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Issues and Challenges of the International Financial Architecture
from the Asia-Pacific Perspective

Strengthening the International Financial Architecture:

An East Asian Perspective

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The Asian financial crisis of 1997 profoundly impacted East Asia's perspective on global financial governance, serving as a blunt reminder of the structural, institutional, and policy weaknesses in the region's domestic economies. It also revealed the volatility of the international capital markets resulting from the imperfect and asymmetric information available, as well as how ill-equipped the international financial system is to help emerging market economies prevent financial crises and manage and resolve them should they arise.

East Asian states were greatly disillusioned with the International Monetary Fund (IMF) and the existing international financial architecture, so they joined other emerging-market economies to demand reform. They hoped the Fund would address the domestic weaknesses and major structural problems of the international financial system, including those on the supply side of the market. In the aftermath of the financial crisis, the Group of Seven (G7) countries led the international community on a course toward reform but, after an initial effort, momentum was lost; few supply-side problems of serious concern to the emerging economies were satisfactorily addressed.

In response, the East Asian states sought their own solutions. They began to amass foreign reserves and explored schemes for regional financial co-operation, of which the Chiang Mai Initiative (CMI) is the most important. Indications are that the East Asian states are on the way to creating a regional financial architecture of their own, which has raised the dual concerns of how workable and effective this approach will be, and whether the new system will be a building or stumbling block in the effort to strengthen the international financial system built around the IMF.

East Asian Critiques of the IMF and the International Financial Architecture

On the whole, the East Asian economies recovered from their 1997 crisis at an impressive pace, although neither speed nor extent of recovery has been even across economies. Much of the recovery is due to the IMF emergency assistance programmes that were extended to the three most severely affected economies: South Korea, Thailand, and Indonesia.

Despite the recovery, East Asian states have become increasingly disillusioned with the IMF's response to the crisis; there has emerged a broad consensus that the Fund's policy prescriptions for the three worst-hit economies, as well as the way they were administered, were inappropriate and that it thereby helped initially deepen the crisis, causing huge output and employment losses and exacerbating the attendant social turmoil.[1]

First of all, the IMF had failed both to see signs of the emerging crisis and to warn the respective governments. While it had extolled the sound fundamentals of the crisis economies, when the crisis occurred the Fund prescribed and imposed extensive structural and institutional reforms that amounted to a fundamental overhaul of the crisis-hit economies.[2] These programmes and the rhetoric with which the IMF justified them—emphasising the seriousness of the structural problems—amounted to a public pronouncement that these economies were fundamentally and structurally unsound. In fact, as aptly put by Sachs (1998), it seemed as though, instead of dousing the fire, the IMF screamed fire in the theatre. Many East Asians thus felt betrayed by what they perceived to be the IMF's about-face.

Second, while East Asians admitted that, if implemented effectively, these reforms would improve the long-term performance of their economies, many could not be implemented effectively or quickly in the limited time allowed by the IMF. Imposed for quick implementation in the middle of the liquidity crisis, many of the reforms merely deepened and prolonged the crisis and appeared to have been imposed without sufficient thought as to their implementability.

Third, the crisis economies were experiencing a capital-account crisis rather than a current-account crisis, which called for supportive fiscal policy and not the tight fiscal and monetary policies the IMF imposed.

Fourth, as noted by de Brower (2003), one strategic aim of many IMF members is to attract the interest of the United States and other similarly powerful countries. This is important because capital account crises are so large that the financing requirements often exceed the Fund's ability to help and should be met by securing broader support through bilateral loans from the so-called second line of defence. This second line of defence also serves to demonstrate the wider endorsement of policy measures.[3] Thus, additional disillusionment with the IMF came when, in 1997, it failed to secure the prompt interest and involvement of the United States in containing the financial crisis. Washington did not contribute bilaterally to the Thai package, although it did later commit to the South Korean and Indonesian packages.

The financial crisis also taught East Asia that imperfect and asymmetric information, an inherent feature of capital markets, can give rise to overshooting, sharp corrections and, in extreme cases, financial crises.[4] Relatively small economies open to international capital flows are thus vulnerable to financial instability and crisis, even if they have a sound financial system and good policies, and the more imperfect the domestic economy, the greater the vulnerability. The crisis also revealed the need to correct serious flaws in the structure of international capital markets and the way they are regulated by altering the way the IMF operates and modifying its environment in order to change the international financial architecture.

While East Asia is yet to work out a vision of its preferred architecture, it will surely contain elements similar to those prepared by the Korean Ministry of Finance and Economy (1999) and comprise the following requirements:

— More effective co-ordination of macroeconomic policies across countries, particularly in the area of exchange rate stability. Exchange rate volatility stems from unduly large and abrupt fluctuations in exchange rates among key currencies.

— Attention to the issue of volatility in short-term capital movements, fuelled by highly-leveraged institutions in advanced countries—and the orderly liberalisation of capital accounts by emerging markets. The risks associated with short-term capital movement should be contained at a proper level, in a market-friendly manner at the lowest possible cost. Capital account liberalisation should be orderly, with safeguards against systemic risks and, particularly, surges of short-term capital inflows. The financial supervisory authorities of the industrial countries should strengthen their supervision of such highly leveraged institutions as hedge funds, as well as derivatives transactions.

— Enhanced transparency. The international community should establish and adopt global transparency standards, ensure the effective surveillance and supervision of capital flows by international financial institutions, and enhance the transparency of the activities and data of international financial institutions (IFIs).

— Greater participation by international private creditors and investors in crisis resolution by means of an orderly workout mechanism that demands greater participation by the private sector and emergency funding linked to a private-sector debt resolution programme through a pre-arranged mechanism.

— A stronger role for the IMF and the World Bank in preventing and managing crises, as their current capacity for providing liquidity support to afflicted countries is overshadowed by the sheer magnitude of international capital flows. Expanded liquidity support by the international community at the initial stage of crisis resolution would be a better alternative in terms of economic costs than the more common prescription of macroeconomic tightening.

— An international lender of last resort. In long-term projects, emphasis should be placed on strengthening the role of the existing international financial institutions, to which end issues surrounding the IMF’s contingent credit line should be resolved. To complement the role of international financial institutions in providing emergency financial assistance, developing regional financial co-operation, including the establishment of bilateral back-up facilities between central banks, should be pursued.

— Discussion of a new international financial architecture should include the perspective of emerging countries that are less secure against external shocks.

— An appropriate social safety net for the disadvantaged should be recognized as an integral part of the recovery programme.

In 2000, a group of experts from emerging markets—the Emerging Markets Eminent Persons Group (EMEPG)—was commissioned by the Ford Foundation to gather consensus views regarding the reform of the international financial architecture. The group, which included world-renowned experts and was chaired by Dr. Il SaKong, a former South Korean finance minister, released a report (Emerging Markets Eminent Persons Group 2001) in October 2001. It contains 33 specific recommendations in eight areas and is remarkably similar the South Korean government’s position outlined above.

One major difference is that, unlike the South Korean report, the group report contains a set of recommendations on setting international financial codes and standards so that they might be sufficiently flexible to permit adaptation to the specific characteristics of the emerging-market economies.

Whither the New International Financial Architecture?

In the aftermath of the 1997 financial crisis, the international community led by the G7 countries set out to reform the international financial structure. The core agenda was agreed among the G7 finance ministers at a meeting in Frankfurt in June 1999, and reported to the G7 Economic Summit (Group of Seven 1999) in Cologne. The goals are as follows:

— Strengthening and reforming international financial institutions and arrangements.

— Enhancing transparency and promoting best practices (in national and international financial markets).

— Strengthening macroeconomic policies and financial systems in emerging markets; maintaining sustainable exchange rate regimes; promoting orderly liberalisation of capital accounts; and promoting best practices in debt management.

— Improving crisis prevention and management, and involving the private sector.

— Promoting social policies to protect the poor and most vulnerable.

The report expresses the G7's strong commitment to international financial reform and was followed in the same year by the launch of the Group of 20 (G20) and the Financial Stability Forum, outside the aegis of the IMF, for the purpose of pursuing the objectives in the Cologne report. At the IMF, the Interim Committee of the Board of Governors was transformed into the International Monetary and Financial Committee (IMFC) with a view to making political oversight by the Board more effective (Houtven 2002). Established in 1974, the Interim Committee had a mandate to oversee the management and continued adaptation of the international monetary system in close collaboration with the Executive Board, and its work served to guide the Board's policy formulation and decisionmaking.

The G20 comprises G7 members, the principal developing and emerging-market economies,[5] as well as the European Union member states and the heads of the Bretton Woods institutions. It is a forum of important countries 'within the framework of the Bretton Woods institutional system' and a gathering at which emerging market economies can periodically meet with the major industrial countries (Houtven 2002). The Financial Stability Forum brings together the financial and monetary authorities of the G7 and the principal international regulatory and supervisory authorities.[6] It is chaired by Andrew Crocket, the General Manager of the Bank for International Settlements (BIS), and is organised as a group of 40 members in which G7 countries have an absolute majority with three members for each country.[7] The G20 was established to identify and correct vulnerabilities in financial systems, improve the functioning of markets, reduce systemic risk, as well as enhance co-ordination and the exchange of information among authorities responsible for financial stability.

The Cologne report proposes that global financial stability be attained through national action and enhanced international co-operation, primarily by applying standards, codes and rules. To this end, all countries, international financial institutions and private-sector financial institutions would adopt and implement internationally agreed standards and rules in various areas, as well as put in place mechanisms for devising standards, monitoring their implementation and making public the results. This would ensure that the right tools would be in place to help countries manage crises, as well as take steps to enhance their effectiveness, accountability and legitimacy. Countries would also co-operate to create the right structure of incentives for participants in the international financial system, national authorities, and the private sector.

Since the Cologne report, the IMF, Financial Stability Forum and G20 have worked to reform the international financial structure (International Monetary Fund [IMF] 2000; IMF 2001; Fisher 2002). Balls (2003) summarizes the achievements in terms of three categories, namely, codes and standards; greater transparency; and stronger focus on vulnerabilities. In addition, the IMF has worked to focus and streamline the conditions attached to its financing, in order to promote national ownership of strong and effective policies (IMF 2002). Balls argues there is evidence that, as a result, the risk of contagion from financial crises is less than might have been the case only a few years ago, and that investors are beginning to discriminate more among countries.

The IMF and various other international standard-setting bodies have developed a set of international standards of minimum best practice covering a whole range of aspects of the financial system. The Financial Stability Forum has decided that 12 of these standards are key, covering data dissemination, banking supervision, insurance supervision, securities regulation, bankruptcy, corporate governance, accounting, auditing, payments settlement, market integrity, fiscal transparency, as well as the transparency of monetary and financial policy (Williamson 2000). And, in working with the World Bank and national supervisory agencies, the IMF has launched the Financial Sector Assessment Program (FSAP) in order to assess countries' performance in meeting the standards. As Brown says, the 'new rules of the game are not incidental to the financial architecture for the new global economy: they are the financial architecture for the new global economy' (Balls 2003). It is to be hoped that FSAPs will help strengthen countries' financial systems by identifying potential vulnerabilities. One caveat here is that the composition of the relevant standard-setting bodies does not satisfy the EMEPG's recommendation that the emerging market economies should be adequately represented. Hence, there is arguably no assurance that the relevant code and standards are sufficiently adaptable to suit the emerging market economies.

Enhancing transparency is considered critical if crisis prevention is to be strengthened. Fischer (2002) says that there has been a transparency revolution in the IMF and that he considers it to be the most important change during the seven years that he was there in the post of First Deputy Managing Director. The great majority of IMF members publish their Article IV conclusions and, more important, most agree to the publication of the Article IV reports themselves. In addition, most borrowers release the Letters of Intent that describe their IMF-supported programmes. An independent evaluation office, reporting to the Board, has been established, and a Capital Markets Consultative Group was set up to discuss general issues with a group of private-sector capital market participants.

The Fund's biennial surveillance review in April 2002 and the IMFC meetings identified specific areas where surveillance could be strengthened for the purpose of ensuring that it focuses on the key risks and vulnerabilities (Balls 2003). These include: more rigorous assessments of potential vulnerabilities, with particular attention to debt sustainability and the private sector's balance sheet exposure; more candid and comprehensive assessments of exchange arrangements and exchange rates; focusing on the global impact of the policies of important countries, including in the area of trade; expanding financial-sector surveillance to the entire membership; and stronger coverage of relevant structural and institutional issues. Article IV reports would then assess the actions taken by authorities in response to past and existing advice from the IMF, which is now making better use of market information, developing a new mechanism for monitoring the risks of capital-market crises, improving and applying the framework for assessing debt sustainability, and continuing the expansion of the FSAP (Balls 2003).

East Asia welcomed the strengthening of the international financial architecture, but considered the steps inadequate to reduce the vulnerability of their economies to financial crises. This is because the effect on any domestic financial systems of the various codes and standards, as well as the FSAPs based thereon, is limited by the capacity of the economy which implements said codes and standards, and can only accrue over time as this capacity grows (Griffith-Jones and Kimmis 2001; Park and Wang 2002). It will take time until local financial and related institutions, as well as the people who run them, adapt to those codes and standards. Furthermore, questions have been raised about their local applicability as well as legitimacy, considering that they have been developed by those who mostly represent the creditor side of the market with little input from the borrower side. Certainly greater transparency and more focus on risks in surveillance will help, but they will hardly be enough to safeguard against future crises.

From the perspective of the emerging-market countries in general, it is striking that the assessment of the strengthened the international financial system hardly matches their wish list. The record of progress on issues relating to the international financial system that are of concern to East Asian and other emerging market countries is disappointing:

— There has been no effective macroeconomic policy co-ordination among the G3 or G7 members in recent years, and the exchange rate gyrations among key currencies continue to cause instability in the exchange rates of the East Asian currencies.

— The Financial Stability Forum produced a study group report which fails to present a consensus position on the need for the greater disclosure of position-taking by highly-leveraged institutions, and the IMF's position on capital controls remains hedged and ambiguous.

— Since no conclusive agreement has been reached on the controversial approach to the issue of private-sector involvement, there are still no well-defined legal procedures for payment standstill and debt restructuring, and no conclusion has been reached regarding the proposed sovereign debt restructuring mechanism (SDRM). It has only been agreed that emerging market countries have the option of including collection action clauses in their bond contracts.

— There has been little progress in expanding IMF instruments. The contingency credit line has been installed but should be considered a failure since it has attracted no applicants.

— Emerging market countries in general, and East Asian countries in particular, remain greatly under-represented in the IMF governing body compared to European states, in terms of quota allocation (and, hence, access to IMF resources), voting rights, and participation in the Executive Board (Van Houtven 2002; Henning 2002).[8] On the Executive Board there are eight Executive Directors from Europe, four Directors from East Asia and one US Director out of a total of 24. The position of Managing Director is reserved for an individual from Europe, and there seems to be no prospect of redressing this imbalance in representation in the IMF governing body.

The G7 countries set the international financial policy agenda and steer the IMF by dominating in its management through its membership of the IMFC and the Executive Board (Houtven 2002). Outside the IMF, the G7 established the Financial Stability Forum and the G20. Developing countries had been unable to participate in global financial governance except through the IMF until the creation of the G20—set up as an informal forum for dialogue between major developed and developing countries at the highest level (finance ministers and central bankers) and seen as a potentially important step toward the better representation of emerging market interests in the discussion of international financial reform. Thus far, however, the G20 has pursued a fairly narrow agenda, heavily focused on addressing domestic vulnerability to financial crises in developing countries, and has ignored systematic issues and problems originating in G10 countries (Griffith-Jones and Kimmis 2001).

While it should be noted that there has been a great deal of progress in the area of transparency, greater attention is being paid the social implications of IMF programmes and the World Bank plays an active role in these issues, there has been little progress on supply-side issues, and the G7 countries seem to have lost their urgent desire for reform in the face of East Asia's rapid recovery from the financial crisis. With neither the G7 countries nor the major international financial institutions apparently interested in sustaining the momentum for reform, it would seem that waiting for new financial architecture to be put in place is, to paraphrase Williamson (2003), like waiting for Godot!

East Asia's Response and Dilemma: a Regional Financial Architecture?

Discontent with multilateralism breeds unilateralism and regionalism, which is what has been happening in East Asia in both trade and finance. In trade, in response to increasing and deepening bilateral and regional trade agreements in Europe and the Americas, and with the United States having emerged as the new champion of trade regionalism in the 1990s, there has been a dramatic shift towards bilateral free trade agreements and away from exclusive reliance on the multilateral trading system (PECC Trade Forum 2003). Similarly in the area of finance, discontent with the IMF and concern over the international financial system have triggered efforts at self-help at the national and regional levels.

After the financial crisis, most East Asian economies began to amass foreign reserves by running surpluses on both their current and capital accounts (Park 2004). In 2003, for example, Japan's foreign reserve holdings had reached US$780 billion, China's US$200 billion, South Korea's US$130 billion, and Taiwan's US$120 billion, for a total held by ten East Asian economies of US$1.5 trillion, accounting for about 60 per cent of the global total. While much of the foreign currency reserves held in East Asia come from current-account surpluses with the United States, there have also been net inflows of capital. The accumulation of reserves is a result of the policy of pegging local currencies to the US dollar or managing exchange rates against the dollar.

The accumulation of reserves has been costly because of the low rates of return on US Treasury bills and other dollar-denominated, short-term assets in which most of reserves are held. They are in fact even negative if the cost of the domestic bond market operation for sterilization is also considered. In any case, sterilization has not been complete and the consequent increases in the money supply have been causing inflationary expectations. The currency-market interventions have been causing domestic misallocations of resources by keeping currencies undervalued. Internationally, this is causing trade disputes with the United States, the current-account deficit of which has been increasing as a result, causing a huge trade imbalance across the Pacific. It has also given rise to the concern that there could be major international instability were certain East Asian governments to dump a major portion of their dollar reserves.

Japan's reserve build-up is the result of the country's strategy of an export-led recovery from its prolonged economic slump. But the reserve build-up policy of other East Asian economies may be explained largely in terms of their fear that the opening up of domestic capital markets might cause another financial crisis (Bergsten and Park 2002). Thus, ironically, the shift to floating exchange rates has increased the demand for reserves, as governments consider their domestic financial markets and the international financial system too weak to prevent further crises.

At the regional level, East Asian economies have been seeking schemes to share or pool their reserves in order to help each other fight possible future crises and further stabilise the exchange rates of regional currencies. A number of schemes have emerged or been discussed in East Asia since the latest financial crisis, the CMI being the most significant, but not the only one.

The first such scheme to be proposed (Sakakibara and Yamakawa 2003) was an Asian Monetary Fund (AMF). It was suggested by the Japanese government in September 1997 for the purpose of establishing mutual liquidity support among East Asian countries and was to be independent of the IMF. The target amount was between US$100 billion and US$110 billion, with US$50 billion to be contributed by the Japanese government and participating governments contributing between US$50 billion and US$60 billion. The original members were to be China, the Hong Kong SAR, Japan, South Korea and Taiwan. The plan was soon abandoned, however, because of IMF and US opposition. In its place was created the Manila Framework Group (MFG), at the initiative of the United States, as a new framework for regional co-operation to enhance the prospects for financial stability in the Asia-Pacific region. The MFG has not sought any co-operative financing arrangement, but discusses how to improve existing IMF financing instruments; it is basically only a forum and not even an influential one at that. For now, the AMF seems to be a dead letter, but all may not be lost.

In October 1998, Japan launched the New Miyazawa Initiative (NMI) as a bilateral support mechanism for the purpose of assisting Asian countries in crisis to overcome their economic difficulties. The total amount committed was US$30 billion, half of which would be available to meet Asian countries' medium- to long-term financial needs for economic recovery in the form of overseas development assistance (ODA) or untied loans. The other half is to be lent to meet countries' short-term capital needs while reforms were being undertaken. The NMI involves short-term swap arrangements that are renewable annually and of which there are currently two—US$2.5 billion with Malaysia and US$5 billion with South Korea.

In 1998, the ASEAN Finance Ministers' Meeting launched the ASEAN Surveillance Process based on the principle of peer reviews, for all member states, and complementary with the IMF's global surveillance. Technical assistance and capacity-building for this process is provided by the Asian Development Bank (ADB), but little information has been available concerning actual peer reviews.

The Chiang Mai Initiative (CMI) was launched by the ASEAN + 3 (the ten Association of Southeast Asian Nations [ASEAN] member states plus China, Japan and South Korea) finance ministers in May 2000 as a regional financing arrangement.[9] It consists of four elements: monitoring capital flows, regional surveillance, swap networks and training personnel. The most prominent component of the Initiative is a network of bilateral swap arrangements (BSAs) among the 13 member countries. According to the agreed framework of principles, the purpose of this scheme is to provide short-term financial assistance in the form of swaps to a country in need of balance-of-payment support or short-term liquidity support. The framework also specifies that the swaps must supplement existing international financial instruments, specifically those of the IMF. Subsequently, it was agreed that up to 10 per cent of the maximum amount of drawing can be provided for a short-term period without linkage to the IMF. To borrow beyond this, the potential borrower must have completed, or be nearing completion of, an agreement with the IMF. This provides the linkage to IMF conditionality, and the IMF is allowed to determine the policy conditionality for most of the swaps. The IMF link was controversial during framework negotiations and was opposed by then-Prime Minister Mahathir bin Mohammed of Malaysia; the provision allowing disbursement of up to 10 per cent independent of the IMF was inserted as a concession to him, as was the promise to review the Initiative in three years.

The BSAs link the international reserves of the 10 ASEAN member states with those of China, Japan, and South Korea, allowing ASEAN members to borrow in US dollars. There are also swap agreements among China, Japan, and South Korea, and individual swap agreements have been bilaterally negotiated. However, there is a multilateral aspect to the CMI: Creditor governments co-ordinate the provision of funds when one or more of their partners are in need of short-term liquidity. The aggregate amount of the BSAs negotiated thus far stood at US$34.5 billion at the end of 2003, so the Initiative is hardly insignificant. Henning (2002) shows that, even given the present magnitude of resources available, the total amount a country can borrow under the Initiative BSAs is a multiple, from two to several, of its IMF quota. This indicates that the Initiative has the potential to develop into, or shape, the regional financial architecture in East Asia. It is this potential that makes the CMI the most important regional financial self-help scheme in East Asia.

Henning (2002) identifies many benefits that the Initiative and other forms of regional financial co-operation in East Asia might bring in terms of their contribution to the stability of the international financial system of which the IMF is the pillar:

— Regional financial arrangements in East Asia can help foster the stability of trade and investment relations in the region.

— Regional efforts at crisis prevention and resolution are likely to be especially effective in coping with the danger of contagion in the region.

— By engendering greater confidence as a result of promising access to a safety net, the mobilisation of the region's reserves in a crisis could enable countries to reduce their reserve holdings.

— By linking themselves to regional partners through swaps and other instruments, the more vulnerable governments can redress the asymmetry in the size of their national capital markets and international financial markets.

— Experience gained from the Asian financial crisis reveals that, because of its size, the diversity of its membership and its dependence on US Congressional support, the IMF has certain weaknesses in responding to local crises in terms of speed, flexibility and dependability. A regional grouping like the CMI can make up for these shortcomings.

— Regional facilities will supplement the resources of the IMF and other multilateral institutions.

— Swaps and financial facilities can provide a focal point for the enhancement of regional surveillance and policy dialogue. Regional policy dialogues can supplement surveillance and IMF-led early-warning exercises; sharing regional markets, ASEAN + 3 might have more up-to-date information about countries in crisis than multilateral institutions and G7 governments, and a greater interest in corrective action.

— Financial co-operation will foster future regional monetary initiatives such as joint exchange-rate pegs and common currencies, and further promote regional economic integration.

— Financial co-operation can contribute to political cohesion in the region.

These benefits will assure the international community that successful schemes for regional financial co-operation in East Asia will contribute not only to the financial stability and development of the region's economies, but also to those of the world economy, not least by supporting and reinforcing the IMF. This is not to say that regional financial co-operation will necessarily complement IMF policy. In fact, the CMI could undermine the IMF were it to offer policy conditionality that is different from, and weaker than, that of the IMF. The Initiative might then allow governments in the region to borrow from it rather than from the IMF, and thereby allow the governments to avoid the IMF's more stringent conditionality, but the prospects of such bail-outs by the Initiative could undercut the financial reform momentum in the region. East Asian governments showed their concern in this regard when they failed to agree to the proposal to de-link the BSAs from IMF conditionality. However, the international community should be alert to this danger and encourage East Asian governments to remain supportive of the IMF and other multilateral financial institutions.[10]

In terms of what kind of regional financial architecture could be shaped out of the CMI, Henning (2002) suggests two possibilities—barring the dismantling of the present BSAs—that should be considered possible complementary pillars of regional financial architecture.

One of the pillars could be an AMF. To this end, the membership of BSAs would be expanded to bring in such new members as the Hong Kong SAR, Taiwan, Australia, and New Zealand. The BSAs would be increased in terms of the total amount of financial resources that could be mobilised, thereby gathering together more of the reserves individually held. At the same time, the BSAs should be developed into a genuine network, and the bilaterally committed reserves pooled and placed under the central management of the AMF. A most critical process in the development of an AMF is the development of a regional surveillance mechanism, because lending countries will not be willing to activate their BSAs unless policy conditionality can be imposed on borrowing countries through a credible and effective surveillance process.

A second pillar of the regional financial architecture might be exchange-rate policy co-operation, but it should be considered a more advanced form of regional financial co-operation that will emerge beyond the stage of liquidity swaps. The objective will be regional exchange rate as well as financial stabilisation. Different levels of monetary integration can be pursued for this purpose through different mechanisms such as pegging to a common basket of currencies, an Asian monetary system, or an Asian common currency, which mechanisms should be considered three different stages of exchange rate or monetary co-operation rather than alternatives. The success of exchange rate policy co-operation will also depend critically on the efficacy of the regional surveillance mechanism.

The vision of a regional financial architecture consisting of an AMF and exchange rate policy co-operation of one level or another sounds sensible to many academics, especially when there is no fixed time frame. However, the reality is that four years have passed since the system was established and the CMI has not even agreed on the operational structure of the BSAs, never mind the monitoring and surveillance mechanism (Bergsten and Park 2002). The Initiative's attention has, instead, shifted to the goal of developing regional bond markets in Asia, but it is unlikely that the group will do so any time soon since there doesn't even seem to be the enthusiasm to undertake the review of the Initiative which should have been launched by now.

The problem is that the 13 governments involved do not agree on the future pace, extent and direction of regional financial co-operation (Henning 2002) and, while that is the case, the Initiative's BSA system will not be accepted by financial market participants as an effective insurance mechanism against financial crises. Nor will the idea of a regional financial architecture in East Asia take off from the academics' drawing board.

The slackening of the momentum for regional financial co-operation at the ASEAN + 3 level may be because the recovery from the latest crisis has fostered a sense of complacency about financial stability; there has been a competitive rush to promote free trade agreements during the past few years; and East Asian states are not ready to compromise their sovereignty, as would be necessary for substantive economic policy co-ordination. Eichengreen (2003) offers four reasons for the East Asian unwillingness to compromise:

— Asian countries are so heterogeneous that no financial and monetary arrangements would be equally appropriate for all East Asian countries.

— Asia is less economically self-contained than other regions, more so in terms of finance than in trade.

— Compared with other regions, Asia has less appetite for political integration and the

Asian Way discourages governments from mutual reproach.

— Asian governments are suspicious of strong supranational institutions and prefer ‘soft’ or ‘weak formal’ institutions.

In the final analysis, all these difficulties boil down to the absence of effective political leadership in the region (Bergsten and Park 2002). It takes a strong political hand to promote and force compromise despite the different interests of group members, and to create and maintain cohesion among the 13 countries. In East Asia, such leadership has to be provided jointly by China and Japan, because South Korea and ASEAN countries are reluctant to accept either of the two countries as the leader of such an enterprise. But China and Japan currently appear unwilling to work together to provide joint leadership because they have not yet overcome several historical issues that divide them and, more importantly, they seem to have different interests in economic integration in East Asia and, hence, wish to pursue different strategies. In the background, there seems to be a keen sense of rivalry between the two states for the leadership role; this makes it particularly difficult to negotiate policy.

Henning (2002) offers an interesting answer to the question of whether this stalemate over regional financial co-operation will be overcome. He states that the future evolution of financial co-operation in East Asia will be largely contingent on shocks. If, on the one hand, financial shocks to regional economies are insignificant or very rare, or if shocks come from inside the region rather than from outside, the momentum for regional co-operation will continue to weaken. Moreover, if shocks are substantial and frequent, and international financial institutions intervene to help out in a timely manner and effectively, the momentum is unlikely to be revived. On the other hand, if extra-regional shocks recur and the multilateral responses are not satisfactory, East Asia is likely to be able to reverse the sagging momentum for regional co-operation. Thus, it seems that the progress of the CMI-based regional financial co-operation will be in inverse proportion to the efficacy of IMF-centred multilateral financial co-operation.

East Asian Strategies for Better Global Financial Governance

East Asian states are now in a dilemma. They believe that the multilateral financial system, in the form of the existing international financial architecture, offers them no more than a rather weak defence system against possible financial crises and that world leaders have lost their determination to seek reform and strengthen the financial system on behalf of the emerging-market and developing economies. East Asians have, thus, begun to promote regional financial co-operation among themselves and have launched the CMI as the first step. But they have not progressed much beyond this stage because they cannot agree on where and how to go from there.

Since it thus seems that East Asia will not be able to create a regional financial defence system any time soon, it is no wonder that member states should be building up their foreign reserves. But building up an armoury of foreign reserves as a defence against future crises is not necessarily a sustainable or effective strategy, since it will create imbalances at home and internationally, sow the seeds of later financial instability, contribute to complacency among policymakers regarding the need to strengthen domestic financial systems, and slow down necessary financial reforms. Focusing on regional financial co-operation at the expense of reforming the international financial architecture will not be a wise move, either.

This is not to say that regional financial co-operation should be abandoned or slowed down. But it should be borne in mind that the creation of a regional financial architecture is a long-term process, whereas reforming the international financial architecture should and could be a shorter-term process. Thus the emerging-market economies should reformulate their strategy for the reform of the international financial architecture.

They might start by seeking greater participation in institutions of global financial governance. The current global financial arrangements that are ruled by the G7 and in which emerging-market countries have negligible representation and participate only minimally should be considered more or less obsolete (Wood 2000). Griffith-Jones and Kimmis 2001). There has been a sea change in the global economic landscape since the 1980s with the acceleration of globalisation, the attendant rise in the global movement of financial capital, the ascendancy of many large emerging economies to the global market, and the rise of East Asia as the third and the most dynamic pillar of the world economy. Accordingly, there has been a huge redistribution of economic power among the countries to the emerging-market states and to East Asia, in particular.

Global financial governance should be restructured accordingly and there is no one to better champion this restructuring than the East Asian emerging economies themselves. Having experienced and overcome a major financial crisis of unprecedented depth, they are in the best position to lead the task of setting the international financial reform agenda. East Asians should thus work together to lead efforts to improve global governance and reform the international financial architecture on behalf of the emerging economies. Their strategy might require that the following steps be taken:

— Recognize the primacy of global financial co-operation and the international financial architecture.

— Seek greater and more effective representation in institutions of global financial governance such as the G7, IMF, G20, Financial Stability Forum, Basel Committee and other international standard-setting bodies (Griffith-Jones and Kimmis 2001).

— Take co-ordinated positions and actions when participating in international discussions of international financial policy issues in those institutions (Van Houtven 2002). In particular, work together through the Asia-Pacific Economic Cooperation (APEC) forum and the Asia-Europe Meeting (ASEM) to persuade the G7 and other industrial countries of the need to re-launch international efforts to strengthen the international financial architecture.

— Organise and pursue regional co-operation for the strengthening of domestic financial systems through continuing reforms.

— Undertake effective and intensified regional policy dialogues to discuss and study all issues of relevance, and to promote joint positions and actions on those issues.

— Work together to further advance regional financial co-operation, placing the highest priority on the development of an effective regional monitoring and surveillance mechanism.

It seems both urgent and feasible that the G7 membership should be enlarged to include China. Participation of East Asian countries in the Financial Stability Forum, Basle Committees, and other international standard-setting bodies should be sought and enlarged, and East Asian countries should play a more active role in the governance of the IMF. Meanwhile, the campaign to secure more quotas (and, hence, more voting rights) in the IMF as well as a larger representation on its Executive Board should be continued; and the process of selecting the Managing Director should be made more transparent and open to all qualified candidates, regardless of their nationality.

The key objective here is to increase the representation and influence of emerging-market economies and other developing countries in international decisionmaking on financial matters. In this regard, the most significant of all possible changes in the global financial governance arrangements would be to enhance the role of the G20. All other institutions share the problem of legitimacy deficits in addressing problems of global finance in that the membership of the institutions is limited to, or at the very least dominated by, leading industrial countries, particularly the United States, which plays the most dominant role in all (Wood 2000; Griffith-Jones and Kimmis

2001; Bergsten 2004). While it would be unrealistic to expect this problem to be rectified any time soon, a major change in global governance might well be attained through the enhancement of the role of the G20.

Unlike the other institutions, the G20 is fairly universal in terms of membership. It includes countries from every region that account for 66 per cent of the world's population, 88 per cent of the global economy and almost 60 per cent of the world's poor (Griffith-Jones and Kimmis 2001). The IMF and the World Bank also participate. Accordingly, Bergsten (2004) argues that the G20 should gradually but steadily supersede the G7 as the informal steering committee of the world economy. Very bluntly he says that 'the inability of the G-7 to resolve some of the most salient issues now facing the global system because its membership excludes countries whose participation is essential for doing so, underline the need for the G-20 to become an effective action organization'. The East Asian members of the G20—China, Indonesia, Japan, and South Korea—should strive to secure such a role for the G20 and put those issues on its agenda in collaboration with the other members, certainly including the G7 members.

More effective and more persuasive representation of East Asian views in all those fora is even more feasible and more important than attaining enlarged participation (Van Houtven 2002; Fischer 2002). Delegates should thus be of the highest calibre, articulate and well prepared in terms of the substance and logic of the positions and actions they pursue. To this end, serious and rigorous studies and discussions of financial policy issues of common concern need to be discussed among East Asians both at the national and the regional level.

ASEAN + 3 should become much more active as the main regional venue and sponsor of policy dialogues as well as policy-oriented research and studies. Issues of international financial architecture should be among the focal and priority issues, and participation should not be limited to officials.

The main reason for the vulnerability of the region's economies to financial shocks, and the main obstacle to the development of a regional financial architecture is the fact that those economies have underdeveloped and under-institutionalised domestic financial systems. But regional co-operation should address these weaknesses, so co-operation to deepen and strengthen regional financial markets should be given the highest priority on the agenda for co-operation (Eichengreen 2003).

Conclusion: An Important Role for APEC Partnership

It is very important that East Asian states engage their partners around the world in open and frank discussion and consultation. East Asia will need understanding, intellectual support and political support as it moves to revitalise, as well as contribute to, the reform of the international financial architecture and to create a regional financial architecture, starting with the Chiang Mai Initiative and moving towards an AMF. The most important partners in such a venture would be the United States and Europe, which should find it important for both global and their own prosperity to help east Asian economies and other emerging economies to defend themselves against global financial instability and crises so that they might be well integrated into the global economy.

APEC and ASEM are two very important venues for dialogue and co-operation for this purpose. They should be utilised to the full, to the maximum benefit of all. In this regard, the importance of APEC, in particular, should be fully appreciated. The East Asian emerging economies in the APEC should begin to try to mobilize the APEC in support of their goal of further strengthening the international financial architecture, and of enlarging and enhancing the participation of emerging market economies including themselves in global financial governance arrangements. They will be better able to do so if they would enlist the Latin American APEC economies as partners in the effort. In this regard, South Korea, China and Indonesia, and Mexico may be able to play a particularly important role by working together especially closely on the issue of the international financial architecture because they all belong to both the APEC and the G-20. By forming a common position on this issue, and also by promoting it through APEC dialogue as well as the G-20 process, they may be better able to win the political support of three other APEC G-7/G-20 countries, i.e., Japan, US, and Canada, for their position on the financial architecture, including for the cause of strengthening the role of the G-20 in global financial architecture.

For this to be possible, however, these four large emerging economies should be seriously interested in the financial architectural issues, as well as be prepared to articulate their interests in those issues. This will not be possible if they each remain passive on those issues, resigned to the thought that there is not much they can do about the international financial architecture. There is much they can do, provided that they prepare themselves to understand the relevant issues thoroughly enough to be able to lead the international discussions on these issues and set the agenda for those discussions. In order to do so, they should be actively engaged in joint studies and in policy dialogues on the international financial architecture, in fact, providing a strong leadership in the promotion of these studies and dialogues.

APEC will serve as a good venue for these studies and dialogues, and so will the PECC (Pacific Economic Cooperation Council).

Notes

1. East Asia's discontent with the International Monetary Funds crisis-resolution policies for the region echoes the critical views advanced by leading Western—mostly from the United States—experts regarding the way the organisation handled the financial crisis (Volcker 1998; Sachs 1998; Feldstein 1998; and Stiglitz 1998; 2003).

2. This was particularly true of the South Korean programme which demanded thorough reforms not only of the financial sector, but also of the corporate structure, governance, the labour market, the public sector, and international trade.

3. The total financial rescue packages were US$17.1 billion, US$36.2 billion, and US$58.9 billion for Thailand, Indonesia, and South Korea, respectively. The IMF's own commitments were US$3.9 billion, US$11.2 billion, and US$20.9 billion, respectively. The differences were to be met by the World Bank, the Asian Development Bank, and the second-line-of-defence governments (de Brower 2003).

4. This paragraph draws heavily on Eichengreen (1999).

5. Argentina, Australia, Brazil, China, India, Indonesia, Mexico, Russia, Saudi Arabia, South Africa, South Korea, and Turkey.

6. The Basle Committee on Banking Supervision, the International Organization of Securities Commission (IOSCO), the International Association of Insurance Supervision (IAIS), the Bank for International Settlements (BIS) together with its two other Basle-based committees—one on payment and settlement systems, the other on global financial systems—as well as the IMF and the World Bank.

7. The Forum includes (1) the international regulators and supervisory groupings in the field of banking, securities, and insurance; (2) the main regulatory authorities of the G7 countries plus those of Australia, the Hong Kong SAR, the Netherlands, and Singapore; (3) the IMF, the World Bank, and the OECD; and (4) two technical committees of central-bank experts (Houtven 2002).

8. According to Henning (2002), as of 2000, the quotas are 12.8 per cent for ASEAN + 3 members, 17.6 per cent for the United States, and 30.5 per cent for the European Union. In terms of GDP measured at 2000 exchange rates, the respective weights are 22.5 per cent, 31.5 per cent, and 25.1 per cent.

9. The discussion of the Chiang Mai Initiative draws heavily from Henning (2002).

10. Henning (2002) proposes that the IMF protect financial multilateralism by codifying legitimate financial regionalism into the spirit of GATT Article XXIV concerning regional trade agreements.

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