attached to a loan to ensure the CMIM's revolving nature (Kawai and Houser, 2008); over time policy coordination and cooperation could increasingly become part of the purpose of surveillance. On the other hand, there is little need to duplicate the efforts of other institutions in providing policy advice, information gathering and dissemination, or technical assistance. Analytically, what is required to identify crisis vulnerabilities and the scope for collective action is similar. In both of these areas, regional surveillance should take an integrated approach that combines country-level and region-level analyses inasmuch as Asian economies are highly interdependent.

In terms of delivering the message, however, these two purposes may require different approaches. For policy coordination and cooperation, greater use can be made of peer review and resultant peer pressure, which is an approach that has been successfully used by the OECD and replicated more recently by ASEAN. The key ingredients of a successful peer review are consultation, mutual trust, and the idea that policy adjustments cannot be expected to occur in an adversarial environment. As a drawback, any publicly released message can become diluted and the process extended through the participation in the drafting of the message of the national officials concerned (Thygesen, 2008; Koromzay, 2008). For the identification of vulnerabilities, on the other hand, a less consultative (and in some cases more adversarial) approach that precludes the concurrence and involvement of the countries concerned may be necessary because disagreement is more likely to emerge over an assessment indicating that a country is in danger of crisis or producing a spillover harmful to the interests of the region. An assessment of exchange rate levels or the ability to service debt would also fall into this category.

- **Centralize surveillance activities in a single organizational unit.** The failure to integrate various strands of surveillance has been a regular finding of past reviews of IMF surveillance. The reasons for this failure include the inherent difficulty of the task and the fact that different departments produce different surveillance products within the IMF. East Asia's regional surveillance mechanism should aim to have an organizational structure that forces integration between bilateral and multilateral surveillance, as well as between macroeconomic and financial surveillance. This is especially important because Asian economies are highly interdependent in terms of both macroeconomic and financial links. The best way to achieve this analytical integration is to put a single organizational unit in charge of all surveillance activities. In addition, a single individual

must be made ultimately accountable for all surveillance outputs at the technical level. Given the small membership of the proposed regional surveillance unit and its expected focus on one or two specific purposes, it should be easy to achieve a compact organizational structure that satisfies these principles.

- **Use objective indicators to inform analysis.** Given the current state of knowledge, the economics profession is rightly skeptical about the ability of economists to find precise metrics for the probability of a crisis or the equilibrium value of a macroeconomic variable. Even so, a model-based approach to economic analysis is a way of forcing surveillance staff to take a position on politically sensitive yet critical issues and include them in the overall analysis. This is especially true when the purpose assigned to surveillance is to identify crisis vulnerability. To aid the process, it is important to develop an analytical framework to assess the level of exchange rates (e.g., a behavioral equilibrium exchange rate model) or the crisis vulnerability of member countries (e.g., an early warning system [EWS]). Within the IMF, a model-based approach has been introduced to bilateral surveillance in order to overcome the resistance by an area department to discuss the sensitive yet critical issue of exchange rate levels with the relevant authorities. Likewise, ADB has developed an EWS for use by its member countries.
- **Design the governance structure to ensure independence.** Independence is a feature that ensures candor and evenhandedness in surveillance, especially when the identification of vulnerability to crisis is involved. Kawai and Pomerleano (2009) state that “the institution that is conducting the analysis and making judgments about the stability of the system must not have anything other than its own reputation riding on its assessment.” Civil servants, whether national or international, may be talented and well-intentioned, but usually do not possess the kind of independence required for dispassionate analysis and advice (Stern, 2009). At the same time, continuity requires that surveillance be organized within an institutional setup. The question then becomes how to shield the surveillance unit’s staff from political interference. A smooth career path is more likely for staff if they maintain a cozy relationship with member country officials. Thus, there must be in place both the right incentives to encourage the surveillance unit’s staff to be candid in raising issues that countries may find uncomfortable discussing openly and an institutional mechanism to protect staff when they displease member country officials.
- **Aim to reach the senior policymakers directly.** Regional surveillance should not follow the organizational structure of IMF surveillance in which the IMF’s Board of Executive Directors is the primary audience. In fact, it is through the utilization of peer pressure that regional surveillance can potentially have the greatest advantage over IMF surveillance. The IMF is a near universal organization with 185 member countries that are represented by 24 resident Executive Directors. By necessity, not all Executive Directors represent their own countries and their seniority limits their relevance as a peer pressure group and in policymaking for individual national governments. If the new regional surveillance unit simply replicates this institutional setup of IMF surveillance, East Asia will lose the greatest potential advantage of having its own surveillance mechanism.

To yield more impact than IMF surveillance, regional surveillance must aim to reach senior policymakers directly by using the periodic forums of finance ministers and central bank governors, or to be even more effective, heads of state or government. It is in such forums that the impact of peer pressure can be maximized. Therefore, there would be no role in a regional surveillance unit for a resident executive board. Such a board could become an instrument of political interference to be used by national governments when uncomfortable issues arise. And given the likely seniority level of resident directors, it also would not be an effective peer pressure group. With even some large international organizations facing calls to replace resident boards with non-resident boards of senior policymakers,<sup>15</sup> there is no reason to create a resident executive board of mid-level officials at the new surveillance unit in East Asia, where the membership is small and the size of the geographical area is manageable.

Peer pressure as the primary channel of influence (Figure 1) should not preclude the surveillance unit's active engagement with the public. After all, it is only through the political process that policymakers are motivated to take action. There may be an occasional need to keep the discussion of some issues confidential, but to be effective surveillance must strive to utilize all channels of influence, including public pressure and market discipline. In order to avoid market surprises in cases when regional surveillance informs the public as the ruthless truth teller, there must be a clear transparency policy for the public disclosure of information. In an age dominated by widespread access to information via the Internet and in which transparency is the governing principle of public administration in most democratic societies, hardly anyone possesses information that can or should be kept from market participants. The surveillance unit should therefore operate with the presumption that it makes a full and complete disclosure of any analysis, view, or information it possesses to the public unless of course privileged information is involved.

## 5. Conclusion

The process is underway in East Asia to establish an independent surveillance unit to support CMIM decision-making. First and foremost, the ASEAN+3 finance ministers need to define the purpose of regional surveillance. Unless there is complete agreement on what the purpose is, surveillance cannot produce a clear message and be effective. The need for regional surveillance is both immediate and evolving. For the immediate need, the purpose is to cover the operational requirements of the CMIM as a conditional lending facility. Regional surveillance must also respond to East Asia's evolving need for a formal framework of policy dialogue and cooperation as economic integration and macroeconomic interdependence deepen.

In a world where other public institutions, notably the IMF, are involved in surveillance, it is important that regional surveillance be designed to complement global surveillance. Because the IMF produces high-quality analyses of global and national economic developments, the regional surveillance unit can have a relatively lean institutional setup for information gathering and dissemination. Likewise, because crisis-relevant financial

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<sup>15</sup> For governance issues related to the IMF Executive Board, see IEO (2008).

expertise can best be fostered and shared at the global level, the regional unit can also be lean in the area of financial surveillance and have a primary role of processing information provided by global and national agencies. Over time, regional surveillance should increasingly focus on the regional equivalent of IMF multilateral surveillance, with a clear mandate for addressing policy spillovers and finding scope for collective action.

This paper has suggested additional ways to make regional surveillance effective in complementing global surveillance. To produce high-quality outputs, the regional unit should centralize surveillance activities in a single organizational unit without making an explicit distinction between bilateral and multilateral surveillance or between macroeconomic and financial surveillance. To present a clear view, surveillance should use objective indicators, while remaining aware of the inability of economics to provide precise metrics. To enhance candor and evenhandedness, the governance structure should be designed to ensure independence, which is particularly critical for the tasks of identifying crisis vulnerabilities and raising issues that national authorities may be uncomfortable discussing openly. To maximize impact through peer pressure, regional surveillance should aim to reach senior policymakers directly. This may be the area where regional surveillance has the greatest advantage over global surveillance.

The primary determinant of success for the East Asian surveillance unit will be whether it can garner respect and credibility from the public based on the merit of its analysis and the effective delivery of key messages. The quality of the unit's people will ultimately determine the quality of outputs. Therefore, it is paramount to staff the unit with competent professionals whose abilities and qualifications are beyond dispute.

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## **Regional Surveillance for East Asia: How Can It Be Designed to Complement Global Surveillance?**

Shinji Takagi suggests that a regional surveillance mechanism for East Asia must cover the operational requirements of the Chiang Mai Initiative Multilateralization (CMIM), and also respond to the region's evolving need for a formal framework of policy dialogue and cooperation as economic integration deepens.

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