

After the Chiang Mai Initiative

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Application of the Chiang Mai Initiative

In May last year, at Chiang Mai in Thailand, an agreement called the Chiang Mai Initiative, was reached among the ten ASEAN countries plus Japan, China, and South Korea (ASEAN + 3), aiming to promote regional monetary cooperation to better deal with future financial crises. The key aspects of the initiative were, first, to reach bilateral swap agreements, and second, to strengthen policy dialogue among the members, such as on monitoring short-term capital flows. Since East Asia had lacked the incentive for regional financial cooperation, the Chiang Mai Initiative, which included a short-term lending support mechanism, was seen as an epoch making agreement and its developments have been followed closely.

As a result of negotiations among the member governments, a swap arrangement involving all ten ASEAN countries, amounting to US\$1 billion, was reached at the ASEAN summit in Singapore in November last year. At the ASEAN + 3 finance ministers' meeting held during the Annual Meeting of the Asian Development Bank in Honolulu in May this year, the Japanese government announced that it had reached bilateral swap agreements with

South Korea, Malaysia and Thailand. Japan will sign a dollar-won swap agreement worth \$2 billion in addition to the present framework of \$5 billion with South Korea, a dollar-ringgit swap agreement worth \$1 billion in addition to the existing \$2.5 billion with Malaysia, and a dollar-baht swap agreement worth \$3 billion with Thailand. Japan is also negotiating a yen-renminbi swap agreement with China and a dollar-peso swap agreement with the Philippines, and has stated that it will continue negotiations with other ASEAN members to build a network of swap arrangements.

The ASEAN swap arrangement, as well as the bilateral arrangements between Japan and South Korea, Malaysia and Thailand, show that the Chiang Mai Initiative is developing into concrete measures. If China and Korea reach swap arrangements with the ASEAN members, a network of bilateral swap arrangements among the ASEAN + 3 will be established.

Slow Progress in Policy Dialogue

There have been some difficulties in reaching an agreement on monitoring short-term capital flows and establishing policy dialogue in a short period of time, due to the circumstances of member countries. No concrete progress was made at the meeting in Honolulu, and it was decided that each country will engage in bilateral exchanges of information on capital flows on a voluntary basis. Apparently some members feel that the disclosure of information on capital flows might affect their exchange rates. But since policy dialogue, such as on the monitoring of capital flows, is indispensable to deepen regional financial cooperation, the countries involved should strive to create a more coordinated system.

Linkage with IMF Facilities

The agreed swap arrangements allow 10% of the bilateral swap amount to be drawn without any linkage to IMF facilities, but the remaining 90% is to be linked. This linkage makes it clear that the East Asian swap network will play a supplementary role to IMF facilities. This may be the temporary but concrete response to the continued debate over the relationship between regional financial mechanisms and the IMF, which surfaced when

Japan proposed the Asian Monetary Fund (AMF) scheme in September 1997. By setting the provision for linkage to the IMF facilities within the swap arrangement, a swap facility is secured by IMF conditionality.

The Effectiveness of the Swap Arrangement

When the monetary crisis erupted in Thailand in July 1997, a financial package worth US\$17.2 billion was agreed upon among international institutions and some of the regional governments. The IMF contributed \$4 billion, the World Bank \$1.5 billion and the ADB \$1.2 billion. The rest was extended on a bilateral basis. Japan contributed \$4 billion, China \$1 billion, Hong Kong \$1 billion, Malaysia \$1 billion, Singapore \$1 billion, Australia \$1 billion, South Korea \$0.5 billion, Indonesia \$0.5 billion and Brunei \$0.5 billion. None of the European countries nor the United States made any contribution, so the package was formed by support from international institutions and Asian countries including Australia. By agreeing to swap arrangements beforehand, the Chiang Mai swaps can be seen as a regional safeguard that will allow immediate bilateral support to be provided in coordination with the IMF facilities in the event of a crisis such as the one that occurred in Thailand.

There are two characteristics to this swap arrangement. First, it is a collection of bilateral swap agreements. Since the rights and responsibilities of a lender and a borrower will be determined by a bilateral agreement and not by an uniform agreement, the Chiang Mai swaps will end up being less effective as a support mechanism, when compared to multilateral arrangements. The second characteristic is that because 90% of the swap amount is linked to IMF facilities, the full amount is not automatically available, even if a country wants to use the pre-arranged swap framework to solve a problem at the pre-crisis stage. These aspects illustrate the fact that there is room for improvement in the Chiang Mai Initiative, but nevertheless, it is symbolically important as East Asia's first step on the long road to regional financial cooperation.

From Bilateral to Multilateral

The swap arrangements are based on bilateral agreements and either country can be the borrower. However, the arrangements presuppose that the ASEAN members, except for

NIES, will be the potential borrowers, while Japan and China will be the lenders. Since these are bilateral agreements, there are likely to be variations among them, which means that they are inferior to multilateral agreements in terms of transparency and efficiency in their operations. That is why, once the network of swap arrangements is complete, it should be developed into a multilateral system.

A multilateral lending arrangement would enable the regional cooperation system to be more transparent and vigorous. Besides using the funds to avoid a crisis, it is also worth considering whether they could be used to deal with the balance of payments problem or currency instability in a pre-crisis stage. However, before such a system can be realised, a multilateral agreement has to be reached on a wide range of policy coordination, including monitoring of capital flows. Countries need to adjust themselves from an inward looking policy management to a more open management by accepting consultations on economic policies.

A Need for an Institution

An independent regional institution should be established in order to implement a multilateral system efficiently. The reactions of the United States and Europe concerning the establishment of a regional organization should not be as negative as they were towards the AMF scheme, since the linkage between a regional system and the IMF was made clear in the Chiang Mai swap arrangement. As long as the linkage to the IMF is maintained, the establishment of a regional organization should be a prerogative of the East Asian countries.

If the member countries contribute a certain amount of funds in the form of capital subscription or by making loan commitments, it will become a more credible institution. The institution would extend funds and carry out general financing transactions, as well as help enhance policy dialogue among the members while promoting the monitoring of such areas as capital flows. Necessary criteria for drawing funds would be defined and there should be a specific system that would allow a member country to draw funds automatically once it meets those criteria. If such a multilaterally agreed mechanism can be created, the regional institution will have some flexibility in coping with the financing needs of the borrower in accordance with the situation before the country goes to the IMF. Once this

arrangement is made, the amount of funds that the regional institution can provide without the IMF linkage should be increased from the 10% laid down in the Chiang Mai swap arrangement.

Regional Cooperation in the Area of Trade

In addition to regional cooperation in financial areas, there has been some progress in regional trade cooperation in East Asia in recent years. Both Japan and South Korea are currently negotiating free trade agreements with several countries in and out of the region. Singapore has already signed free trade agreements with New Zealand, and is presently negotiating with Australia, the United States, Mexico and Canada etc. Until recently, Japan has given priority to multilateral trade agreements formed around the GATT and the WTO, and has not signed free trade agreements yet. However, if Japan and Singapore sign a free trade agreement by the end of the year as planned, this will be the first free trade agreement for Japan, i.e., a significant shift from the basic government policy of preferring multilateral trade agreements.

East Asia's free trade area will be expanded, in addition to the Asian Free Trade Area (AFTA), when member countries enter into bilateral free trade agreements. In the midst of this trend, at the ASEAN + 3 summit held in November last year, China proposed a scheme to construct a free trade area among China and the ASEAN countries. ASEAN made a counterproposal including Japan and South Korea to build an ASEAN + 3 free trade area. These are some dynamic developments which have occurred towards creating a regional free trade area in East Asia, and may be considered as the initial step on the long road from a tariff agreement to a common market that Europe has walked in the last fifty years.

After the Chiang Mai Initiative

The financial crisis in East Asia served as a stimulus for regional cooperation, resulting in the Chiang Mai Initiative. There is a danger that the momentum for regional cooperation may be lost, once East Asia overcomes the crisis and returns to a sustainable growth. However, I believe that the government leaders of the East Asian countries agreed to the Chiang Mai Initiative not only to cope with future crises, but also to promote regional

cooperation in the areas of trade and currency.

East Asia has only begun to test the waters of regional cooperation. Collaboration should start wherever possible, instead of debating the sequence, in the areas of trade, finance or currency. The purpose of regional cooperation, besides the political aspect of promoting peace, is to strengthen the regional economies through free trade and free movement of capital to raise the living standards of the people. In order to enhance intra-regional trade, East Asia will start with free trade agreements and aim for a common market in the long run. The stability of regional currencies is a prerequisite in this process and it will be necessary to build some form of regional currency and foreign exchange system. Academics and government authorities are currently discussing a currency system linked to a basket of the dollar, euro and yen. In the future, regional governments may strengthen policy dialogue on balance of payments and establish a mechanism through which they can intervene in the foreign exchange market in order to achieve currency stability in the region. Such developments will lead to debates over a mechanism which will provide the necessary funds in an efficient manner.

There will be an even stronger need to deepen the dialogue over economic policies and to enhance policy coordination if discussions develop into the creation of a regional currency stabilizing system and move on to considering a common currency. As we have already seen, the actual implementation of the policy dialogue agreed in the Chiang Mai Initiative has been far from easy, and there is a long road ahead to reach policy coordination. But it is clear that there will be no deepening of regional cooperation without overcoming this hurdle.

Lessons of Europe

The Kobe Research Project was launched at the Finance Ministers' meeting of the Asia-Europe Meeting (ASEM) in Kobe this January with the backing of both Asian and European governments. This project will support studies in the private sector on currency systems and regional financial cooperation. East Asia can learn a great deal from Europe's experience of regional cooperation in the past half century, and there are high expectations for this research project.

The situation in East Asia is very different from Europe. The income gap and the level

of economic development within the East Asian region are not the same as that of Europe. There are countries where the per capita GDP is more than US\$30,000 and there are others where it is less than US\$1,000. Countries in the region have diverse political systems. Christianity is the dominant religion in Europe but different religions, such as Buddhism, Islam and Christianity, spread throughout East Asia. There are huge disparities in social and cultural aspects. Western Europe is bound by NATO, a single security system, but there is no such framework in Asia. Because East Asia greatly differs from Europe in the political, economic, social and cultural aspects, arguments that it is impossible to achieve economic integration based on the European model, appear somewhat convincing.

However, East Asia will not simply stay content with the present situation and turn its back on regional cooperation. The EU has succeeded in currency integration, and by adding the new East European members it will expand from the current 15 to some 20 members in the year 2004. Furthermore, a gigantic North/South America free market may be created within several years with the integration of NAFTA and MERCOSUR. Observing these examples, it is natural to assume that East Asia will also move towards a closer regional economic relationship. This is because regional cooperation and integration are thought to bring solid benefits to the regional economies through trade, finance and stable currency. East Asia may not follow the same road as the EU. It will eventually choose an optimum path for the region.

Drawing a Long-Term Vision

The key question now is how East Asia will draw a blueprint of regional cooperation, following the Chiang Mai Initiative, before the momentum created by the Asian financial crisis is lost. Stimulated by the developments towards regional integration in other regions, active debates over cooperation in trade, finance and currency in Asia have been conducted in recent years. However, until now, these regional arrangements have been focusing on crisis prevention and therefore considered defensive in nature and have been basically carried out by government administrators.

Regional cooperation that faces political and economic hurdles will require political leadership at some stage in the process. Looking at the fifty year experience of the EU, it

was strong political leadership that envisioned long term objectives and lead the public opinion towards integration. Dr. Eichel, the German Finance Minister, said in his speech in Tokyo this January, “Fifty years ago nobody in Europe would have dreamed that a good number of European countries would exchange their national currencies for a common currency. Today this has become a reality.” Predicting what East Asia will be like fifty years from now may be like writing a fairy tale. But we must continue discussing the means to promote closer cooperation that will bring mutual benefit to the region, and to project a medium to long-term vision for East Asia after the Chiang Mai Initiative, even if it may only be a distant dream for now.

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