A Study on Information Exchange, Surveillance Systems, and Regional Institutions in East Asia*

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1. Introduction

- The case for effective global economic institutions is now stronger than ever.
  - The establishment of the World Trade Organization in 1995 is just a case in point: an example of responding appropriately to changed circumstances
  - Globalization has accelerated the flow of goods and the operations of the international product cycle, and a new strengthened global institution was badly needed to coordinate individual national efforts to cope with the continual structural adjustments
  - The WTO story is actually a rare example of successful collective action
  - Under-supply of public goods
Financial Globalization and New International Financial Architecture

- Globalization has also quickened the pace of international capital flows
- The international community has yet not, however, responded either in a timely manner or in a creative way to the equally serious economic adjustments generated by the increased mobility of capital
- Numerous destructive speculative attacks on currencies in the last decade of the 20th century:
  - the European exchange rate mechanism crisis in 1992-93
  - the Tequila crisis in 1994-95
  - the Asian financial crisis in 1997-98
  - the ruble-to-ruble conversion in August 1998
  - the crash of the Brazilian real in January 1999
  - Turkey, Argentina and more...
The general lesson: new circumstances require new forms of collective actions, they include both the founding of new economic organizations, and the closure of obsolete ones.

- The global community needs to redesign its global economic institutions to bring them in line with the emerging economic trends of the 21st century.
- For the particular case of global financial instability, there was a short burst of serious creative thinking after Robert Rubin identified in 1998 the need for a new international financial architecture.
- But with the quick strong recovery of most East Asian economies in 1999-2000, the wind has gone out of the efforts to reform the international financial institutions.
Regional Architecture: the attention is clearly gone from the reformulation of the international financial architecture, but the problems that had aroused the attention are still with us.

- Although East Asian economies have taken numerous measures (e.g. improving bank supervision, allowing greater exchange rate flexibility) to inoculate themselves against future capital account shocks, most of them are still vulnerable to very large negative capital account shocks.
- The national strategy of having a very large stock of foreign reserves to deal with the infrequent large capital flight may work but it is an extremely expensive strategy.
- Naturally, it has occurred to many astute economists in East Asia that a regional pooling of foreign exchange reserves may be a cost-effective response to the problem of big but infrequent capital flight.
At present, the East Asian countries share a broad sense of financial cooperation.

- In 1999, the leaders of ASEAN invited China, Japan and South Korea to join them in Manila to discuss economic cooperation in the region. The ASEAN+3 summit in November 1999 declared a “Joint Statement on East Asian Cooperation” that covers a wide range of possible areas for regional cooperation.

- Recognizing the need to establish regional financial arrangements to supplement the existing international facilities, the finance ministers of ASEAN+3 at their meeting in Chiang Mai, Thailand, in May 2000 agreed to strengthen the existing cooperative frameworks in the region through the “Chiang Mai Initiative (CMI).”

- Significant progress has been made in implementing the CMI to further strengthen the self-help mechanisms in East Asia.
The goal of this study is to contribute to the effort to construct regional financial arrangements that would reduce the occurrences of financial crisis, and lower their costs.

- This study will confine itself to the issues related to crisis prevention through mutual surveillance and policy dialogue.
- In relation to the current development of the Chiang Mai Initiative (CMI), this analysis will focus on how to strengthen mutual surveillance processes through regional policy dialogue.
2. Objectives and Modalities of Monitoring and Surveillance

- Financial crises usually have a regional component.
  
  - Neighboring countries have a strong incentive to engage in mutual surveillance and to extend one another assistance in the face of potentially contagious threats to stability.
  
  - If the channels of contagion cannot be blocked off through multilateral cooperation at the early stage of a crisis, neighboring countries may not be able to fend off the crisis even if they hold a large amount of foreign reserves. Hence, neighbors have an interest in helping put out a financial fire before it spreads to them.
Policy dialogue among neighboring countries, together with a regular monitoring and surveillance process, is essential for the prevention of crises and of contagion when they break out.

- The collected information will help detect and identify the characteristics of the looming crisis at the early stage so that proper remedial actions can be taken in a timely manner.

- A joint exercise based on a region-wide early warning system will facilitate closer examination of financial vulnerabilities in the region.

- The regional policy dialogue process will contribute to ensuring effective implementation of collective policy targets through peer pressure and to improving accounting and auditing standards, disclosure requirements, corporate governance and efficiency of credible rating agencies.
Like private bank loans, official financial assistance needs economic surveillance to ensure that assistance is imperative and effectively used.

- Like the international financial institutions such as the IMF and World Bank, the CMI requires surveillance for its lending to member countries.
- Economic surveillance is not merely an observation of economic indicators, but also an assessment of macroeconomic, financial, and structural policies of member countries.
- Only when creditworthiness of borrowers is warranted on the basis of economic surveillance, a group of lenders will be able to make loans.
- At the same time, regular surveillance would enable quick disbursements in times of crises.
As a supporting instrument and mechanism for regional financial arrangements, regional monitoring and surveillance will vary, depending upon given policy objectives and the stage of regional financial and monetary integration.

- The spectrum of the modality of monitoring and surveillance can be wide, ranging from simple information exchanges and informal consultation forums to a supranational entity like the EMU.
- If common policy objectives were more broadly spelled out, an informal exchange of views and non-binding policy recommendations would be sufficient. If more specific policy objectives were pursued such as convergence criteria in EMU, tighter coordination and penalties on violations would be required.
- Thus, the process of monitoring and surveillance only serves the function mandated by the specific body involved.
3. Regional or Sub-regional Initiatives among the ASEAN+3 Countries

- Manila Framework Group: only limited success (no actual peer review process)

- ASEAN+3 Surveillance Process: the ASEAN+3 group recognizes the importance of establishing an effective system of policy dialogue to complement the CMI operations.
  - An enhanced regional policy dialogue process could promote sound macroeconomic policies and prevent any moral hazard problems that might arise in operating the CMI.
  - Despite this recognition, the ASEAN+3 countries have been cautious, and as a result slow in creating a formal mechanism of surveillance.
Since the inception of the CMI, informal economic reviews and policy dialogues have taken place at the ASEAN+3 Finance and Central Bank Deputies’ Meeting (AFDM+3) and ASEAN+3 Finance Ministers' Meeting (AFMM+3).

- In order to enhance the existing process of economic reviews and policy dialogues, this group of countries made the decision to establish the Study Group at their meeting in Honolulu on 9 May 2001.

- The first meeting of the ASEAN+3 Study Group was held in Kuala Lumpur on 22 November 2001. At this meeting, they agreed to a two-phase approach toward enhancing a regional surveillance mechanism.
During the span of phase one, the ASEAN+3 countries are to move one step forward in formalizing the current process.

- They agreed to hold an informal meeting of the AFDM+3 to focus on economic reviews and policy dialogues back to back with the IMF/World Bank annual meeting.
- It is essential that all of the countries involved in the network of the BSAs (namely the CMI countries) assume the responsibility of participating in the informal meeting and circulate a brief report on their recent economic developments.
- A common template or format for the report will be developed to ensure the comparability of the reports submitted by countries at the meetings.
At this stage, it is not clear how long it would take to complete the phase one plan.

- As the informal process of economic review in phase one proves to be successful, the ASEAN+3 countries are expected to move to phase two in which an enhanced regional policy dialogue mechanism will be established.

- Under phase two, it is proposed that a group or an institution be designated to undertake high quality and in-depth reviews and assessments. As for the possible candidates for this group or institution, the following have been suggested for further discussion:
  (i) developing the ASEAN secretariat;
  (ii) using an existing institution such as regional multilateral institutions, think-tanks, or universities; and
  (iii) operating through a working group
Whichever option is chosen, however, the proposal makes it clear that the group or institution will not be a substitute for the Fund surveillance process and certainly will not be another bureaucracy.

- Instead, the assessment by a working group or an institution could be used in negotiations for those countries requesting financial assistance from the IMF or under IMF programs by providing information and possible policy recommendations different from those prescribed by the IMF.

- The ASEAN+3 countries would also use these assessments, but they would only be used for peer review at the AFDM+3 and would not be available for public use.
4. Construction of a Surveillance Mechanism: A Proposal

- In keeping with the ASEAN policy of non-interference, the regional surveillance process in East Asia would be built on the basis of consensus and informality.
  - At this stage of development of the CMI the participating countries are not prepared to negotiate regional agreements which include provisions for sanctions and fines for countries that do not adjust their domestic policies as needed for common policy objectives.
  - This unwillingness would then make it difficult for a regional surveillance process to impose politically unpopular policies on the member countries and, hence, may pose a serious moral hazard problem.
  - How to prevent moral hazard?
  - Good neighbors vs happy family
Realizing this difficulty of creating a regional monitoring and surveillance unit as part of the CMI, the ASEAN+3 have chosen to rely on the IMF for imposing and enforcing policy conditionalities for those countries drawing from the BSAs.

- However, in the long run the participating countries are planning to wean themselves from their reliance on the IMF.
- If the CMI develops into an independent regional financial arrangement from the IMF, the architect of the CMI will have to decide whether the arrangement could be supported by a surveillance mechanism based on peer reviews and pressure instead of formal policy conditionalities and sanctions.
A surveillance mechanism in East Asia could be constructed in the following three phases:

- **Phase I**: Building a regular policy dialogue framework.
- introduce a system for information sharing and enhancing the transparency of domestic economic policies through a peer review process.
- No independent surveillance unit is required to serve as a secretariat.
- Phase I may be tantamount to phase one proposed by the ASEAN+3 Study Group.
• Phase II: Introduction of an integrated policy dialogue mechanism.
• An independent surveillance unit is expected to serve as a warehouse of information and a manufacturer of warning signals for both individual countries and the group as a whole.
• By conducting extensive early warning exercises at the national and regional levels, this unit identifies the problems and prepares independence surveillance reports to the Group.
• Following the ASEAN tradition of non-interference into domestic policies, the report focuses on the provision of warning signals.
• Combined with country reports submitted by all member countries, this unit’s surveillance report will be a *Compendium Report* based on its own assessment.
• The unit may also be entitled to conduct preparatory research on future cooperative issues such as exchange rate policy coordination and financial market integration.
• In establishing an independent unit, various options may be considered:
  • ASEAN Secretariat
  • ADBI
  • ADB REMU
• Phase III: Monetary integration and strengthened surveillance process.
• East Asians presently appear to pursue financial cooperation in the absence of exchange rate coordination.
• It is not yet clear whether East Asia will emulate the European experience by adopting some form of monetary integration.
• However, if East Asia starts monetary integration someday in the future, the regional surveillance mechanism should be structured and managed in order to support the coordinated exchange rate mechanism.
5. Concluding Remarks

- No exchange rate coordination
  - incentives for mutual surveillance will be limited because a member country facing a speculative currency attack may be free to float its exchange rate vis-à-vis those of other neighboring countries.

- The immediate task now is to establish an independent surveillance unit as a standing secretariat to support the ASEN+3 policy dialogue process.
  - This unit should start on a modest scale.
  - The future role of ADB: regional monetary fund to provide the regional public goods.
Thank you!