Essay

A Framework for Regional Monetary Stabilization

by Chalongphob Sussangkarn

An important outcome of the East Asian economic crisis has been the realization by countries in the region of the need for greater financial and monetary cooperation to prevent and to deal with future economic crises that may affect the region. Although the idea of setting up an Asian Monetary Fund (AMF), first suggested by Japan during the early part of the crisis, was quickly shot down by countries from within and outside the region, this was mainly because of inadequate prior discussions to clarify the purposes and modes of operation of such an institution, and to gain a degree of consensus on the idea. More recently, countries within East Asia have taken concrete steps to demonstrate their commitment toward greater financial and monetary cooperation. At this year's annual meeting of the Asian Development Bank in Chiang Mai, Thailand, finance ministers of the Association of Southeast Asian Nations (ASEAN) member countries, together with those from China, Japan, and South Korea (known as the ASEAN+3 group), announced a Joint Ministerial Statement on strengthening East Asian financial cooperation, including what is called the Chiang Mai Initiative.

With the Chiang Mai Initiative, the ASEAN+3 group expressed "a need to establish a regional financing arrangement to supplement the existing international facilities,"[1] and reached agreement on expansions of swap facilities[2] among ASEAN

1 See the Joint Ministerial Statement of the ASEAN+3 Finance Ministers Meeting, May 6, 2000, Chiang Mai, Thailand, available on the web site of the ASEAN Secretariat at http://www.aseansec.org/.

2 Under the swap facilities, a participating member country with temporary international liquidity problems can swap domestic currency for U.S. dollars with an agreement to buy back the domestic currency at an agreed date in the future.

member countries to include all members and also countries of the +3 group. Although the agreement is a significant political step toward greater financial and monetary cooperation in East Asia, its symbolic nature is probably more important than the substance of the agreement. The initiative demonstrates a broad consensus among the group that East Asian countries need to cooperate more closely to protect themselves from risks arising from volatile international financial and capital markets, and to ensure future sustainable economic development for the region.

It could be a first step toward the setting up of a Framework for Regional Monetary Stabilization (FRMS) for the East Asian region, an evolution of the Asian Monetary Fund idea. If an FRMS is to be set up, the key is to reach consensus *within the region* on its rationale, functions and formats. It will be a politico-economic decision of countries in the region with no need to try reaching a global consensus on the idea.

A regional monetary organization is nothing new. It may surprise many people to hear that an AMF already exists in the form of the Arab Monetary Fund. The AMF was set up by the Economic Council of the League of Arab States in 1976 to assist member countries in eliminating payments and trade restrictions, in achieving exchange rate stability, in developing capital markets, and in correcting payment imbalances through the extension of short- and medium-term loans. It also sought the coordination of the monetary policies of member countries and the liberalization and promotion of trade and payments, as well as the encouragement of capital flows among member countries.[3]

THE IDEA OF SETTING UP AN ASIAN MONETARY FUND, FIRST SUGGESTED BY JAPAN DURING THE EARLY PART OF THE CRISIS, WAS QUICKLY SHOT DOWN BY COUNTRIES FROM WITHIN AND OUTSIDE THE REGION

Another regional monetary organization is the Latin American Reserve Fund (LARF), which was established in 1991 as the successor to the Andean Reserve Fund (ARF). LARF's aims are to assist in correcting payment imbalances through loans with terms of up to four years and guarantees extended to members; to coordinate their monetary, exchange, and financial policies and to promote the liberalization of trade and payments in the Andean subregion.[4] Thus the FRMS would not be a new species of regional arrangements, but simply a new East Asian incarnation of an existing one.

Many suggestions have been made about the possible functions of an East Asian monetary arrangement. These include policy dialogues and regional surveillance, monetary policy coordination in the region, emergency liquidity (or even lender of last resort) support, extension of loan guarantees to member countries, promotion of the usage of regional currencies in intraregional trade and investment, the development of currency settlement systems, the development of a regional framework for management of short-term capital flows, the promotion of regional capital markets to recycle surplus savings in the region for long-term development financing, and work related to possible

3 The AMF consists of 22 members: Algeria, Bahrain, Comoros, Djibouti, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, Palestine, Qatar, Saudi Arabia, Somalia, Sudan, Syrian Arab Republic, Tunisia, United Arab Emirates, and the Republic of Yemen.

4 The LARF has 5 members: Bolivia, Colombia, Ecuador, Peru, Venezuela. Details of the AMF and LARF can be found on the IMF web site http://www.imf.org/.

regional monetary integration in the longer term.[5]

The various suggested functions can be broadly separated into three groups. The first relates to initiatives that may help in preventing the reoccurrence of a future financial crisis in the region. The second relates to measures to be taken when some countries face financial difficulties or get into a crisis, and the third relates to some form of possible longer-term monetary integration in the region. My own view is that the FRMS should be able to make rapid and effective progress on the first group of functions, and this should be the main focus at the beginning. The second and third groups require many more analyses and discussions to reach a consensus on the details, along with practical and effective implementation plans. Technical work on these latter issues can also be part of the short-term agenda for the FRMS.

MANY CRISIS-AFFECTED COUNTRIES HAVE HAD TO USE FISCAL DEFICITS DURING THE CRISIS

In relation to the first group, some suggestions made about the prevention of a future crisis in the region include (a) *dialogues on policy coordination*. Policy coordination is important given the diverse exchange rates and macroeconomic policy regimes in the region. A policy stance in one country may have implications for macroeconomic outcomes in others, so a process of regular dialogue supported by technical analyses at the national and regional levels would be useful. This process would also include the surveillance of potential problems.

A second suggestion has been to include (b) *technical and cooperative work on the promotion of regional long-term financing for development*. This will be important to avoid the past mistake of countries resorting to short-term foreign debt to finance (or more than finance) their saving-investment gaps. An advantage should be taken of the surplus savings in the region (which was running at around US$150 to US$180 billion per annum before the crisis) to recycle to countries with saving deficits in the form of long-term investment financing.

Many crisis-affected countries have had to use fiscal deficits during the crisis. This has led to more active government and corporate bond markets (especially because financial institutions are still not fully recovered). Work is needed to develop regional bond markets, where savers, notably institutional savers, will find it attractive to subscribe to long-term bonds across national frontiers.

Ideas have also been floated on linking (or merging) some stock markets in the region to offset the small size of many national stock markets. This can help companies to raise funds more easily through equity. The FRMS can also include this issue in its work agenda.

Related to this point is the need to (c) *strengthen credit rating capabilities in the region*. With the recycling of surplus savings within the region, the importance of credit ratings by regional credit rating agencies will increase dramatically. Work is needed to strengthen their capabilities and to develop common standards and possibly certification for the rating of regional credit. Joint ventures or mergers, or both, may also lead to the emergence of regional credit rating companies that could play important roles in complementing the development of regional capital markets. As the regional capital market becomes more active and more investment needs in the region are met by funds from within the region, the influence of credit rating agencies from outside the region, whose rating criteria may not always be suitable for East Asian economies, will inevitably decline.

Work is also needed to (d) *promote regional*

5 See, for example, Hajime Shinohara, "On the Asian Monetary Fund," *IIMA Newsletter*, Institute for International Monetary Affairs, March 31, 1999; "Asian Currency Settlement System," *IIMA Newsletter*, Institute for International Monetary Affairs, January 1, 1999. Also, Chalongphob Sussangkarn, "East Asian Financial Architecture for Stable Economic Development." Paper presented at the 10th GISPRI Symposium on *Beyond the Crisis — Rethinking Japan's Role in Asia*, Global Industrial and Social Progress Research Institute, Tokyo, Japan, March 22, 2000.

currencies or indexes of regional currencies for trade and investment within the region, including currency settlement systems. This is related to the internationalization of the yen and the idea of Bilateral Payment Arrangements (BPAs) that have been suggested among ASEAN member countries. Regional currency indexes could play important roles for intraregional trade and investment as a means of currency risk sharing among participants from countries with very different exchange rate regimes. As the regional capital market develops, the emergence of these currency indexes may be a natural outcome of market forces.

The FRMS might contain a mechanism for (e) *the development of a regional framework for the management of capital flows*. Apparently a greater consensus now exists on the need for countries to have instruments to manage capital flows, especially short-term capital flows.[6] Even the IMF appears to have accepted that measurements for the management of capital flows may be necessary under certain circumstances, and this issue is also included as part of the current discussions on the reform of the international financial architecture.[7] Some regional consensus should be reached on the best practices for the management of short-term capital flows so that risks can be minimized while benefits from access to the short-term capital market can still be achieved. Some clear guidelines could be drawn up so that each country will not need to come up with its own scheme, which could lead to confusion and inconsistencies.

SIMPLY LENDING HUGE AMOUNTS OF MONEY TO THE AFFECTED COUNTRY IN THE WRONG EXPECTATION THAT THE PROBLEM INVOLVES LIQUIDITY CAN LEAD TO AN EVEN WORSE SITUATION

The development of these concrete measures, together with the national reforms that various countries have already taken as a result of the crisis, should go a long way toward minimizing risks of a future crisis with characteristics similar to the current one. Crises are bound to arise from unexpected sources, so measures preventing a reoccurrence of symptoms similar to a previous crisis may not be fully relevant in preventing a future one arising from different and now unknown causes.

Should a crisis occur again, what should be the role of the FRMS? In the event of a small-scale crisis when countries simply face temporary liquidity problems in foreign reserves that can be reversed with minor policy changes, the provision of liquidity by the FRMS may be useful, provided that it has established an appropriate surveillance mechanism and a willingness by various governments to pursue appropriate policies. In this situation, the amount of money involved should be small, and an expansion of the swap facilities along the lines of the Chiang Mai Initiative would be sufficient.

When a major currency crisis occurs, however, it is usually because of the failure of the surveillance mechanism to have foreseen it, or because governments are unwilling to take appropriate corrective policies for political or other reasons. In these situations, the problem usually becomes one of insolvency and not liquidity. If it is one of insolvency, it must be accepted that strong and painful corrective policies (and thus "painful conditionalities") will be needed. This is the only way to ensure

6 Some see the need for the management of short-term capital flow as a normal part of the rules of the game: e.g., Joseph Stiglitz, "Must Financial Crises Be This Frequent and This Painful?" McKay Lecture, Pittsburgh, Pennsylvania, September 23, 1998, and UNCTAD, *Trade and Development Report 1998*, (chapter 4). New York and Geneva: United Nations publication. Others suggest that capital controls may be necessary during currency crises: e.g., Paul Krugman (1998). "Saving Asia: It's Time to Get Radical." *Fortune*, September.

7 IMF (1999). "A Guide to Progress in Strengthening the Architecture of the International Financial System," December 22, 1999.

that the affected country can accumulate enough foreign currencies to become solvent again (mainly through a severe recession and a large current account surplus). Simply lending huge amounts of money to the affected country in the wrong expectation that the problem involves liquidity can lead to an even worse situation, with more rapid speculative capital outflows (by nonresidents and residents) and a delay in corrective policies by the government. In this situation, if the FRMS were to play a role similar to the IMF with Asian money and Asian management, it is not clear how much would be achieved. Just as the painful conditionalities of the IMF led to criticisms that they appeared to be in the interests of the countries that dominate the IMF (the Western powers, especially the United States), painful conditionalities by the FRMS would inevitably lead to similar criticisms against the country or countries that dominate it (probably Japan). It may be judged that cases of insolvency should still be left for the IMF to manage, though hopefully if the various effective preventive measures can be developed, these cases may be rare in the future, isolated and without outstanding regional effects.

In the longer term, closer monetary integration (as well as trade integration) in much of East Asia appears inevitable. The EU model may be too far-fetched to contemplate at this point. The suggested functions for the FRMS above, however, already point the way toward much greater regional monetary cooperation and institutional building. Building on the Chiang Mai Initiative, greater policy coordination, the development of regional capital markets and supporting infrastructures, and the promotion of regional currencies or currency indexes would take East Asia much further toward greater financial and monetary integration than could have been imagined only a few years ago. The impetus for these initiatives obviously arose from the crisis, but the outcome could lead to a much stronger and more resilient East Asia for the century ahead.

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