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The Future of the IMF and of Regional Cooperation in East Asia[1]

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1. Introduction

The US Subprime crisis that broke out in August 2007 has since developed into a full-scale global financial crisis. Despite a series of measures taken by the US and European countries, investors are in a state of panic and financial markets display an extreme degree of volatility all over the world.

Having experienced a major financial crisis in 1997-98, most of East Asian countries are expected to be better prepared than before for managing fallout from the crisis. Compared to other regions, East Asia has so far suffered less. But with deepening of the crisis, East Asia will not be immune to what appears to be the most serious recession since the 1929 depression. Already some of the East Asian economies are sliding into recession and enduring severe financial market instability. Could the economic deterioration in Eat Asia be mitigated, if not reversed? It could, if the member states of ASEAN+3 cooperated more closely for policy coordination and mutual liquidity support by activating the bilateral swap arrangements (BSAs) under the Chiang Mai Initiative (CMI), a system of currency swaps among the members which was a region's response to ward off future crises and if occur, mange them better than before.

The system of bilateral currency swaps has undergone many structural changes since its inception. Current efforts aim at developing a self-managed reserve pooling arrangement (SRPA), which will replace the existing swap system sometime in 2009. This, however, requires that the members agree on operational details including surveillance. To the disappointment of many within and outside the region, leaders of ASEAN+3 have so far been rather inactive and hence imparted the impression that they are not as much concerned about

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1 This paper draws heavily on section 3 of Park and Wyplosz (2008)

the crisis as their counterparts are in the US and Europe, except for reiterating the need to vitalize the CMI-BSAs..

The unfolding crisis has exposed many structural defects of the existing international financial system. And understandably they have elicited a chorus of voices calling for creating a new international financial architecture. Although the structural defects have yet to be clearly identified, it is almost certain that the reform of the IMF will occupy the center stage of the debate on a new international financial architecture.

The purpose of this paper is to analyze the role of a regional financial arrangement such as the BSAs or the SRPA in East Asia in the context of the expected global financial reform whether it can be a building bloc for a new international financial architecture by complementing the lending and surveillance operations of a new IMF that may emerge after the completion of the reform. For this purpose, section 2 analyzes the role of the IMF in the resolution of the 1997-98 Asian crisis. It argues that the IMF failed to manage in a way that could have minimized the cost of working out the crisis and that its mismanagement is in part responsible for the loss of its credibility in East Asia. Sections 3 and 4 are devoted to an examination of policy and regional cooperative measures the crisis-hit countries have taken in their efforts to prevent future crises including the regional movement that led to the creation of the Chiang Mai Initiative. Section 5 discusses future prospects for regional financial cooperation within the framework of the SRPA and whether the reserve pooling at the regional level can be an important component of a new international financial architecture. Concluding remarks are in a final section.

2. IMF and Management of the 1997-98 East Asia's Capital Account Crisis

A number of recent studies (Park 2007, Park and Wyplosz 2008, and Takagi 2008) show that the IMF was responsible for several misjudgments in managing the 1997-98 Asian crisis. One of them failed to identify structural vulnerabilities of the crisis-affected countries that had made them susceptible to a financial crisis-those weaknesses of both the financial and corporate sector and macroeconomic policies that prevented speedy adjustments to external shocks. Instead, it was giving misleading information on the plight of the crisis-hit countries, thereby undermining its credibility. For instance, the staff report of the 1997 Article IV consultation with Indonesia, which was released in June of the same year, states that contagion of the Thai crisis, as for as the country was concerned, was limited and that its economic fundamentals were sound and prospects for maintaining the development momentum were promising (Takagi 2008). The 1997 Article IV consultation for Korea, which took place a month before the country was engulfed in a crisis, was very sanguine about Korea's future economic prospects as it concluded that the country was well prepared to deal with further external pressure.[2]

In retrospect, it is clear that the IMF did not fully comprehend the nature and depth of the crisis, which originated in the capital rather than current account. This failure led to imposition of policy adjustments inappropriate to a capital account crisis such as fiscal tightening and high interest rate policy. A review of the 1997-98 Asian crisis management by the Independent Evaluation Office of the IMF (2003) makes it clear that it was a capital account crisis and as such required a management and resolution strategy different from the traditional IMF recipe for crises originating from current account deterioration. In the run-up to the crisis, a large increase in capital inflows into some of the East Asian countries set off an asset market boom and a precipitous increase in the current account deficit, thereby making these countries vulnerable to speculative attacks. The perception of vulnerability of these countries triggered a sharp and large capital outflow, which was further aggravated by the panic and herding behavior of foreign investors. Once the dollar peg had become indefensible, the value of the currencies plummeted. Many banks and corporations with balance sheet mismatches could not service their foreign currency denominated debts and eventually became insolvent. A sharp contraction in the level of output then followed.

In addition to fiscal and monetary tightening, the crisis resolution strategy of the IMF required these crisis countries to undertake a wide range of institutional reforms of the corporate, financial, and public sectors, with the aim to strengthen the structural foundation of the economy and, therefore, to restore the confidence of international lenders. Even before the crisis, cynics would often express their doubt by saying that nothing short of a major shock could force East Asian economies to accept reforms that were badly needed and overdue. It was not surprising therefore that the IMF rescue programs for the crisis countries mandated structural reforms along the lines of the Washington consensus without a careful scrutiny of their appropriateness and of reform capacity. Implementing deep reforms in the midst of a crisis is a questionable objective. As a result, many of these reforms have been

[2] See Takagi (2008). To be fair, the IMF expressed its concerns about the gaping current account deficit of Thailand and recommended tightening of fiscal policy, financial sector reform, and a more flexible exchange rate system before the onset of the crisis. It should be noted, however, that its failure to assess contagiousness of the crisis may have exacerbated the difficulties of resolving the financial meltdown.

ignored, put on the backburner, or at best resulted in cosmetic changes. The view that structural problems were the root causes of the crisis has not been borne out by subsequent events.

It has also became known that, when a crisis in a country originates in the capital account, policy coordination or at least policy dialogues and reviews among neighboring countries is essential in preventing contagion. Without a constant exchange of information and policy dialogues among close economic partners, individual countries often find it difficult to understand the causes of large changes in capital flows and exchange rates. The crisis brought home the lessons that the IMF did not have the institutional capacity to prevent or manage properly capital account crises and that monitoring of developments in regional financial markets crucial for fending off crisis contagion would not be effective unless an efficient mechanism of policy coordination is constructed at the regional level. Even smoothing-out of high frequency movements of the nominal exchange rate in individual countries may have to be coordinated at a regional level in order not to send wrong signals to other countries.

The IMF can monitor capital flows within and between regions and also the behavior of market participants but it is difficult to imagine that it could establish close working relationships with individual member countries and coordinate their policies. Furthermore, as an institution entrusted with monitoring economic developments in the member countries, the IMF may have to maintain an arm's length relationship with them. Moreover, to the extent that it cannot serve as a lender of last resort, the IMF cannot serve notice to the international financial markets that it is ready to supply whatever amount of liquidity it takes to thwart an impending speculative attack.

In managing a liquidity crisis, an effective strategy would have focused on squelching the speculation by supplying a large amount of short-term financing to replenish foreign exchange reserves, instead of tightening monetary and fiscal policy. But there were neither regional nor global lenders of last resort. With limited financial resources, the IMF could not resolve the East Asian crisis by itself; in the end, it had to enlist the financial support of the G-7 and other countries.

At the time of the Asian crisis, the ASEAN + 3 countries jointly held about US$700 billion in foreign reserves. The total amount of financing required to restore financial stability in Indonesia, Korea, and Thailand by the IMF, other international financial institutions, and a number of donor countries amounted to US$111.7 billion. If the thirteen countries had established a cooperative mechanism in which they could pool their reserves and immediately supply liquidity to stave off speculative attacks when they saw one, they could have nipped the Thai crisis in the bud and minimized contagion by making available a small fraction of their total reserves and more so the total amount of financing needed to resolve the Asian crisis. In view of the large loss of output and employment that followed, such a cooperative response was indeed desirable.

The lesson is that regional support is logical when contagion is geographically concentrated. In addition to providing financial assistance in tandem with international support, a regional financial cooperation mechanism may conduct policy reviews and initiate a dialogue process. Policy dialogue, including monitoring and surveillance, is the bedrock on which coherent policy formation under regional financial arrangements rests. Monitoring and surveillance processes are needed to provide prompt and relevant information and to assess the situation of countries in trouble and potential contagious effects.

Another misjudgment stemmed from its decision to bring into effect a large number of structural reforms to restore foreign investors' confidence, some of which were not relevant to the crisis management. Indeed, the Fund programs laid out for the three East Asian crisis countries in terms of the number, scope, and detail of structural policy conditions were overwhelming. As recounted by Goldstein (2003) "the number of structural policy conditions included in these programs with the three Asian crisis economies is very large: many more than you can count using all your fingers and toes."At the peak, the numbers were 140 in Indonesia, 94 in South Korea, and 73 in Thailand.

Particularly striking is the case of Indonesia. The Fund program included a surprising numbers of nontraditional areas of conditionality. 'There were, inter alia, measure dealing with reforestation programs; the phasing-out of local content programs for motor vehicles; discontinuation of support for a particular aircraft project and of special privileges granted to the National Car; abolition of the compulsory 2 percent after-tax contribution to charity foundations. Appointment of high-level advisors for monetary policy; development of rules for the Jakarta Clearing House; the end of restrictive marketing arrangements for cement, paper, and plywood; the elimination of the Clove Marketing Board; the termination of requirements on credit scheme to assist small businesses, and the raising of stumpage fees' (Goldstein 2003). Goldstein speculates that these reform measures were included 'for anti-corruption reasons, to facilitate monitoring of commitments, and (for some commitments) to reflect the structural policy agendas of either other IFIs (the World Bank and the Asian

Development Bank) or certain creditor countries' (p.401).[3]

To make matters worse, there has been a widespread perception that the imposition was dictated by the IMF's major shareholders (Bluestein 2001) and that the IMF took the crisis and its position as a lender as an opportunity to push through many of the reforms the crisis-hit countries had refused to implement before. Such an attempt, which may have been justifiable, viewed as opportunistic, earned the resentment of the general public and may have overburdened the reform capacity of the crisis-affected country to increase the cost of crisis resolution and to delay recovery.

Should then the IMF be criticized and bear responsibility for the mismanagement of the crisis? The answer is no. From the outset, the IMF reform programs for the crisis countries did not have a well-defined road map to guide the formulation and implementation of stabilization policies, financial and corporate restructuring, as well as institutional reforms, except for the general policy prescription of the Washington Consensus (Lane et al. 1999). The IMF should not be criticized for its failure to develop a comprehensive framework *ex post facto*. After all, the IMF did not have the luxury of spending many months in designing a coherent program as the crisis was deepening every day, threatening the total collapse of the various reform measures that were presumed to help restore market confidence, reduce the likelihood of a recurrence, and improve the long-term economic performance of these countries without due consideration of possible conflicts between different reform objectives. At the same time, the economic profession could not agree on how to deal with a capital account crisis in emerging economies, even when it saw one.

What confounded the East Asian policymakers and public in general is that "the IMF has remained defensive and refused to engage in frank and constructive dialogue with stakeholders in Asia instead of explaining the errors it commented with openness and humility (Takagi 2008). This failure has deprived the IMF of the opportunity to regain its credibility in East Asia. As the ongoing crisis exemplifies, a financial crisis can breakout in any economy whether it is developed as underdeveloped as western finance, which East Asia has accepted as their model, is ingrained with bubbles, excesses, and calamities. Enactment of the Sarbanes-Oxley Act of public company accounting reform and investor protection of 2002 in the US that governance problems related to auditing disclosure and non transparency

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[3] In the case of South Korea, the creditor country was the U.S Blustein (2001: 143) quotes a remark made by an IMF official, which says 'the U.S. saw this (crisis) as an opportunity…to crack open all these things that for years have bothered them.'

of internal control were not unique features of East Asian corporations. In retrospect, it is clear that the IMF did not have a viable framework for corporate reform.

Nevertheless, the IMF continues to argue that financial and corporate sector frailties were at the root of the crisis and that the crisis-hit countries have made a great deal of progress in improving efficiency and safety of their financial systems (Burton 2007). Because of this refusal, it is unclear whether the IMF and its East Asian members (excluding Japan) are better prepared now than before to deal with the ongoing global financial crisis that is likely to throw the global economy into a severe recession. The refusal has created the environment in which East Asia's emerging economies do not seek and often ignore the IMF policy advice and even economic analyses.

3. East Asia's Responses to the 1997 Crisis

3.1 Reserve Accumulation

The 1997 Asian financial crisis marked a watershed in East Asia's recent economic history. It signaled the end of the East Asian economic miracle and opened up a long and painful period of economic reform and restructuring. As part of their efforts to build resilience to external shocks, most of the East Asian countries including the crisis-hit ones have voluntarily or under external pressure increased the flexibility of their foreign exchange rate system and the pace and scope of domestic financial and corporate reform. In order to draw a secure line of defense against speculative attacks, they have also amassed large amounts of reserves. In theory, floating rates and capital account liberalization are supposed to minimize holdings of reserves. In contrast to the theory, however, the East Asian countries have increased their reserve accumulation since the crisis. Part of the reason, of course, is that they have not let their currencies float freely and have resisted a significant appreciation vis-à-vis the depreciating US dollar. Another part of the reason is the widely held belief that large reserve stocks provide an insurance against currency crises. Except for Malaysia, all other crisis countries have deregulated their capital account transactions to a considerable degree since 1998. This liberalization has increased, not reduced, Asian demand for reserves. The emerging market countries have not witnessed any marked improvement in their access to international capital markets. Crucially, capital flows are perceived to remain unstable and unpredictable.

There is also the argument that East Asia is using the financial services of the US to channel its savings, and will continue to do so for many years (Dooley et al. 2003), much as

Europe did in the 1950s and 1960s, as then argued by Kindleberger (1965). These various reasons explain the controversy on whether reserve accumulation has been excessive in some countries is highly controversial. On the other hand, the widely held belief that large amounts of reserves provide a solid guarantee against speculative attacks may one day be revealed misleading. Before the onset of capital account liberalization in the 1990s, as far as the adequacy of reserves was concerned, developing economies were generally preoccupied with the management of their current accounts. A popular rule of thumb was to hold an amount of reserves equivalent to imports of three to four months. With considerably increased capital mobility, this rule has become inadequate. For instance, Korea has accumulated a large volume of foreign reserves (US$ 260 billion as of the end of 2007) equivalent to 25.5 percent of its GDP. At the same time, its capital account transactions have increased tenfold in gross terms.

This has led to another rule of thumb, sometimes referred to as the Greenspan-Guidotti-Fischer (GGF) rule, which prescribes the holding of an amount of reserves equal to the country's short term foreign currency liabilities. The intuition is simple: in an emergency situation, the rule would allow a central bank to buy back all the liabilities that investors liquidate. This intuition can be deceptive, however there is no doubt that very large reserves stocks discourage speculative activity. On the other side, determined markets can virtually overwhelm any stock. Speculators chiefly operate by taking short positions on currency that they perceive as weak. If they are unsure about their expectations, they will not act when facing a central bank which holds sufficient reserves to sustain a speculative attack, because the outcome can be costly for them. If, however, the market sentiment builds up and expectations are firmly held, speculators can hold short positions of any size. In effect, a speculative attack is a run on the reserves of the central bank; the larger the reserves, the bigger the run.[4] The main advantage of very large reserve stocks is that they are likely to raise the level of conviction required for markets to dare trigger a speculative attack. Yet, once an attack is under way, this protection is lost.

[4] The argument if formalized in Jeanne and Wyplosz (2003).

Table 1. Foreign Exchange Reserves (% of GDP)

2000		2008	
China	13.8	China	39.8
Hong Kong	63.6	Hong Kong	70.4
Indonesia	17.1	Indonesia	11.5
Korea	18.7	Korea	27.0
Malaysia	29.2	Malaysia	58.2
Philippines	17.1	Philippines	18.9
Singapore	79.9	Singapore	91.8
Taiwan	33.2	Taiwan	68.7
Thailand	26.0	Thailand	37.9

Note : GDP for 2008 (IMF Estimates)
Source : International Financial Statistics, IMF

3.2 Regional Economic Cooperation and Integration

The 1997 financial turmoil has also served as a catalyst for a movement for building a region wide defense system against future crises as well as financial market and monetary integration in East Asia. This movement has culminated in the institutionalization of the two regional initiatives: the Chiang Mai Initiative (CMI) and Asian Bond Market Development Initiative (ABMI).

In 1997, the leaders of ASEAN invited China, Japan and the Republic of Korea to join in an effort to build a regional mechanism for economic cooperation in East Asia. This invitation resulted in creating the grouping known as ASEAN+3. The Joint Statement on East Asian Cooperation released by the ASEAN+3 summit in November 1999 covered a wide range of possible areas for regional cooperation. One area was in creating regional financial arrangements to supplement the existing international liquidity support facilities at the IMF.

Following up on the summit, the finance ministers of ASEAN+3 agreed at their meeting in Chiang Mai, Thailand, in May 2000 to set up a system of bilateral currency swap arrangements (BSAs) among the eight members of ASEAN+3. The eight countries participating in the CMI have also institutionalized, in addition to the annual ASEAN+3 summit, regular meetings of finance ministers (the ASEAN+3 Finance Ministers' Meeting, AFMM+3) and deputy ministers (the ASEAN+3 Finance and Central Bank Deputies' Meeting, AFDM+3) for policy dialogue and coordination and concerted regional efforts at financial reform in the region.[5] The CMI rests on three pillars: liquidity assistance,

[5] The eight members include the five original members of ASEAN (Indonesia, Malaysia, the Philippines,

monitoring and surveillance, and exchange rate and other policy cooperation. It is anticipated that cooperation will evolve over time, much as has been the case in Europe. It has started with a mutual credit arrangement in the form of bilateral swaps, which is being restructured into foreign reserve pooling without any commitment to exchange rate coordination.

4. Evolution of the CMI

4.1 The Currency Swap Arrangements

The CMI consists of two regional financial arrangements: a network of bilateral swaps and repurchase agreements among the eight members of ASEAN+3 and an expanded ASEAN swap arrangement (ASA) created by the original five ASEAN countries in 1977. In May 2000, the ASA was expanded to include the other five new ASEAN members and the total amount of the facility was raised to US$ 1 billion from the initial amount of US$ 200 million.[6]

- Structure

The bilateral swap arrangements (BSA) provide for liquidity assistance in the form of swaps of US dollars for the domestic currencies of the participating countries[7]. In the initial agreement, for each BSA, the contracting parties determine the maximum amount of swap. A member country can draw automatically up to 10 percent of the contractual amount (now 20 percent) When exceeding the limit, the member is placed under the IMF surveillance including a macroeconomic and structural adjustment program. The BSA network is thus complementary to the IMF lending facilities. Participating countries are able to draw from their respective BSAs for a period of 90 days. The first drawing may be renewed seven times. The interest rate applicable to the drawing is the LIBOR (London interbank offered rate) plus a premium of 150 basis points for the first drawing and the first renewal. Thereafter, the premium rises by an additional 50 basis points for every two renewals, but it is not to exceed 300 basis points.

The BSAs include one-way and two-way swaps. China's and Japan's initial contracts

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Singapore and Thailand) plus China, Japan, and Korea.

[6] The five new members of ASEAN do not participate in the Chiang Mai Initiative.

[7] China chose swaps between local currencies with Japan, Korea, and Indonesia. With Indonesia, it has also a dollar-local currency swap.

with the five Southeast countries were one-way BSAs from which only the ASEAN five can draw. The first round of CMI contractual agreements was completed in May 2004 with sixteen BSAs totaling US$ 36.5 billion having been concluded. Japan contracted seven agreements and China and Korea six respectively. Korea, which is the largest beneficiary of the CMI, could draw a maximum of $13 billion from the system, including the resources made available under the Miyazawa initiative. However, the amount of liquidity available from the CMI was seen as insufficient to support members suffering from short run balance of payment problems and hence to prevent contagion of future crises in the region. This realization led to doubling the total size of the CMI in 2005. Since then further contributions have been made to increase the total amount to US$84 billion by April 2008.

- Surveillance

Most participating countries agree that, in principle, the BSA network needs to be supported by an independent monitoring and surveillance system. At this stage, however, they do not seem to be prepared to establish such a system, although collective efforts are being made in this regard.[8] In the initial agreement, surveillance is not required because up to 10 percent of each BSA swap can be disbursed without the consent of swap-providing countries and any additional drawing is subject to the IMF surveillance. Hence, there is no provision for the resolution of defaults on repayments. This deficiency effectively puts the onus of surveillance on the lending countries and the IMF. With the increase in the size of the BSAs and the automatic drawing limit, however, there has emerged general consensus that the CMI would need in the future its own surveillance mechanism to make it a credible liquidity support system with procedures for the activation, execution, and default resolution.

In fact, a number of participating countries have proposed to sever the CMI from its linkage with the IMF conditionality and to replace it with an independent regional monitoring and surveillance system that could also serves as an institutional framework for policy dialogue and coordination among the members. At the 2005 annual AFMM+3 ASEAN+3 finance ministers reaffirmed the necessity of enhancing the ASEAN+3's economic surveillance capacity and integrate it into the CMI, but was not able to make any decision on the structure, role and the location of the proposed surveillance institution. The joint statement of the AFMM+3 at the 2006 ADB annual meeting once again reiterated their

[8] For instance, the ASEAN surveillance process is built on the basis of consensus and informality in keeping with the tradition of non-interference (Manzano, 2001).

commitment to improving the regional surveillance capacity, but all they could do was to establish a group of experts and an technical working group composed of finance ministry officials to study further the feasibility of constructing a regional monitoring and surveillance system.

As is currently structured, the CMI is a small regional source of financial assistance. And there is no guarantee that bilateral swaps will be activated in times of crisis. These deficiencies do not mean that the CMI is irrelevant. To the contrary, in addition to providing liquidity, it has been evolving into a regional forum for policy dialogue and even coordination for regional financial stability that has been wanting in East Asia for a long time. Most CMI members are not likely to draw from the BSAs in the foreseeable future as they have managed to reduce some structural weaknesses of their financial systems through reform and more importantly they have amassed large amounts of foreign exchange reserves. At the end of 2007, the seven CMI members excluding Japan held more than $2.5 trillion in reserves.

Now that they feel more secure and are hence less in need for regional liquidity assistance, the ASEAN+3 members have turned their attention more to policy dialogue and coordination, which has led to institutionalization of a peer review mechanism known as "Economic Review and Policy Dialogue (ERPD)". ERPD assesses regularly the overall economic outlook of the region and serve as a forum for policy dialogues among members. ASEAN+3 have also established an early warning system for crisis management and formal and informal channels of communication within the framework of the CMI on significant market changes such as a large appreciation or depreciation of any regional currency caused by speculative capital inflows or outflows.

Regional cooperation may open other formal and informal channels of liquidity support in addition to the BSAs among the ASEAN+3 countries. For example, when Indonesia and the Philippines showed signs of financial strain in 2005, which was deemed contagious, ASEAN+3 policymakers considered short term public sector loans a first line of defense before activating the BSAs. In 2007, when Vietnam was suffering from a gaping current account deficit, it was reported that both China and Japan offered short-term US dollar loans although Vietnam does not participate in the BSAs. In the end these loans were not needed in all three cases.

4.2 Enlargement and Multilateralism of the CMI

Since its inception, the eight participating members of ASEAN+3 have gone through several rounds of discussion for enlarging the size and improving operational procedures of the CMI such as the limit of automatic drawing, and the linkage with the IMF. As pointed out in the previous section, the total size of the BSAs has been raised to $84 billion. Several members of the CMI had previously proposed that the 10% limit available without the IMF conditionality be raised to 20 or 30 percent. The limit was lifted to 20 percent in 2005.

In redesigning the CMI the member countries have been mostly preoccupied with the joint activation or multilateralization of the BSAs. Multilateralization has been of particular concern, because there is no guarantee that, under the existing system, the BSAs will be activated promptly, in time to support a member in need of short term liquidity. Some of the swap-providing countries could exercise their right to opt-out. Any country wishing to obtain short-term liquidity must negotiate the activation with all swap-providing countries individually. If a large number of the members refuse to provide swaps and different swap providers demand different terms and conditions, then the CMI may cease to be an efficient liquidity support system. Swap activation with multiple parties may take time and hence may deprive the swap requesting country of the ability to mount an effective and prompt defense against a speculative attack.

Despite these defects, the CMI members realize that neither the multilateralization of nor an increase in the drawing limit will be possible unless an effective surveillance system is established. This has been a controversial issue. The working group assigned to produce recommendations for surveillance has not been able to produce a system acceptable to all members: the member countries are divided on its role and structure. The bilateral swap arrangements, when activated collectively and supported by a surveillance system, can function as a de facto regional monetary fund and could lay the foundation for monetary cooperation and integration in the long run that follows in the footsteps of European monetary integration At this stage of development, it appears that at least some members of the ASEAN+3 are not prepared to restructure the CMI into an Asian Monetary Fund, an idea that was proposed by Japan in 1997 and quickly abandoned.

5. Future Prospects of Regional Financial Cooperation in East Asia

5.1 Creation of Self-Managed Reserve Pooling Arrangement (SRPA)

In recognition of the structural deficiencies of the BSAs, ASEAN+3 began a review of the system to develop a more effective multilateral framework of regional liquidity support in 2005. The proposal for multilateralization that was approved at the 9th meeting of finance ministers in 2006 has culminated in the conversion of BSA bilateral contracts into a single contract informally known as a common fund or a self-managed reserve poling arrangement (SRPA). At their 10th meeting held in Kyoto, Japan, the ASEAN+3 finance ministers "agreed in principle that a self-managed reserve pooling arrangement governed by a single contractual agreement is an appropriate form of multilateralization" of the existing swap system (ASEAN+3, 2007). They also agreed to carry out further in-depth studies on the key elements of the multilateralization including surveillance, reserve eligibility, size of commitment, borrowing quota, and activation of a new system. For these studies a task force was established in November 2006.

The SRPA, which is meant to replace the BSAs, essentially replicates the model of reserve pooling of the European Monetary Cooperation Fund (EMCF). From the Asian perspective, the innovation of the SRPA is that it is meant to be a legally binding and enforceable contract, which would give effective protection to participating members. Even when finance ministries or the central banks manage the system, unlike the BSAs, the new reserve pooling system would require a single contractual agreement to be governed by a third country's law so as to make it a multilateral arrangement.

Constructing an efficient system of surveillance would be crucial to garnering public credibility of the SRPA. For them to contribute sizable amounts to the fund, the ASEAN+3 countries need reassurances that moral hazard will be contained. Unless an effective system of surveillance is established, there is the danger that the SRPA may not function as an efficient liquidity support system.

At the 11th meeting of finance ministers in Madrid in May 2008, some of the features of the SRPA, such as the size, the respective shares of the members, the modality of decision making, and terms and conditions of borrowing were agreed upon (ASEAN+3 2008). On other issues, such as borrowing accessibility, the activation mechanism, custody and surveillance, the ministers could not reach consensus and decided to wait for recommendations to be made by a task force. The size of the pooled reserves was agreed to be at least $ 80 billion (20% provided by ASEAN countries - and 80% by the Plus Three). The shares of individual countries will be determined through negotiations among the members belonging to the two respective groups.

The ASEAN members agreed in principle that the maximum amount of borrowing in US dollars against collateral in local currency could be equal to a multiple of the member's contribution to the pool. However, the exact figures remain undecided, except that multiples are likely to be higher for the ASEAN members than the Plus Three. On the pooling structure of reserves, four options have been proposed: 1) pooling of investment assets; 2) cash contributions to the SRPA in return for a claim on the arrangement; 3) pooling of promissory notes to be issued to the ADB or ASEAN secretariat which acts as an administrator; 4) pooling in a single global custodian.

As for the conditions and covenants of borrowing from the pool, ASEAN+3 has decided to adopt those of the BSAs. They will also retain the 20 percent IMF rule. On the mechanism of making management decisions, the members appear to be divided between a majority and unanimity rule. They are likely to adopt a consensus based rule on important matters such as lending, but other routine management issues could be decided by a majority rule. There are two critical issues on which the members have not been able to obtain consensus: the pooling structure and surveillance. On the pooling structure, they are debating the feasibility and relative merits of two options: pooling of promissory notes and pooling in a single global custodian.

As previously emphasized, surveillance has been a major concern ever since the establishment of the CMI. It has become critical with the introduction of a reserve pooling arrangement. Despite a series of protracted discussions, the members have not been able to agree on a modality of surveillance. At present ASEAN+3 relies on informal surveillance conducted through ERPD when finance ministers and their deputies meet (once a year for the ministers and twice a year for their deputies). The ERPD will serve as the normal mechanism for monitoring and for exchange of information, but when a request for borrowing is made by a member, it will be decided by other members either by a majority or unanimity rule. There will be more ERPD meetings and more standardized information and data will be shared among the members. Obviously, this type of peer review and informal exchanges on policy coordination will not be sufficient. Up until now, the member countries have not shown much interest in setting up an independent surveillance. This ambivalence means that ASEAN+3 will have to rely on the IMF and other IFIs for surveillance but they could not agree on the extent to which they are going to depend on them.

Since China and Japan, the two largest contributors to the arrangement, are not likely to borrow from the reserve pool, there will be a clear line of demarcation between potential lenders and borrowers. China and Japan will be lenders and four ASEAN members – Indonesia, Malaysia, the Philippines, and Thailand – are potential borrowers, while South Korea and Singapore can be either lender or borrower. As the two major contributors, therefore, cooperation between China and Japan, which has been wanting in recent years, will be crucial to a successful launching of the SRPA.

Would the $80 billion reserve pool will be enough to make it a credible liquidity support system? Would it not be dismissed outright by the market as its size is so small compared with the amounts of foreign exchange reserves held by the ASEAN+3 members? More generally, when markets can take huge position, is the pool likely to deter speculative attacks? Answers will not be known until the SRPA is put through to market tests in the future. However, as noted earlier, the ASEAN+3 members are going to increase their contributions as they have done with the BSAs. The SRPA has symbolic significance for regional solidarity and cooperation for mutual assistance among the ASEAN+3 members and if the members could make use of other formal and informal channels of assistance, they may not need a large regional liquidity support system. But in reality it appears they also.

Because of their small size and complicated activation procedure, the BSAs have been very much ignored. The new system could well meet the same fate. As long as the reserves remain under respective members' custody and management instead of being centrally managed by an independent third party, the activation mechanism becomes crucial. The mechanism under discussion does not appear to be a major improvement on that of the BSAs. This raises concern that liquidity will be no more readily available than it was the case with the BSAs. Furthermore, to be helpful, the new facility needs to raise the maximum amount a member can draw well above the level of the BSAs. It may be necessary to include an opt-out clause but this clause should only be available under exceptional circumstances. If the IMF link were to be maintained, precise and transparent agreements between the IMF and ASEAN+3 would need to be spelled out.

The new system signals a desire to deepen financial and monetary integration through an advanced institutional structure. Few details are known about and how long it will take to construct an operational framework. The shortcomings of the BSAs have long been well known, but what is not known is how effective they can be because the system has never been activated. ASEAN+3 are introducing a new system without having had the opportunity of learning the advantages and drawbacks of the bilateral swap system. In the end, it seems that the SRPA is not designed so much as a regional liquidity assistant mechanism as it is a regional forum for policy cooperation. As discussed in the following section, together with BSAs, the SRPA is likely to be put to a market test of whether it can operate as a regional liquidity support system during the ongoing crisis.

5.2 The Reform of the Global Financial Architecture: Viability and the Role of Regional Financial Cooperative Arrangements

There is an emerging consensus that the US Sub-prime crisis that broke out in August 2007 and has since exploded into global financial turmoil has exposed many structural deficiencies of the global financial system related to large and volatile cross-country capital flows, in particular in areas of both domestic and global financial regulation and supervision of financial actors and the role of the IMF (ASEM 2008). Although these deficiencies and their causes have yet to be spelled out, there is broad agreement that unless rectified, they could continue to play havoc with the global financial system and provoke retreat from economic globalization.

A series of financial crises that erupted in Asia in 1997 and then spread to Russia, Turkey, and Argentina in subsequent years brought to the fore the need to construct a new international financial architecture. Many international committees including G-22 were established to examine issues related to strengthening the global financial system.[9] Few of the reform proposals were, however, seriously considered for implementation largely because of the difficulty in compromising different interests of different countries at the global level, and with the return of financial stability most major players in global finance lost interest in the proposed restructuring. Since then the reform efforts have fizzled out. The latest IMF fact sheet on the reform of the international financial architecture (IMF 2000) was released in July 2000. Two years later, the IMF MD delivered a speech on the urgency of international financial reform (IMF 2002).That was the last time when a new international financial architecture was ever mentioned again.

Would the new initiatives meet the same fate as before or break with the precedent to spearhead global reform efforts? Although it is too early to judge, this time the scope and intensity of the demand for reform would be much greater than before. This is because the US Sub-prime crisis has thrown all countries, whether developed or developing, into financial turmoil, inflicting collateral damage of which magnitude is likely to be unprecedented and

[9] On various proposals see IMF(2000)

because there is a widespread awareness that a crisis resolution requires “strengthening coordination and cooperation of the international community by taking effective and available economic and financial measures in a comprehensive way” (ASEM 2008).

ASEM and G-7 member states acknowledge the urgency of reform and would take action. Although ASEM leaders have fallen short of offering solutions to the crisis, they “pledged to undertake effective and comprehensive reform of the international monetary and financial systems….. in consultation with all stakeholders and the relevant international financial institutions including the International Monetary Fund to help stabilize the international financial situation” (ASEM 2008).

As before, the reform is expected to focus on structural changes in both domestic and global financial supervision and regulations that may ensure durability of global financial stability and the restructuring of the IMF. The global financial crisis in progress has underscored what has been known all along that the IMF is not structured to manage a capital account or short-run liquidity crisis whether it is a local or regional one, let alone a global one[10]. Traditionally, the IMF has had very little to do with the G-7 countries in their lending operations. The IMF has been able to do little in the way of preventing or mitigating contagion of the US sub-prime crisis. It also finds itself unable to bring major players including the G-7 economies to coordinate their policies to bring under control the global financial turmoil. At the same time the IMF may not have sufficient resources to help ease US dollar liquidity shortages faced by a growing number of emerging economies[11].

In view of the growing demand for reform of the international financial architecture, questions arise as to (i) whether there is room for regional financial arrangements (RFAs) such as the SRPA along with the IMF, however it will be restructured, in a new international financial architecture and (ii) if there is, whether the BSAs or the SRPA could be a building bloc of the new system as they are constructed as regional lenders.

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10 Eichengreen (2008) suggests that the US and EU will be unresponsive to “an IMF-directed Multilateral Consultation bringing together the U.S., European Union, and others to discuss the credit crisis. European finance ministers meet as the Ecofin Council, and if they need to reach Mr. Paulson they know his number. They do not need a Multilateral Consultation to bring them together.”

11 Eichengreen (2008) is skeptical whether the IMF could have a role is in aiding emerging economies caught up in the crisis. As he sees it, “Eastern Europe crisis countries may be bailed out by the EU and the ECB, while their East Asian counterparts may receive swaps and credits through the Chiang Mai Initiative. Once again the Fund may end up being sidelined unless it demonstrates that it has a better idea, in this case about how to link emergency lending with policy adjustment”

On the first question, there are several arguments that RFAs could enhance efficiency and stability of a new international financial architecture by complementing the role of the IMF. One such argument invokes the European experience with financial and monetary integration. If the EMU has contributed to deeper economic integration of Europe and also has developed into a critical component of the international financial system, countries in other region may believe they could replicate a similar experience. This is certainly the case in East Asia. In establishing the CMI its architects shared a vision of laying the foundation of financial and monetary integration as a long-run objective by following in the footsteps of the EU. They may or may not succeed, but in view of the European achievement their endeavor to promote regional economic integration deserves a try and support of the global community.

A second argument refers to a host of institutional weaknesses of the IMF that narrow its role as an institution entrusted with global lending and surveillance. One such weakness is the limited ability of the Fund to raise financial resources large enough to make it a lender of first resort, if not the last. It is reported that the IMF has more than $200 billion of loanable funds and can draw on additional resources through two standing borrowing arrangements with groups of its members. But this amount may fall short of what they need to rescue those emerging and developing economies suffering from the fallout of the US sub-prime crisis. The Fund is already negotiating provision of emergency financing with Iceland, Hungary, Pakistan, and Ukraine and expects that other emerging economies are likely to approach it for liquidity.

If global availability of liquidity tightens further, " the International Monetary Fund may soon lack the money to bail out an ever growing list of countries crumbling across Eastern Europe, Latin America, Africa, and parts of Asia, raising concerns that it will have to tap taxpayers in Western countries for a capital infusion[12]. Regional lenders can join forces with the IMF to provide additional funds for emergency lending. However, the limited availability of loanable funds at the IMF does not provide rationale for establishing regional lenders such as the SRPA. This is because one could make a counter argument that the members of the IMF including regional organizations such as ASEAN+3 could contribute more financial resources to the IMF instead of creating RFAs. The IMF could then benefit from scale economies and dispel any concerns of potential moral hazard that may beset the

[12]See http://www.telegraph.co.uk/finance/comment/ambroseevans_pritchard/3269669/IMF-may-need-to-print-money-as-crisis-spreads.html

RFAs..

. As noted earlier, the IMF is specialized in surveillance of and crisis lending for emerging and developing economies. In recent years, it has been trying to diversify its functions to serve as a forum for multilateral surveillance and consultation. But adding this relatively new global role may impinge further on its human and financial resources. For example, one department cannot effectively monitor and analyze economic developments of such a wide region as the Asia and Pacific that includes ASEAN+3, India, Australia, and New Zealand - 46 percent of the global population. Emerging and developing economies in different regions do not have many in common as far as their structural characteristics are concerned. They have different economic and social backgrounds, are susceptible different external shocks, and also display different cyclical patterns. Given these dissimilarities, the IMF may overburden itself with covering a broad spectrum of emerging and developing economies. In development financing the role of the World Bank is complemented by a large number of regionally specialized development banks. As it is organized, the IMF is not a global lender of last resort. Nor is it capable of coordinating macroeconomic policies of its members.. Logic fails to support the argument that there should be only one global monetary fund.

A third institutional weakness is related to the key role of the IMF as a provider of policy advice and economic analyses. As many emerging economies are moving up the ladder of development, they have been able to improve and diversify their research and surveillance capacity. The IMF has also become one of many private and public providers of market information, economic analyses, and even policy advice. As a result the role of the IMF as a confidential adviser has declined in importance, much more so in East Asia since the 1997-98 Asian crisis Furthermore, as Takagi (2008) points out, an IMF mission that comes with a preset agenda offers little to East Asian policymakers. Because of these developments, many emerging economies are likely to find it in their interest to take advantage of all these sources of information plus their own surveillance. And a RFA with a lending function may facilitate compilation and assessment of information on regional as well as global economic developments from diversified sources.

The third and perhaps the most frequently raised argument for creating RFAs is that they may be better adapted to managing a regional capital account or liquidity crisis than the IMF. A review of the Asian crisis management by the Independent Evaluation Office of the IMF (2003) makes it clear that the 1997-8 capital account crisis required a management and resolution strategy different from the traditional IMF recipe for crises originating from current account deficits. What was needed was a speedy provision of a large amount of liquidity at the beginning of the Asian crisis to prevent contagion of output contraction and the turbulence of the foreign exchange and other financial markets through trade and financial market linkages.

The IMF appears to have learned the lesson that capital account crisis requires emergency lending for resolution. According to a recent IMF announcement (IMF 2008), the fund is ready to "lend billions of dollars through Short-term Liquidity Facility (SLF) to support nations with a good track record in economic management hit by fallout from the global financial turmoil." The IMF MD says that its lending will have to be accompanied with some policy conditions, although they will be fewer and more targeted than in the past (IMF 2008). While the SLF would mean a departure from the traditional role of the IMF, at this stage it is too early to make any judgment about its effectiveness as little is known about its operational details including policy conditionality and most of all it has not been tested.

Although the SLF will enhance the IMF role as a crisis manager, it should be noted that, when a crisis in a country originates in the capital account, policy coordination and exchanges of information among neighbouring countries are essential in preventing contagion. In the absence of these exchanges and policy dialogues among close economic partners, individual countries often find it difficult to understand the causes of and fail to implement proper policies to counter large changes in capital flows and exchange rates.

The Asian financial crisis has brought home the lesson that monitoring of developments in regional financial markets crucial for fending off crisis contagion would not be effective unless an efficient mechanism of policy coordination is constructed at the regional level. Even smoothing-out of high frequency movements of the nominal exchange rate in individual countries may have to be coordinated at a regional level in order not to send wrong signals to other countries.[13]

The IMF can monitor capital flows within and between regions and also the behavior of market participants but it is difficult to imagine that it could establish close working

[13] This is one of the functions fulfilled by the EMS in Europe. Exchange rate realignments must be agreed upon by all members of the Exchange Rate Mechanism (ERM), i.e. those countries that are party to the fixed exchange rate arrangement.[13] This implies that a country that wants to change its exchange rate must convince its partners and negotiate the size of the adjustment. This feature does not just imply a significant loss of sovereignty, it also means that each country must present to the other members detailed information on its economic situation. Mutual surveillance, therefore, is part of the mechanism. It can be noted that the IMF is not involved in this process

relationships with individual member countries and coordinate their policies and as a crisis lender the IMF may have to maintain an arm's length relationship with its members. Moreover, since it is not a lender of last resort, the IMF cannot serve notice to the international financial markets that it is ready to supply whatever amount of liquidity it takes to thwart an impending speculative attack.

There is rationale for creating RFAs. Despite their potential, however, questions have been raised as to whether either the BSAs, which will remain in operation until replaced by the SRPA, or the SRPA itself can be a credible regional lender and hence viable building blocks for a new international financial architecture. It is true that depending on how it is organized, the SRPA could command a large amount of loanable funds. For instance if the CMI members are able to contribute 5 percent of their combined reserves ($4 trillion) to and establish surveillance appropriate for the operations of the SRMP, the pooled reserve will be large enough to supply as much liquidity to the CMI members as the IMF facilities can. As far as the potential amount of funding is concerned, the SRPA can therefore easily qualify as a major regional lender, although whether the CMI members are willing to create such a large fund is a different matter

The IMF and the SRPA could also complement each other by working out division of labor in policy coordination and surveillance in the region. One possible division of labor is that the IMF consolidates its financial and human resources to strengthen its activities for multilateral consultation together with global and cross-country surveillance, whereas the SRPA specializes in monitoring and analyzing country and region wide economic developments. The IMF could also provide technical assistance to ASEAN+3 for expanding the scope and improving quality of ERPD's research and surveillance. In this framework of cooperation, the IMFs' participation in various fora of ASEAN+3 including the AFMM could enhance efficiency and complementary relations between the two institutions.

Effectiveness of the BSAs is not known as it has never been subject to a market test. The SRPA will not become operational until the CMI members agree on its structural details. At an informal ASEAN+3 summit held during the 7th ASEM meeting in Beijing on October 24, the East Asian lenders agreed to contribute their reserves up to $80 billion to complete the funding of the SRPA and to speed up the creation of a regional surveillance system before the end of June 2008. Until then the members of the CMI will have to rely on the BSAs as the regional source of liquidity. Would any member in need of liquidity consider activating their swap agreements with other members?

Despite the deepening turmoil, given the stringent withdrawal process, few members of the CMI will be inclined to approach the BSAs for liquidity. The decision to borrow from the BSAs could mean an admission that the member in question is in a serious financial difficulty which could erode confidence of foreign investors, thereby risking further capital outflows. The amount of liquidity available to each member through the BSAs is relatively small. Korea, which is the largest beneficiary of the BSAs, can draw $17 billion for a maximum on its currency swaps with both China and Japan. To complicate the disbursement process further, the members will have to weigh in the possibility of the opt-out of and conditions to be attached to its borrowings by its contractual partners before activating the swap agreements. In addition, if the member requesting the swap activation needs more than 20 percent of its swap limit, it will have to accept the IMF policy conditions.

According to a recent IMF announcement "the Short-Term Liquidity Facility (SLF) is designed to help emerging market countries with a track record of sound policies address the fallout from the crisis. The new facility, approved by the IMF's Executive Board on October 29, comes with no conditions attached once a loan has been approved and offers large upfront financing to help countries restore confidence and combat financial contagion "(IMF 2008)[14]. The US Federal Reserve has also authorized the establishment of temporary liquidity swap facilities with the central banks of four large and systemically important emerging economies suffering from liquidity shortages. These new facilities will support the provision of U.S. dollar liquidity in amounts of up to $30 billion each by the Banco Central do Brasil, the Banco de Mexico, the Bank of Korea, and the Monetary Authority of Singapore.

If the IMF could offer large loan packages with streamlined policy conditions attached, the CMI members will have few incentives to borrow from the BSAs. Unless, therefore, the members participating in the CMI are prepared to increase swap amounts substantially to meet financing needs of its members and impose conditionality less demanding then that of the IMF, the CMI will become oblivious to the international financial community, causing an irrevocable set back to ASEAN+3's aspiration for regional financial cooperation and integration. Yet leaders of ASEAN+3 appear to be in no hurry in revamping the BSAs or expediting the construction of the BSAs. In fact, unlike their counterparts of the EU, they have been most conspicuous by being inactive, watching the global financial crisis from the sideline as if they could ride out the financial turbulence. Most of East Asia's

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14 See Appendix

emerging economies have a strong aversion to turning to the IMF for possible loan packages in case they need dollar liquidity. Given the widespread distrust of the Fund, seeking an IMF financial assistance, in particular for those crisis-affected countries, would be politically disastrous: they will not entertain the idea of returning to the IMF until all other possible sources of liquidity are exhausted.

As the global financial crisis takes hold, all members of ASEAN+3 are sliding into recession and enduring financial market instability, although the degree of the plight differs from country to country. All economies have seen sharp deceleration of their export earnings while domestic demand has remained sluggish. Stock prices have nosedived all over the region. The sovereign spreads have widened (See Table 2), and the quality of their liabilities denominated in the US dollar measured by the CDS premium has deteriorated (See Table 3). In this atmosphere of crisis, bank and other financial institutions have been pulling back from their lending operations by recalling loans instead of extending new ones as future economic prospects look dim and their losses are piling up. This procyclicality in lending will accelerate the economic downturn.

Table 2. Emerging Market Sovereign Bond spread

Trade Date	China	South Korea	Malaysia	Philippines	Indonesia
Dec-06	51	64	66	128	138
Jan-07	50	66	71	136	128
Feb-07	50	64	69	155	136
Mar-07	53	62	73	142	131
Apr-07	50	60	69	132	125
May-07	49	57	69	114	101
Jun-07	54	63	75	139	122
Jul-07	74	95	100	203	166
Aug-07	80	85	100	214	211
Sep-07	88	74	108	144	155
Oct-07	87	73	99	140	148
Nov-07	114	102	111	202	224
Dec-07	119	98	115	164	204
Jan-08	128	173	138	267	327
Feb-08	150	194	174	312	342
Mar-08	154	206	154	279	326
Apr-08	154	178	136	223	285
Jun-08	143	174	202	338	363
Sep-08	198	260	255	392	516
Oct-08	220	335	285	588	921

Source : Korea Center of International Finance

Table 3. CDS Premium

CDS 5yr Premium	Korea (A2)	Japan (Aaa)	China (A1)	Malaysia (A3-)	Taiwan (B1)	Vietnam (Ba3)	Philippines (B1)	Indonesia (B1)
07-Dec	45	8	29	42	55	126	153	153
08-Mar	96	26	82	99	110	214	239	245
08-Jun	104	15	75	112	135	321	262	282
08-Sep	180	19	88	168	170	359	285	360
08-Oct	301	32	116	175	212	468	414	753

Note : Ratings by Moodys.
Source : Bloomberg

Few of East Asia's emerging economies will be able to pull through the crisis without considerable loss of output and employment Some countries such as South Korea have suffered a large increase in capital outflows as foreign investors are shifting to high quality assets such as US treasuries and liquidate their investments to deleverage and cover their losses back home. The flight to quality together with the pessimistic economic outlook has generated an expectation of depreciation of their currencies, inducing further capital outflows. At present, the only recourse to short-term US dollar liquidity is borrowing from the overnight interbank market. A vicious circle seems to be setting in. Although it was designed to support dollar liquidity to its members, the BSAs do not offer any relief and the completion of SRPA remains uncertain.

Understandably East Asian countries are reluctant to seek IMF rescue financing again. Unless the international community joins forces to create a new international financial architecture that could ensure global financial stability by preventing or responding in a concerted manner to future crisis when it occurs, there is the danger that most emerging economies would conclude that their foreign exchange reserves are not enough to cushion external shocks. Indeed, if this happens, East Asia's emerging economies may be tempted to return to the export-led growth strategy, delaying global recovery and worse yet sowing the seed for another crisis that is likely to be sparked off by ever growing global imbalances and the fall of the US dollar.

This danger can be preempted if the members of ASEAN+3, the US, and EU collaborate to elevate the status of the SRPA to a credible regional lender. On its part, AEAN+3 should consider enlarging the size of the reserve pool to be taken seriously by the market. The UK and Japan have proposed that the reserve rich countries including China and Saudi Arabia contribute $200 billion to the IMF to bolster its lending operations. Given the large amount of reserves held by the CMI member countries, the size of the BSAs or SRPA could be easily doubled. Policy conditions to be attached to SRPA loans should be no more stringent than those of the IMF's SLF. Most of all, the disbursement process will have to be relatively straightforward and expeditious. On their parts, the US and EU could consider including the SRPA in the reform agenda for constructing a new international financial architecture.

Despite the talk of "capitalism at bay", the region is bound to integrate more extensively and deeply with the global trading and financial system unless the multilateral trading system collapses. The proposed reform of the international finance will not break up the IMF: it is likely to create a new IMF instead (ASEM 2008). East Asia needs to establish presence at and closer and broader cooperative arrangements with the new IMF. If the SRPA could help East Asians present a united front at the new IMF, ASEAN+3 would benefit from a stronger Fund insofar as it relies on the IMF surveillance for the management of the BSAs and SRPA.

6. Concluding Remarks

The ongoing global financial crisis has brought into the light many deficiencies of the existing international financial system that threaten global financial meltdown. In a globalized financial system, a crisis originating in a country or region can spill over into other countries with impunity and lightening speed. As in the case of the US Sub-prime crisis, a crisis in a large economy can be more devastating as it leaves few countries unscathed, whether they are developed or developing. The lesson of the global financial turmoil is that such a crisis cannot be resolved without policy coordination and mutual support among the affected countries. There is an emerging consensus that unless removed, they will continue to haunt the international financial community. This consensus has led to global calls for a fundamental restructuring of global financial system, although few new ideas have been proposed on the direction of the needed reform.

The purpose of this paper has been to discuss reform of the IMF and the potential role of the SRPA in a new international financial architecture in light of the recent global financial turmoil and the regional movement for financial cooperation in East Asia that began after the 1997 Asian Crisis.

This paper argues that the regional financial cooperative arrangement in East Asia such as the BSAs and SRPA, even though they may not be effective to provide protection against crises, may be transformed into one of the building blocks for a new international financial architecture. For that to happen, it would need to be supported by the international financial community in general and the IMF in particular by recognizing legitimacy of the

BSAs and the SRPA as a regional crisis manager and lender. Although the CMI was launched almost eight years ago, the creation of a credible liquidity support system has been a slow process in East Asia. As many members of ASEAN+3 have accumulated large amounts of reserves as self-insurance against future crises and developed other means of safeguarding their domestic financial markets, complacency has set in to delay the consolidation of the BSAs. Although the current financial crisis could degenerate into a global recession that is likely to be the most serious economic debacle since the 1929 depression, East Asia's political leaders have been rather complacent and watching the financial meltdown from the side line.

East Asian countries can prevent further deterioration of their own economies and in so doing the global economy as well, if they can coordinate their policies to boost internal demand in the region. So far leaders of ASEAN+3 have been not able to organize what they can and should do collectively to help resolve the crisis. This is unfortunate. The US and Europe believe that the member states of ASEAM+3 could play a critical role in working together with the US and Europe to mitigate the severity of the impending global recession. East Asia should not let them down. Now is the time for ASEAN+3 to rise to the expectation of the rest of the world.

ASEAN+3 member states must be prepared to do three things if they are going to meet expectations of the US and Europe. First, the members need to agree to a region wide stimulation of demand to sustain robust growth and to absorb more imports from the US and Europe. Second, they should utilize all formal and informal channels of mutual assistance in providing US dollar liquidity to those members in need of liquidity so that they can pursue expansionary monetary and fiscal policy without the fear of running into a liquidity crisis. The eight members participating in the CMI are currently sitting on a total of $ 4 trillion in foreign exchange reserves. The lack of US dollar liquidity is therefore one thing they can easily overcome if they enlarge the bilateral swaps or the SRPA and speed up this disbursement process.

Third, they should actively participate in reforming the global financial system. There is a real danger that after financial stability is restored most of the East Asian countries go back to the export-led strategy to accumulate more reserves than before by running current account surpluses for the prevention of future crises unless the reform assures their access to international financial markets. Otherwise there will be retrenchment from financial globalization in East Asia. As it is structured the SRPA can be a building bloc of a new international financial architecture. In this regard, it is important that the US and Europe support East Asia's efforts to construct an efficient SRPA that can fill in as a regional liquidity supplier to complement the global role of a new IMF.

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Appendix: Short-term Liquidity Facility of the IMF

• ***Purpose.*** Provide large, upfront, quick-disbursing, short-term financing to help countries with strong policies and a good track record address temporary liquidity problems in capital markets.

• ***Eligibility.*** Countries with a good track record of sound policies, access to capital markets and sustainable debt burdens may qualify (the IMF's standard debt sustainability analysis should indicate a high probability that both public and private debt will remain sustainable). Policies should have been assessed very positively by the IMF's most recent country assessment.

• ***Conditions.*** Financing is made available without the standard phasing and loan conditions of more traditional IMF arrangements. However, borrowers are expected to certify that they are committed to maintaining strong macroeconomic policies.

• ***Size of loan.*** Disbursement of IMF resources can be up to 500 percent of quota, with a three month maturity. Eligible countries are allowed to draw up to three times during a 12-month period