INSTITUTIONS FOR REGIONAL FINANCIAL COOPERATION IN ASIA: IMPLICATIONS FOR REGIONAL ECONOMIC COOPERATION

Maria Socorro Gochoco-Bautista
University of the Philippines
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I. Introduction

Regional economic cooperation in East Asia is generally characterized as being 'lightly' institutionalized. This is understood to mean that in East Asia, there are few shared rules, norms, and obligations whose adoption is fostered by formal and permanent intergovernmental and supranational actors.[1] Furthermore, the scope of issues addressed by regional institutions, the extent of binding decisions and commitments made, and the extent of delegation to these institutions is limited.[2] The reasons cited for the low degree of institutionalization in East Asia are numerous and include: cultural norms such as the ASEAN way of doing things, including a preference for informal rules, non-interference by states in the affairs of their neighbors and voluntary compliance, and a consensus approach to decision-making; the nature of East Asian elites and the informal networks that connect them, and their power to thwart reform processes in domestic economies; as the outcome of a geopolitical power play among the big powers like the US, Japan, and China; a great degree of heterogeneity in preferences, level of economic development, and political systems among countries in ASEAN as well as between ASEAN and the +3 (APT) countries.[3]

Despite the paucity of formal institutions, however, regional economic cooperation in East Asia, particularly in trade, has been increasing dramatically, with positive effects on economic growth in the region. East Asia has become a viable regional production network, in which goods are produced in a fragmented production process across the various countries, and finished goods exported to the rest of the world. Market-driven processes of integration in production and trade have thrived despite the lack of extensive institutionalization in East Asia. East Asia appears to be integrated in terms of trade both internally and externally.

In the area of finance, regionalism involves the creation of institutions to support and shape financial transactions at the regional level and to provide public goods, such as financial market stability, currency stability, the prevention of financial crisis and financial contagion across countries in the region, the development of local financial markets, etc. The 'lightness' of regional financial institutionalization is perhaps not too surprising given its place in the history of regional cooperation in East Asia. ASEAN, the core cooperation group in the region and the center of APT, was organized loosely by a small group of states with few formal rules. Guided

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[1] Eichengreen, 2009.
[2] Haggard, 2009, p. 4.
[3] These explanations are cited in Arner, et al., 2009, Grimes, 2009, and Haggard, 2009, respectively.

by principles of non-interference and voluntary compliance, ASEAN was designed primarily as a conflict avoidance system to allow newly-independent states to prosper in peace rather than as a problem-solving mechanism.[4] There were some financial regionalist projects in the 1990s initiated by Japan. These included the BOJ-led initiative to establish a regional central bank as early as 1990 and its hosting the first central bank forum in the Asia and Pacific region in 1991, the Japan-ASEAN Finance Ministers' Meeting in 1994, the Four Markets Group and the Six Markets Group aimed at strengthening the relationship among regional financial authorities.[5]

The Asian Financial Crisis of 1997-1998 was the defining event that set the stage for financial regionalism in East Asia. In large part, the absence of institutions and mechanisms at the regional level prevented an effective regional response to the Crisis, and adequate and timely support for countries especially hard hit by it. Countries such as Indonesia had to seek help from the IMF. In addition to the stigma attached to borrowing from the IMF, the harsh measures imposed on borrower countries were seen as having worsened the effects of the Crisis. In the eyes of many countries in the region, the credibility of the IMF as an institution was irreparably damaged. This was not only because of its seeming insensitivity to the suffering unleashed by the measures it imposed, but also because of the apparent lack of understanding on its part about the nature and origins of the Crisis and the inability to prevent its occurrence. This was despite the IMF's institutional capacity to monitor and collect necessary information from governments of countries and enforce its policies and programs. The Crisis showed the limits of the global financial architecture and the vulnerability to crisis of small, open economies anchored on the global US dollar standard regime.

The Asian Financial Crisis was significant in a broader context. Even the most avid of free trade advocates, such as Bhagwati, cited its occurrence as reason to reject the myth that unfettered capital markets are desirable, and as evidence of the inherently crisis-prone nature of freer capital movements.[6] The perpetuation of this myth, it is argued, unnecessarily makes the IMF an international lender-of-last-resort, allowing it to interfere in the domestic policies of countries, such as those on matters of social policy, e.g., the 1994 Sanders-Frank Amendment which sought to attach labor standards to any increase in bailout funds.[7] The occurrence of the Asian Financial Crisis is also significant because it derailed a plan taken by the IMF at its Annual Meeting in Hong Kong prior to the Crisis to update Article VIII for its members to move to capital account convertibility.

Given the failure of global financial institutions and the global financial architecture to prevent and satisfactorily resolve the Crisis, countries in the region perceived the need for a regional safety net and greater independence from Western financial institutions.[8] This may have been in part a reaction to the inability of such financial institutions to make a distinction between countries that had behaved appropriately in terms of pursuing the right macroeconomic policies prior to the Crisis and those that had not. It seemed that countries in the region were similarly treated and punished by the retreat of capital during the Crisis.

[4] Weatherbee, 2005, p. 121.
[5] Hamanaka, 2009.
[6] Bhagwati, 1998, p. 7.
[7] Bhagwati, 1998, pp. 8-9.
[8] Dieter, 2007, p. 123.

It also became apparent that the US had a domestic agenda to attend to and upheld its national interests and the interests of its financial institutions over those of its allies in Asia.[9] These interests were incompatible with a timely reform of the global financial architecture in which the US and Western financial institutions, referred to by some as the "Wall Street-Treasury complex," set the agenda and the rules.[10]

It was in this context that regional financial and monetary cooperation began. The Chiang Mai Initiative (CMI), an offshoot institution of the supra-structure APT Process[11] was created to serve as a regional liquidity reserve, to offer liquidity support in the form of bilateral swap agreements during a crisis to supplement already existing sources of liquidity. The offer of these short-term credit lines was basically the extent of the regional response in dealing with the effects of the Crisis. However, the limited amounts of liquidity support under CMI, the requirement of negotiation of a standby agreement with the IMF and subsequent fulfillment of IMF conditionalities to access CMI funds, and the lack of a credible surveillance and enforcement system alternative to the IMF hampered the usefulness of CMI to deal with the effects of the Crisis.

In the post-Asian Financial Crisis period, Asian countries have resorted to a build-up of their individual war chests of foreign reserves as a form of self-insurance. Aside from disappointment over the failure of the global financial architecture to find a satisfactory resolution to the crisis then and the large swings in current account imbalances today, there was likewise a feeling of disappointment with the inadequate regional response. This form of self-insurance is not costless, however, as there is an opportunity cost and implicit fiscal burden that comes with countries holding lower-yielding foreign assets in place of higher-yielding domestic assets. The extent to which surplus countries accumulate dollar reserves for self-insurance also further reduces world aggregate demand and worsens the global crisis.

Part of the reason for the perceived need for self-insurance was a conflict in the views countries held about what caused the Crisis and what optimal policies countries could or should pursue in a financially-globalized world with global imbalances. In turn, these affected the incentives countries faced in their willingness to give up some measure of autonomy over national policy and delegate authority to a regional institution whose economic moorings or rationale were consistent with what countries were fundamentally conflicted about.

This conflict had to do with the desirability of capital mobility. On the one hand was the belief that capital mobility is not always welfare-improving or desirable. Some saw excessive capital mobility as the cause of the Asian Crisis. At the same time, individual countries wanted to retain control over exchange rate policy and policies to address the effects of the crisis on their own economies. On the other hand was the belief that small, open economies benefit from open capital markets. However, with capital mobility and openness to foreign capital, an independent monetary policy would not be possible if there were simultaneously a desire to maintain control over the exchange rate as well as other domestic concerns such as inflation and output growth.
Many countries in the region had adopted freer capital mobility prior to the Crisis and this policy has largely remained in place since. One could argue from an economic perspective alone that since a high degree of capital mobility precludes the conduct of an independent monetary policy

[9] Dieter, 2007, p. 126.
[10] Bhagwati, 1998, p. 7.
[11] Soesastro, 2009.

to begin with, countries would evidently have an easier choice to give up some degree of sovereignty and control over certain aspects of national policy over which they could not exercise full control anyway under the circumstances, e.g., exchange rate policy, and delegate these to an external entity such as a regional institution. However, the political reality is that this is obviously much more difficult as it involves surrendering some degree of sovereignty. Apart from limited delegation, there is also a limited degree of the commitment by countries to participate in a regional endeavor because of the uncertainty about what a regional institution can in fact deliver.

It is important to bear in mind that the benefits from financial regionalism are largely in the form of the provision of international public goods. The nature of public goods precludes a country from having an incentive to participate in their provision despite benefits being enjoyed by all (non-exclusion) if the costs of providing such goods are not borne by all (the free-rider problem), such as would be the case if not all of the other countries participate. The incentive to participate in the provision of public goods like financial stability arises from the fact that financial instability in one country can spread to other countries (the problem of externalities). There are negative externalities for countries in the region associated with a regional country experiencing financial instability or a full-blown financial crisis.

A great degree of asymmetry of information exists between the principals, leaders of countries, and the agent, a regional institution that they help create and to which they would effectively delegate certain functions or authority (principal-agent problem) but whose actions they cannot perfectly control.[12] Even in autarky and without capital mobility across national borders, a financial market suffers from asymmetry of information between lenders and borrowers that gives rise to moral hazard and adverse selection. The inherent public good nature of financial stability means that financial markets need to be regulated by governments. The degree to which governments are able to assert their sovereignty and control over the agenda of these international institutions as well as ensure compliance by other member countries to agreed-upon rules-of-the-game is uncertain. Many countries are therefore reluctant to delegate certain functions and powers to external agents such as international, including regional, institutions.

The Asian Financial Crisis not only provided the basis for financial regionalism, it also largely shaped expectations about what benefits financial regionalism ought to deliver. These include: protection from liquidity shortages and having to borrow in dollars and to depend on the IMF during a crisis; support of the regional production network by reducing the likelihood of crises and instability through the development of local currency bond markets in the region; cooperation on exchange rates; surveillance measures such as the monitoring of short-term capital flows; and as a way for certain states to make other states conform to rules considered attractive by the former.[13] In relation to all these, therefore, CMI, as a regional liquidity support arrangement, appears to have a narrow scope. It does not encompass all these other areas of beneficial cooperation and at best, covers only a subset of them. CMI’s ability to act as a lender-of-last-resort under a dollar standard is also limited and indeed, CMI was designed to be merely supplementary to other sources. Another unsettled issue is the degree of commitment and depth of cooperation even in these few areas.

[12] Haggard, 2009, p. 2.
[13] Grimes, 2009, p. 69; Dieter, 2007, p. 124.

In addition to CMI, initiatives to develop bond markets in the region were also subsequently included in the agenda for regional financial cooperation. These were meant to offer a supplementary or alternative source of finance for Asian economies, in which bank-finance is still dominant, and reduce systemic risk, particularly currency risk which was experienced during the Asian Financial Crisis by enlarging the use of regional currencies and reducing dependence on the US dollar. Collective efforts by Asian governments included the APT's Asia Bond Market Initiative (ABMI) and the EMEAP's Asian Bond Funds (ABF1 and ABF2) designed to develop the supply and demand sides, respectively, of Asian bond markets.

The objective of this study is to understand how regional financial institutions in East Asia have evolved in pursuit of their objectives given the global political and economic context in which they were created and in which operate. In particular, the factors that have driven the process of institutional development as well as those that hamper institutional development will be examined, understanding that the global political and economic contexts are likewise evolving as well. An assessment of the effectiveness of the institutions covered in this study, based on the scope of issues addressed by regional financial institutions, the extent of binding decisions and commitments made, and the extent of delegation to these institutions will also be made.

The next two sections discuss the history of regional financial cooperation and the various issues related to financial regionalism in East Asia. The challenges to evolving financial institutions that were created to form a strong line of defense against future crises are examined next, while also assessing the responses of these offshoot institutions to the current global financial crisis and relevance of regional efforts.

Today, the multilateralization of CMI has progressed to an extent that there is agreement on transforming the bilateral swap agreements into a single contractual arrangement. This is a significant development and could create the conditions for regional institution- building. It may also be a sign that financial regionalism in East Asia has become a mainstay in today's globalized world. The study makes some suggestions for future directions that CMIM can take. It concludes that now may actually be the best time to push financial regionalism, as vanguards of the existing global financial architecture remain preoccupied with their own problems and greatly humbled by their role as originator of the current global financial crisis, allowing bolder changes elsewhere in the world to become possible.

II. History of Regional Financial Cooperation in East Asia

The ASEAN is the earliest institution of regionalism in Asia that had minimal organizational backing and a preference for non-binding agreements.[14] In 1990, Prime Minister Mahathir of Malaysia called for the formation of the East Asian Economic Group (EAEG), deliberately leaving out the US as well as Australia. The original idea for the creation of the EAEG was for it to function as a trade bloc, but this was unappealing to Japan because the latter was concerned about not losing access to US markets. EAEG was repackaged into the East Asian Economic Caucus (EAEC) in 1991 and was made into a caucus within APEC in 1994. This eventually served as the basis for APT.

[14] It was only in 1992 when AFTA was proposed and 2003, when some kind of core AFTA regime was implemented, that ASEAN states had an institution with clear rules and decision-making procedures.

While the Asian Financial Crisis was raging in 1997, the Japanese government, specifically, the Ministry of Finance, proposed the creation of an Asian Monetary Fund (AMF). The idea behind the AMF was to provide liquidity support for crisis prevention, management and resolution supplementary to IMF resources. As much as USD100B would be mobilized by pooling foreign exchange reserves held by East Asian authorities in order to deter currency speculation, and contain a currency crisis and contagion in a member country.[15] Unlike IMF packages, however, AMF would not have strict conditionalities attached to accessing them and would be for countries in East Asia only. Opposition to this from the US government and IMF on the grounds of moral hazard and duplication, and some key countries in the region such as China, which was not ready at the time to be involved in a common arrangement with Japan, led to the scuttling of this proposal in September 1997.

Instead, the US Treasury shortly thereafter initiated the Manila Framework Group (MFG) under APEC auspices to deal with the effects of the financial crisis. This would be accomplished through mutual surveillance among a subset of APEC countries, technical assistance, and if needed, access to an expanded pool of IMF funds premised on preconditionality so that the funds could be accessed more rapidly and with fewer conditionalities. MFG created a mechanism for the coordination of voluntary contributions to multilateral bailouts but did not formally commit its members to provide any liquidity to countries in crises.[16] The MFG consisted of senior central bankers and finance ministry officials of ASEAN and others in APEC and therefore included those from the US and Australia as well. Non-common membership is indeed one feature of Asian economic cooperation.[17]

The MFG met for the first time in November 1997. Japan saw the possibility of establishing a new set of standards for surveillance more applicable to the East Asian economies, such as efforts to create an Early Warning System, as well as the promise of new funds and acquiesced to the MFG. However, by 2004, the MFG was dead and the only remnant of it was its surveillance function.

In 1998, Japan activated the New Miyazawa Initiative, in which a pool of funds valued at US$ 30B, was made available for short-term and medium- to long-term lending. The Asian Crisis Support Facility within ADB includes US$ 5B of these short-term funds. One-way swap lines were established with South Korea and Malaysia to augment their foreign exchange reserves. Furthermore, governments of crisis countries could avail of credit guarantees to be able to borrow in international markets.

The APT heads of state met at an initial informal meeting in December 1997. The focus of the APT process was initially on macroeconomic and financial issues. This was later expanded to include ministerial processes for foreign affairs, health, labor, science and technology, etc. APT became a formal grouping by 1999 when they issued a joint communiqué following their third meeting. In 2002, the APT leaders received the East Asia Study Group's Final Report which identified short-term and medium- to long-term measures to promote East Asian cooperation. In 2003, APT leaders endorsed the implementation strategy for the short-term measures to be

[15] Kawai, 2009, p. 46.
[16] Grimes, 2009, pp. 78-79.
[17] Haggard, 2009.

implemented in 2007, and in 2004, they encouraged a faster implementation of these as well as implementation of medium- to long-term measures.[18]

APT has been regarded as being based on the original EAEC proposal as the membership is approximately the same. APT is significant in that it is the only East Asia-only regional cooperation group formed in the post Asian Crisis period, although its organizational roots which never came to fruition, EAEC, was established within APEC and a much wider membership. APT is a group centered on ASEAN and as such, is seen as non-threatening by the US and other countries. It has been the major force behind the various initiatives launched after the Asian Crisis, namely, CMI and ABMI, to defend the region against future financial and economic instability.

The Chang Mai Initiative (CMI)

Two years after the AMF was rejected, the leaders of ASEAN invited the +3 countries to deepen economic and monetary cooperation. ASEAN is therefore at the center of APT and indeed initiated it. A joint statement following the November 1999 APT Summit identified a wide range of potential areas for cooperation including the creation of a regional financial arrangement to supplement IMF liquidity support.

In May 2000, the then existing ASEAN swap agreement was widened to cover all ASEAN members. The CMI was also announced by finance ministers of the APT countries and the amount available was raised to US$ 1B from the initial US$ 200M.[19] CMI guidelines were announced in May 2001 and arrangements were set in place by the end of 2003. CMI's goal was to act as a regional liquidity reserve for APT countries, primarily ASEAN countries as the potential borrowers, by creating a mechanism for large-scale multilateral financing to help member countries during periods of financial crises.

CMI is composed primarily of bilateral swap agreements (BSAs), plus the original ASEAN Swap Arrangement (ASA). BSAs under CMI is a system in which ASEAN countries could borrow predetermined amounts of US dollar reserves from a Northeast Asian country such as China, Japan, or Korea for 90 days renewable up to two years to add to their reserves. In exchange, the borrowing country would transfer an equivalent amount of their currency to the lender during the swap. At the end of the period of the swap, the borrowing country would return the amount of US dollars borrowed with interest. BSAs were originally one-way agreements in which the lender would provide the hard currency to the borrower but not vice–versa. As of April 2009, the total amount of BSAs reached USD 90B under 16 BSAs while the total ASA amounted to USD 2B.[20] At the 2005 Istanbul Agreement of the APT finance ministers, all BSAs were supposed to become two-way agreements. However, as of 2008, 6 of 16 BSAs were still one-way, such as all of China's BSAs with ASEAN states and Japan's BSA with Malaysia.[21] The small amounts of the BSAs, at least relative to the size of dollar reserves in countries like China and Japan, is perhaps a reflection of the reluctance of countries, in general, to part with their reserves, their self-insurance against crisis.

[18] Kawai, 2009, p. 47.
[19] Dieter, 2007, p. 128.
[20] Kawai, 2009, p.49.
[21] Grimes, 2009, p. 82.

There are those who see a degree of ambiguity in the goal(s) of CMI.[22] In particular, a question arises as to what the liquidity support is for. On question is whether CMI is designed primarily to provide liquidity support to the banking sector in the event of a credit crunch or a 'sudden stop' capital during a crisis, such as when all or a majority of a country's lenders retreat. Alternatively, it is possible that the implicit goal of such access to foreign reserves under CMI is to stabilize exchange rates when currencies are subject to speculative attack during a crisis. Note that a clearer understanding of the goal(s) of liquidity provision under CMI is important since the viable options in either of these cases are not always the same. Capital controls or the threat by a country of imposing such controls during a crisis could scare away potential lenders and exacerbate a credit crunch, but may help stabilize a currency under attack by preventing further volatile capital inflows and outflows.

On the other hand, if CMI were to function as a supplemental regional lender-of-last-resort, then it could help alleviate or prevent a credit crunch as well as potentially stabilize currencies if the amounts provided as liquidity support were large enough to discourage destabilizing speculation. The fact is, however, that the amount of funds contributed by China and Japan to CMI is but a fraction of their total dollar reserves. Seen from this perspective, it is unclear whether CMI is really a coalition of *willing* lenders.

The problem of the small amounts that can potentially be accessed during a crisis is serious. This feature of CMI gives rise to uncertain potential benefits and again, may affect the willingness of parties to participate in CMI and commit themselves to certain rules. Foreign exchange reserves equivalent to twenty percent of BSAs are insufficient to deal with a crisis. To begin with, the total amounts referred to in CMI tend to be overstated and misleading since no country is crisis would have access to the total or half of the total amount of funds in CMI, and two-way agreements are double-counted.[23]

Nevertheless, countries evidently do have access to a larger amount of funds under CMI relative to its IMF quota. The Philippines, for example, has access to US$ 9.5B through CMI, which is roughly seven times its IMF quota of SDR 880M or approximately about US$ 1.3B.[24] But in times of crisis, this amount would undoubtedly be insufficient and in any case is inferior to a situation in which the US Fed were to act as the-lender-of-last-resort as it did in the case of South Korea recently in the midst of the current global financial crisis.

It appears, therefore, that the lender-of-last-resort function, albeit supplemental, is the real raison d'être of CMI. To a large extent, the ability of CMI to perform this function will be the basis on which its success will be judged. CMI's liquidity provision on a regional level could play a role complementary to the global lender-of-last-resort function presently exercised principally by the IMF and by the US Fed under the global dollar standard.

Operationally, CMI sought to borrow credibility from the IMF, not only to prevent moral hazard from lending during a crisis, but also to address certain political considerations by linking IMF conditionality to the ability of borrower countries to access CMI funds. There are no policy conditions attached to borrowing in CMI and CMI operates on a purely request basis. Initially, only 10 percent of the funds could be released without the IMF link, but a country would have

[22] Dieter, 2007, p. 134.
[23] Grimes, 2009, p. 85.
[24] Grimes, 2009, p.85.

to be negotiating a standby agreement with the IMF. There is no certainty that the country wishing to borrow could actually do so under CMI as it is unclear whether a borrower country could be induced to negotiate a standby agreement with the IMF after the experience of the Asian Financial Crisis.

Potential creditors, like Japan, see the region's inability to formulate and enforce effective adjustment programs during crisis periods as a reason for requiring CMI to be linked to IMF programs.[25] CMI largely delegates decision-making regarding which states could access such funds to the IMF. These political considerations require working within the framework of the global financial architecture dominated by the US in a way that would not be seen as threatening by the latter, thereby also not jeopardizing Japan's ties with the US, including it important security relationship.

The IMF also appears to be the only institution with effective powers of surveillance and enforcement in the region. Cultural norms and principles of non-interference in ASEAN which would make it difficult for any country to reject requests or impose conditions on a potential borrower country neighbor in CMI. CMI might therefore been regarded as a revival of the original AMF proposal but with links to the IMF via the practice of delegated decision-making.

The delegation of a great degree of decision-making to the IMF under CMI is a compromise of sorts between the MFG's principle of preconditionality and the New Miyazawa's provision of liquidity without new conditions.[26] Perhaps the linkage to the IMF is a major stumbling block to the willingness of countries in the region to participate in financial regionalism in a deeper way given the IMF's damaged reputation from the Asian Financial Crisis. Borrowing conditionality from the IMF implied that states needed to follow responsible policies to be eligible to receive funds during a crisis. By using the CMI arrangement, however, this conditionality could, in principle, be made appropriate to conditions of countries in East Asia through the development of a regional surveillance mechanism in APT.[27] Indeed, there does not appear to be an ex-ante good reason to preclude such a regional surveillance mechanism from performing better than the IMF did prior to the Asian Financial Crisis.

Apart from the IMF link, there are performance criteria in the bilateral swap agreements in CMI that are preconditions for the release of funds. There is a process of regional economic surveillance process formally called the Economic Review and Policy Dialogue (EPRD), which was put in place in 2004 when a decision was made to unify the APT + 3 policy dialogue with that of CMI. EPRD was the first serious experiment with multilateral surveillance among the APT countries. EPRD was designed to help prevent crises by early detection of irregularities and vulnerabilities and the swift implementation of remedial actions. Countries would be able to implement better macroeconomic policy and financial sector policy and institutional reforms through peer pressure.[28] In the opinion of many, however, the level of multilateral surveillance among APT countries remains low and there have not been strong supporting mechanisms for surveillance under EPRD. Since May 2005, EPRD has been integrated into the CMI framework. IMF representatives also have a role in the meetings of the finance ministers that take place during the annual meeting of the ADB.

[25] Kawai, 2009, p. 50.
[26] Grimes, 2009, p. 81.
[27] Grimes, 2009, p. 81.
[28] Kawai, 2009, p. 48.

Beyond peer pressure and non-binding informal cautions, however, there is no formal enforcement mechanism in CMI.[29] There is merely an informal gentleman's agreement that if a CMI participating country does not express disapproval of another country's economic policy, then the former is morally obligated not to reject the latter's request for funds on the grounds of economic mismanagement in the event of a crisis. This is a weak, norm-driven mechanism of enforcement. Dependence on this informal mechanism creates uncertainty about the actual probability of being able to access CMI funds during a crisis and is therefore likely to affect the degree of commitment to mutual surveillance and liquidity provision under CMI.

In May 2004, the APT finance ministers issued a statement that was meant to be the outcome of an earlier agreed-upon review of CMI every 3 years. Aside from initiating a process of re-examination every two years, the statement was significant for several reasons. The review was an opportunity to revisit the idea of AMF as well as examine ways to eliminate the weaknesses in the CMI arrangement.[30] Ironically, however, the statement announced the postponement of further discussion on multilateralization, the IMF linkage, and fund size until the APT finance meeting in 2005. These are the very contentious issues that have made it difficult to improve the operational aspects of CMI. Given the heterogeneity of preferences etc. of the countries in APT, within the ASEAN countries themselves as well as between ASEAN and the + 3 countries, it is not hard to understand why consensus is easier to obtain on 'low' issues and difficult to obtain on contentious ones and why postponing discussion of contentious issues or simply talking shop is the least common denominator outcome.

To date, despite the onset of the global financial crisis, none of the BSAs under CMI have been activated. This is likely due to the insufficient amounts involved as well as the rather complicated activation procedure, including the IMF link.[31]

Multilateralization of CMI

How CMI is to be multilateralized remains an unsettled issue. The multilateralization of CMI refers to the conversion of the bilateral swap agreements under CMI into a common fund that would be managed on a collective regional basis. This necessitates the creation of an institution in which countries in the region would agree to bind themselves to certain rules and decisions. The 2005 Istanbul Agreement on CMI made some progress on multilateralization via the advance designation of a coordinating country for each potential crisis country. The central bank of this coordinating country would aggregate funds and manage swaps in case of an emergency. The designated coordinating country is required to have a BSA with the crisis country to begin with, so it is not a stretch to have the creditor country do more of what it is already doing when the borrower country is in crisis. Again, it seems that there is consensus on less controversial matters although this means that movements toward multilateralization, in this case, are very incremental.

The 2005 Istanbul Agreement also raised the ceiling for withdrawal without an IMF program in place from 10 percent to 20 percent of the total and a doubling of the size of BSAs. It also established a roadmap for three stages of development of CMI. First is the completion of the BSA network in which CMI was explicitly supplementary to the global facility (IMF) and had no

[29] Grimes, 2009, p. 89.
[30] Grimes, 2009, p. 90.
[31] Park and Wyplosz, 2008, p. 80.

link to regional surveillance; the second is the integration of APT surveillance, introduction of collective decision making, expansion and standardization of BSA network, and greater effectiveness and discipline; finally, enhanced surveillance, multilateralization, utilization of local currencies, and intra-regional exchange rate stability as the agenda under future regional cooperation.[32]

With CMIM (Chiang Mai Initiative Multilateralized), the issue of the IMF link is being revisited but the question being posed is increasingly becoming whether a break from the IMF link or not is necessary. There are several questions attached to this issue.

One is whether CMI will complement the existing global architecture as represented by the IMF, be a, additional source of liquidity and act as a supplementary lender-of-last-resort in times of crisis, or whether CMI is aimed at competing with or becoming a substitute in the future for the IMF. The expectation is that if CMIM were to substitute for or reduce the role of the IMF, adequate and timely liquidity will be provided when there is a crisis under a system where countries in the region have greater control over decision and agenda-making compared with the present system.

Another question is the degree to which CMI may be used effectively as leverage by being an alternative to the IMF, together with the threat of exit from the global financial architecture, in order to secure better terms from the IMF and international financial institutions. By explicitly recognizing the supplementary role of CMI to the global facility, however, the credible threat of a challenge to the IMF and the global financial architecture dominated by the US and the US dollar is weakened. Therefore, the potential threat of CMI being used as leverage to obtain better treatment from the global financial system's institutions is limited.

Under the current global financial architecture, the function of bailing out crisis countries is primarily, although no longer exclusively, delegated to the IMF. The ability of APT to develop a credible regional analysis and surveillance mechanism, necessary in order to define whatever conditionality is to be attached to the funds, is likewise an important issue. Integration of APT surveillance, included in the second stage of development, is not a very meaningful concept when the surveillance function is delegated to the IMF and the region does not have the same capacity as the IMF to undertake it. However, some argue that given the performance of the IMF prior to and during the Asian Financial Crisis, it is not a foregone conclusion that a regional surveillance system will necessarily be inferior to the IMF. Indeed, since May 2006, the APT finance ministers have worked to improve the functioning of EPRD and CMI and to multilateralize CMI. A collective decision-making procedure for CMI swap activation was adopted as a step toward multilateralizing CMI.[33]

The 2007 APT finance ministers meeting in Kyoto saw an agreement in principle to form a self-managed reserve pooling arrangement governed by a single contractual agreement as an appropriate form of multilateralizing CMI. On the surface, this was a major step toward multilateralization because of the agreement for individual countries to provide resources in the form of foreign reserves in which each country will continue to manage its own foreign reserves. However, the release of such reserves when an emergency arises is to be governed

[32] Grimes, 2009, pp. 90-92.
[33] Kawai, 209, p. 50.

by a contractual agreement among the states. But there was no governing contractual agreement arrived at, only an agreement in principle for the creation of such a contract.

Nevertheless, the agreement to bind each country to a common rule and pre-committing a country to the release and use of such foreign reserves is significant. This removes one of the sources of uncertainty regarding the release of funds when the funds are needed. More importantly, this is a case in which an entity other than that country's own central bank or finance ministry makes such a decision to release foreign reserves. In delegating this function to a regional arrangement such as CMI, a degree of national sovereignty is given up. This is why central banks in the region, which jealously guard their influence over monetary policy and the exchange rate and have tried to build-up foreign reserves as a form of self-insurance, have little incentive to do this unless there were a greater degree of certainty that the benefits from insuring via CMI more than cover such costs at the margin. However, there was still no actual contractual agreement on regional pooling.

In May 2008, agreement was reached on the total size of CMIM to be at least USD 80B as well as on the 20:80 proportion of contribution from ASEAN and the Plus 3 countries, respectively.
In February 2009, at a special meeting of the APT finance ministers in response to the global financial crisis, the agreed-upon size of the common fund for CMI was raised to US $120B from US$ 80B.

The specific arrangements regarding how these funds are to be collectively managed are not vey clear yet and there are different opinions within the region regarding this issue.[34] It was agreed that different rules of decision-making under CMIM would apply depending on the nature of the issue. Fundamental issues such as the review covering size, contribution, and borrowing multiples, readmission, membership, terms of lending, etc. would be decided on by consensus. Lending issues pertaining to lending, renewal, or default would be decided on by majority voting. This adoption of formal decision-making rules represents an improvement over informal methods such as gentleman's agreement in the past.

There was also agreement on the establishment of an independent surveillance unit and a possible increase in the IMF-de-linked portion above the current 20 percent. The Statement of the finance ministers explicitly makes mention of the importance of conducting cooperative economic policies to ensure the economic recovery of the region given the current global financial crisis, promote capital flows into the region, and strengthen regional financial cooperation to ensure financial stability and promote market confidence. It states that the core objectives of CMIM are to: (i) address short-term liquidity difficulties in the region and (ii) to supplement existing international financial arrangements.[35] These stated objectives of CMIM are a reiteration of those of CMI after the 1997 Asian Financial Crisis.

The APT finance ministers' regular meeting in Bali in May 2009 saw agreements reached on all main components of CMIM, including individual country contributions, borrowing accessibility and the surveillance mechanism, and on the implementation of the scheme before the end of 2009. Japan and China plus Hong Kong will each contribute US$ 38.4B each or 32 percent of the total US$120 B pool of funds in CMI. Korea's share is 16 percent. The ASEAN countries

[34] Henning, 2009, p. 3.
[35] See the Joint Media Statement of the 12th APT Finance Ministers' Meeting, 2009.

decided amongst themselves how to come up with the 20 percent aggregate contribution. Indonesia, Malaysia, Singapore and Thailand each contribute US$ 4.44B while the Philippines, with substantially lower dollar reserves, was allowed to contribute only US$ 3.68B. There was also an agreement on the establishment of an independent surveillance unit "as soon as possible" to monitor regional economies and support decision making. The ministers agreed to establish a panel of experts to work with the ADB and the ASEAN Secretariat to enhance the current surveillance mechanism. Hong Kong was formally welcomed to participate in the CMIM. However, since Hong Kong is not a member of the IMF, it can potentially only access the de-linked portion of 20 percent. CMIM is now designed as a US dollar liquidity support arrangement so that the local-currency swaps in place under CMI BSAs are excluded.

Regional bond market initiatives

Regional bond market development is important because it helps prevent currency mismatches, enlarges the choice set of borrowers and savers, improves the efficiency of financial intermediation by providing competition to bank-based finance, and promotes financial regionalism. CMIM and the bond market initiatives are different in that the former does not veer away from dollar dependence whereas the latter tries to offer an alternative. Also, CMIM function and goals are more in the nature of a public good. Bond market initiative is only partly so and relies on the greater participation of the private sector for success.

In 2002, the Japanese Ministry of Finance (MOF) proposed the Asian Bond Market Initiative (ABMI), whose creation was endorsed by the APT finance ministers in August 2003 to develop regional bond markets. Attempting to increase the supply of local bonds in the regional market, the ABMI aims to create an environment conducive to the issuance of bonds in regional financial markets. The finance ministers established six different working groups, including on standardized debt instruments, the creation of credit rating agencies, the setting-up of clearing and settlement and credit guarantee mechanisms, and creation of local currency bonds issued by foreign government agencies, multilateral institutions and multinational corporations.[36] The ADB supports ABMI, for example, by issuing Thai baht-, Malaysian ringgit- and Philippine-peso denominated bonds.

In 2005, the first road map for gathering and sharing information was released to give the initiative greater direction. This launched two new studies on "Asian bond standards", which sought to outline infrastructure and procedures comparable to global bond markets, and on the possibility of issuing Asian currency basket bonds. APT finance ministers also endorsed new research that would collectively look at capital flows liberalization and institutional arrangements. By May 2006, the six working groups had been collapsed into four groups which focused on the development of market infrastructure, specifically the credit guarantee and investment mechanism, the clearing and settlement system, credit ratings and Asian bond standards. More studies were initiated the following year which sought to explore and promote new debt instruments for infrastructure financing, securitization of loan credits and receivables and an Asian medium term-note program.

May 2008 saw the release of the second ABMI road map with the realization that the institution still did not meet earlier expectations. This created four task forces to promote issuance of and demand for local currency denominated bonds and improve the regulatory framework and

[36] Dieter, 2007, p. 132.

related infrastructure for bond markets.[37] The new plan also asked country members to develop references for self assessment to serve as their benchmarks and thus capitalize on "peer pressure", which is a favored method of the ASEAN.

An agreement to establish a Credit Guarantee and Investment Mechanism (CGIM) as trust fund of the ADB was in place by 2009, with an initial capital outlay of $500M to support private local currency bond issuance in the region. However, details such as the scope of coverage, leverage ratios and country limits still needed to be resolved in the 2010 meeting.[38] Country members also endorsed a plan to establish a settlement mechanism known as the Regional Settlement Intermediary (RSI).[39] Independently, India, Malaysia and Indonesia have announced efforts to promote a regional ratings agency.

Meanwhile, in 2003, the Asian Bond Fund (ABF) was established under the auspices of EMEAP (East Asian and Pacific Central Banks and Monetary Authorities). In contrast to the ABMI which seeks to improve market infrastructure, the ABF seeks to widen market demand via creation of bond funds. Its aim is to reduce dependence on non-Asian financial markets and enable borrowing in domestic currencies of the region to reduce dependence on US dollar finance, which will reduce the vulnerability of the region to swings in the values of domestic currencies against the US dollar through reduced risk and better management in the region's financial markets.

Nine Asian governments, including Hong Kong, agreed to contribute to the ABF which invests in Asian debt securities. This initiative is designed to speed up the development of local bond markets by having active government participation in the pooling of foreign reserves for investment in a highly liquid asset designed to deepen the regional bond market, the ABF, which will bypass having to wait for active participation from the private sector. The first ABF fund was launched in June 2003. Managed by the BIS, it had a capital of US$ 1B in a basket of dollar-denominated sovereign and quasi-sovereign bonds issued by the governments of EMEAP except those of Japan, Australia, and New Zealand.[40] ABF 2 introduced in December 2004 invests in sovereign and quasi-sovereign bonds denominated in local currency and comprises a Pan-Asia Bond Index Fund as well as a Fund of Bond Funds, which are investments in eight separate country sub-funds. EMEAP has allocated US$ 2B for ABF2.[41]

The initiatives to develop Asian bond markets have had mixed but generally positive results. The ABF has had relatively little impact as the amounts involved are small — $3 billion in total against a $4 trillion Asian bond market (ex-Japan). Overall efforts to encourage bond market development have been fairly successful, with volumes of issuance more than doubling in the region, creating more liquidity as evidenced by lower bid-ask spreads.[42] Bond market initiatives have also met some success in promoting local currency bond market, as growth in total regional issuance has been remarkable. In value terms, the region has witnessed a doubling of

[37] Park and Wyplosz, 2008, p. 83.
[38] Spiegel, 2009, p. 23.
[39] Park and Wyplosz, 2008, p. 87.
[40] Dieter, 2007, p. 133.
[41] Dieter, 2007, p.133.
[42] Spiegel 2009, p. 17.

corporate issuance in local currency while government issuance nearly tripled.[43] Progress though has been heterogeneous with some economies lagging behind.

By and large, the Asian region is still found to be underserved by local bond markets.[44] Efforts to develop Asian bond markets have met roadblocks in terms of failure to achieve scale economies and a glaring absence of a common currency. The small size of underlying economies and insufficient per capita incomes serve as major hindrances to the development of local-currency bond markets which require minimum threshold levels to realistically develop and flourish. Continued adherence to the US dollar standard and absence of a common currency impede the development of a truly regional bond market as these underpin obvious weaknesses in infrastructure such as the lack of an efficient common settlements system. Non-harmonization of standards (e.g. accounting and legal, bond issuance and trading) has also held back advancement in Asian bond markets. On the whole, there does not seem to be compensation for potential losers or incentives for greater participation in regional efforts to develop bond markets apart from peer pressure in the form of a "demonstration effect."

III. Issues Related to Financial Regionalism in East Asia

The State of Financial Regionalism and Integration in East Asia

In contrast with trade in goods, there is an absence of 'home bias' or the usual strong own-country or own-region effect arising from geographic proximity and same-time zones effect in East Asia in the area of finance. Using standard measures of the degree of financial integration, East Asia is more integrated financially with the rest of the world than it is within its borders. Looking at price convergence criteria, for example, while average cross-border differentials in bond yields and money market rates have declined dramatically since the Asian Financial Crisis, they have remained substantial.

Tests of covered interest parity for several countries in Asia, particularly for the ASEAN 5 countries, are roundly rejected, and represent little change from the pre-Asian Crisis situation. Bilateral correlations of either bond or money market rates do not exhibit a high degree of co-movement relative to those in developed country markets.

Alternatively, using quantity indicators of regional financial integration, excluding Japan, there appears to be an "East Asian" effect in both portfolio assets and bank claims, as seen in the substantial improvement in intraregional portfolio activity in Asia over the years. However, when a dummy variable for bilateral trade is included in regressions that measure the degree of regional financial integration, this "East Asian" effect becomes negative and lower than that of random pairs.

In theory, regional financial integration should allow better consumption smoothing. However, recent evidence shows that consumption growth in an individual country is still closely linked with national income growth and that domestic savings and investment are still highly correlated even in the post- Asian Crisis period. The correlation between national and regional consumption remains unclear, although it increased somewhat in the post-Asian crisis period.[45]

[43] Spiegel 2009, p. 17.
[44] Eichengreen and Luengnaruemitchai, 2006.
[45] Lee and Kim, 2008 and Takagi and Hirose, 2004.

Consumption risk-sharing in East Asia has largely occurred through major global centers[46], not a surprising result as the output of countries in the region are highly correlated and would therefore not be conducive to regional consumption smoothing.

Hence, the same market-driven processes of integration that have worked well in trade have evidently not done as well in the area of regional financial cooperation and integration in Asia. This is so even as financial integration in East Asia appears to be driven by regional trade as seen, for example, in the amount of bank claims which support real trade.[47]

Financial regionalism and the provision of international public goods

Several explanations of the pattern of regionalism that has emerged in East Asia have been given. One explanation as to why trade integration has progressed faster than financial regionalism has is that whereas trade involves the exchange of private goods and the reaping of private gains by private actors, financial regionalism involves the production of international public goods. Stable currencies, well-functioning financial markets, and liquidity provision are public goods that have important externalities.

National governments are the main actors involved in the process of financial regionalism, specifically, the provision of these international public goods, in the absence of a world government. But national governments differ in their perception of self-interests, sovereignty, preferences, degree of adherence to rules, and standard setting. Because of the public good nature of these goods, however, states are the only actors with the ability and motive to lend in a financial crisis, set monetary and exchange rate policies, and regulate transactions within and across their borders, but whose ability and inclination to do so are inextricably linked with issues of sovereignty as well as internal domestic political dynamics.

There is a world of difference between international trade in goods and international trade in financial assets or as Bhagwati's (1998) says, a "difference between trade in widgets and dollars." This was first noted by Diaz-Alejandro many years ago, in his discussion of the Chilean Crisis of the early 1908s, when he said that domestic and financial markets were different from the markets for apples or meat.[48] Unlike trade in goods, there is little empirical evidence that financial liberalization and unfettered capital flows and trade in financial assets raises economic welfare or the growth rates of developing countries.[49] The Asian Financial Crisis is cited as proof that unlike international trade in goods, international trade in financial assets in an economically-globalized world could lead to devastating outcomes because of inherent risks in financial trade. These inherent risks can reduce or nullify mutual gains to the trading parties, contra theory. Unfortunately, the costs, such as potential crises occurring as a result of capital mobility that eliminate gains from freer trade in financial assets, are generally ignored in the calculus of gains from trade in financial assets.

One of the most important characteristics of financial trade absent in goods trade is its intertemporal nature and the potential for asymmetric information to eliminate trade gains. In a

[46] Jeon, Ohm and Yang, 2005.
[47] Shin and Yang, 2006.
[48] Diaz-Alejandro, 1985. Obstfeld, 2008, p. 8 notes that food production processes in many countries are heavily regulated by government because of the possibility of disease transmission through the food chain.
[49] Obstfeld, 2008.

perfect world, theory says that capital will flow from a low-interest country to a high-interest one. The recipient country can consume and invest more than its own domestic savings allow, and generate more income to enjoy and with which to pay the lender country. The lender country produces less currently but can potentially enjoy higher future consumption from the interest income it will earn upon payment by the borrower country. This means that this future payment is a contingent one and depends on the ability and willingness of the borrowing country to pay at a later date. In any case, theoretically, there is a gain in efficiency capital is allocated efficiently and interest rates are equalized, and countries enjoy more consumption and growth than they would in autarky.

However, there are inherent risks here because the contingent payment and the circumstances surrounding this payment depend on information available only to the borrowing country. Asymmetric information between the borrowing country and the lending country can give rise to moral hazard, in which borrowing countries behave irresponsibly once they have accessed the loan and become unable to pay when due, and adverse selection, in which bad credit risks in the form of irresponsible countries, are the ones selected for lending to. This is why there is a need for an institution, such as government, even under autarky, to regulate financial markets and reduce the distortions present there.

The problem is magnified many times over with international trade in financial assets, when trade is between countries whose citizens may have different preferences, such as rates of time preference, and which necessitate the use of some form of insurance, adoption of prudential policy, transparency requirements, etc. by government. The international dimension raises problems of sovereignty, regulatory end-run and arbitrage, competitive forbearance, currency mismatch, and contagion.[50] Sovereignty issues arise when two or more governments are parties to international contracts. Regulatory end-run and arbitrage occurs when domestic supervision is evaded through international transactions. Competitive forbearance occurs when national regulators succumb to pressure to be lenient towards domestic financial institutions in competition with foreign ones. Currency risk occurs when bank liabilities and assets are denominated in different currencies so that earning streams and liabilities are mismatched. Contagion occurs when fears of a financial crisis spread a crisis from one country to another. During the Asian Financial Crisis, perhaps all of these were present, but it is more difficult to assess the roles of regulatory arbitrage and competitive forbearance.

While trade is welfare-improving in theory, in reality, there are winners and losers. The move to freer trade (in goods or financial assets) can be Pareto-improving if government is able to redistribute income domestically. However, the government has limited ability to eliminate ex-post losses through income redistribution. One reason for this is the difficulty in determining exactly the income redistribution due to international trade per se (in goods or financial assets) versus the redistribution arising from deep economic factors. On the other hand, if government were to successfully eliminate all ex-post losses regardless of source, it would generate flawed incentives and induce moral hazard that would reduce economic efficiency and growth.[51] This means that it is difficult to compensate losers. This makes it difficult to entice potential members to participate given the high risk of potential losses or crisis as outcome of trade, particularly, in financial assets.

[50] Obstfeld, 2008, p. 12.
[51] Obstfeld, 2008, p. 9.

Financial regionalism in the global context

Today's globalized financial system is characterized by the presence politically sovereign countries that are highly economically-interdependent, operating within a predominantly US dollar standard alongside multiple currencies. In this more economically-interdependent world, the less industrialized world's share of global GDP valued in purchasing power parity exchange rates of 45 percent in 2008 has become more equal to that of the industrialized world's share, of 55 percent.[52] The importance of the less-developed world, including emerging markets, in developed countries' financial markets has grown even more rapidly than the growth of trade. Evidence of this is seen in terms of the share in developed countries' GDP of net asset acquisition of about 6 percent prior to the current global crisis and the total amounts of reserves plus non-reserve government foreign assets of about 15 percent.[53] Despite the increase in economic power of the less-industrialized world and emerging markets, however, the political power afforded them, such as their voting rights in multilateral bodies that set global standard and rules, have not risen commensurately or as rapidly. This has been a deep source of dissatisfaction with the existing global economic architecture among emerging economies. Even the proposal in April 2008 to raise the voting shares of certain developing countries in the IMF has yet to be ratified and in any case, has not appeased these countries.

Greater economic interdependence means that there is thus less scope for "decoupling" and the containment of externalities arising from the actions of any country or group of countries. Instead, there is a higher degree of systemic risk that comes with greater economic interdependence among states. Unfortunately, as in the simple model of a bank run, it is difficult to distinguish cases of illiquidity from insolvency when there is widespread financial distress and the prospect of systemic risk rises. Illiquidity could quickly turn into insolvency, especially if counter party risk is hard to assess, which leads to the quick drying up of credit and "sudden stops" of capital not only to the private sector within a state but to those in other states as well. The threat of a concerted default by heavily indebted countries in the early 1980s, for example, could have wiped out the capital of banks in developed countries, and resulted in a "sudden stop" of capital to developing countries.

In the more recent global financial crisis, both deleveraging in the developed countries and "flight-to-quality" purchases of assets of developed countries after the bursting of the real estate bubble in the US have severely constrained credit in emerging markets, including those in Asia. Episodes of severe dollar liquidity occurred and were dealt with in different ways by different countries. Some in the region, like South Korea and Singapore, were given a dollar swap line by the US Federal Reserve Bank, each amounting to US$ 30B.

That South Korea went to the US Fed instead of accessing dollars from CMI is evidence that CMI is not a first-best option for a country in need of large amounts of dollar liquidity. It recognizes that the US Fed, rather than a group of regional central banks in possession of a large aggregate but finite amount of dollars, is the only entity that is the ultimate lender-of-last resort under a dollar standard.

This experience of South Korea does not bode well for CMI. After all, here was a country that under normal conditions would not have had to secure a source of dollar funds, is developed

[52] Obstfeld, 2008, p. 2.
[53] Obstfeld, 2009, p. 3.

and wealthy enough to presumably be a good credit risk if it needed to borrow US dollars, implements correct macroeconomic policy and would meet the requisite IMF conditionalities. Therefore, South Korea would have been eligible even under a gentleman's agreement to borrow from CMI but did not or could not. Instead, the solution involved a bilateral arrangement instead of a regional one. Perhaps the small amounts could be accessed from CMI were insufficient for its needs and since borrowing from the US Fed, being the real lender-of-last-resort under a dollar standard, was the only way to prevent a financial crisis. Also, the domestic political ramifications for the government of Korea of having to go for a program with the IMF if it had accessed CMI funds, given the experience of 1997 and 1998, were probably just too great.

Hence, even within APT or within ASEAN itself, there appears to be variable geometry, as the possibility of bilateral arrangements with the US tends to undermine the regional arrangement and is based on considerations other than purely economic reasons. Here is a case where the economic rationale of going to the US Fed as the ultimate lender-of-last-resort during a crisis, a function that only it can perform without any limitations, is not always compatible with political realities and in which a regional solution is second-best.

This situation also highlights the inability of a single national lender to fully perform the lender-of-last-resort function in a globalized financial system. In theory, a national central bank cannot provide unlimited amounts of "outside liquidity" — in US dollars under the current US dollar standard — both as a way to forestall a crisis, such as a run on the currency, or to provide needed liquidity to stabilize the financial market and support the currency should a crisis take place. Liquidity provision is a public good but in a financially-globalized world, the limits to being a lender-of-last-resort are quickly reached by a national central bank. This is because outside of the US Fed, no central bank can print US dollars. Even the massive amounts of foreign reserves, primarily US dollar reserves, accumulated by individual countries as a form of self-insurance, are finite. Indeed, even South Korea's massive amounts of dollar reserves were insufficient to cover its maturing debt and prevent it from obtaining a dollar swap line from the US Fed recently. Indeed, recently, there have been numerous proposals for reform in the international monetary standard away from the US dollar.

Furthermore, the use of such dollar reserves by a central bank might itself be seen as a signal of currency weakness and invite speculation against the currency. Worse, the placement or withdrawal of such massive amounts of foreign reserves in the global market by central bank(s) of a state or a group of states could lead to drastic declines in the value of the US dollar as predicted by the Triffin Dilemma, greater volatility in financial markets and exchange rates worldwide, the creation of asset bubbles, and greater counterparty and systemic risk from the externalities arising from a financial institution's failure that could precipitate defaults as the creditworthiness of other institutions could become doubtful. Illiquidity could quickly turn into insolvency. The internationalization of the operations of private financial institutions itself has also made it difficult to assign responsibility to specific central banks.[54]

Hence, the likelihood of a crisis occurring rises, even though ironically, the accumulation and deployment of such large amounts of foreign reserves by states sought to prevent such crisis from occurring in the first place. There is a "fallacy of composition" argument at work here in

[54] Guttentag and Herring, 1983.

which the accumulation of massive amounts of reserves by a single state as a form of self-insurance against a crisis raises the prospect of financial stability for the state but if all states do the same, the likelihood of financial instability rises.[55]

Lenders-of-last-resort

Quite apart from a better system financial regulation to ensure financial stability, what is needed in today's globalized financial system is to ensure the availability of credit during and in the aftermath of a financial crisis. Stricter financial regulation without ensuring credit availability can be counterproductive.[56] Currency mismatches in a system with multiple currencies tied to the US dollar are highly likely. These make it more difficult for a single central bank to intervene effectively, beyond the usual term mismatches possible associated with a fractional reserve banking system in which short-term liabilities fund long-term assets. Financial markets need to be assured that credit can and will be made available to institutions that would be solvent under normal conditions but are temporarily experiencing liquidity problems to prevent panic and a crisis.[57]

Ideally, of course, a first-best solution would be a global government and a global monetary authority with unlimited ability to act as a lender-of-last-resort and possibly provide credit guarantees as well. Given the limitations of a single national lender-of-last-resort, alternative or supplementary lender(s) of last resort could include a key group of central banks acting in concert, a new and improved version of the IMF, the US Federal Reserve Bank alone or in tandem with the IMF and/or with a group of key central banks, for the benefit of a specific state, region, and/or the entire world.

In the current global financial crisis, the US Fed has expanded reciprocal swap lines with developed country and emerging markets' central banks. Both South Korea and Singapore were each given a US$30 B swap line by the US Fed. Limits on the size of dollar credits to the ECB, the BOJ, the Bank of England, and the Swiss National Bank were removed in October 2008, in turn allowing non-US central banks potentially unlimited amounts of US dollars on a temporary basis.[58] In a sense, the Fed has temporarily subcontracted to a group of central banks the role of lender-of-last-resort. These central banks collaborate with each other to add to the supply of US dollars in financial markets.

However, the reality is that the US Fed will only act as a lender-of-last-resort if it feels that it is in its best interests to do so. In the case of the ASEAN countries such as the Philippines, this is unlikely to be so (unless, for example, Mindanao is really important in the global war on terror) and thus, having CMI as an option for a small country like the Philippines may be a more realistic supplemental source of liquidity than the US Fed.

Furthermore, lending to countries by the US Fed cannot go on indefinitely as it does not exercise supervisory power over these central banks. US financial institutions themselves may borrow from these other central banks rather than from the Fed in an effort as well to evade the Fed's supervision.

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[55] Obstfeld, 2009, p. 15.
[56] Calvo, 2009, p. 1.
[57] Fischer, 1999, p. 8.
[58] Obstfeld, 2009, p. 8.

Role of the IMF

The original raison-d'être for setting up the IMF was to support exchange rate stability without resort to overly contractionary macroeconomic policy.[59] It was not intended to prevent financial contagion in the global economy. Emerging markets, in particular, have a limited source of dollar liquidity. The latter has been exacerbated by the downsizing of IMF lending in this century as the demand for crisis lending dried up. Indeed, the IMF has been hard-pressed to find client states during this current crisis despite its willingness to pre-qualify practically all countries. Ironically, developed countries like Iceland are the ones that have turned to the IMF for help in this current crisis. In addition to financial deleveraging during the current crisis, the "flight-to-quality" and investment in US dollar-denominated financial assets, perceived to be "safe assets" under a global US dollar standard and funded by short-term dollar borrowing, also led to a shortage in dollar liquidity.

Whether the IMF should continue to have a role to play in the current global and regional monetary order or in a future one is a contentious issue. Some want to leave the IMF out of proposals to address the current global financial crisis, largely because the IMF did not understand the nature of the Asian Crisis and prescribed the wrong medicine for its cure which worsened the outcomes for crisis countries.[60] The actions of the IMF in the past evidently showed how out of touch it was with reality and in the present context, countries are themselves averse to approaching the IMF. Seen in this light, that CMI borrows credibility from the IMF and delegates much of the decision–making on who can borrow from CMI is problematic. The agreement to establish an institution for regional surveillance is a step toward gradually eliminating the IMF from the picture, especially if such an institution becomes a credible alternative.

In contrast, others do see an important role for the IMF to play, particularly as a lender-of-last-resort, in a world in which there is a greater degree of exchange rate flexibility, more open capital markets worldwide and financial globalization.[61] The IMF has several advantages as a lender-of-last-resort. Its institutionalized multilateral lending capacity to provide emerging economies with partial insurance against the risk of liquidity runs by extending liquidity in multiple currencies is its most important tool and obviates the necessity of forming groups of willing lenders during a crisis.[62] But its biggest problem is its loss of institutional credibility vis-à-vis countries in region and perhaps, developing countries worldwide.

Some argue that reforms in international financial governance need to be undertaken in order to enable the IMF to be more effective in its role as a global lender-of-last-resort. One limitation faced by the IMF it that it does not create outside liquidity.[63] Nevertheless, its ability to borrow under the General or New Arrangements to Borrow is akin to an infusion of outside liquidity if it is financed by money creation by central banks. Unfortunately, some central banks, e.g., the ECB and the People's Bank of China, have been unwilling to be elastic suppliers of their currencies in the recent crisis. Over time, however, it is possible for the IMF to become a global lender-of-last-resort by institutionalizing certain methods to access credit lines from individual

[59] Obstfeld, 2009, p. 7.
[60] These include Stiglitz, Sachs, and members of the Asian Economic Panel.
[61] See, for example, Obstfeld 2009, Calvo and members of the Latin American Shadow Financial Regulatory Committee in their Statement no. 16, 2007.
[62] Roubini and Setser, 2004, p. 338.
[63] Obstfeld, 2009, p. 18.

central banks. Another liability of the IMF is that it is not seen as being politically-neutral. Instead, it is seen as being under the control of the US Treasury in particular, with the US government having veto power in its decisions.

Financial regionalism and great power politics

Aside from opportunities for mutual gain, some regard the pattern of regionalism in East Asia as largely reflective of competition for leadership in the region among the big powers such as the US, Japan, and China, and whose individual state interests sometimes converge but more often do not.[64] Japan's interests are to insulate itself through regional diversification from the adverse effects of policies in the US and elsewhere and from currency volatility primarily in the yen-dollar rate while trying to contain China, its political rival for leadership in the region, and maintaining as good political and security relations with the US. China's interests are to continue to grow rapidly under the current global US-dollar dominated monetary regime, in which its currency is largely fixed to the US dollar, and to better position itself vis-à-vis it rival, Japan, for eventual leadership in the region. Of course, China itself may have an incentive to find or offer an alternative to the US dollar standard in the future, especially as it becomes a more important and possibly dominant global player.

Finding an alternative to the US dollar standard is of course something that Japan, in particular, has long tried to do, in large part to minimize fluctuations in the yen-dollar rate and thereby better insulate its economy from such exchange rate fluctuations. To this end, Japan proposed the internationalization of the yen. When that proposal was met with lukewarm response, Japan proposed that currencies in East Asia peg to a basket of currencies. Unfortunately, the latter proposal also received a lukewarm reception from the other countries in the region.

The US, through the dollar standard and dominance of its financial institutions globally as well as in the region, is the global leader. It regards a growing China as a rival for global and regional leadership. The US has concerns about its ability to continue setting global standards, postpone action on its twin deficits given the soft budget constraint it faces under a dollar standard, and thus, its ability as well to pass on the costs of adjustment to other states.[65] The US needs to ensure good bilateral ties with excess-saving countries in East Asia and open capital markets that will allow it to continue financing its way of life with foreign savings under a global financial architecture whose rules and standards it sets.

CMI represents an attempt at collaboration between Japan and China in an exercise in formal financial regionalism which has not happened in the past (as in the case of the AMF which China opposed) and is therefore significant in this regard. To a great extent, the outcome of financial regionalism and arrangements such as CMI will be determined by the rivalry and cooperation between China and Japan. It is unclear exactly what China and Japan envision in terms of the evolution of CMI and whether they share a common vision.

For Japan, CMI is a way of furthering its desire for regional insulation and being a provider of liquidity to regional countries during times of crisis, without being seen as directly challenging the US and the IMF. At the same time, CMI may give some leverage to APT by creating a threat

[64] Grimes, 2009, p.85.
[65] Grimes, 2009.

of exit by the region from the global financial regime although the extent to which this can be done is limited by the fact that Japan cannot use this option credibly. With CMI, Japan can act as a regional leader without bucking global standards even in the absence of support from its greatest ally, the US, and its greatest regional rival, China.

For China, being one of the main lender countries and the country with the largest dollar reserves, participating in CMI allows it to be able to seen as willing help its neighbors in the region in times of need (also in light of the fact that China did not devalue the yuan during the Asian Crisis), which will enhance its prestige in the region. Importantly, it is recognition of China's rising status in the world, not only as a rival for leadership in the region together with Japan, but a worthy global player. Given its strong economic performance over several decades in stark contrast with Japan's weak performance, China is expected to be the dominant regional power in the future. As the current global system is still working to allow China to grow rapidly, and the fact that any action it takes with regard to the disposition of its massive dollar assets could severely affect the value of these assets, China cannot afford to flex it muscles at the moment. In terms of its rivalry with Japan, this seems to be the best time for Japan to attempt to further its regional leadership through arrangements such as CMI. China's participation in CMI also, in some way, locks China into a position of committing itself to not only regional but global standards and rules as well, since CMI is really embedded within the existing global financial architecture and indeed delegates important decision-making functions to the IMF.

Role of ASEAN

Despite the importance of the outcome of the rivalry between China and Japan for leadership in the regional, it is important to remember that APT is centered on ASEAN and indeed, initiated at the request of the latter. ASEAN has an important role to play in APT, such as modulating the rivalry between Japan and China, as well as in the evolution of financial regionalism, such as the participating actively in setting the terms and shaping potential outcomes under CMI. Under conditions of heterogeneous preferences and freedom of exit, models of cooperation and delegation show the influence "low demanders" are likely to wield.[66]

ASEAN countries are the potential clients or demanders of funds from CMI and would expect to make their presence felt in the crafting of rules to make CMI effective. There are, however, also stark differences in the preferences of ASEAN versus the creditor countries in CMI. ASEAN countries would prefer faster releases of funds with little or no conditionality attached to the IMF. Japan, in particular, is not keen on the idea of little or no conditionality and would not like to upset the US by leaving the IMF out of CMI.

However, ASEAN itself is not a monolithic entity that always speaks with one voice. Not all countries in ASEAN are equally vulnerable to a crisis and would therefore need CMI funds. Not all of them have the political will or political and economic systems to accommodate access to CMI funds. Several strategies to mitigate this absence of homogeneity in preferences, systems and levels of economic development have been proposed and include variable speed geometries, side payments, and the formation of convergence clubs.[67] In the latest increase in the amount of CMI funds, for example, the individual ASEAN countries were not each made to

[66] Haggard, 2009, p. 3.
[67] Haggard, 2009, p. 3.

contribute the same amount of dollar reserves. Instead, a country's contribution to the common pool is based on the ability of the country to contribute certain amounts.

ASEAN or the smaller countries in East Asia play a role in acting as a mediator in moderating great power rivalry within the region. In the process, they also attempt to extract what it/they can in terms of the provision of such public goods as liquidity provision in times of crisis, less currency volatility, and insulation of its economies from adverse external shocks. In exchange, ASEAN will be a good follower of the regional leader(s).

Financial regionalism as a second-best solution

One can regard financial regionalism as a second-best solution to the problem of the absence of a world government and a global financial architecture that can provide the necessary international public goods. In the case of a lender-of-last-resort function, how can the present international lender-of-last-resort function be enhanced given certain political realities? Alternatively, if the global dollar standard is regarded as the root of savings imbalances as well as imbalances of power globally and regionally, then efforts at a lasting solution need to be directed towards fixing the global monetary standard and financial infrastructure away from US dollar dominance.

In this sense, CMI has a rather narrow scope as it does not veer away from the use of the US dollar. CMI as a form of financial regionalism is a second-best solution to the problem of living under a dollar standard. In part, this is understandable because it is difficult to replace the global dollar standard. China and Japan, the two regional leaders, have no incentive at the moment to do so. China benefits from pegging to the dollar while Japan does not want to openly challenge the US. Indeed, successful disengagement from the US dollar standard is seen as a future occurrence and largely determined by the actions of Japan and China. The ASEAN countries are used to the dollar standard and countries generally do what their competitors are doing.

CMI is a regional liquidity arrangement nested within the global financial architecture. It delegates a large amount of decision-making to the IMF. It does not attempt to replace nor move away from the US dollar standard. CMI is not a radical solution to the problem of a global US dollar standard and does not offer a viable alternative or move in a direction away from the US dollar standard. The amounts that can potentially be accessed under CMI are too small and not sufficient enough to address a crisis. The implication of these is that even the lender-of-last-resort function necessary to avert financial crises under CMI is necessarily limited by the inability of central banks in the region to produce US dollars and the finite amounts of these, no matter how large, in the hands of China and Japan.

CMI is also second-best and narrow in scope because it is a form of financial regionalism that has not implemented important elements of financial regionalism such as monitoring and surveillance, and exchange rate stabilization effectively or at all. It bears noting, however, that the roadmap for CMI includes all these as part of the future agenda of regional financial cooperation. However, given the diverse preferences and incentives facing the APT countries, the level of cooperation countries are willing to engage in is rather low. CMI as a reserve pooling exercise and without exchange rate coordination or meaningful surveillance as it has been thus far, is basically a low-risk and low-profit strategy in that not much sovereignty is lost, but there will be no large gains either.[68] It is not surprising that perceived benefits under CMI are uncertain and if at all, low, and countries in APT are hesitant to deepen financial regionalism and delegate the production of public goods to an external entity such as a regional institution.

IV. Challenges to Evolving Institutions

Global power play

The context in which financial regionalism evolves in East Asia occurs is one in which there is competition and rivalry among countries such as Japan and China for regional leadership, alongside the US, whose currency is the global monetary standard and who provides a bilateral security relationship with Japan and with other allies in the region. The institutions that do exist, such as CMI, are nested within the global financial architecture, and CMI's most important decision-making functions have been delegated to an extent to global institutions. The challenges faced by the region include how to increase their ability to set the terms and determine their own economic fate as a region despite these global political and economic realities as well as the extent to which their actions can affect the evolution of these global and economic realities as well.

Domestic politics

Domestic politics contributes to the underdevelopment of national financial markets and institutions in East Asia, which is perhaps the greatest impediment to greater regional financial intermediation and integration. When financial sectors are not restricted to domestic players and domestic financial systems are opened up, competition and cross-border financial flows have increased and financial integration advanced. The relatively faster liberalization of stock markets, for example, has resulted in greater co-movement in stock indices across the region, in contrast with the domestic banking sector in several countries where core banking, insurance, and securities services remain closed to foreign players.

The dominance of bank finance in East Asia and the underdevelopment of capital markets impede financial integration and financial regionalism. Both the long history of financial repression and the continued dominance of and dependence on bank finance have stymied the development of equities and bond markets. Domestic banks are typically tied to powerful domestic interests and are shielded from competition, including competition from foreign players. Domestic elites are inter-connected with each other through informal networks. There is incentive-incompatibility between the interests of these powerful domestic non-state actors to compete, foster free capital markets, or give up any degree of financial governance to any existing or potential regional institution.

Domestic banks typically rely on the state to maintain their dominance by preventing competition from alternative sources of financial capital. In many countries, the relationship between the central bank, which exercises a regulatory function over domestic banks, is less than arm's length. The same regulator can prevent competition from foreign financial institutions and other potential domestic players and reduce the openness of the capital account or retard the development of domestic bond markets which can provide alternative to bank finance. It becomes very difficult to create institutions in such a setting because the dominance

[68] Wang, 2004.

of domestic elites resistant to change and to states delegating part of their functions to an institution they only partly create and cannot control completely needs to be overcome. While the battle for behind-the-border financial reforms is being waged primarily domestically, the region is clearly an important stakeholder. The necessary reforms to make trade in financial assets safer for developing countries are the same as those needed to liberate the country's productive potential and curtail the power of vested interests.[69]

Not surprisingly, considerable barriers to financial flows still exist in Asia.[70] Inadequate deregulation and opening of national financial markets impede the development of capital markets by preventing the issuance of local currency bonds, investment in foreign bonds by domestic investors, and the issuance of bonds denominated in the different Asian currencies by foreign borrowers. Ironically, opening up capital markets may promote financial regionalism but also open countries up to greater risks of crisis. The challenge is for countries to find the proper degree of capital market opening and have policies in place that prevent or inhibit the welfare-reducing effects of largely unfettered trade in financial assets.

Cultural norms

One consequence of ASEAN being the basis of APT is that the core members have heterogeneous political and economic backgrounds, preferences and systems-CMLV countries vs. the ASEAN 5, for example. It also means that the processes involved in getting things done largely reflect the ASEAN way: minimal institutionalization, informal, consensus, non-intervention principle, voluntary compliance, conflict avoidance. Under this framework, there are often no binding rules.

Cultural norms within ASEAN, specifically the consensus approach to decision-making and principle of non-interference, have also been cited as giving rise to shallow regional reform.[71] These norms may be incentive-incompatible with financial innovation and reforms that require the surrender of an amount of state sovereignty. This does not create the confidence about the future environment that is the main potential benefit of economic institutions.

In CMI, for instance, progress has been very incremental, dealing mostly with operational issues rather than openly advocating radical solutions such as an alternative to the dollar standard or the removal of the IMF link. There is low degree of delegation, with the crucial task of surveillance basically left to the IMF perhaps due to a lack of trust among member countries and as a consequence of the principal-agent problem where countries can create regional institutions and cloak them with certain functions and authority but cannot control what such institutions will actually deliver. The ABMI, meanwhile, relies largely on peer pressure to influence outcomes.

Ambiguity and postponement to get around difficult issues, also part and parcel of the ASEAN way of making decisions, are seen to be a key feature of financial cooperation in Asia. This partly reflects a common desire to project solidarity even against wide heterogeneity of preferences and provides a way to keep the region's options open and preserve bargaining power vis-à-vis international institutions.[72]

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[69] Obstfeld, 2008.
[70] Chinn and Ito, 2007 and Takagi and Hirose, 2004.
[71] Arner et al., 2009.
[72] Henning, 2009, p. 7.

Changing the incentive structure and Institutionalizing CMIM

How then can the incentive structure facing countries change so as to induce them buy into institutionalizing many ad hoc methods of financial regionalism? Institutions create incentives to comply, either in the form of centralized inducements and constraints or by increasing the reputational consequences of reneging.[73] The institutional design of CMIM must be such or evolve in a way that as a regional economic institution, it will give countries an incentive to 'buy in' by creating the perception of positive gains for countries.

What are the incentives to comply in CMIM? — Only an expectation of substantial help with liquidity during a crisis. But at the moment, states know that the amounts that can be accessed are small. There appear to be no reputational consequences for reneging or for failing to use this regional option (e.g., S. Korea going to the Fed instead of CMIM).

Even in its limited form as a supplementary lender-of-last resort, therefore, one challenge is how to turn an ad-hoc coalition of somewhat willing lenders into a multilateralized institution with sufficient lending capacity during a crisis, or perhaps, in the run-up to a crisis. Ways must be found so that the present lender-of-last-resort structure in CMIM can be enhanced even if it is only a limited, second-best solution to the absence of a global government under the current dollar standard. In order to significantly enlarge the amounts available under CMI, perhaps something akin to the Short-Term Liquidity Facility already in place at the IMF for countries to be able to access funds quickly and with little or no conditionality should also be considered in CMIM.

As we had mentioned, international institutions like domestic ones involve delegation and are subject to principal-agent problems and organizational slack. There is a limited range of delegation on the part of existing institutions at the moment for CMIM although APT has recently agreed to establish a regional surveillance system. It is possible that gradually, the role performed by the IMF currently will be transferred to this regional institution.

However, the regional surveillance institution that is to be established should not merely be a clone of the IMF. Perhaps Asian governments should think about what "surveillance" means and what kind of system they want to establish. Along these lines, perhaps incentives for countries to be more transparent regarding their policies and preferences should be the focus of any surveillance system to be established. Such transparency is needed to address the asymmetric information characteristic of financial transactions and reduce systemic and counterparty risks.

One view is that most of the barriers to greater financial integration in East Asia are due either to bad government interventions or the failure of government to provide public goods rather than market failure per se. The availability of adequate and timely information to be able to assess risks, an adequate legal framework and regulatory structure, adoption of new and transparent rules in bankruptcy workouts, legal remedies and grievance procedures, are examples of public goods that need to be provided regardless of whether regional financial integration per se is a goal or not. While government is responsible for the provision of public goods, government may be unconvinced or unaware of the consequent welfare gains, may not know how to proceed, or may not be able to finance the costs of behind-the-border reforms and adjustment. The incentive incompatibility between the need for government to provide public goods versus the lack of desire or inability of government to do so represent "non-

[73] Haggard, 2009, p. 2.

market" or "governance failures" that need to be addressed by the creation of better institutions.

Strengthening bond market initiatives

Private sector actors, both national and international, are important actors in bond market development. Their interests are heterogeneous and not necessarily compatible with each other. The government meanwhile has to deal with and regulate these various actors and their various interests. It has less control over the outcome and speed of bond market development because it cannot completely control the actions of these private sector actors. Yet at the same time, it must delegate some of its functions to the private sector, reduce its interventions in the financial sector, and allow market forces to work for bond market development to succeed. In this setting, financial market development and financial stability can be viewed as public goods whose provision depends to a great extent on the actions of a private sector with competing interests, and governments that need to reduce intervention and give up some sovereignty over domestic policy.

Bond market development allows the private sector to have an alternative source of funds. This means that domestic banks, normally the dominant source of funds in countries in the region, will have competition. This is of course a welcome development were it to occur because competition will tend to drive down the price of credit and raise the amount of credit available in the domestic economy. In reality, domestic banks likely encourage government issuances since these provide them with a riskless and highly liquid asset but not the development of corporate bond markets which are rivals as a source of finance.

Domestic political constraints in the absence of a coalition for reforms therefore bar overall advancement of domestic bond markets by hindering needed financial reforms. Domestic banks are dominant because of their ties to powerful domestic interests and government. Domestic banks are therefore likely to resist bond market development and it is difficult to build a constituency for reform and greater competition. There is also a conflict of interest here between government's role in ensuring an adequate level of competition in the financial market to increase efficiency, on the one hand, and its links to powerful vested interests and the possibility that excessive competition may cause bank runs and failures (through the loss of franchise value of banks, for example), on the other. In this way, informal networks among elites profitably work against reform and institution building.

It is unclear whether governments in the region really have an incentive to push bond market development both for economic reasons as well as political ones. The point is that the structure of domestic financial markets, in which powerful domestic interests prevent meaningful reform of these markets, is a hindrance to developing regional bond markets. In any case, regional bond market development is not a substitute for the reform of domestic financial markets.

Bond market development, in which bond finance in local currencies of the region is encouraged, has been aimed at lessening dependence on the US dollar standard. To the extent that this happens, there could be an alternative to dollar standard and potentially, more stable currency and financial markets. However, bond market development may not be enthusiastically encouraged by both governments and the private sector in countries who do not want to openly challenge the US and the current global financial architecture and/or view dependence on the dollar standard as difficult to break away from in the absence of an alternative at the moment.

The willingness to hold wealth or for transactions purposes in assets other than the US dollar, such as the currencies of the different countries in the region, cannot be forced on market participants. Using regional currencies to conduct trade and for invoicing purposes instead of the US dollar may insulate the region from exchange rate volatility arising for the US dollar volatility, but the lack of deep markets for trading regional currencies make them less liquid than the US dollar. It is difficult to compete against the power of the most powerful country in the world backing its currency. Political interests are not always compatible with interests seen from a purely economic perspective.

Regional bond market development requires that capital markets remain open to global capital flows. This means that countries are more vulnerable to capital flows that could suddenly change direction leading to financial market and exchange rate instability.[74] Furthermore, countries need to adhere to global standards and rules in order to access capital in global markets. Therefore, the desire to set standards appropriate for the region is unlikely. It is difficult to imagine that regional bond markets could develop by being open only to regional capital flows since capital originating from the region cannot be distinguished ex-post from global capital inflows to the region. Hence, the idea of recycling the region's savings within the region may not be implementable and in any case, could results in lower returns if not allowed to flow where expected returns are high. Forcing the region's savings to remain in the region can lead to inefficiency.

The regional bond market initiative is a self-paced cooperative effort among countries in the region. Given the diversity of preferences and interests among and within competing groups in countries in the region, cultural norms, and reluctance of government to delegate power over its policies and functions, there is no strong urgency to deal with problems associated with developing domestic bond markets like liquidity and infrastructural issues. The latter include shortening the approval processes for bond issuance, clarifying default rules, introducing hedging instruments, addressing the lack of financial intermediaries such as pension funds and insurance companies, strengthening weak financial institutions, encouraging credit ratings for Asian companies, reforming the family-held ownership structure of many Asian companies which makes public disclosure difficult, data scarce and not conducive to financial evaluation by independent evaluators etc.[75] The region needs to invest in financial infrastructure, but the costs of adopting a system different from the current global financial infrastructure may not be justified by the potential benefits to the region and are likely to be higher than simply maintaining status quo and using the global financial architecture.

Of course, ABMI has been trying to address many of these infrastructure problems such as the need for common settlement and credit guarantee mechanisms, credible ratings agencies and unifying bond standards. Whether peer pressure and the demonstration effect will be enough to encourage member countries to participate intently in the process to develop their own domestic bond markets and work towards the development of regional bond markets remains to be seen. The latter goal, a way to go around the problem of lack of economies of scale hindering domestic currency issuance, is particularly thorny in its purest form as building such a

[74] Increased holding of local currency bonds by foreigners, for instance, could expose an economy to currency speculation and erode control over monetary policy (Park and Park, 2003).
[75] Grimes, 2009, pp. 77-78; Dieter, 2007, pp. 132-133.

market requires coordinating policies at the regional level and eventually calls for a common currency to facilitate settlement.

The global financial crisis originating from the US has been a difficult test for Asian bond markets. Bid-ask spreads increased at the height of the credit with local bond markets showing deviation from a smoothed yield curve and emerging bond markets exhibiting aberrant behavior (e.g. inversion of Vietnam's yield curve).[76] There has been doubt as to the contribution of government-led efforts in the region to promote bond market development as a global chase for yields in the past era of high global liquidity and risk appetite naturally spurred expansion in a number of emerging markets. The corollary question is how much of the gains will remain with risk tolerance on a decline. Clearly, one will need to wait for the global turmoil to settle down and for tranquility to return to global financial markets to assess whether improvements were permanent. However, there are indications that the gains made were indeed stable and that government-led initiatives likely helped in the dramatic bond market expansion.[77]

What is clear from the global financial crisis is that bond markets and bank and equity finance are more complements than substitutes as disruptions in one market spills over to the other. A bank-dominated system had been a root cause in the earlier Asian crisis, when banks collapsed and the real economy contracted, but not in the current global one. This time, bank dominance may actually be the saving grace since it was securities markets that had collapsed (CDOs, etc). The global crisis revealed how bond markets can lead to imprudent lending because of information asymmetries and weakened incentives of creditors to seek information about their borrowers. However, it also showed that bond market development remained a worthy endeavor as events also highlighted the danger posed by currency mismatch particularly in emerging markets while underscoring the need for regional initiatives in order to protect and nurture the smaller economies.[78] In an environment of increased cross-border flows, for example if foreigners buy more of the locally-denominated bonds by successful bond market development, the region may be vulnerable to sudden stops of capital. In such case, the banking sector clearly needs to be strong.

V. Conclusions

Born in the aftermath of the Asian Financial Crisis, CMI and the bond market initiatives were intended to provide a way for the region to cope with the effects of financial crises as well as to help in the prevention of future crises. Despite the incremental nature of progress on the multilateralization of CMI, CMI has not been relegated to the dustbin of history. Instead, agreement has been achieved on all the main components of CMIM, namely, the amount of individual country contributions, borrowing accessibility, the establishment of an independent regional surveillance mechanism and an advisory panel of experts, and the implementation of CMIM before the end of 2009. The volumes traded in certain bond markets in the region, those small relative to other markets, have increased tremendously, although how much of this is due to the regional bond market initiatives versus the global demand in recent years for high returns in emerging markets is unclear. There is also a regional credit guarantee mechanism being set-up.

[76] Spiegel, 2009, p. 19.
[77] Spiegel, 2009, p. 25.
[78] Spiegel, 2009, p. 24.

That agreement on many contentious issues has been achieved at all is testament to the desire of the region to continue pursuing financial regionalism. This is undoubtedly because the APT leaders acknowledge that there are substantial benefits that can be obtained from regional efforts, while acknowledging the limitations of national efforts in dealing with crises and keeping in mind the fact that the two most significant crises to have hit the region in the last decade have been financial in origin. Countries need to understand the public good nature of goods like financial stability and the fact that bilateral dependence on a superpower for aid or rescue in times of crisis may be more uncertain than the uncertainty surrounding benefits from a regional institution which the countries create and whose rules they help craft. The reality is, with the exception of Singapore, not all the ASEAN countries would have been given a dollar swap line by the US Fed had they needed one during the current global crisis. Only serendipity would have the domestic interests of the US coincide with the possible rescue of small open economies in Asia. If countries are risk averse, they should rationally opt for a regional solution in the absence of a first-best global solution and given the limits of national policy.

Financial regionalism serves as a way for countries in the region to continue to engage each other in searching for ways to deepen and enlarge economic cooperation, despite the difficult political and economic realities in which these initiatives have evolved and continue to evolve in. It is an area where regional efforts at setting-up a regional institution probably have the greatest marginal benefit (as opposed to trade and security issues, for example) as there are many opportunities and possibilities that are still exploitable and for which formal rules to guide state actions have yet to be fully established. East Asian leaders appear convinced that efforts at financial regionalism in East Asia have not yet reached the point of diminishing returns and that these are therefore worth continuing. Indeed, it appears that more than a decade after the Asian Financial Crisis, financial regionalism has taken hold in East Asia. The inadequacies of the global financial architecture notwithstanding, no discussion of resolving or coping with financial crises or economic shocks that affect the region, whether externally or internally-generated, can afford not to include or be seen in the context of regional financial initiatives. Today, the main regional financial initiative is CMIM.

Recent actions have resulted in the enlargement of the amount of liquidity assistance under CMIM, a reduction in the proportion requiring IMF linkage and perhaps further reduction or removal of the IMF linkage in the future. More in the direction of these efforts needs to be done. More importantly, however, the scope of CMIM could be enlarged to increase its usefulness and encourage greater regional economic cooperation. One aspect for consideration is the access to CMIM funds **prior** to a financial crisis, when countries experience dollar liquidity shortages as occurred in the early part of the current global financial crisis, rather than only in the midst of a full-blown financial crisis in any country within the region or when contagion has occurred. At such a juncture, being able to make fine distinctions between illiquidity and insolvency, so critical but difficult to make in the midst of a crisis, will not matter too much. This suggestion may also be seen as a pre-emptive move complementary to efforts at developing early warning systems in the region. Countries may be more willing to provide information and necessary inputs to the regional early warning system if their efforts can be seen as having a potential benefit for themselves. Perhaps if there were a way for countries in the region to have access to CMIM funds prior to a full-blown crisis, at least some of them would have availed of CMIM funds in the early period of this current global financial crisis because the stigma of being in a crisis would not have been there. Of course, the linkage to IMF may still have discouraged borrowing, which is why the future of CMIM must seriously consider severing this tie and putting a credible “surveillance” mechanism in place.[79]

Another suggestion especially relevant in the region’s attempts to overcome the effects of the current global financial crisis is to be able to use CMIM funds for regional stimulus efforts, akin to a coordinated monetary stimulus or a coordinated fiscal stimulus response. Instead of a coordinated reduction in interest rates as implemented by the US Fed and the ECB which would require an obvious subordination of someone’s policy to a leader, for example, a collective decision to use some CMIM funds for liquidity support as discussed above or for regional investment projects in infrastructure, for example, to stimulate economies in the region (Something which is usually mentioned in the region’s desire to recycle its savings within the region) could have been implemented. All these efforts require a greater degree of institutionalization and cooperation from the APT countries. Part of the reason for the absence of this kind of response in the midst of the current crisis is precisely the absence of a regional institution to formulate and implement these.

One suggestion is that the regional system of “surveillance” not merely be a clone of the IMF and duplicate its work, but focus on finding incentives for countries to be more transparent about their policies and preferences. The aim of such transparency is to reduce the degree of asymmetric information, especially in financial markets, so that systemic and counterparty risks and negative externalities of domestic policies on the region are reduced significantly. Takagi (2009) suggests that the nature of regional surveillance must be multilateral surveillance, whose goal is to identify vulnerabilities to crisis and the scope for collective action by analyzing policy interdependence and externalities. His suggestion, as well as the suggestion of others, is first, for a CMIM secretariat to be set-up. Second, he suggests assigning regional multilateral surveillance as the primary activity of this secretariat. Unlike IMF surveillance, which is primarily but not exclusively in the nature of bilateral surveillance, this multilateral surveillance needs to be well-integrated with a lean form of bilateral surveillance and with financial surveillance. A lean form of bilateral surveillance can be understood as having as its objective the identification of the regional aspects of domestic policies rather than the mere gathering of information about individual countries or an elaborate assessment of their domestic policies, both of which are already done by the IMF. Unlike the IMF, however, regional surveillance must also better integrate macroeconomic surveillance with financial surveillance. As such, any domestic policy, including structural policies, which have the potential to have externalities on the rest of the region, would be within the scope of regional surveillance. This would obviously include difficult issues like exchange rate policy. Unlike IMF surveillance, East Asian regional surveillance would importantly take into consideration political feasibility.

The lack of a common currency and the presence of multiple currencies and small financial markets in the region prevent economies of scale from being realized and the further development of bond markets in the region. While the banking supervision and regulatory framework improved in the aftermath of the Asian Financial Crisis, not as much progress has been made in the financial infrastructure in the region. The absence of a common currency is extremely problematic for bond trading settlement. There are heterogeneous laws and accounting systems etc. across the region. The fact that many countries in the region have not

[79] “Surveillance” is not used here in the dictionary sense of “a watch being kept over a person or group”. Instead it should be understood to mean “an analysis, scrutiny, or advice concerning countries’ economic policies, situation, and prospects as suggested by Crow et al. and cited in Takagi, 2009, p. 165.

reached an income per capita threshold level that would make bond market development a realistic option is also a major problem.

Some hope that CMIM and the regional bond market initiatives will help in the evolution of an Asian Monetary Fund. Aside from clarifying rules for lending under CMIM, setting up a secretariat and a credible surveillance system, and intensifying policy dialogues among policy makers in the region are seen as essential elements.[80] The goals of a more institutionalized CMIM need to be thought out. Is APT going to aim for a first-best strategy of finding an alternative to the dollar standard or stay within the current global framework, improving the CMIM as a second-best solution, including CMIM becoming a fast-disbursing lender-of-last-resort with adequate funds and no delegation of important functions to the IMF? Would CMIM attempt to address global imbalances by redirecting the sources of growth toward domestic and regional demand? Will the demonstration effect be sufficient incentive for countries to want to develop their own bond markets and contribute to the development of regional bond markets?
Of course, anything is possible and whatever the desired end point, much progress in financial regionalism can be had in the interim. In many ways, the region is going to have to grapple with certain questions. Nevertheless, now is the best time to push greater institutionalization of a regional financial arrangement. First, the US is pre-occupied with its domestic economic and political concerns. Second, the fact is that the global financial crisis originated in the US financial market. This means that the US, and by extension, the IMF, cannot present itself as the model for financial stability nor expect countries in the world to be enthusiastic about emulating its financial model and regulatory framework nor would the US be easily able to push its own model of financial deregulation as one that the rest of the world should adopt. At most, the US is likely to be benignly indifferent to the desire of the region to build institutions to facilitate and deepen the ability of the region to protect itself from and prevent the occurrence of financial crises. This would represent a significant weakening of the global political constraints that have impeded even the two regional powers from pursuing bolder steps in a more transparent manner. Third, unlike the period in the run-up to the Asian Financial Crisis in which many countries in the region were running current account deficits and therefore were in need of capital inflows, the countries in the region are now running current account surpluses despite the record amounts of US treasuries bought by central banks in the region. This means that the external financing constraint is also very much less, and therefore the push to have a regional lender-of-last-resort like CMIM and the need for self-insurance are likewise less. But it presents an opportunity to recycle some of the surpluses within the region and raise the investment to GDP ratios of countries in the region to their pre-Crisis levels at least. Caution must also be exercised so that these surpluses do not fuel a massive increase in credit and asset bubbles which may burst and wreak havoc.

Much of the future evolution of financial regionalism in East Asia will depend on the actions of the two regional powers, especially under the assumption is that the US is benignly indifferent to deeper financial regionalism in East Asia. In the limited context of the CMIM initiative, China and Japan have more than enough dollar reserves between themselves to act as lenders of last resort even under a dollar standard if they want to. If this were to happen, the conditionalities imposed by the IMF need not be a hindrance to accessing needed liquidity during crises. The willingness of China and Japan to do so eventually is dependent on how important their economies become globally, especially China. A very economically powerful China may see

[80] Kawai (2009).

allowing the yuan to become a global currency as a natural consequence. The fact that China and Japan each extended swaps to South Korea almost as big as the Fed swap line after the latter had received a swap line from the Fed might be seen as mere tokenism since South Korea really needed dollars at that point, not yuan or yen. However, nothing prevents the two countries from extending dollar swaps to any country in the region in need. But China's actions in particular, including the issuance of yuan-denominated bonds in international financial markets, have also opened the door a bit for the internationalization and convertibility of the yuan, something that is necessary if the yuan is to become one of the global reserve currencies in the future. In the end, anything is possible and the region should not waste the current opportunities to initiate bold steps to further concretize the dream of financial regionalism.

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