

# Regional Surveillance for Economic Stability<sup>8</sup>

## Regional Surveillance for Economic Stability

**The rapid spread of the 1997/98 Asian financial crisis across much of emerging East Asia brought home the need for greater regional economic cooperation.**

Following the 1997/98 Asian financial crisis, East Asia launched several initiatives to move regional cooperation forward, particularly for early detection and management of financial and macroeconomic vulnerabilities, to ensure economic stability. Three key initiatives were undertaken by the finance ministers of ASEAN+3<sup>9</sup> to promote regional financial cooperation:

- Introduction of a regional economic review and policy dialogue process (ASEAN+3 ERPDP);
- Establishment of a regional reserve pooling arrangement, the Chiang Mai Initiative (CMI); and
- Development of local-currency bond markets through the Asian Bond Markets Initiative (ABMI).

The ASEAN+3 ERPDP and the CMI were both launched by the ASEAN+3 Finance Ministers in May 2000, while the ABMI was launched 3 years later. All three are inter-related and were designed to address weaknesses behind the Asian financial crisis and to either prevent a recurrence or better manage future crisis effects.

**The creation of ASEAN+3 and the major initiatives undertaken since the crisis were done with an eye on future crisis prevention and management to ensure economic stability.**

In this special section on regional surveillance in East Asia, we focus on the ASEAN+3 ERPDP and CMI and how each has developed, interacted, and will likely evolve in the future.<sup>10</sup>

The analysis addresses the following questions:

- (i) What is surveillance?
- (ii) Why “regional” surveillance?
- (iii) How is regional surveillance currently carried out in East Asia?
- (iv) How should an effective regional surveillance mechanism be designed?
- (v) How should regional surveillance in East Asia be strengthened?, and
- (vi) What role has ADB played—and what is its future role—as regional surveillance deepens?

## What is Surveillance?

**“Surveillance” is often used in the context of economic monitoring; there is no universally agreed definition.**

The first modern era example of surveillance of the international monetary system occurred in

<sup>8</sup>Parts of this section draw upon a background paper prepared by Shinji Takagi of Osaka University.

<sup>9</sup>ASEAN+3 comprises the 10 members of the Association of South-east Asian Nations (Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam) plus the People's Republic of China, Japan, and Republic of Korea.

<sup>10</sup>Although the development of local currency bond markets reduces crisis risk by minimizing double (currency and maturity) mismatch problems related to international borrowing, its objectives are multifaceted and long term in nature.

the analytical work of the League of Nations. The word “surveillance”, however, appeared for the first time in the internal documents of the International Monetary Fund (IMF) in the early 1970s. Surveillance became part of the lexicon of international economics in connection with the Second Amendment of the IMF Articles of Agreement, which came into force in 1978. Article IV establishes obligations for the IMF to “oversee the international monetary system in order to ensure its effective operation” and to “oversee the compliance of each member with its obligations” specified therein (Section 3[a]) as well as to “exercise firm surveillance over the exchange rate policies of its members” (Section 3[b]). The Surveillance Decision of 1977, superseded by the subsequent Surveillance Decision of 2007, held that the surveillance of exchange rate policies encompasses all macroeconomic and macro-critical structural policies that may influence the member country’s exchange rate or balance of payments (“external stability” in the language of the 2007 Decision). The definition of surveillance offered by Crow and Thygesen (1999) is more specific: “analysis of, scrutiny over, and advice concerning, countries’ economic situations, policies, and prospects.”

**To make surveillance effective, however, defining its underlying purpose is far more important than precise semantics.**

A 1999 study<sup>11</sup> lists the following possible purposes of surveillance: (i) policy advice, (ii) policy coordination and cooperation, (iii) information gathering and dissemination, (iv) technical assistance, and (v) identification of vulnerabilities.

These principles are part and parcel of surveillance activities in East Asia.

**In IMF terminology, it has been customary to use “bilateral” and “multilateral” for the two broad categories of surveillance activities.**

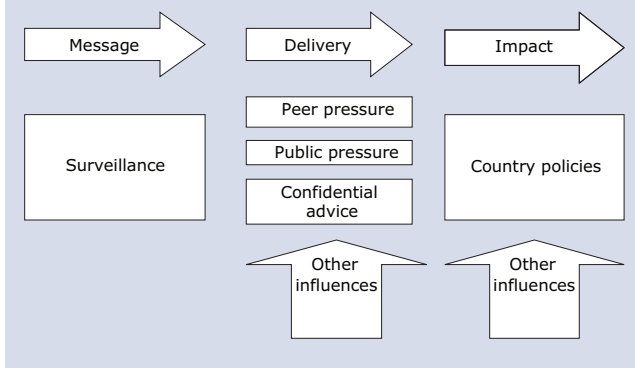
Bilateral surveillance refers to surveillance over policies of individual countries. Within the IMF, it is typically conducted through periodic Article IV consultations with all member countries. Multilateral surveillance refers to the surveillance of economic links and policy spillovers between countries, taking into account international or regional economic and market developments. It can complement bilateral surveillance by bringing into the analysis global and cross-country perspectives. Within the IMF, multilateral surveillance is most visibly apparent through publication of the semiannual *World Economic Outlook* and *Global Financial Stability Report*. Multilateral surveillance was in fact first developed at the Organisation for Economic Co-operation and Development (OECD) in the 1970s, at a time when the IMF was preoccupied almost exclusively with bilateral surveillance.

**Still, “regional” surveillance is a fairly new concept that is increasingly gaining in importance.**

The term “regional surveillance” now appears in various IMF documents. For example, in summarizing the Executive Board review of surveillance in 2008, the IMF’s official statement states that one of its core activities is “to monitor global, regional, and national economies through bilateral, regional, and multilateral surveillance.”<sup>12</sup> The IMF’s area departments are currently producing regional economic outlooks twice a year as part of their regional surveillance activities. In this definition, regional surveillance covers a geographically defined group of countries or a regional monetary union, while multilateral surveillance applies to the world economy as a whole. But, in the context of East Asia, this is

<sup>11</sup>J. Crow, R. Arriazu and N. Thygesen. 1999. *External Evaluation of IMF Surveillance, Report by a Group of Independent Experts*. Washington DC: International Monetary Fund.

<sup>12</sup>International Monetary Fund. 2008. IMF Executive Board Reviews the Fund’s Surveillance. *Public Information Notice* No. 08/133. 11 October. <http://www.imf.org/external/np/sec/pa/2008/pn08133.htm>

**Figure 67: The Results Chain of Surveillance**

not the only sense in which the term regional surveillance can be used. Regional surveillance could also mean surveillance conducted by a regional body, whether it is bilateral, multilateral, or even “regional”.

**The process of surveillance can be better understood when viewed as a results chain of three stages.**

A surveillance mechanism produces results in three stages (**Figure 67**). In the first stage, it produces a message—for example, a particular country’s vulnerability to crisis or the need for a particular country to make policy adjustments. In the second stage, this message is relayed to the relevant audience using one or more of three available channels: (i) peer review or peer pressure involving high-level government officials, (ii) public pressure through the markets or the general public (elected officials or the electorate itself in a democracy), and (iii) quiet persuasion through a confidential advisor to the government. Although the IMF has traditionally relied on supplying confidential advice, it has increasingly been utilizing public pressure by publishing surveillance documents more frequently. In contrast, OECD surveillance has relied more on peer pressure by structuring surveillance as a

peer review process (Thygesen 2008).<sup>13</sup> Finally, in the third stage, the message affects policymaking and leads to appropriate policy adjustments. This framework can be useful in guiding the design of an effective surveillance mechanism for East Asia (see page 56).

## Why “Regional” Surveillance?

### Surveillance assumes an added dimension as the region’s economic integration continues to deepen.

As economic integration deepens, East Asia is faced with an increasing need for a cooperative mechanism to identify vulnerabilities and help prevent crises from occurring. It will also need a more effective framework of regional policy dialogue and cooperation to deal with policy spillovers, both to mitigate political tensions and to find scope for collective action. Surveillance is the foundation upon which such cooperative schemes can be built.

### Regional surveillance can help fill existing gaps in the IMF’s overall surveillance mechanism.

Although the IMF has started to do some regional surveillance, it is clear that its main focus remains on global and national perspectives. Gaps remain, however, and strengthening regional surveillance is needed to complement bilateral and multilateral efforts. In this context, a regional surveillance mechanism implemented by an independent regional surveillance unit can add value through its evaluation mechanism. That is, there could be benefits from shifting from a “top-down” to a “bottom-up” approach to regional surveillance, with a regional institution playing the central role. This would ensure that there are stronger channels of communication that run not just “top-down” from global analysis to national and regional policymakers, but also bottom up by

<sup>13</sup>N. Thygesen. 2008. Comparative Aspects of Peer Reviews: OECD, IMF and the European Union. In *Shaping Policy Reform and Peer Review in Southeast Asia: Integrating Economies Amid Diversity*. Paris: Organisation for Economic Co-operation and Development.

drawing on national and regional monitoring in global surveillance and dialogue processes.

**Regional surveillance by an objective regional institution should create a more effective crisis prevention mechanism.**

Such a regional set-up would be distinct from the organizational structure of IMF surveillance, in which its Board of Executive Directors is the primary audience. In fact, peer pressure within a regional organizational structure is where regional surveillance potentially has the greatest advantage over IMF surveillance. The IMF is a global organization with 185 member countries represented by 24 resident Executive Directors. By necessity, not all Executive Directors represent their own countries, and their non-ministerial status limits their effectiveness as a peer pressure group or for national policymaking. Retaining the existing institutional setup and reporting channels for regional surveillance will preserve one of the greatest advantages of having an independent surveillance mechanism for East Asia.

**Effective economic governance requires surveillance at the national, regional, and global level.**

In an increasingly globalized world, surveillance really needs to be done at three distinct levels—national, regional, and global. Global forums can identify issues that can lead to systemic failure; regional dialogue can forge common policies to ward off contagion; while national surveillance identifies specific vulnerabilities to individual economies. Taken together, this can become an effective three-tiered filtering mechanism for identifying emerging policy issues. Moreover, should an emerging vulnerability slip through one filter, there is a good chance it will be spotted at one of the remaining two surveillance levels.

**Most importantly, an effective regional surveillance mechanism can help bring East Asian policy dialogue—and cooperation in general—to the next level.**

Ultimately, effective regional surveillance opens the door to greater regional policy coordination. An objective surveillance mechanism can identify emerging economic vulnerabilities and suggest ways of overcoming them. This is true whether in consolidating bilateral trade issues, coordinating monetary and fiscal responses to regional or global trends, or in establishing entirely new coordination efforts—for example, in constructing a regional exchange rate monitoring system. The bottom line is that good surveillance deepens the dialogue process, allows for a collegial approach to problem resolution, and acts as the foundation for building viable regional institutions.

**With the multilateralization of the Chiang Mai Initiative, the need for effective regional surveillance in East Asia has taken on a more immediate, yet evolving, purpose.**

Prior to its multilateralization, the CMI—lacking a dedicated surveillance mechanism—required that financing beyond 20% of the bilateral swap facility be available only to a country under an IMF-supported program. The new expanded, multilateral CMI requires that an effective surveillance mechanism be put in place. This allows the CMI to rely more on its own assessment to make lending decisions—including both the amount and any conditionality—without creating moral hazard or the concern that the problems leading to balance of payments difficulties may be fundamental in nature. Once the new regional surveillance unit is fully operational, it is likely that the percentage of the swap facility that requires an IMF-supported program will be reviewed.

## How is regional surveillance currently carried out in East Asia?

### Regional surveillance is not new to East Asia; immediately after the Asian financial crisis, the ASEAN Surveillance Process was established.

Established in the second half of 1998, the ASEAN Surveillance Process (ASP) was designed to strengthen policy dialogue and policymaking capacity over monetary, fiscal, and financial stability issues through information exchange, peer review, and policy recommendations. It brought ASEAN finance ministers together twice a year in a new forum for strengthening dialogue. The ASEAN Surveillance Coordinating Unit (ASCU) was established within the ASEAN Secretariat (ASEC) to coordinate the surveillance process. The ASCU, with input from respective national units, prepares semiannual ASEAN Surveillance Reports, which analyze recent global and national developments, identify emerging vulnerabilities, and raise relevant policy issues for consideration at ASEAN Finance Ministers meetings. A key feature of the ASP has been the use of peer review and peer pressure to elicit desirable policy changes across member countries. Nevertheless, there remains room for improvement, and the effectiveness of the process could be increased, for instance, by improving the timeliness and quality of data provided.<sup>14</sup>

### Once ASEAN+3 came into being, the ASEAN+3 Economic Review and Policy Dialogue (ERPD) process was established in conjunction with the initial CMI reserve pooling arrangement.

The ASEAN+3 ERPD was introduced, along with the CMI in May 2002, as a regional financing arrangement to supplement existing international facilities. It was designed to assist in the prevention and management of financial crises, through the early detection of vulnerabilities

and the swift implementation of remedial policy measures. The mechanism eases information sharing, promotes dialogue among policymakers, and fosters collaboration on financial, monetary, and fiscal issues of common interest. The ASEAN+3 ERPD process (i) assesses global, regional, and national economic conditions; (ii) monitors regional capital flows and currency markets; (iii) analyzes macroeconomic and financial risks; (iv) looks at how to strengthen banking and financial system conditions; and (v) gives East Asia a unified voice in the reform of the international financial system. Steps have been taken to strengthen cooperation in these areas, including the establishment of expert groups.

### Economic surveillance through the ASEAN+3 ERPD is carried out in two stages:

- ***The first stage is conducted at the ASEAN+3 Finance and Central Bank Deputies' Meeting (AFDM+3) held bi-annually in April and November.*** The AFDM+3 is an unofficial forum that lasts a day and a half. The ASEAN+3 ERPD session, which typically lasts about half a day, begins with presentations on the global and regional economic outlook by the IMF and ADB.<sup>15</sup> Outside experts are also invited to participate and discuss emerging or urgent issues as the need arises. Surveillance reports are prepared by participating countries following predetermined templates. All surveillance reports and the minutes of discussions are kept confidential.
- ***The second stage of the review is conducted at the ASEAN+3 Finance Ministers' Meeting (AFMM+3) held once a year on the sidelines of the ADB Annual Meeting.*** This stage of the review focuses more on issues related to policy. The ADB President takes part in these discussions and discusses regional economic developments and policy issues with the ministers.

<sup>14</sup>W. Manupipatpong. 2002. The ASEAN Surveillance Process and the East Asian Monetary Fund. *ASEAN Economic Bulletin*.

<sup>15</sup>Representatives from the IMF were invited to the AFDM+3 beginning November 2005.

### **The AFDM+3 surveillance stage includes a peer review, allowing participating countries the opportunity to exchange views and discuss corrective policies.**

In practice, however, the deputies typically refrain from assessing the economic developments and policies of other countries and in recommending policy adjustments. As such, the ASEAN+3 ERPD largely remains a mechanism for exchanging information on economic developments and policies (Murase, 2007; Kawai and Houser, 2008; Jung, 2008).<sup>16</sup> The lack of a permanent secretariat has further limited its usefulness at this stage.

### **How should an effective regional surveillance mechanism be designed?**

#### **At least five principles can help guide the design of an effective regional surveillance mechanism for East Asia.**

Following the framework presented in Figure 67, at least five principles can help guide the design of an effective regional surveillance mechanism for East Asia. The first three deal with ensuring a high-quality message (the first stage of surveillance), while the last two principles deal with getting the message across and making its impact more effective (the second and third stages).

#### **The purpose of surveillance needs to be clearly defined.**

Unless the purpose of surveillance is clearly defined, no focused message can be produced from any surveillance mechanism. Among the possible objectives of surveillance, “policy coordination and cooperation and identification of vulnerabilities”

appear most relevant for East Asia. There is no need to duplicate efforts of other institutions in providing policy advice, information gathering and dissemination, or technical assistance. The overriding goal should be to analyze policy interdependence and spillovers, with a view to identifying crisis vulnerabilities and the scope for collective action. The focus should be on providing the regional equivalent of IMF multilateral surveillance. This should include the due diligence of assessing a potential borrowing country’s capacity to pay, as well as defining the conditions that should be attached to any credit line from the multilateralized CMI.

#### **Require an independent unit to conduct regional surveillance in close coordination with other multilateral and regional institutions.**

The organizational structure of East Asia’s regional surveillance mechanism should encourage coordination with other multilateral and regional organizations that conduct surveillance. At the multilateral level, the institution needs to work most closely with the IMF, while ensuring complementarity and avoiding duplication. At the regional level, it will likely continue to work closely with ADB, which has supported the evolving surveillance process since the Asian financial crisis through the ASEAN+3 ERPD, technical assistance, and training programs. It is best to have a single organizational unit in charge of all surveillance activities, as has been proposed at the AFMM+3 in Bali in May 2009. A single individual should also be made ultimately accountable for all surveillance outputs at the technical level. Given the small membership of the organization and the focus on one or two specific purposes, it should be easy to achieve a compact organizational structure that satisfies these principles.

#### **Use objective indicators as data for analysis.**

Model-based economic analysis allows an independent surveillance mechanism or unit to take a position on politically sensitive but critical

<sup>16</sup>(i) T. Murase. 2007. Economic Surveillance in East Asia and Prospective Issues. *The Kyoto Economic Review* 76(1). pp 67–101. (ii) M. Kawai and C. Houser. 2008. Evolving ASEAN+3 ERPD: Towards Peer Reviews or Due Diligence? In *Shaping Policy Reform and Peer Review in Southeast Asia: Integrating Economies amid Diversity*. Paris: Organisation for Economic Co-operation and Development; and (iii) J-Y. Jung. 2008. Regional Financial Cooperation in Asia: Challenges and Path to Development. In *Regional Financial Integration in Asia: Present and Future*. BIS Papers No 42. Basel: Bank for International Settlements.

issues and put them on the table for discussion. This is especially true when surveillance is used to identify crisis vulnerability. To aid the process, it is important to develop an analytical framework to assess critical macroeconomic or financial issues. For instance, the IMF uses a Behavioral Equilibrium Exchange Rate model to assess the level of exchange rates and to provide policy advice. Also, this model-based approach has been used in bilateral surveillance to overcome resistance by area departments to sensitive but critical issues of exchange rates. Similarly, a country's vulnerability to impending crisis is certainly a sensitive issue, and this is where an objective approach that allows for independent verification can be extremely useful. The use of an early warning system (EWS) to signal crisis vulnerabilities is one such approach—ADB has developed an EWS for use by developing member countries.

### **Design the governance structure to ensure independence.**

Independence ensures candor and impartiality in surveillance, especially when the identification of crisis vulnerability is involved. There must be both the right incentive and protection to encourage the staff of the independent surveillance unit to be candid in raising issues that authorities may find uncomfortable discussing openly.

### **Direct contact with senior policymakers is essential.**

Regional surveillance must aim to reach senior policymakers directly by using periodic forums of finance ministers and central bank governors, or better still, heads of state or governments. It is in such forums that the impact of peer pressure can be maximized. There is no reason to create a resident executive board of mid-level officials for an East Asian surveillance unit when appropriate forums for dialogue already exist.

## **How should regional surveillance in East Asia be strengthened?**

### **An effective regional surveillance system in East Asia is essential for the successful establishment of a multilateralized CMI.**

Surveillance is a necessary component of any mutual financial assistance facility. Unconditional financing when there is a need for policy correction could create moral hazard, both for potential borrowers and for international investors, even when it does not adversely affect the prospect of timely repayment. It is only through surveillance that the appropriate combination of financing and adjustment can be identified in a lending program. At the AFMM+3 held in Istanbul in May 2005, finance ministers agreed to integrate the ASEAN+3 ERPD with the CMI as part of efforts to transform the CMI into a centrally-administered facility—independent from the IMF for surveillance and policymaking decisions. Follow-up agreements to explore ways to further strengthen surveillance capacity were adopted subsequently (**Table 13**).

### **Multilateralization requires that monitoring and surveillance be enhanced and expanded.**

In a multilateral setting, monitoring and surveillance need to be enhanced to include national policies as well as regional and global issues that can affect external stability and borrowing countries' capacity to meet repayment conditions of lending countries. This requires enhancing the scope and methodology of existing assessments, and improving the institutional mechanism for surveillance. The recent decision by AFMM+3 to establish an independent surveillance unit within East Asia recognizes that these existing processes need to be further strengthened.<sup>17</sup>

<sup>17</sup>Details of the CMI and its multilateralization are provided in Box 3 of the July 2009 issue of the *Asia Economic Monitor*.

**Table 13: Key Agreements by AFMM+3 on Surveillance**

	Date	Place	Key Decisions and Agreements Relating to Surveillance
1st	30 Apr 1999	Manila	• No statement issued
2nd	6 May 2000	Chiang Mai	<ul style="list-style-type: none"> <li>• Strengthen policy dialogues and regional co-operation activities in, among others, the areas of capital flow monitoring, self-help and support mechanisms, and international financial reforms</li> <li>• Use the ASEAN+3 framework to facilitate the exchange of consistent and timely data and information on capital flows</li> <li>• Strengthen the existing co-operative frameworks among monetary authorities through the CMI</li> </ul>
3rd	25 Sep 2000	Prague	• No statement issued
4th	9 May 2001	Honolulu	<ul style="list-style-type: none"> <li>• Update the capital flow situation in each member country and exchange data on capital flows bilaterally among members on a voluntary basis</li> <li>• Review the current main principles of the bilateral swap arrangement under the CMI in the next three years</li> <li>• Establish a study group to examine ways of enhancing the effectiveness of their economic reviews and policy dialogues</li> <li>• Continue to exchange views on the early warning systems (EWS) and work towards developing appropriate EWS models for East Asia</li> </ul>
5th	10 May 2002	Shanghai	• No significant decision or agreement
6th	7 Aug 2003	Makati	<ul style="list-style-type: none"> <li>• Strengthen the current peer review process by implementing the recommendations made by the ASEAN+3 Study Group to Examine Ways of Enhancing the Effectiveness of Economic Reviews and Policy Dialogue</li> <li>• Intensify efforts to develop regional bond markets through the Asian Bond Markets Initiative (ABMI)</li> </ul>
7th	15 May 2004	Jeju	• Undertake further review of the CMI (known as the “second phase of the CMI review”) to explore ways of enhancing its effectiveness
8th	4 May 2005	Istanbul	<ul style="list-style-type: none"> <li>• Take measures to enhance effectiveness of CMI through:               <ol style="list-style-type: none"> <li>(i) integration and enhancement of ASEAN+3 economic surveillance into the CMI framework;</li> <li>(ii) clear definition of the swap activation process and the adoption of a collective decision-making mechanism (as a first step of multilateralization);</li> <li>(iii) a significant increase in the size of swaps; and</li> <li>(iv) improvement of the drawdown mechanism (the size of swaps to be withdrawn without the IMF-supported programme to be increased from the current 10% to 20%)</li> </ol> </li> </ul>
9th	4 May 2006	Hyderabad	<ul style="list-style-type: none"> <li>• Successfully complete the strengthening of the regional liquidity support network initiated in Jeju in May 2004</li> <li>• Adopt the collective decision-making procedure for CMI swap activation</li> <li>• Launch the Group of Experts (GOE) and the Technical Working Group on Economic and Financial Monitoring (ETWG) to explore ways of further strengthening surveillance capacity in East Asia</li> </ul>
10th	5 May 2007	Kyoto	<ul style="list-style-type: none"> <li>• Agreement in principle on a self-managed reserve pooling arrangement governed by a single contractual agreement as an appropriate form of CMI multilateralization</li> <li>• Agreement to explore ways to link the ERPD, the GOE and the ETWG to strengthen surveillance</li> <li>• Task the deputies to carry out further in-depth studies on the key elements of CMI multilateralization including surveillance, reserve eligibility, commitment size, borrowing quota, and activation mechanism.</li> </ul>
11th	4 May 2008	Madrid	<ul style="list-style-type: none"> <li>• Agreement that CMI Multilateralization will be underpinned by rigorous principles to govern its key aspects, including economic surveillance</li> <li>• Agreement to implement measures to strengthen the ERPD, such as increasing the frequency of the dialogues and developing a standardized format for the provision of necessary information and data</li> <li>• Agreement to explore the role of international financial institutions in providing useful information when necessary as reference</li> </ul>
12th	3 May 2009	Bali	<ul style="list-style-type: none"> <li>• Agreement on the governing mechanisms and implementation plan for the CMI multilateralization (CMIM)</li> <li>• Agreement to establish an independent regional surveillance unit</li> <li>• Task the ASEAN Secretariat and the ADB to work out an interim surveillance agreement</li> </ul>

Source: M. Kawai and C. Houser. 2008. Evolving ASEAN+3 ERPD: Towards Peer Reviews or Due Diligence? In *Shaping Policy Reform and Peer Review in Southeast Asia: Integrating Economies amid Diversity*. Paris: Organisation for Economic Co-operation and Development, and Joint Ministerial Statements of ASEAN+3 Finance Ministers' Meetings. May 2008–May 2009. <http://www.aseansec.org>.

**For the ASEAN+3 ERPD to grow stronger, it will need enhanced capacity to conduct surveillance and an appropriate institutional mechanism for carrying it out.**

- ***The ASEAN+3 ERPD process must move away from its current focus on information exchange to include stronger peer review and due diligence.*** Peer review will allow ASEAN+3 countries to identify domestic policies that can impinge on regional economic stability, as well as enable them to persuade poorly-performing countries to take corrective policy measures. ASEAN+3 can use peer review not only to conduct country-by-country examinations, but also to assess cross-country thematic issues or broader issues of regional cooperation.<sup>18</sup> Due diligence, on the other hand, will be necessary to guide the activation of the CMI in times of crisis. Due diligence involves an assessment of a potential borrowing country's ability to pay, in order to determine whether assistance should be extended, and what conditions should be attached to this assistance. At present, due diligence for the CMI is linked to the IMF's Article IV surveillance and program conditions; enhancing the ASEAN+3 ERPD's due diligence function will enable the CMI to be more flexible in managing credit lines at the sole judgment of participating countries.
- ***The institutional mechanism for conducting regional surveillance is being strengthened with the decision to establish an independent surveillance unit responsible for analyzing economic developments, potential risks and policy options, and overseeing the operations of the multilateralized CMI.*** The AFMM+3 held in Bali in May 2009 agreed to establish an independent regional surveillance unit to monitor and analyze regional economies and support decision-making relating to the implementation of the multilateralized CMI. While the formal unit is being set up, the AFMM+3 has asked the

ASEC and ADB to set up an interim surveillance arrangement based on the existing surveillance process. The interim surveillance arrangement is already in force.

**Efforts to strengthen regional surveillance in East Asia must avoid duplication and maximize complementarities.**

The ASEAN+3 independent regional surveillance unit is expected to help strengthen due diligence for the multilateralized CMI. It is not intended as a substitute for existing surveillance activities provided by other multilateral or regional institutions. If surveillance is meant to deliver "policy advice", "information gathering and dissemination", or "technical assistance" as its primary objective, then there already exists a number of competing institutions. Furthermore, there is no reason to expect that the new independent surveillance unit will have any comparative advantage in producing surveillance reports. To duplicate efforts at other multilateral and regional institutions would not be an efficient way of using the world's scarce public resources. In particular, the IMF produces high-quality bilateral and multilateral surveillance outputs using resources no other institution can realistically match. East Asian policymakers are well aware of this. The existing ASEAN+3 ERPD and as well as the ASP are designed to receive considerable technical surveillance inputs from the IMF and ADB, both invited to present their analyses at high-level meetings. There is no reason to believe that the new surveillance unit will be designed to operate any differently.

**Avoiding duplication, however, does not mean that the new surveillance unit should shy away from analyzing global and national economic developments as well.**

As the custodian of the pooled reserves and arranger of financial packages under the multilateralized CMI, the independent surveillance unit must understand the economic policy

<sup>18</sup>OECD. 2007. Fostering Regional Integration: Peer Review in South-east Asia. OECD Policy Brief.

challenges each country faces, and the global environment in which they operate. Indeed, it must be in a position to make judgments based on its own assessment, both during normal periods and in times of crisis. Although the need is clear during crises—as it has to undertake due diligence—it must also have the technical expertise to form its own judgment of crisis vulnerability, identify regional policy spillovers, and suggest the scope for collective action during times of relative calm. While it should draw upon the outputs of the IMF and other multilateral organizations, these should enhance rather than substitute for its own assessment.

**Regional surveillance can add value by identifying and focusing on issues pivotal to East Asia’s financial stability.**

The 1997/98 Asian financial crisis brought to the fore the threat of regional contagion based on similarities between several countries’ financial vulnerabilities. The 2008/09 global financial crisis brought contagion to a new, worldwide level. East Asia was surely affected, but its regional vulnerability was less pronounced. Individual economies suffered to varying degrees based on size and their dependence on external rather than domestic demand. Regional surveillance can thus add value by focusing on those areas that define the region in terms of economic integration—issues related to trade, investment, and finance, including capital flows. For example, the regional surveillance unit may well assume the role of promoting the development of local currency bond markets under the Asian Bond Markets Initiative (ABMI). Currently, ADB performs this role informally on behalf of ASEAN+3 by producing the quarterly *Asia Bond Monitor* and related market analyses. This ADB function may need to be transferred to the new surveillance unit if policy cooperation in the financial area becomes one of its mandates.

**What role has ADB played—and what is its future role—as regional surveillance deepens?**

**ADB’s support for regional surveillance dates back to 1998, following the creation of the ASEAN Surveillance Process.**

In the Terms of Understanding on the Establishment of the ASEAN Surveillance Process (4 October 1998), ASEAN finance ministers specifically requested ADB to take the lead in providing training and capacity-building assistance to the ASEAN Secretariat (ASEC), particularly the ASEAN Surveillance Coordinating Unit (ASCU), and relevant staff in the finance ministries, central banks, and other relevant departments of ASEAN members. ADB responded by setting up the Regional Economic Monitoring Unit (REMU), which provided a range of short- and long-term training programs, conducted both in-house and externally. REMU’s terms of reference (TOR) explicitly noted a role for contributing to the surveillance process through “monitoring of economic and sector policies, conditions of financial markets, and macroeconomic performance in a regional/subregional context.” The TOR goes on to note that “regional/subregional economic monitoring complements existing models of national and global economic surveillance.”

**ADB’s establishment of the Office of Regional Economic Integration (OREI) on 1 April 2005 significantly expanded its role in supporting surveillance activities.**

Created to replace REMU with a stronger mandate, OREI’s TOR builds on REMU’s by refining three key responsibilities that extend its role on surveillance-related matters. These include (i) monitoring economic policies and financial architecture issues from a regional and subregional perspective and disseminating results to promote prudential economic management; (ii) strengthening the capacity for economic monitoring at the regional and subregional levels through provision of

technical assistance and advisory services; and (iii) strengthening ADB's relations with other international financial institutions, as well as regional and subregional bodies, by providing monitoring inputs to various meetings and discussions. OREI's personnel and technical assistance resources were also increased to serve this expanded surveillance role.

### **ADB has been directly involved in supporting and contributing to the ASEAN+3 ERPD process.**

A key contribution of REMU, and now OREI, is a Confidential Note, presented at the AFDM+3 meetings on Economic Prospects and Policy Issues for ASEAN+3. One by-product of this work is the *Asia Economic Monitor*, which OREI publishes twice a year and is also posted on the Asian Regional Integration Center (ARIC) website <aric.adb.org>. In November 2009, ADB collaborated with ASEC to produce the inaugural issue of a consolidated surveillance report, as part of the interim surveillance arrangement until the new formal unit is up and running. These economic and financial reports are used as background by ASEAN+3 governments in conducting regional economic and financial monitoring and peer review.

### **ADB has also provided technical assistance to strengthen the capacity of the ASEC in economic surveillance.**

- ***Full-time international consultants were contracted under ADB technical assistance and based in-house at ASEC.*** With the support of these ADB consultants, the quality of the ASEAN Surveillance Reports has been improving. The next phase of the technical assistance is expected to start in early 2010. Although this phase will have a similar focus as previous ones, the unfolding financial crisis and global economic slowdown will require more resources to be devoted to the strengthening of ASEC's macroeconomic surveillance unit.

- ***Through several technical assistance projects, ADB also assisted in establishing National Surveillance Units in six ASEAN countries, which today operate with little or no assistance.*** These countries include both original (Indonesia, Philippines, Thailand) and new (Cambodia, Lao PDR, Viet Nam) ASEAN members. OREI has also supported establishment of the Surveillance Unit in the People's Republic of China and Brunei Darussalam, following the latter's accession to full membership in ADB in 2006.

- ***ADB's development and installation of early warning system (EWS) software in these countries contribute to the advance detection of emerging vulnerabilities.*** Box 2 discusses EWS models in general and describes the EWS prototype and software developed at ADB.

### **Since 1999, ADB has been conducting training programs on regional economic and financial monitoring, with the aim of enhancing the capacity of ASEAN+3 countries in assessing macroeconomic and financial vulnerabilities.**

To date, some 260 staff from ministries of finance and central banks of ASEAN countries and the PRC—as well as staff from the ASEAN Secretariat—have graduated from this course. The course covers a wide range of issues related to economic and financial monitoring, macroeconomic conditions, financial programming, and early warning systems. Effective development of technical expertise in regional economic and financial monitoring is particularly important in the preparation of national and regional economic surveillance reports. This course is also instrumental in the creation of a regional alumni community which, based on its collegial experience in Manila, can effectively communicate among themselves and exchange relevant information and views on key economic issues and policies.

### **How can ADB further contribute to a more effective regional surveillance mechanism for East Asia?**

Apart from undertaking the interim surveillance arrangements jointly with ASEC, ADB has already been requested by ASEAN+3 to assist in establishing its new surveillance unit and to play a longer-term role in developing its expertise. Apart from the provision of support through technical assistance, ADB also has an active program of research on a range of issues relating to regional cooperation and integration—including economic and financial surveillance—that could be used. Both internal staff and external consultants contribute to OREI's research. The ability to do research helps allow OREI to respond to changing needs in a timely fashion, as well as remain at the cutting edge of developments relevant to surveillance in a rapidly changing world. The importance of this is perhaps best illustrated by the recent global financial turmoil. OREI plans to strengthen its research capacity in the future.

## **Conclusion**

### **Regional surveillance has come a long way since the 1997/98 Asian financial crisis.**

Regional surveillance to date has come via the regional economic review and policy dialogue process, or the ASEAN+3 ERPD. The ASEAN+3 ERPD has served the region well, and ADB has played its part in supporting the process. But the ASEAN+3 ERPD needs to evolve to meet changing circumstances and new demands.

### **The recent multilateralization of the CMI increases the urgency to strengthen and expand regional surveillance.**

No longer can the surveillance mechanism serve only to detect vulnerabilities to avoid crises, or to help manage them should they occur. A multilateralized CMI also requires due diligence to assess requests for assistance. It is envisaged that a new, independent surveillance unit will serve this

expanded role. Until this unit is fully operational however, ADB and ASEC are jointly working out an interim surveillance arrangement based on the existing surveillance process.

### **Any new regional surveillance mechanism should be designed to ensure that a high-quality message is generated and then delivered to maximize impact.**

At least five principles can help guide the design of an effective regional surveillance mechanism for East Asia. First, the purpose of surveillance needs to be clearly defined so that the message is focused. Second, the organizational structure of the regional surveillance mechanism should encourage coordination with other multilateral and regional organizations that conduct surveillance. Third, it should use objective indicators as data for analysis, and methodologies that are objective and independently verifiable so that politically sensitive but critical issues can be addressed. Fourth, the governance structure should be designed to ensure independence and facilitate candor and impartiality in conducting surveillance. And finally, the reporting mechanism should allow the results of regional surveillance to reach senior policymakers or heads of state or governments so the impact of peer pressure can be maximized.

### **It is important that the work undertaken complements that of the IMF and other multilateral organizations.**

As the IMF tends to focus on bilateral and multilateral surveillance, the need to strengthen regional surveillance conducted by a regional institution, not only remains, but is urgent. Although complementarities are important, avoiding duplication does not mean that the new surveillance unit, or any regional surveillance activity for that matter, should focus only on regional surveillance. The unit must be in a position to review and decide on applications for regional liquidity support based on its own assessment. Thus, while it should focus on strengthening the regional component of overall surveillance, with

the capacity to offer a unique regional perspective, it will also have to be aware, based on its own assessment, of economic policy challenges in each country and the global environment in which it operates. When surveillance is undertaken by a regional institution that reports directly to key decision makers, the ability to exercise peer pressure in preventing crises grows. The reporting structure of the ASEAN+3 ERPD enables access to key decision makers represented by AFDM+3 and AFMM+3. As long as the new regional surveillance unit retains the existing institutional setup and reporting channels, it will preserve one of the greatest potential advantages of having its own surveillance mechanism.

**ADB continues to expand its own capacity to support and assist regional surveillance in East Asia.**

In addition to undertaking the interim surveillance arrangements jointly with ASEC, ADB has been requested by ASEAN+3 to assist with the establishment of the new surveillance unit and to play a longer-term role in developing its expertise. Apart from the provision of support through technical assistance, ADB also maintains an active program of research on a wide range of issues relating to regional cooperation and integration—including economic and financial surveillance.

## Box 2: Spotting a Crisis Before It Happens

The large social and economic costs associated with financial crises have long sparked interest in finding ways to help define the probability of a crisis occurring so that preemptive measures can be taken to avert or at least mitigate crisis effects. These models for predicting financial crises are known as early warning systems (EWS). Simply put, an EWS monitors available data to signal when an economy becomes vulnerable to potential crises.

Kaminsky and Reinhart<sup>1</sup> have proposed a signaling model that can be used as the basis of an EWS. Their model first identifies historical crisis episodes and seeks leading indicators that could have forewarned of an imminent financial crisis, either banking- or currency-based. Identifying currency crisis episodes is relatively easy as historical exchange rate data is readily available. But identifying a banking crisis is more complex because many are not fully reflected in available data. A variety of macroeconomic and

financial indicators are used to monitor various trends, such as the current account deficit and fiscal deficit, among others. With a large set of indicators, several will suggest deteriorating conditions at any one time. The challenge for an effective EWS is to find the right set of leading indicators whose composite value breaks a threshold when there is heightened probability of a crisis occurring. One approach is to choose a threshold value that minimizes the “noise-to-signal ratio” for each indicator. The noise-to-signal ratio measures how accurate the indicator is in predicting a crisis—the ratio of the probability of the indicator signaling a “false alarm” to the probability that the indicator signals a true crisis.

Once the threshold for each indicator is determined, a composite index of indicators can be created. The more indicators signaling a crisis, the greater the probability of a crisis occurring. Usually, indicators are also weighted in favor of those indicators that predict better. So indicators with low noise-to-signal ratios carry greater weight. Once the composite index has been constructed, it can be used to provide a warning if the probability of a crisis exceeds a certain threshold.

Following the 1997/98 Asian financial crisis, the Asian Development Bank (ADB) developed an EWS in an attempt to warn against future crises. The Kaminsky-Reinhart model was adapted and improved into a prototype ADB EWS model to support regional surveillance in ASEAN+3<sup>2</sup> countries. The model was tested using 1970–1995 sample data to see how well it could have predicted the 1997/98 Asian financial crisis. The results show that there was heightened probability of a crisis in four of the six countries that experienced a currency crisis. The Thai example is illustrative (**Figure B2**).

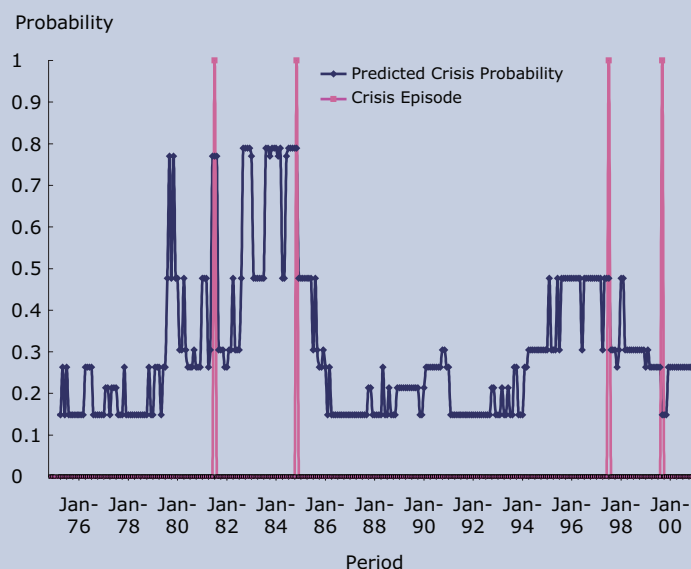
ADB developed a user-friendly software package—Vulnerability Indicators and Early Warning Systems, or VIEWS.<sup>3</sup> The program has been distributed to ASEAN+3 finance ministries and central banks as a tool to assist them in monitoring their economies. In addition, ADB has provided training

<sup>1</sup>G. L. Kaminsky and C. Reinhart. 1999. The Twin Crises: The Causes of Banking and Balance of Payments Problems. *American Economic Review*. 89(3). pp. 473–500.

<sup>2</sup>ASEAN, People’s Republic of China, the Republic of Korea, and Japan.

<sup>3</sup>Asian Development Bank. 2005. *Early Warning Systems for Financial Crises: Applications to East Asia*. New York: Palgrave, Macmillan.

**Figure B2: Predicted Crisis Probabilities in Thailand, 1970-1995 (in-sample) and 1996-2000 (out-of-sample)**



to ASEAN+3 to better use and interpret the results from VIEWS software. ADB also maintains and regularly updates the large database of vulnerability indicators for ASEAN+3 economies.

While VIEWS has performed well thus far, a major concern is whether EWS models are as effective predicting future crises as they are predicting past ones.

The structure of the economy is constantly evolving with new financial products and instruments being introduced regularly. Thus, what worked once may not work again in predicting future crises. Models must be constantly refined to ensure their predictive power is kept up-to-date.

Another constraint is that indicators used in EWS models tend to lag

several months. Therefore, they may not be able to flash warning signals on time. One possible solution would be to rely more on real time market-related data. For example, option contracts on foreign exchange could be used as an indicator of the “tail risk” of the exchange rate. The drawback is that liquid options markets exist in only a few ASEAN+3 economies.

Finally, it is important to emphasize that EWS models are but one tool for diagnosing economic vulnerability. Further analysis is required once a warning signal is issued to evaluate the severity and probability of a crisis. So EWS results should be used as a complement to—not a substitute for—conventional policy analysis. An EWS model is a useful aid in improving economic monitoring. It must be complemented with other monitoring tools for it to function effectively.