The case for regional financial and monetary cooperation in the PECC economies: Background issues and questions for inquiry

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Background

Governments face a basic issue when they integrate their economies into the world economy. How should such opening be sequenced and at what pace? The risks of managing integration were illustrated in the 1997-98 Asian financial and economic crises, the earlier 1994-85 Mexican peso crisis, and the 1980s Latin American debt crises. What is worrisome about the recent ones is the contagion that accompanied them and the scale and complexity of the impacts on the real economies.

The purpose of this paper is to identify some of the main lessons from and implications of these crises for the PECC economies. This paper provides background for a PECC survey of the status of and prospects for closer financial and monetary cooperation in the PECC area. There are two dimensions to prospective developments. First what role can regional actions play in preventing future crises and managing them if they occur? Second, how important is it to ensure that regional actions are consistent with the functioning of the international financial system.

Encouraging foreign financial flows, particularly short term private flows, entails significant risks (vulnerability to capital surges and reversals) as well as benefits (faster growth in living standards than would be possible relying only on domestic savings intermediated by domestic financial systems). PECC governments have liberalized their capital accounts at varying rates. Some opened their capital accounts rapidly (for example, Indonesia in the early 1980s) while others opened more slowly (for example, PRC still restricts convertibility to FDI transactions only).

Prior to the Asian crisis, some governments adopted exchange rate and structural policies that biased market participants' perceptions of the risks of greater openness. De facto exchange rate pegs in several of the crisis economies encouraged complacency about exchange rate and interest rate risks associated with foreign borrowing. In some cases, structural policies favored certain forms of foreign capital. Thailand's relatively lighter taxation of foreign capital than other capital was one example. South Korea's restrictions on FDI inflows relative to foreign debt was another.

At the same time, foreign funds were plentiful. Rates of return in the OECD economies fell as inflation and interest rates dropped in the late 1980s. With aging populations and growing pension funds in these economies, institutional investors emerged seeking higher rates of return offshore. New technologies and financial instruments helped make that possible. As flows to emerging markets grew in magnitude, however, investors increasingly made decisions on rumors and assumptions that thirty years of rapid growth would continue indefinitely, instead of on objective assessments of creditworthiness. Unfamiliar with these markets, they headed for the exits when the first signs of trouble appeared.

The 1994-95 Mexican crisis was a traditional sovereign debt crisis while that in East Asia was driven by private sector indebtedness. In 1994, following a political assassination Mexico encountered difficulties in financing its current account deficit. Instead of tightening monetary policy or devaluing the peso, the government issued short term debt indexed to the US dollar, known as *tesobonos*, to foreign investors. The shock of a second political assassination reduced confidence in the sustainability of this policy framework. Since the foreign assets were widely held it was impossible to arrange a rollover of the obligations in time to avert a default. An attempt at a controlled devaluation failed in the face of a second political shock, triggering a large loss of the currency’ s value against the US dollar and a financial crisis.

In East Asia, structural weaknesses played a significant role in the exchange rate, financial and economic crises. Domestic financial systems in the crisis countries were slow to adapt to the added externally-generated risks of open capital accounts. Dominated by banks supplying short-term debt, corporations became highly-leveraged during the years of high growth. Both corporations and financial institutions borrowed heavily abroad, often in unhedged foreign currencies. When domestic interest rates were raised to defend an exchange rate parity, highly-leveraged firms failed causing recession and unemployment.

The US Treasury and the IMF stepped in to provide Mexico with short term liquidity. East Asian governments turned to the International Monetary Fund and to neighboring countries, accepting in return some controversial strings attached to the subsequent IMF adjustment programs.

Various combinations of structural weaknesses, macroeconomic policy mistakes and panicked foreign investors were all contributing factors to the crises. East Asians, drawing their own lessons from the crises, vowed “never again” to be as dependent on the international institutions for crisis management.

What has been learned from the crises?

At least five lessons can be drawn from the crises, each of which is relevant to our consideration of the desirability and feasibility of closer regional financial and monetary cooperation.

Lesson 1: Strengthen weak domestic financial systems

Most emerging market economies in the PECC area other than Chile and the international financial centers in Hong Kong and Singapore, need to strengthen their financial systems so that banks, securities firms, asset management companies and insurance companies are well-regulated and well-managed, providing a diverse range of financial services and products that enable their customers to evaluate and manage risk. To increase the efficiency with which they intermediate savings and foreign capital flows, financial system supervision also needs to be strengthened, accounting practices standardized, legal practices adopted; the infrastructure for efficient and liquid capital markets including payments and clearing systems, credit rating agencies and deposit insurance schemes must also be developed.

The BIS is now stressing the need for bank regulators to establish proper incentives to match assets with liabilities. Guidelines for managing bank debt and liquidity structures have been drawn up. National regulators are being encouraged to act in a proactive, rather than passive, manner in which they regularly inspect banks' books, including by surprise spot checks.

The rationale for stronger financial systems is that as economies become more complex, the financial system cannot lubricate growth and development if it lacks institutions that allow savers and investors to interact with confidence with borrowers and issuers who are not known to them. Strong financial systems that provide this confidence require strong banks, diversified institutional frameworks that supply financial instruments of longer duration such as bonds and commercial paper, and flows of transparent information and payments and settlement arrangements that make deep and liquid financial markets possible.

Lesson 2: Financial liberalization should be carefully sequenced with domestic financial systems modernized before full scale capital account liberalization occurs.

Ideally, national financial systems should be strengthened before short term capital is allowed to come and go freely as Latin American economies learned in the 1980s. One of the reasons China and India seem to have weathered the crisis is because of the insulation from volatile capital flows afforded by relatively closed capital accounts. Where liberalization has already occurred, foreign capital must be intermediated in ways that provide accurate signals of the interest rate and foreign exchange risks of foreign borrowing. Short term borrowing in foreign currencies prior to the crisis did just the opposite -- with pegged exchange rates and foreign interest rates much lower than domestic ones, banks and firms helped themselves to Japanese and German (and sometimes US) borrowing, assuming they faced no exchange rate or interest rate risks. They lent and invested onwards for long term assets. This set the stage for the classic asset-liability mismatch, between unhedged short term offshore liabilities and long term, often speculative domestic assets. It also set the stage for inappropriate foreign borrowing by corporations. Foreign capital stoked the speculative bubble and inadequate risk evaluation and management by financial intermediaries and borrowers meant the latter had to bear the risks.

Lesson 3: The impact on the real economy is prolonged by structural obstacles to reducing the debt overhang.

Highly leveraged firms, dependent on domestic and foreign borrowing now delays recovery. The extent of corporate distress in the crisis countries is indicated by the size of non-performing loans. Debt restructuring takes several forms: through negotiations between creditors (usually banks) and debtors in restructuring or workout arrangements, through bankruptcy proceedings, through transfers of bad assets to state-owned asset management agencies and through the outright nationalization of banks weighed down by non-performing loans.

Asset management organizations are now significant holders of corporate assets in Indonesia, South Korea and Malaysia. In Korea, the banks have been charged with responsibility for workouts, with the Financial Supervisory Commission issuing guidelines for both banks and the *chaebol*. Malaysia has a mix of government and private sector measures. Thailand has chosen a market-based approach in which the private commercial banks are left to restructure these assets themselves. Indonesia has no one approach.

Lesson 4: There should be an appropriate fit between an economy's exchange rate arrangements, fiscal and financial discipline, and the economy's ability to adjust to shocks.

Countries choose among three main exchange rate regimes in integrating their economies into the international system: floating exchange rates, fixed exchange rates, and intermediate arrangements in which exchange rate volatility is limited in some way. This choice has important consequences for an emerging economy since the exchange rate is one the most important price signals. Since the crisis, consensus has emerged that the intermediate arrangements of fixed but adjustable exchange rate "soft pegs" do not work well. These pegs, while they produced stability for long periods, in some cases stayed fixed long after they should have been revised to reflect changing economic fundamentals. Their subsequent collapse had serious economic impacts, in part because borrowers and investors alike behaved as if they faced neither exchange rate nor interest rate risks. Defense of the pegs required monetary stringency that pushed highly-leveraged business borrowers into insolvency, taking jobs, income and output with them.

What should the small open East Asian economies do now? With the exception of China, Hong Kong and Malaysia, most economies practice some form of managed floating (see Table). Brazil is one of the recent Latin American examples which, when it floated the currency in 1998, subsequently adopted inflation targeting to anchor expectations.

Floating exchange rates allow a country to pursue an independent monetary policy, but markets can be easily overwhelmed by capital flows and changes in market sentiment causing overshooting -- on the downside creating inflation, and on the upside damaging exports, creating a trade deficit and undermining employment and economic growth. Developing economies also need to anchor expectations of both inflation and the long term real exchange rate, especially when they seek foreign capital to assist their development, since exchange rate volatility raises the cost of capital through a higher risk premium. They are under heavy pressure to make domestic policies appear prudent to international investors. Rather than leave policy at the mercy of the markets they can resort to prudential controls on capital inflows, but these provide a short term palliative, not a long term solution.

Going forward, East Asian economies are exploring other alternatives that are credible and avoid the costs of capital controls. One way is to strengthen the link to the major currency by passing a law to install a currency board. The board substitutes for the central bank and only issues local currency that is backed by the dollar (or the euro). However, currency boards tend to be created for special reasons: to restore credibility after a hyperinflation in Argentina in 1991 and, in 1983, to maintain credibility during and after the political transition in Hong Kong SAR. Even so, both economies experienced severe market pressures during recent crises and paid high costs in terms of lost employment and output. Argentina' s currency board collapsed in early 2002 after foreigners and residents lost confidence in the sustainability of its economic policies.

Lesson 5: Crisis prevention and management

This recent experience underlines that there is more to liberalizing capital markets than simply opening the capital account or deregulating the domestic financial system. Efficient and stable capital markets must rest on a solid financial infrastructure and operate in a sound macroeconomic environment, one that has low inflation, sound public finances and an exchange rate regime consistent with the policy framework. Such fundamentals are necessary to reduce the risks of financial crises.

East Asians recognize the need to remove structural obstacles to the free play of market forces, but they argue these changes cannot realistically be made overnight. Their substantial savings and foreign exchange reserves imply growing clout in the world economy. Why not use this clout to create regional financial arrangements to augment or substitute for IMF emergency financing? Such arrangements would have to be carefully crafted to avoid adding distortions to international capital markets such as moral hazard.[1]

Reducing exchange rate volatility is also necessary to reduce the risks of future financial crises. There is skepticism that capital controls can be administered in ways that avoid serious distortions through time.[2] Why not work towards monetary integration and a common currency if intermediate exchange rate arrangements attract speculative activity and volatility?

Up to now, responsibilities for preventing and managing financial and exchange rate crises have been centralized in the IMF. If centralized crisis prevention were to be more effective the IMF should deepen its surveillance of national economies and extend to financial market issues. To become a more effective centralized crisis manager, it would be necessary to make the IMF into a world central bank and global lender of last resort (ie. like a national central bank which provides

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[1] Moral hazard refers to the impact on incentive structures if regional funding were perceived to be available on easier terms than that available from the IMF. Governments, central banks and financial regulators might be more relaxed about risk taking by domestic financial institutions if there is an expectation of such bailouts.

[2] See Edwards, Sebastian. 1999. “How Effective are Capital Controls?” *Journal of Economic Perspectivies*. 13:4. 65-84.

unlimited liquidity at penalty rates to the market at times of crisis to avert damaging credit crunches). This is not going to happen any time soon, so much of the official debate revolves around whether and how to increase the IMF' s resources to a size that can realistically deal with private capital flows.

One alternative is to decentralize surveillance needed to prevent crises and the lender of last resort function to manage crises in two ways. First, lender of last resort facilities could be decentralized to regional facilities that use IMF surveillance and conditionality during adjustment programs. Second, since the international financial institutions are unable to keep up with the increasingly large and sophisticated financial players and are not able to discipline malpractice in developing countries, their focus should shift towards the national regulators in the G-10 countries to work on the "supply side" of international finance. National regulators would adopt measures to reduce the volatility of bank lending and portfolio investments in emerging markets and ensure the private financial players absorb more of the risks and more of the price declines.

Crisis prevention and management options in the PECC area

The goals of both centralized and decentralized options are to prevent future financial crises and to manage them more effectively if they occur. Achieving these goals requires closer cooperation, particularly among neighboring economies. In this section, decentralization of the global framework for cooperation is first considered. Regional institutions are then discussed.

A. Reform of international financial institutions to promote "neighborhoods"

Several options might be considered for regional financial and monetary cooperation. However, a key assumption is that the IMF should and will remain at the center of the international financial system. It could then become more representative and focused in its role and more flexible in its approach to surveillance.

Fund surveillance is central to its effectiveness in crisis management and prevention. Legitimacy is essential to the credibility of its surveillance. Yet its governance structure suffers from several flaws that undermine its legitimacy. Although it has 182 members, the Fund is dominated by the G-7, and mainly the United States[3]. Yet there are nearly two dozen "systemically significant" economies in the world, a small subset of which own most of the world' s international currency reserves, and not all of them are Fund members, such as Taiwan, nor do they have much say in the decisions of the Fund under the current governance structure[4]. The Interim Committee

[3] A full-time executive board is responsible for the ongoing operations, chaired by the Managing Director who they appoint. The G-7 governments (Canada, France, Germany, Japan, Italy, United Kingdom and the United States) dominate decisions. Countries with some of the largest foreign reserves other than Japan and China (Singapore and Hong Kong SAR) are folded into constituencies.

[4] A Board of Governors is ultimately accountable for the Fund' s direction and consists of 8

performs both institutional governance and surveillance of the international monetary system but it has become known as a talk shop. In September 1999, it was finally renamed the International Monetary and Financial Committee (IMFC) and to some extent refocused.

The IMFC could become more of an executive committee for the world economy and crisis manager. The appearance of the G-20 (consisting of the G-7 and a small group of "systemically significant" countries) may set the stage for this to happen at some future time. Emerging market members of PECC who are also G-20 members include China, India, Indonesia, Mexico and South Korea. The G-20's mandate is to promote informal dialogue on key economic and financial policy issues among these economies and to promote cooperation. Its current (Canadian) Chair sees it complementing and coordinating efforts underway in other fora and overseeing the technical work of the Financial Stability Forum. The predecessor organization, the G-22, made up of economies selected for their size or the size of their reserves, played a significant catalytic role in creating the basis for a number of reforms that are now being implemented in the international system[5]. The potential political significance of such a group should not be under-estimated. It could be the modest forerunner for a much-needed globalized G-7.

These innovations would increase the legitimacy of the IMF in the international system by responding to the chronic problem of insider-outsider tensions. The Europeans and other G-7 members are the "insiders". They see each other frequently and engage in regular surveillance of each other' s economies in these and other forums. The rest of the world' s economies are the "outsiders" which do not have such institutions, outside of the large and formal IMFC.

Another innovation is possible. Surveillance discussions could become more decentralized within the IMF structure. As the G-7 has found, informality and frankness, are the most highly valued attributes of the surveillance process. But these attributes tend to decline as group size increases. Smaller forums, linked to the IMF for the basic information necessary for surveillance, but operating on their own, could be considered. The IMF constituency structure could be revised to promote consultation among neighbouring countries (who are the first to be affected by bad policies and therefore the most interested in seeing that potential offenders receive and respond to sound advice). Two groupings, around the world' s two major currencies, could initially be considered: Europe including the Middle East and Africa, and the PECC/APEC group, including North and South America and East and South Asia. Although there is a danger that such structures might increase regional awareness at the expense of the world economy, network

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individual large country members and 16 groups of countries. These members are assigned quotas and voting rights according to their economic clout. They meet at the Interim Committee twice a year (the Interim Committee was so-named in the 1970s as a compromise when governments failed to agree on IMF governance post-Bretton Woods).

[5] Smaller European countries which consider themselves to be systemically significant questioned the group' s legitimacy, however, which ended its work after one round of excellent technical reports.

structures of this kind allow for wider involvement and commitment to consultation and policy cooperation. With more commitment *inside* the IMF framework, proposals such as Japan's 1997 call for a separate Asian Monetary Fund (which was rejected by China and the United States) might have survived to become a special regional IMF facility.

The potential value of regionalizing surveillance structures flows from the fact that countries are still reluctant to take outside advice, especially during the booms that often precede financial crises. The political economy of surveillance is such that outside advice can strengthen the position of national groups pushing for reforms. And it is neighbors who have the greatest stake in each other's good policies and performance.

Decentralization of financing and surveillance, more emphasis on strong national financial systems and clearer rules for private capital market participants in crises, in turn, would set the stage for a more focused, smaller IMF in several respects. The IMF would focus on exchange rate systems and their sustainability (a traditional role) and expand its focus to include surveillance of commercial banking systems and their regulation. It would be the arbiter of whether a crisis is brewing and it would still provide capital to crisis countries, but for liquidity purposes, not for largescale bailouts of financial institutions.

B. Regional financial institutions in the PECC/APEC Area

Should PECC economies regionalize the international financial system? Should the Asian economies develop a regional financial system as some in the region have suggested? A consensus seems to be emerging in East Asia that the region's governments should rely more on their own institutions. Discussions in Latin America are at earlier stages. National governments in Brazil and Argentina and some smaller countries have faced financial crises more recently; these have not been associated with wider contagion.

The regional institutional issue has several dimensions:

- a stronger Asian and Latin American or PECC/APEC area presence in the international system;
- regional infrastructure for more efficient financial intermediation in the regions; up to now, much of the emerging markets' substantial savings are intermediated in the world's money centers which contributes to the volatility of capital flows;
- regional infrastructure for deeper financial and monetary cooperation; cooperative regional mechanisms that could underpin regional monetary integration do not exist.

Higher profiles in the international financial institutions

The rationale for a greater regional presence in international institutions is a longer term one. The interdependence created by capital and trade flows with the mature industrialized capital-surplus countries can be expected to increase. But as the former developing countries mature and become financial forces in their own right, eventually the apex of global economic leadership must evolve to include them. This is already an issue since most of the world's large stocks of foreign exchange reserves reside in East Asia.

The PECC emerging market economies participate in all of the international financial institutions. With the exception of Taiwan they are all represented in IMF constituencies. Those with major reserves are members of the New Arrangements to Borrow and some central banking representatives attend regular meetings organized in parallel with G-10 central bank governors meetings at the BIS. Some of the same economies participated in the G-22 group of systemically significant economies and are now members of the G-20. Australia, Hong Kong and Singapore participate in the Financial Stability Forum (also convened by the BIS to create an inter-institutional coordinating body of groups working on codes of best practice). All are members of the World Bank and the regional multilateral development banks, the Asian Development Bank and the Inter-American Development Bank.

Regional institutions for cooperation

The rationale for closer regional macroeconomic and financial cooperation is developmental. Bad macroeconomic performance and structural weaknesses in national financial systems can create problems that spill over to neighboring economies through interest rates and capital flows, exchange rates and trade flows. It helps to have a hand on the policy levers of one' s neighbors, through surveillance discussions and peer pressure. Investments in such closer relationships can pay off in terms of early warnings of future crises and when it comes to managing crises. Technical assistance for institution building can also help address problems.

The Pacific Asian region has a dearth of official regional financial institutions. Until recently, PECC and associated APEC-related institutions such as the ABAC focused mostly on trade issues. One of the reasons for the absence of comparable financial institutions is that there is no accepted economy with the resources to be the regional leader. Japan is a systemically significant country but with a currency that is not internationalized and financial institutions that are not strong enough to intermediate mobile capital flows efficiently.

Before the financial and economic crisis, there were two main regional financial institutions: the APEC Finance Ministers and the Executive Meeting of East Asian and Pacific Central Banks (EMEAP). APEC Finance Ministers deals with a plethora of issues from social safety nets to capital flows. EMEAP provides a regular forum for central bankers which Japan and Australia helped to organize in the early 1990s. This organization has no secretariat and is organized each year by one of the participating central banks. Despite its informality, it has a solid record of technical cooperation to develop best practice templates and the infrastructure necessary to closer central bank cooperation in the region.

Since the East Asian crisis, the Manila Framework Group (MFG) has begun to meet regularly. It convened a number (but not all) of APEC members before the 1997 APEC Leaders Meeting in Vancouver to address crisis issues and to fill the vacuum in initiatives left by the demise of the Asian Monetary Fund proposal. It has initiated regular macroeconomic surveillance discussions at the senior official level and also discusses issues relevant to the international financial architecture such as dollar-yen fluctuations. This group includes the United States and Canada as well as the Pacific Asian economies. It is considered to be a useful surveillance forum and a valuable link with the G-7. It has a link with the IMF, receiving surveillance reports from IMF officials and providing a report to the Managing Director of the IMF from its Finance Secretaries and Central Bank Governors.

The most significant player, created since the Asian crisis, is ASEAN + 3 (China, South Korea and Japan) which has developed a fairly complex structure, including regular summits of leaders, meetings of finance ministers and central bank governors and commissioned a “Vision” group of officials and former officials to map out its long term goals. These goals include a common regional currency.

Ultimately, the question on the minds of many is whether these embryonic forms of cooperation can solve the problem of exchange rate uncertainty that these export-oriented economies face. How can the long-term vision of a common currency be realized? In theory, the route is quite clear. Governments must be willing to give up some domestic policy autonomy to participate in surveillance exercises aimed at promoting and sustaining good macroeconomic performance among participating economies. This means they must be willing to give and receive constructive criticism of potentially risky fiscal or monetary policies. Over time, they will seek convergence in macro performance on low inflation and fiscal balance. Pressures for greater central bank independence can be expected. They will also promote economic integration through trade and financial flows. As markets become more integrated, market pressures will grow to reduce differences in domestic laws, regulations and standards.

In reality, some significant first steps in this direction have been taken in East Asia.[6] Sub-regional financial cooperation began informally in the ASEAN economies when several central banks agreed to currency swaps in 1996–97. These agreements had relatively little effect during the crisis, but cooperative arrangements moved forward in May 2000 when the idea was expanded and formalized among ASEAN+3 central banks. In what has become known as the Chiangmai Initiative (after the location at which the scheme was agreed) the ASEAN+3 central-bank governors and finance ministers agreed to work out currency swap arrangements among central banks in Northeast and Southeast Asia. These arrangements are part of the Network of Bilateral Swap Arrangements (NBSA), which will supplement the reserves of such countries as Singapore with Japanese, South Korean, and Chinese foreign exchange reserves.

Details of the scheme are being worked out for quick activation and disbursement of swaps. In 2001 Japan finalized agreements with South Korea, Malaysia, and Thailand in which borrowers will be permitted to draw 10 percent of their allowance without conditions; beyond that amount, IMF conditionality applies. So far, the amounts, however, are small, totalling roughly $7 billion announced in 2001. It is also anticipated that monitoring and surveillance of member economies' performance will take place in the ASEAN+3 meetings of central bankers and finance minister.[7] This network will take some time to become operational, and the magnitude of its resources will be relatively modest.

How deep is regional integration in East Asia? Several studies have found that, so far, the economic integration necessary to closer monetary cooperation is missing. The risks of adopting one monetary policy and a regional currency still outweigh the potential benefits.[8] For example, Bayoumi and Eichengreen (1994) studied the costs and benefits of monetary union by simulating adjustment to aggregate supply and demand shocks of different groups of economies with close linkages through trade and capital flows. They identified Japan, South Korea and Taipei China to be one possible regional grouping since they responded similarly to supply shocks and Hong Kong SAR, Indonesia, Malaysia, Singapore and possibly Thailand to be another since they responded similarly to supply and demand shocks. Kwan (1998) studied the possibility of monetary union using the yen. To reduce yen volatility the economies would use the yen as the

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[6] Some steps towards greater integration have also been taken in Latin America through the Andean Pact and the formation of Mercosur in the southern cone.

[7] See for example, Japan, Ministry of Finance. 2000. "Exchange Rate Regimes for Emerging Market Economies". Discussion paper jointly prepared by MOF and French Tresoire. www.mof.go.jp.

[8] See Bayoumi, Tamim and Barry Eichengreen. 1994. "One Money or Many?" *Princeton Studies in International Finance*. No. 76; Kohsaka, Akira. 2000. "Macroeconomic Interdependence in the APEC Region". In Ippei Yamazawa, ed. *APEC: Challenges and Tasks for the Twenty-first Century.* London: Routledge, 19-56; and Kwan, C.H. 1998. "The Theory of Optimum Currency Areas and the Possibility of forming a Yen Bloc in Asia". *Journal of Asian Economics*. 9:4. 555-80.

international currency and maintain stable exchange rates against the yen. Kohsaka (2000) used an approach similar to Bayoumi and Eichengreen. He simulated aggregate supply and demand shocks to the East Asian economies, comparing the results with similar shocks to the regions of the US economy and with European economies. He found that the East Asian economies adjusted in a manner similar to the European economies.

The results of these theoretical enquiries are illuminating but they say nothing about institutional and political feasibility. To realize the benefits of monetary union, countries must have similar macroeconomic policy objectives; their central banks should have some institutional similarities and be independent of political pressure; they must have similar economic structures; trade and capital markets must be increasingly closely integrated and labor must be mobile. While trade and investment flows increasingly link the Asian economies, financial intermediation is still under-developed; labor movements are restricted; central banks are not independent; and governments still guard national sovereignty closely.

Intermediate exchange rate regimes such as managed floating, a common basket peg or an Asian currency unit, ACU[9], are steps along the road. Economies would choose an appropriate basket of currencies based on trade shares with their major trading partners and peg to that and to each other' s currency. The common basket peg would suffer from some of the same problems of de facto pegs in that both the yen and US dollar shares would be large in such a basket. The ACU is more flexible in that, like the ECU, each country would peg to a common currency unit, the ACU. The ACU could be composed of the yen, dollar, euro and home country currencies. Or it could be composed only of the home currencies; it in turn could be linked to a currency basket consisting of the yen, dollar and euro. This link could be within an exchange band. Monetary authorities would be obliged to intervene in foreign exchange markets in order to keep their home country exchange rates within a band against the ACU and to each other. They would also intervene to keep the ACU in a band in relation to the yen/dollar/euro basket.

It is difficult to envisage such an arrangement without a regional monetary institution doing the second stage of intervention. It is also difficult to see how markets would find such an arrangement understandable and credible, and therefore an improvement over the status quo.

Even so, while the regional financial architecture in East Asia is still rudimentary, considerable work is underway and a road map exists. Further steps will be needed as institutions at both the national and regional levels deepen and mature. These steps will be essential prerequisites to the development of the regional institutional structures needed for monetary integration.

[9] See Ito, Takatoshi, Eiji Ogawa and Yuri Sasaki. 1999. "A Regional Currency System in East Asia". In *Stabilization of Currencies and Financial Systems in East Asia and International Financial Cooperation*. Tokyo: Institute for International Monetary Affairs; and Williamson, John. 2000. *Exchange-Rate Regimes for Emerging Markets; Reviving the Intermediate Option.* Washington, DC: Institute for International Economics.

The future in Latin America is a rather different one. US political and economic linkages dominate the region. Most community building efforts focus on trade, such as Mercosur and Free Trade Area of the Americas. Perhaps these discussions will generate the understanding that could become the basis for financial arrangements. As well, greater macroeconomic stability will be needed as well in a number of countries.

ANNEX

Survey of Regional Arrangements for Financial and Monetary Cooperation in the PECC economies

The purpose of this survey is to assess the views of individual governments on closer regional cooperation that reduces the risks and realizes the benefits of integration into the world economy.

Regional and international cooperation gives some basis for optimism about a regional framework linked to the global institutions. Monetary integration is probably a very long way in the future. But moves are being made to increase the profile of significant economies in the international financial institutions.

What are governments' views on and commitments to these developments? What is the status of regional cooperation and what is needed to deepen it? Below is a series of questions designed to collect information on these issues. At the end of the questionnaire is a list of the relevant regional institutions on which views are sought.

Questionnaire

1. Do you think PECC Area financial cooperation is desirable? Necessary? Regional financial cooperation is desirable? Necessary?

2. What do you think about the status of regional financial cooperation? Is it satisfactory or unsatisfactory?

3. Which regional institution best achieves the goal of regional financial cooperation? Why?

4. Please indicate how the relevant institution (identify which one, there may be more than one) focuses on preventing future financial crises. If possible indicate *which* early warning signals are monitored and *how* they are monitored? (*see below)

5. Does the institution identified in (4) monitor economic performance in member economies in a regular and systematic way? Please describe what economic variables are monitored, the frequency of such monitoring and how member economies review this monitoring.

6. Which member country(ies) in your view provide the leadership in each institution? Can you explain why this particular member provides such leadership?

7. Can you elaborate on the respective roles played in these meetings by the central bank and finance ministry representatives? (eg, does one of them take the lead at all time? Or depending on the topic; do they cooperate before and after meetings?)

8. Given the "Degrees of Cooperation" spectrum in the Figure below, how would you rate the level of cooperation in each institution?

9. Please provide an example(s) of current cooperation among members that, in your view, provides a positive example of the potential for deeper cooperation? A negative example? Please connect these examples of cooperation to the particular institutions.

10. What attention is paid in each regional institution to linkages between regional and global financial initiatives, such as, for example, with the IMF?

11. Do you think such linkages are needed? Why? (eg, for possible division of labor?)

12. What does your ministry consider are the priority goals for each of these regional institutions?

13. Do you think any of these regional institutions should be reformed (eg. to add a secretariat? to clarify a mandate, or to consolidate institutions with overlapping mandates?)

14. What reforms, in your view, are needed to move towards closer monetary cooperation to lay the basis for reduced currency volatility in the region and, in the long term, for a common currency?

Regional Institutions in this survey include:

- ASEAN
- ASEAN + 3
  Chiangmai Initiative
  Asian Monetary Fund
- Manila Framework Group
- Executive Meeting of East Asia and Pacific (EMEAP) central banks
- South East Asian Central Bank forum
- Four Markets Group
- APEC Finance Ministers
- Others? (It would be useful to know whether interviewees consider any "Other" institutions that provide opportunities for cooperation)

*** Examples of early warning of currency crises indicators:**

- Current account balance/GDP
- Current account balance/Investment
- Budget deficit/GDP
- Short term capital flows/GDP
- Real exchange rate appreciation relative to trend
- Fall in exports
- High ratio of M2 to international reserves

Figure: The Spectrum of Cooperation

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Independence **Cooperation** **Coordination** **Supranational Integration**

Cooperation is viewed in a spectrum:

- Independence is at one end; here a government chooses domestic policies in isolation; no regard is given to potential impact on neighbors
- Cooperation is at the center of the spectrum; governments are willing to work together through consultation with each other in choosing national policies
- Coordination is more formalized cooperation in which governments are willing to participate in monitoring each other' s performance and to give and receive peer pressure. Domestic autonomy is reduced in exchange for influence over neighbors' policy choices.
- Supranational integration is at the other end; governments give up domestic autonomy in policy making to a common institution

Table: Exchange Rate Regimes, 1997 and 1999

Economy	1997	1999	Notes
China	Intermediate	Intermediate	Soft peg plus capital controls
Hong Kong SAR	Hard peg	Hard peg	Currency board
Indonesia	Intermediate	Float	Soft peg
Malaysia	Intermediate	Intermediate	Capital controls and fixed exchange rate since 1997
Philippines	Intermediate	Float	
Singapore	Intermediate	Intermediate	Managed float
South Korea	Intermediate	Float	Managed float
Thailand	Intermediate	Float	Managed float
Taiwan	Intermediate	Intermediate	Managed float
Other PECC			
Australia	Float	Float	
Canada	Float	Float	Inflation target
New Zealand	Float	Float	Inflation target
US	Float	Float	
Chile	Intermediate	Float	Managed float; central bank had 10% band around a reference basket
Mexico	Float	Intermediate	Managed float
Peru	Float	Float	

Source: IMF. Various years. *Annual Report on Exchange Arrangements and Exchange Restrictions.* Washington, DC: IMF; Fischer, Stanley. 2001. "Distinguished Lecture on Economics in Government – Exchange Rate Regimes: Is the Bipolar View Correct?" *Journal of Economic Perspectives*. 15:2. 3-24.