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"Framework for Regional Monetary Stabilization(FRMS)"

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Framework for Regional Monetary Stabilization: Suggested Functions*

1. The *Chiang Mai Initiative*, whereby the ASEAN+3 group reached agreement on expansions of swap facilities among ASEAN member countries to include all members and also the +3 countries (China, Japan and South Korea), is a significant political step toward greater financial and monetary cooperation in East Asia. The symbolic nature of the agreement is probably more important than the substance of the agreement. The Initiative signifies a willingness of the group to work together to forge greater cooperation in order to prevent and deal with future economic crises that may affect the region. It exhibits a broad consensus among the group that East Asian countries need to cooperate more closely in order to protect themselves from volatilities and risks arising from international financial and capital markets and ensure future sustainable economic development for the region.

2. The Initiative could be a first step toward the setting up of a Framework for Regional Monetary Stabilization (FRMS) for the East Asian region, which is an evolution of the Asian Monetary Fund (AMF) idea first suggested during the early part of the economic crisis, and has been an on-again, off-again, and on-again idea since then. An important point is that 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, and there is no need to try to reach a *global consensus* on the idea.

3. A regional monetary organization is nothing new. It may surprise many people that an AMF already exists, in the form of the Arab Monetary Fund. This was set up by the Economic Council of the League of Arab States in 1976, with the aim of assisting member

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countries in eliminating payments and trade restrictions, in achieving exchange rate stability, in developing capital markets, and in correcting payments imbalances through the extension of short- and medium-term loans; the coordination of 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.[1] Another regional monetary organization is the Latin American Reserve Fund (LARF). The LARF was established in 1991 as the successor to the Andean Reserve Fund (ARF). The aims are to assist in correcting payments 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 sub-region.[2] Thus, the FRMS would not be a new species of regional arrangements, but simply a new East Asian incarnation of an existing species.

4. Many suggestions have been made about 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 intra-regional 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 saving in the region for long-term development financing, and work related to possible regional monetary integration in the longer term.[3]

5. The various suggested functions could be broadly separated into three groups. The first group relates to initiatives that may help in preventing the reoccurrence of a future financial crisis in the region. The second group relates to measures to be taken when some countries face financial difficulties or get into a crisis, and the third group 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,

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[1] There are 22 members of the AMF; 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.

[2] There are 5 members of the LARF: Bolivia, Colombia, Ecuador, Peru, Venezuela. Details of the AMF and LARF can be found on the IMF web site.

[3] See for example; Hajime Shinohara, "On the Asian Monetary Fund," IIMA Newsletter, Institute for International Monetary Affairs, March 31, 1999, and "Asian Currency Settlement System," IIMA Newsletter, Institute for International Monetary Affairs, January 1, 1999, and 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, 22 March 2000.

and this should be the main focus at the beginning. The second and third groups require a lot more analyses and discussions to come up with consensus on the details, and practical and effective implementation plans. Technical work on these latter issues can also be part of the short-term agenda for the FRMS.

6. Suggested functions of the FRMS that may help to prevent a future crisis in the region include:-

a) Dialogues on policy coordination. Policy coordination is important given diverse exchange rate and macroeconomic policy regimes in the region. Certain policy stance in one country may have implications on macroeconomic outcomes in other countries, so a regular dialogue process supported by technical analyses at the country and regional level would be very desirable. This will also include surveillance of potential problems.

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. Advantage should be taken of the surplus saving in the region (running around US$ 150-180 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 course of the crisis. This have led to more active government and corporate bond markets (especially since financial institutions are still not fully recovered, and savers are attracted to bonds given low deposit rates in financial institutions). Work is needed to develop regional bond markets, where savers, particularly 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 more easily raise funds through equity. The FRMS can also include this issue in its work agenda.

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

d) Work related to the promotion of regional currencies or indices of regional currencies for trade and investment within the region, including currency settlement systems. This is related to the idea of Bilateral Payment Arrangements (BPAs) that has been suggested among ASEAN member countries, and also the internationalization of the yen. Regional currency indices could play important roles for intra-regional 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 such currency indices may be a natural outcome of market forces.

e) The development of a regional framework for the management of capital flows. There appears to be a greater consensus now on the need for countries to have instruments to manage capital flows, especially short-term capital flows. [4] Even the IMF appears to have accepted that capital flows management measures 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.[5] Some regional consensus should be reached on the best practices for 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 have to come up with its own scheme, which could lead to much confusion and inconsistencies.

7. The development of concrete measures related to the various functions of the FRMS as suggested above, together with national reform measures that various countries have

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

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

taken as a result of the crisis, should go a long way toward minimizing risks of a future crisis with similar characteristics to the current one.[6] However, a crisis may occur or may be on the verge of occurring again in the future, and in such a case what should be the role of the FRMS. Here, if an appropriate surveillance mechanism together with the willingness of various governments to pursue appropriate policies can be established through the FRMS, and countries simply face temporary liquidity problems in foreign reserves which can reverse itself with minor policy changes, then having the FRMS provide the needed liquidity creates no problem. In this case, the amount of money involved should be relatively small, and possibly an expansion of the swap facilities along the lines of the Chiang Mai Initiative would be sufficient. However, when a major currency crisis occurs, it is usually because of the failure of the surveillance mechanism to foresee the crisis, or because governments are unwilling to take appropriate corrective policies for political or other reasons. In such cases, the problem usually becomes an insolvency problem and not a liquidity problem. If the problem is one of insolvency, then it has to be accepted that strong and painful corrective policies (and hence "painful conditionalities") will be needed, so 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 is a liquidity problem, can led to an even worse situation, with more rapid speculative capital outflows (by both non-residents and residents) and a delay in corrective policies by the government. In such a case, if the FRMS was to play a role similar to the IMF, except with Asian money and Asian management, it is not clear how much valued added 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, particularly the United States), painful conditionalities by the FRMS would inevitably lead to similar criticisms against countries that dominate the FRMS (in this case probably Japan). May be cases of insolvency should still be left for the IMF to manage, though hopefully if the various effective preventive measures can be developed, then such cases of insolvency in the future may be rare isolated cases without major regional impacts.

8. 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. However, the suggested functions for the FRMS above, already point the way toward much greater regional monetary cooperation and institutional building. Building on the

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6 Of course, crises normally arise from unexpected sources, so that measures preventing a reoccurrence of symptoms similar to a previous crisis may not be fully relevant in preventing a future crisis arising from as yet unknown causes.

Chiang Mai Initiative, greater policy coordination, the development of regional capital markets and supporting infrastructures, and the promotion of regional currencies or currency indices would take East Asia much further toward greater financial and monetary integration than could be imagined only a few years ago. The impetus obvious arose from the crisis, but the outcome could lead to a much stronger and more resilient East Asia for the century ahead.