



## REGIONAL FINANCIAL COOPERATION IN EAST ASIA: THE CHIANG MAI INITIATIVE AND BEYOND<sup>1</sup>

### The East Asian financial crisis and regional cooperation

**I**t goes without saying that countries in East Asia<sup>2</sup> have benefited greatly from the globalization of financial markets. Starting from the mid-1980s, large inflows of capital helped to finance the vigorous economic growth of the region. However, with rapid globalization, the volatility of these markets and the concomitant risks for developing countries have increased drastically. The shift in market perception that heralded the onset of the East Asian financial crisis in July 1997 led to capital outflows from the region amounting to US\$ 150 billion in the subsequent three months, whereas inflows had been US\$ 100 billion the preceding year. The unprecedented scale of the reversal of external flows caused enormous damage to countries in the region as it was followed by sharp depreciations of real exchange rates, precipitous falls in asset prices, collapses in investment and in consumer confidence, and the destruction of incomes. With such a self-reinforcing financial collapse, even a developed country with a basically sound economic system would have been unable to protect itself.

*Globalization has  
brought greater  
volatility to  
financial markets*

The financial crisis in 1997 was a wake-up call to East Asian Governments that their financial markets and institutions were insufficiently prepared to manage globalized capital flows. Financial institutions had to be reformed and restructured, capital markets broadened and deepened, and supervision and regulation standards brought up to international best practices. In addition, the success of the Japanese-led financial support package for Thailand in September 1997 encouraged Governments to consider establishing regional financial facilities, as in their view the provision of international financial help through existing multilateral arrangements had been neither timely nor sufficient to put a rapid end to the crisis. Not only were the East Asian countries discontented with the IMF approach, but there was also a growing consensus among them that a collective response to similar critical situations

*The 1997 crisis forced  
a reconsideration  
of the ability of  
Governments to  
manage globalized  
financial flows*

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<sup>2</sup> East Asia is defined here as comprising the countries of ASEAN plus China, Japan and the Republic of Korea, i.e., the group more commonly known as ASEAN+3.

in future would be necessary because of their growing regional integration, evidenced in part by the mutual susceptibility to contagion.<sup>3</sup>

*The Chiang Mai Initiative was born from measures to improve regional self-protection*

The self-protection measures by and for the East Asian countries first took shape in the form of the Manila Framework Group in November 1997, which was set up as a forum for regional economic surveillance and crisis management that aimed at strengthening the role of IMF. Its membership consists of 14 Pacific nations. Subsequently, the ASEAN Surveillance Process was established in 1998 with the overall objective of strengthening policy-making capacity within the grouping. Peer review and surveillance were extended to cover not only the major macroeconomic aggregates but also sectoral and social policies so as to improve policy coordination in the broadest sense, particularly in the light of adverse developments. Finally, in May 2000, the finance ministers of ASEAN+3 countries reached agreement on the Chiang Mai Initiative (CMI), which was the first significant regional financing arrangement to enable countries to cope with disruptive capital flows and maintain exchange rate stability.

*CMI raises many important issues*

CMI raises several important issues, such as its likely effectiveness in bringing about exchange market stability in member countries; its relationship with IMF; and the possibility of its evolution towards an Asian monetary fund and a new regional financial architecture. After a brief description of CMI, the discussion in this paper will focus on these issues as well as provide perspectives on further economic integration in the East Asian region.

### **The Chiang Mai Initiative**

*Quick activation and disbursement are the hallmarks of CMI*

The Chiang Mai Initiative was designed to expand the existing ASEAN Swap Arrangement (ASA), by extending its coverage to all members of ASEAN and by increasing the size of the swap arrangements, and to create a network of bilateral swap agreements (BSAs) between the countries of ASEAN+3. ASA, first established in August 1977, was designed to alleviate temporary liquidity shortages among central banks in member countries, and the facility has been extensively used.<sup>4</sup> Since pre-emptive measures are very important in the battle against a speculative currency attack, quick activation and disbursement are essential and the funds available under ASA and the first 10 per cent of the drawing available under the BSAs are unconditional. Under the expanded ASA, the Agent Bank, whose appointment is subject to rotation among the members, has the task of confirming a request for liquidity and assessing and processing it as expeditiously as possible in consultation with other member banks. Member banks are allowed to swap their own currencies for major international currencies for a period of up to six months

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<sup>3</sup> See the appendix table for an indication of intraregional trade dependence in the ASEAN+3 countries.

<sup>4</sup> The original agreement was signed by Indonesia, Malaysia, the Philippines, Singapore and Thailand.

and for a sum up to twice the amount committed by the member under ASA (Manupipatpong 2002: 116).<sup>5</sup>

The network of bilateral swap arrangements and repurchase agreement facilities<sup>6</sup> so far established is shown in table 1. The idea is that a country under speculative attack can borrow foreign currency, usually the United States dollar, from another country and use the funds to buy its own currency so as to stabilize the exchange rate. The BSAs thus involve a credit risk. The general terms of borrowing are a maturity of 90 days, renewable up to a maximum of seven times, with interest to be paid at a rate based on the London Inter-bank Offered Rate (LIBOR) plus a spread.<sup>7</sup> Although the maximum amount of the automatic disbursement, which is free of any linkage to an IMF programme or conditionality, is currently limited to 10 per cent of the BSA facility, additional assistance can be provided to members requesting it under an IMF programme or an activated Contingent Credit Line.

*The network of bilateral swap arrangements between ASEAN+3 countries is almost complete*

**Table 1. Bilateral swap arrangements under CMI (as of October 2002)**

	<i>Currencies</i>	<i>Maximum drawing</i>
Japan & China	Yen-yuan renminbi	US\$ 3.0 billion equivalent
Japan & Malaysia	US dollar-ringgit	US\$ 3.5 billion*
Japan & Philippines	US dollar-peso	US\$ 3.0 billion
Japan & Republic of Korea	US dollar-won	US\$ 7.0 billion*
Japan & Singapore	US dollar-Singapore dollar	Under negotiation
Japan & Thailand	US dollar-baht	US\$ 3.0 billion
China & Malaysia	US dollar-ringgit	US\$ 1.5 billion
China & Philippines	US dollar-peso	US\$ 3.0 billion under negotiation
China & Republic of Korea	Yuan renminbi-won	US\$ 2.0 billion equivalent
China & Thailand	US dollar-baht	US\$ 2.0 billion
Republic of Korea & Malaysia	US dollar-ringgit	Under negotiation
Republic of Korea & Philippines	US dollar-peso	Under negotiation
Republic of Korea & Thailand	US dollar-baht	US\$ 1.0 billion
<p><b>Sources:</b> &lt; <a href="http://www.mof.go.jp/jouhou/kokkin/pcmie.htm">http://www.mof.go.jp/jouhou/kokkin/pcmie.htm</a> &gt; (Ministry of Finance, Japan, 28 March 2002) and other country-specific web pages.</p> <p>* Including a dollar-won swap arrangement of US\$ 5 billion and a dollar-ringgit swap arrangement of US\$ 2.5 billion from the New Miyazawa Initiative.</p>		

<sup>5</sup> Brunei Darussalam, Indonesia, Malaysia, the Philippines, Singapore and Thailand have committed US\$ 150 million each; Viet Nam has committed US\$ 60 million; Myanmar US\$ 20 million; Cambodia US\$ 15 million; and the Lao People's Democratic Republic US\$ 5 million.

<sup>6</sup> The seller of securities, particularly government bonds, agrees to repurchase them at an agreed price and date, essentially obtaining extra liquidity (short-term loans).

<sup>7</sup> For the first drawing and first renewal the spread is 150 basis points and for every two renewals 50 additional basis points, subject to a maximum of 300 basis points.

*The United States dollar remains the dominant currency in the BSAs but local currencies also play a role*

Currently the United States dollar is the dominant currency under the BSAs with the exception of the China-Japan and China-Republic of Korea arrangements, which will be denominated in local currencies. Cambodia, the Lao People's Democratic Republic, Myanmar and Viet Nam have been given some flexibility for gradual accession to the Arrangement.<sup>8</sup> Details on the phasing-in mechanism are still under consideration.<sup>9</sup>

### The efficiency and effectiveness of CMI

*CMI may help countries to economize on foreign exchange reserves thus increasing efficiency*

After the Asian financial crisis, most countries in the region started to build up their foreign exchange reserves, quite dramatically in some cases (table 2). The main justification seems to be to ensure themselves of the liquidity needed in the event of a future speculative currency attack.<sup>10</sup> The build-up in reserves has occurred even though exchange rate regimes in the region are now much more flexible (see the appendix table) and the resources available to IMF have greatly increased and new lending facilities have been established. It can be argued that the large size of these reserves, in relation

**Table 2. Post-crisis developments in international reserves in ASEAN+3 countries**

(Billions of US dollars, end-year)

	1996	Mid-1997	End-1997	1998	1999	2000	2001
Cambodia	0.3	0.3	0.3	0.3	0.4	0.5	0.6
China	107.0	122.8	142.8	149.2	157.7	168.3	211.8
Indonesia	18.3	20.3	16.6	22.7	26.4	28.5	27.3
Japan	216.7	221.1	219.6	215.5	286.9	354.9	395.2
Lao People's Democratic Republic	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Malaysia	27.0	26.6	20.8	25.6	30.6	29.5	30.5
Myanmar	0.2	0.2	0.2	0.3	0.3	0.2	0.4
Philippines	10.0	9.8	7.3	9.2	13.2	13.1	12.6
Republic of Korea	34.0	34.1	20.4	52.0	74.0	96.1	102.8
Singapore	76.8	80.7	71.3	74.9	76.8	80.1	76.5
Thailand	37.7	31.4	26.2	28.8	34.1	32.0	32.3
Viet Nam	1.7	..	2.0	2.0	3.3	3.4	3.7

Source: IMF, *International Financial Statistics*, various issues.

<sup>8</sup> Cambodia, the Lao People's Democratic Republic and Viet Nam are also currently under the IMF Poverty Reduction and Growth Facility, which "... provides longer-term assistance for deep-seated balance of payments difficulties of a structural nature and aims at sustained poverty-reducing growth" (IMF 2001: 38).

<sup>9</sup> Refer to <<http://www.mfa.go.th/dea/chiangmai%20initiative.htm>> for more details.

<sup>10</sup> In addition to increasing the absolute size of the foreign exchange reserves, the countries have also been paying careful attention to managing the usable amounts of the reserves, as some of these reserves were locked in various financial products or other commitments during the financial crisis and could not be mobilized for protecting their economies when needed.

to trade and to GDP, is inefficient and reflects concern about access to IMF resources on acceptable terms (Henning 2002: 5). Despite the importance of foreign exchange reserves in maintaining investors' confidence and managing exchange market pressure, countries should seek to balance the opportunity costs of holding large amounts of reserves against the perceived benefits. One of the ways to reduce the costs of holding reserves, which tend to increase with the growing volume of international financial transactions, is for a group of countries to pool a portion of their reserves to create new credit facilities for themselves. In this respect, it can be said that CMI has enabled ASEAN+3 countries to improve efficiency in the use of financial resources.

In the 1997 financial crisis, IMF and lender nations granted the Philippines US\$ 1 billion; Thailand US\$ 17.2 billion (of which US\$ 9.5 billion came from ASEAN+3 member countries); Indonesia US\$ 42.3 billion (of which US\$ 13 billion came from ASEAN+3 member countries); and the Republic of Korea US\$ 58.4 billion (of which US\$ 10 billion came from Japan).<sup>11</sup> Clearly, the amount of liquidity currently available through CMI is small relative to the size of past financial rescue packages for the East Asian crisis-hit countries. Furthermore, the current maximum amount that can be provided to a country in distress under the CMI swap arrangements is a drop in the ocean compared with the amounts that global financial markets can mobilize and thus its effectiveness in stabilizing exchange markets is open to question.

Their size notwithstanding, the swap arrangements have a strong symbolic effect as a signal to market participants that liquidity is immediately available and can be extended, if necessary, by the ASEAN+3 member countries themselves, together with the assistance from IMF. The swift availability of liquidity, together with the exchange of information among member Governments on the size and origin of capital movements, helps in curbing currency speculation and in countering investors' herd behaviour, often observed when markets turn down. In this sense, it contributes to reducing the volatility of market sentiment. Although the amount of liquidity that can be quickly mobilized is currently small, it may be increased in the near future through further negotiations among the ASEAN+3 member countries, whose combined foreign exchange reserves are currently estimated (table 2) to be as much as US\$ 900 billion.<sup>12</sup> In this sense, it can be said that the effectiveness of CMI can only improve, if further cooperation, backed by the political will of the member Governments, is forthcoming.

*The swap arrangements under CMI are small but send a strong signal to financial markets*

<sup>11</sup> Indonesia is also currently under the IMF Extended Fund Facility, which provides "... longer-term assistance to support members' structural reforms to address balance of payments difficulties of a long-term character ..." (IMF 2001: 38); the Philippines and Thailand recently concluded Post-Programme Monitoring Discussions with IMF (i.e., the arrangement has expired, but there are still credits outstanding) and Thailand began repayment in late 2000; the Republic of Korea repaid the final installment of its outstanding credits in August 2001 <<http://www.imf.org/external/country/index.htm>>.

<sup>12</sup> For example, if ASEAN+3 member countries would agree to pool 10 per cent of their foreign exchange reserves, additional liquidity of US\$ 90 billion would be available to serve as "first-aid" funds for stabilizing the markets.



## The relationship of CMI and IMF

In 1997, the four crisis-hit East Asian countries (Indonesia, the Philippines, the Republic of Korea and Thailand) had to seek international financial rescue. From the viewpoint of these countries, the help provided was neither swift nor sufficient to pacify turbulent markets, and the policy prescriptions imposed by IMF conditionality caused the economies of the affected countries to sink into unprecedentedly deep and enormously painful recessions. When speedy measures were needed, the negotiation of conditionality requirements with IMF took time, and the news that assistance was being sought actually aggravated the situation as it shook investor confidence further. By the time the assistance package finally took shape, a great deal of damage had already been done and restoration of confidence took a long time.

*CMI has found a compromise with IMF conditionality so as to minimize moral hazard*

Part of the problem was that countries in distress tended to postpone approaching IMF for liquidity assistance as long as possible in order to avoid the austere IMF conditionalities and the associated loss of confidence. The unconditional and immediate disbursement of some of the funds available under CMI swap arrangements is a partial answer to these concerns. However, the requirement that countries needing assistance beyond the initial 10 per cent available under the BSAs accept a linkage to IMF conditionality is something of a compromise. In this sense, the swap arrangements under CMI can be said to be supplementary to the existing IMF financing facilities. The linkage to IMF conditionality requirements provides some comfort to lenders as it limits the moral hazard problem, together with the progressive interest rate structure; but it also leaves open the danger that sufficient swap funds will not be available until it is too late.

*Complementarity to existing multilateral arrangements is the key to developing regional financial facilities*

In September 1997, Japan proposed the idea of creating an Asian monetary fund (AMF) that would supplement IMF resources for crisis prevention and resolution. Among Asian countries discussions had been taking place that a regional fund could have a comparative advantage in diagnosing regional economic problems and prescribing appropriate solutions, and that pluralism would increase competition and yield better results in the market for ideas. Some doubts were also cast on the effectiveness of international standards and the legitimacy of imposing them on developing countries, on the grounds that perhaps there was no universal best practice. International standards were neither closely aligned with regional interests nor sensitive to regional conditions or needs. The AMF proposal, however, met with stiff opposition from the United States and IMF, on the grounds that it could encourage countries to postpone needed restructuring measures, and it came to nought. After some vicissitudes, the idea of AMF was reformulated and modified to a simpler form of swap arrangements and more recently IMF has appeared to be willing to accommodate the trend to regionalization as long as it is not pursued in opposition to IMF but in a complementary fashion.

### Further refinement of CMI

The swap arrangements are intended to be a preventive measure for providing support for the balance of payments and short-term liquidity. In this sense, they are similar to the IMF Emergency Financing Mechanism, which is to be used only in circumstances representing, or threatening to give rise to, a crisis in a member's balance of payments requiring an immediate IMF response.<sup>13</sup> If CMI is to function effectively, providing added value to existing mechanisms, the network of BSAs will need to establish a very good regional surveillance system, as well as a coordinating and decision-making process for speedy activation and disbursement of swaps.

*A strong regional surveillance system is needed to improve the effectiveness of the network of BSAs*

Further, it could be argued that it would make CMI more effective and acceptable if certain policy conditionality requirements were specified in advance before liquidity is needed to save time in conducting the swap procedure. IMF introduced in 1999, and revised in 2000, Contingent Credit Lines for member countries not at risk of an external payments crisis of their own making but vulnerable to contagion effects from capital account crises in other countries, assuming that these countries were already fulfilling key requirements regarding the fiscal balance, economic growth, inflation, capital flows, international reserves, the current account balance and the soundness of the financial system. In either the ASEAN+3 or the IMF context, policy conditionality could be defined and incorporated in monetary cooperation along the lines of aiming to meet the criteria for non-crisis periods, so enhancing the effectiveness of the mechanism. Adhering to or aiming at fulfilling reasonably strict criteria for non-crisis periods would add to the stability of a country and so contribute to lowering its risk premium in international capital markets, thereby giving the country an incentive to comply. If a crisis still occurred, interim financing could become available immediately without the need to implement normal IMF conditionality, since presumably these countries would have met such conditions beforehand. In effect, it might even help in furthering regional financial and monetary cooperation.

*Adherence to reasonably strong macroeconomic criteria for non-crisis periods will go far in stabilizing exchange markets*

### Perspectives on regional cooperation in East Asia beyond the swap arrangements

The concept of monetary and financial cooperation can range from swap arrangements to a full monetary union, with various stages in between. Hence, there are wide-ranging considerations regarding the possible evolutionary paths from the current situation to an East Asian monetary fund, not the least of which is the implicit choice of exchange rate regime.

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<sup>13</sup> It is also similar to the IMF Supplemental Reserve Facility (SRF) established in December 1997 to provide financial assistance to members experiencing exceptional balance of payments difficulties due to short-term financing needs resulting from a sudden and disruptive loss of market confidence, reflected in pressure on the capital account and the member's reserves. SRF is to be used in cases where the magnitude of the outflows may create a risk of contagion that could potentially threaten the international monetary system.

Although the Chiang Mai Initiative is often viewed as potentially being the foundation of a monetary system for East Asia, it is premature to say whether this will, in fact, be the case in the near future.

*Regional financial integration is still a distant goal despite the creation of CMI*

The recent liberalization and deregulation of financial markets in East Asian countries has driven them to closer integration into global financial markets rather than strengthening regional financial integration. Differences in the stages of development and in the legal and regulatory environments between countries in the region have so far hampered greater financial integration. Increased economic convergence, combined with the adoption of international best practices in terms of financial legislation and regulation, may eventually generate a situation conducive to the creation of an AMF. However, the huge gap in financial expertise, technology, infrastructure and market size between the emerging markets of East Asia and the international financial centres in developed countries has led to a situation where financial services in the region are increasingly being provided by international corporations. This could have the effect of preventing sufficient expertise from being built up in the region and also limit the extent to which regional identification develops as a driving force.

*The creation of free trade areas is now the focus of interest*

After having achieved some tangible results through the creation of CMI, the focus of interest of ASEAN+3 member countries seems to have shifted from regional financial and monetary cooperation to the establishment of free trade areas (FTAs). The ASEAN Free Trade Area (AFTA) is now in operation, while China and ASEAN are soon to sign an agreement creating an FTA within 10 years. Japan has an FTA with Singapore and is pursuing closer economic partnerships with other countries in the region. The Republic of Korea and Thailand are also in discussions on establishing an FTA. The final outcome of these developments will depend on the political will and economic goals of the Governments concerned. There could be an ASEAN+1, an ASEAN+2 or even an East Asian Community comprising ASEAN+3 countries. Were a North-East Asia FTA to emerge, it could provide a strong impulse to further regional integration, alongside the global integration process now taking place.

*Japan's leadership role is diminishing as economic problems linger*

However, there are some barriers on the path to broader integration of East Asian countries. First, Japanese commercial banks have reduced their lending to other East Asian countries, and Japanese investment banks have been driven out of the financial services markets as a result of protracted financial problems. Thus, the role of Japan as the leader in the creation of an East Asian economic entity has diminished and the yen is declining in importance as an international currency. Second, China is growing fast and expanding its trade relations with neighbouring countries including ASEAN, but its currency and banks are not quite ready as yet for international business transactions. Forging a consensus on greater economic and financial integration is likely to be more difficult in an increasingly bipolar East Asian region. An economic revival in Japan and closer Sino-Japanese economic and financial ties would advance regional integration considerably. Nevertheless, the greater diversification in Governments, levels of economic development and history of the region than was present in the case of Europe, for example,



suggests that the integration process in East Asia will have to chart its own course and will need considerable time. Further, no serious consideration has yet been given to the possible evolution of CMI into a regional mechanism for exchange rate coordination. Thus, at this stage, it would be desirable and more appropriate for the CMI member countries to focus on areas where consensus is most likely to be reached and to start from there in expanding cooperation further.

### Summary

Based on the discussion above, the following conclusions can be highlighted:

- The experience of the 1997 financial crisis suggests that the size of the swap arrangements in CMI may not be commensurate with the amounts that global markets can mobilize. However, these arrangements should be considered to be complementary to existing IMF facilities. Further, they have an important symbolic value in terms of the signal they give to markets of a regional commitment to support a currency under attack. In this respect, it is relevant to note that the region was able to raise substantial liquidity to supplement the IMF disbursements during the crisis.
- Other countries in the Asian and Pacific region may be interested in copying CMI, although its effectiveness in the face of a looming crisis remains to be tested.
- Establishing swap arrangements does not supersede addressing structural and financial sector weaknesses. The Argentine crisis is a case in point. It is desirable that countries aim at fulfilling reasonably strict criteria (prudent budgets, low inflation, strong banking systems, low levels of short-term debt, and so on) in normal times, which will actually reduce their exposure to a crisis. Should a crisis still occur, the disbursement of swaps can be speeded up and some comfort provided to lenders, as conditionalities will already have been met. It is important to note that there has to be room for manoeuvre in the event of a crisis; for example, expansionary fiscal policy might be justified even if it means breaching the criterion on prudent budgets temporarily.
- The Chiang Mai Initiative of the ASEAN+3 countries has contributed to improving exchange rate stability and in doing so may also have contributed to closer regional economic and financial integration. However, much work remains to be done in this regard, not least in strengthening the network of bilateral swap arrangements.

**Appendix table. Intraregional trade dependence in ASEAN+3 countries**

	<i>Trade (percentage of total in 2000)</i>			<i>Exchange rate regime</i>
	<i>ASEAN+3</i>	<i>Japan</i>	<i>United States</i>	
Brunei Darussalam	74.2	29.5	11.6	Currency board peg to Singapore dollar
Cambodia	32.5	2.5	27.8	Managed float
China	33.1	17.5	15.7	Fixed peg to US dollar
Indonesia	50.6	20.7	12.4	Float
Japan	31.0	..	25.3	Float
Lao People's Democratic Republic	74.9	3.0	1.2	Managed float
Malaysia	49.4	16.7	18.8	Fixed peg to US dollar
Myanmar	53.4	7.4	10.6	Fixed peg to US dollar
Philippines	39.4	16.6	23.9	Float
Republic of Korea	36.7	15.7	20.2	Float
Singapore	46.5	12.3	16.2	Managed float
Thailand	47.7	20.5	17.5	Managed float
Viet Nam	56.2	16.3	4.2	Managed float
<p><i>Sources:</i> IMF, <i>Direction of Trade Statistics Yearbook 2001</i> ; IMF, "Exchange rate regimes: is the bipolar view correct?", available at &lt;<a href="http://www.imf.org/external/np/speeches/2001/010601a.htm">http://www.imf.org/external/np/speeches/2001/010601a.htm</a>&gt; ; BIS, <i>Quarterly Review</i> , December 2001; and ADB, <i>Key Indicators of Developing Asian and Pacific Countries 2002</i>.</p>				

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