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**From the Chiang Mai Initiative to an
Asian Monetary Fund**

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Abstract

Following the 1997–1998 Asian financial crisis, financial authorities in ASEAN+3 embarked on several new initiatives for East Asia’s financial cooperation, including: (i) regional economic surveillance led by the Economic Review and Policy Dialogue (ERPD); (ii) a regional liquidity support facility, called the Chiang Mai Initiative (CMI); and (iii) local-currency bond market development. The global financial crisis of 2007–2009 demonstrated the need to further strengthen East Asian financial cooperation. This paper summarizes and evaluates the progress of regional financial cooperation, particularly the ERPD, the CMI and its subsequent multilateralization (CMIM), and the ASEAN+3 Macroeconomic Research Office (AMRO). It identifies the challenges in strengthening the CMIM, ERPD, and AMRO and suggests that the CMIM and AMRO be transformed into an Asian monetary fund (AMF). The paper argues that for an AMF to emerge, ASEAN+3 authorities need to: (i) contribute part of their foreign exchange reserves to the fund; (ii) establish a secretariat in charge of all aspects of the CMIM, including its activation; and (iii) delink the CMIM from the International Monetary Fund (IMF) programs by upgrading their capacity to conduct regional surveillance, formulate independent conditionality associated with crisis lending, and monitor policy and economic performance. In the transition period, eligible member countries should be allowed to have more flexible access to the CMIM facility. The CMIM and AMRO should work with the IMF to promote East Asian financial stability, but at the same time the IMF needs to undertake significant operational and governance reforms so that it regains the trust of emerging economy members in the region.

JEL Classification: F33, F36

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1. INTRODUCTION: KEY ISSUES

The Asian financial crisis of 1997–1998 devastated not only the currency values and the financial systems of crisis-affected countries (Indonesia, the Republic of Korea, Malaysia, and Thailand), but also their overall economic activity, social conditions and, in some countries, political systems. The financial crisis and its spread across the region revealed several important points: financial systems and economic conditions were closely interconnected across East Asia; reliance on the International Monetary Fund (IMF) alone for crisis management was not the best option; and there was a need to create a regional self-help mechanism for effective prevention and management of financial crises. Recognizing this, central banks and governments in East Asia—particularly the 10 Association of South East Asian Nations (ASEAN) countries plus the People’s Republic of China (PRC), Japan, and the Republic of Korea¹—embarked on several new initiatives for regional financial cooperation, including regional economic surveillance led by the Economic Review and Policy Dialogue (ERP), a regional liquidity support facility, called the Chiang Mai Initiative (CMI), and local-currency bond market development.

The global financial crisis of 2007–2009 demonstrated the need to strengthen East Asia’s regional financial cooperation. While the crisis severely affected many East Asian countries through trade channels, it also created shortages of international liquidity in a few countries, particularly the Republic of Korea and Indonesia. The Republic of Korea saw sudden capital flow reversals in the aftermath of the collapse of Lehman Brothers in September 2008 and encountered a "mini currency crisis," i.e., a rapid loss of foreign exchange reserves and sharp currency depreciation. Unwilling to go to the IMF or the newly established CMI for short-term liquidity support, the Korean authorities chose to secure a \$30 billion currency swap line from the United States Federal Reserve (US Fed). This had an immediate, positive, and stabilizing impact on the financial and foreign exchange markets in Seoul. The World Bank, the Asian Development Bank (ADB), Australia, and Japan provided financial support to ensure that the Indonesian government could raise sufficient fiscal resources in the international capital market.

Responding to the deepening global, financial crisis, central banks in the major developed economies—the US Fed, the Bank of England, the Bank of Japan (BOJ), and the European Central Bank—reduced their policy rates to near zero and all of them eventually adopted unconventional monetary policy measures, called quantitative easing (QE). In particular, the US Fed resorted to several rounds of QE. Its adoption of the first round (QE1) in March 2009 generated considerable debate about its global impact as this led to US dollar depreciation which was seen as the launch of a “currency war.” But when the US Fed Chairman, Ben Bernanke, suggested a possible tapering off of QE policy in May 2013, global financial markets reacted with volatility because they expected that the US ultra easy monetary policy would end and US policy interest rate would go up. The “fragile five” emerging economies—Brazil, India, Indonesia, South Africa, and Turkey—experienced significant capital outflows, stock price declines, and exchange rate depreciations. This "taper tantrum" generated the fear that some East Asian economies might experience another currency crisis if US monetary policy was normalized prematurely.

This paper is organized as follows. Section 2 contains a review of the experiences and lessons learned from the Asian financial crisis, the global financial crisis, and the recent taper tantrum as a background for the analysis of financial safety nets in East Asia, particularly the CMI. Section 3 summarizes and evaluates the progress of financial cooperation in the region on the ERP, the CMI, its multilateralization, and the establishment of the ASEAN+3 Macroeconomic

¹ These 13 countries are collectively called ASEAN+3.

Research Office (AMRO). Section 4 discusses the challenges that East Asian economies face in strengthening the Chiang Mai Initiative Multilateralization (CMIM), ERPD and AMRO, and a possible evolution of CMIM and AMRO toward an Asian monetary fund (AMF). Section 5 concludes the paper.

2. LESSONS LEARNED FROM THE FINANCIAL CRISES AND TURMOIL IN ASIA

2.1 Asian Financial Crisis

The Asian financial crisis of 1997–1998 devastated the economies of Indonesia, the Republic of Korea, Malaysia and Thailand, and adversely affected several neighboring economies such as Hong Kong, China and the Philippines. The crisis—in the form of a combination of currency and banking crises—was driven by rapid capital inflows followed by equally rapid outflows of capital, which led to sharp currency depreciations in affected economies. In this sense, the currency crisis was a capital account crisis, rather than the more traditional current account crisis that had characterized many Latin American crises before the mid-1990s. The banking sector played a critical role in intermediating excessively large amounts of external short-term funds in foreign currency for long-term domestic investment, thereby creating “double mismatch” problems (in currency and maturity) and potential for bad loans. Essentially volatile capital flows together with inadequately managed domestic banking systems generated the Asian financial crisis.

2.1.1 Crisis Development

The baht devaluation of July 1997 was the beginning of the crisis. It was triggered when investors perceived that the financial sector was deteriorating and that the currency was unsustainably overvalued. Once the value of the baht declined sharply, currency speculation and crises spread quickly, in a matter of a few months, to Indonesia, the Republic of Korea, Malaysia and the Philippines. The speed and extent of the regional “contagion” of the currency crisis was remarkable, suggesting that the economic linkage through intra-regional trade, investment, and finance had been much more pronounced within East Asia than had been previously realized.

During 1997–1998, a crisis that at first seemed to be relatively benign evolved into a full-blown financial and economic crisis in the affected countries. The crisis deepened because of pervasive weaknesses in the financial and corporate sectors of these economies. Gross domestic product (GDP) growth in the crisis-affected economies declined sharply from a precrisis average of positive 7.1% during 1990–1996 to negative 7.6% in 1998. The depth of the collapse in Indonesia, with GDP contracting by more than 13% in 1998, was among the largest peacetime contractions, excluding the experience of several socialist transition economies in the early 1990s. The simultaneity of this economic contraction in the affected economies in 1998 reflected strong regional economic interdependence.

2.1.2 Lessons from the Crisis for Regional Financial Cooperation

There are many lessons to be learned from the crisis, including those that arose from some alleged mistakes committed by national policy makers as well as the IMF, which intervened in Indonesia, the Republic of Korea, and Thailand. It has been claimed that several IMF misjudgments actually exacerbated the crises in the countries where they intervened (IMF 2003). Particular issues were the:

- (i) limited size of financing packages, particularly in Thailand, which received only \$17.2 billion;
- (ii) tight fiscal policy in the condition of deteriorating aggregate demand;
- (iii) use of tight monetary policy with a fragile banking sector instead of putting in place standstill arrangements and avoiding prolonged monetary tightening;
- (iv) free floating of currencies that led to steep exchange rate depreciations in the presence of balance sheet risks of currency mismatches;
- (v) banking sector mismanagement, including the premature closure of 16 banks in Indonesia without bank deposit guarantees;
- (vi) excessive structural conditions beyond macro-related issues particularly in Indonesia; and
- (vii) lack of early focus on corporate debt and insolvency issues.

Clearly the IMF could have offered much better services for crisis-affected countries. The most important lesson was that it was better to prevent a crisis than cure one, which highlighted the importance of macroeconomic and financial surveillance. However, as crises can occur, a system of crisis management and resolution would have to be put in place and/or strengthened. For example, appropriate policy responses and timely provision of large-scale international liquidity (through the IMF or a regional liquidity arrangement) is needed to prevent the economy from slipping into a serious economic contraction of systemic proportions. Following the crisis, it was recognized that a well-designed regional framework could contribute to the stability of East Asia's financial systems in three ways. First, reliance on the IMF alone for crisis management was not the best option. Second, a regional self-help mechanism would allow for effective prevention and management of financial crises. Third, a regional framework for financial cooperation was logical, given the presence of strong regional economic and financial interdependence.

2.1.3 Proposal for an Asian Monetary Fund

In August 2007, soon after the financial crisis in Thailand began, the Japanese government hosted a meeting among the "Friends of Thailand" to reach an agreement on a much-needed financial support package for the country.² In September, following on from this success, Japan proposed to establish an AMF, which was designed to supplement IMF resources for crisis prevention, management, and resolution. The idea was supported by the Republic of Korea and several major ASEAN countries. The aim of the AMF was to pool foreign exchange reserves held by the East Asian authorities both to deter currency speculation and, once a crisis had occurred, to contain a currency crisis and the resulting contagion in a member economy. It was said at the time that as much as \$100 billion would be mobilized.

² The "Friends of Thailand" were economies which extended financial assistance to Thailand in 1997 and included Australia, Brunei Darussalam, the People's Republic of China (PRC), Indonesia, Japan, the Republic of Korea, Malaysia, and Singapore.

However, the United States and the IMF opposed this proposition on the grounds of moral hazard and duplication. They argued that an East Asian country hit by a currency crisis would bypass the tough conditionality of the IMF and receive easy money from the AMF, thereby creating the potential for moral hazard. They also reasoned that an AMF would be redundant in terms of its expected businesses and operations in the presence of an effective global crisis manager, the IMF. Without the clear support of the People's Republic of China (PRC), Japan eventually shelved the idea.³

In return, in 2000 the regional economies jointly embarked on initiatives to strengthen the three pillars of the regional financial architecture: an economic and financial surveillance mechanism led by the ERPD, a liquidity support facility called the CMI, and Asian bond market development.

2.2 Global Financial Crisis

The global financial crisis provided important lessons for the CMI, as no country wished to use it, even when hit hard by currency speculation and capital flow reversals. The Republic of Korea and, to a lesser extent, Indonesia, provide good case studies.

2.2.1 Impact of the Crisis and the Policy Responses of the Republic of Korea

The economy of the Republic of Korea had enjoyed relatively stable economic growth in the early 2000s. The banking system was well-capitalized, nonperforming loans remained low, and the balance sheets of large firms were generally healthy. However, there were some concerns over the high levels of foreign debt (\$210 billion in June 2008) and loan–deposit ratios (127%) in the banking sector. The collapse of Lehman Brothers in September 2008 hit the financial market of the Republic of Korea hard as foreign investors began to withdraw funds from the country and both domestic currency and foreign exchange liquidity tightened for domestic banks with large wholesale financing requirements.

The Bank of Korea had lost large amounts of foreign exchange reserves since March 2008; the reserves declined from \$264 billion in March to just below \$200 billion in November. The spread of credit default swap in the Republic of Korea had started to rise in late 2007, reaching a peak of 700 basis points in late October 2008. The won started to depreciate rapidly, from a strong W907 per US dollar recorded in October 2007 to W1,483 per US dollar in November 2008.⁴

The authorities in the Republic of Korea responded swiftly to the impacts of the global financial crisis. The Bank of Korea aggressively eased its monetary policy in order to soothe the financial market unrest and ward off a sharp contraction of the real economy. It brought its base rate down by a total of 3.25 percentage points, to its lowest level of 2% in six steps from October 2008 to February 2009. Along with this, it expanded liquidity in those sectors badly affected by the credit crunch through its open market operations and lending facilities. At the same time, it

³ The PRC did not express clear views over Japan's proposal; it neither supported nor rejected it. Eisuke Sakakibara, then vice minister of finance for international affairs of Japan's Ministry of Finance, told the author that if the PRC had supported Japan's proposal then he would have gone all the way to create an AMF despite the US and IMF opposition. He also acknowledged that the lines of communication between the finance ministries of Japan and the PRC had not been well-established then and the lack of intensive information exchange had prevented the PRC's clear support of the Japanese proposal from being obtained. Taking this as an important lesson, the lines of communication between the two ministries, and those among wider ASEAN+3 countries, have deepened since then.

⁴ The value of the won recovered afterward but then reached its weakest level of W1,516 to the US dollar in February 2009. Since then the won has strengthened.

actively provided foreign-currency liquidity to domestic financial institutions through, for example, the swap market, in order to stabilize the foreign exchange market that was directly hit by the impact of the global financial crisis. The government also guaranteed all foreign debts in the banking sector until 2011 and adopted expansionary fiscal policy as soon as the global financial crisis began to affect the economy.

Unwilling to go to the IMF or CMI (which was tightly linked with the IMF), the financial authority of the Republic of Korea entered into a \$30 billion bilateral currency swap arrangement with the US Fed in October 2008 and with the BOJ and the People's Bank of China in December 2008. The currency swap arrangement with the US Fed had an immediate, stabilizing impact on the market. In 2009, the low won helped export recovery and reserve accumulation to \$249 billion in September. The won began to restore its value gradually.

2.2.2 Indonesian Experience

Although Indonesia did not face financial turmoil or a (mini) currency crisis as severe as that of the Republic of Korea in the aftermath of the Lehman Brothers shock, it similarly sought a bilateral currency swap arrangement with the US Fed as the rupiah depreciated sharply. But the US Fed declined to provide a currency swap for Indonesia. In 2009, to overcome difficulties in raising funds for fiscal purposes, the country secured \$5.5 billion in "standby loan facility," or "deferred drawdown options" from the World Bank (\$2 billion), the ADB (\$1.5 billion), Australia (\$1 billion), and Japan (\$1 billion). This facility gave the Indonesian government access to financial resources for budgetary support to cope with the crisis.

The Ministry of Finance of the Government of Japan introduced a mechanism to enable developing Asian economies to issue Samurai bonds to a maximum value of ¥500 billion (\$5 billion) by providing sovereign guarantees through the "Market Access Support Facility" established by the Japan Bank for International Cooperation (JBIC). In this framework, a maximum of \$1.5 billion equivalent of yen was committed to Indonesia so that the government could issue Samurai bonds to the amount of ¥35 billion (\$350 million) with JBIC's full guarantee of the principle and partial guarantee of interest payments.⁵ This support helped Indonesia to raise yen funds at a time of market turbulence.

2.2.3 Lessons

The most important and significant measure to calm panic in the financial market of the Republic of Korea was the currency swap arrangement with the US Fed. There were several success factors. First, it was a preemptive measure in the sense that the US dollar liquidity support was provided in the middle of the market turmoil but before a currency crisis. It had an important calming effect on the financial market. Second, the size was large enough to contain currency speculation. Third, it was done through the US Fed's arrangements with other countries (Brazil, Mexico, and Singapore) and the Republic of Korea was not the only country that received a commitment of liquidity support from the US Fed.

But the fact that Indonesia could not obtain the US Fed's currency swap line suggests that a bilateral currency swap with the US Fed might not be guaranteed in the future and that emerging economies would have to seek alternative ways to maintain currency and financial stability. The IMF would be a global solution and the CMI would be a useful regional solution, while other arrangements, such as those from multilateral development banks and bilateral agencies, could also play a useful role. An important lesson for East Asia was that the region

⁵ In the event that Indonesia would not be able to issue bonds, it was agreed that JBIC would participate in the joint lending arrangement for Indonesia organized by the World Bank and ADB. Indonesia was able to issue Samurai bonds.

had to strengthen the CMI so that the region's economies hit by serious financial turmoil and large-scale capital outflows would be able to use it to ensure macroeconomic and financial stability without going to the IMF.

2.3 Taper Tantrum

US monetary policy changes can significantly affect many countries, including emerging economies. Indeed, the introduction and successive strengthening, as well as the tapering off, of the US Fed's QE exerted symmetrical spillover effects on several emerging economies.

2.3.1 United States Quantitative Easing Monetary Policy

Responding to the impact of the global financial crisis, the US Fed reduced their policy rates to near zero and resorted to several rounds of QE measures. The adoption of the first round (QE1) in March 2009 generated large capital flows from the US to the rest of the world, particularly emerging economies with strong growth prospects.⁶ This resulted in US dollar depreciation and currency appreciations in several emerging economies. Some emerging economy policymakers claimed that the US had launched a “currency war.”

Data suggest that the QE policy in the US, particularly QE1 (but not necessarily QE3), did affect financial markets and capital flows in emerging economies. For example, ADB (2013) concluded that QE1 had pronounced effects on domestic financial variables in Asian emerging economies, especially on nominal exchange rates, while QE2 and QE3 effects were relatively mild. There is some evidence that economies that allowed their exchange rates to appreciate did not experience significant asset price rises, implying that central banks in emerging economies had to strike a balance between maintaining international price competitiveness and preventing asset price bubbles when they face large and sustained capital inflows.

2.3.2 Impact of the United States Federal Reserve Indication of Quantitative Easing Tapering

In May 2013, former US Fed Chairman, Ben Bernanke, indicated a future unwinding of QE3. Financial markets, both domestic and global, reacted in a volatile way. Domestic long-term yields on Treasuries went up by around 100 basis points, and capital outflows were triggered from a group of major emerging economies—notably the “fragile five,” i.e., Brazil, India, Indonesia, South Africa, and Turkey—causing stock prices to decline and their currencies to depreciate. Several countries lost sizable amounts of foreign exchange reserves due to currency market pressures. These key emerging economies saw currency depreciations of 15%–20%, and some of them experienced similar declines in stock prices.

The economies whose exchange rates were affected most—Brazil, India, and Indonesia—had large current account deficits, high inflation rates, and high public debt to GDP ratios. Large current account deficits and unfavorable debt conditions seem to have made these economies more susceptible to changes in market sentiments, even though these problems had been there for some time. Other emerging economies with sound macroeconomic fundamentals were not affected to the same degree.

⁶ The US Fed adopted a zero interest-rate policy in December 2008, QE1 in March 2009–March 2010, QE2 in November 2010–June 2011, and QE3 in September 2012–October 2014. It should be noted, however that the US Fed has never referred to its measures as QE, preferring the expression “large-scale asset purchase program.”

2.3.3 Quantitative Easing Unwinding and Policy Normalization

The US Fed decided to begin tapering QE in December 2013, and gradually and cautiously proceeded with QE unwinding over the next 10 months. Starting in January 2014, it reduced the amount of asset purchases, step by step, at every Federal Open Market Committee meeting until October 2014 when the Fed finally ended the QE3 program. The Fed managed the process of QE3 unwinding remarkably well, without generating serious market turmoil in the US or in the rest of the world.

Following the end of QE3, the US Fed, under Janet Yellen, has been heading toward monetary policy normalization. Policy normalization could be achieved by reversing the QE program (i.e., selling the assets the Fed had purchased), by raising the policy interest rate, or by a combination of the two. The Fed could dispose of assets in two ways: by not replacing the assets as they mature and by actively selling them back into the market. The first option seems likely to have a less disruptive impact on the market than the second. However, if the pace of the interest rate hike is faster than expected, the reactions of financial market could be volatile. There is a risk that fragile emerging economies will be affected and that some of them could potentially face considerable liquidity shortage problems. The potential for financial turbulence is likely to remain until the Fed raises the policy rate to a level that is consistent with stable economic growth and low inflation.

3. CHIANG MAI INITIATIVE AND ECONOMIC REVIEW AND POLICY DIALOGUE

Leaders of the ten ASEAN member countries plus the PRC, Japan, and the Republic of Korea initiated the ASEAN+3 process in 1997.⁷ When the leaders met in 1999, their statement on monetary and financial cooperation included the following: “they agreed to strengthen policy dialogue, coordination and collaboration on the financial, monetary and fiscal issues of common interest, focusing initially on issues related to macroeconomic risk management, enhancing corporate governance, monitoring regional capital flows, strengthening banking and financial systems, reforming the international financial architecture, and enhancing self-help and support mechanisms in East Asia through the ASEAN+3 Framework, including the ongoing dialogue and cooperation mechanism of the ASEAN+3 finance and central bank leaders and officials” (Government of Japan, Ministry of Foreign Affairs 1999).

The group’s finance ministers have been active in regional financial cooperation, including the launch of the CMI as the region’s liquidity support arrangement, and the ERPD process as the region’s economic surveillance mechanism, both in May 2000, and the Asian Bond Markets Initiative as the region’s project for local-currency bond market development in August 2003.⁸ Since then, the ASEAN+3 finance ministry officials have begun to improve the functioning and effectiveness of the CMI and ERPD (Box 1).

⁷ ASEAN+3 leaders initially focused on macroeconomic and financial issues but later expanded to include many other processes for ministerial departments, including foreign affairs, economy and trade, environment, energy, health, labor, science and technology, and social welfare, among others.

⁸ See Kuroda and Kawai (2002), Rajan and Siregar (2004), Kawai (2005), and ADB (2008).

Box 1: Progress on the Chiang Mai Initiative, the Economic Review and Policy Dialogue, and the Association of South East Asian Nations+3 Macroeconomic Research Office

Continuous progress has been made to strengthen the Chiang Mai Initiative (CMI) and Economic Review and Policy Dialogue (ERPD) since their launch, including the multilateralization of the CMI and the establishment of the Association of South East Asian Nations+3 Macroeconomic Research Office (AMRO). Some of the major developments over the last 10 years include

- the launch of the CMI and ERPD process to strengthen the existing financial cooperation frameworks in East Asia (May 2000);
- progress on the bilateral swap arrangements (BSAs) and repurchase agreements under the CMI, and enlargement of the Association of South East Asian Nations Swap Arrangement to \$1 billion in November 2000 (May 2001);
- progress on the CMI with six BSAs with a combined size of \$17 billion (May 2002);
- progress on the CMI with the total number of BSAs doubling to 12 and the size of the network rising to \$31.5 billion, support for the establishment of the early warning system to strengthen participating members' surveillance capacity, and the launch of the Asian Bond Markets Initiative to promote local-currency bond markets (August 2003);
- expansion of CMI BSAs to sixteen with the total size of the network reaching \$36.5 billion (May 2004);
- integration and enhancement of ERPD into the CMI framework (May 2005), expansion of ASA from \$1 billion to \$2 billion, and raising the ceiling for withdrawal without an IMF program in place from 10% to 20% of the total (May 2005);
- adoption of the collective decision-making procedure for CMI swap activation, as a step toward multilateralizing the CMI (May 2006);
- agreement in principle on a self-managed reserve pooling arrangement governed by a single contractual agreement as an appropriate form of Chiang Mai Initiative Multilateralization (CMIM) (May 2007);
- agreement on the total size of the CMIM to be between \$80 billion and \$120 billion and on the proportion of contribution coming from ASEAN countries and the Plus-3 countries to be 20:80 (May 2008);
- agreement on all the main components of the CMIM, with its total size set at \$120 billion, and its implementation before the end of the year, and agreement to establish an independent surveillance unit as soon as possible (May 2009);
- agreement on all the main components of AMRO (May 2010);
- endorsement of the "Operational Guidelines for Enhancing Effectiveness of CMIM" (May 2011);
- participation of the central bank governors in the meeting, agreement to strengthen the CMIM through doubling the total size of CMIM to \$240 billion, increasing the IMF-delinked portion to 30%, and introducing a crisis prevention facility called the "CMIM Precautionary Line" (May 2012);
- finalization of the amendment of the CMIM Agreement, and agreement to transform AMRO to an international organization (May 2013); and
- continued efforts to develop CMIM operational readiness through the revision of the Operational Guidelines of the amended CMIM Agreement, and commitment to enhance the organizational structure and capacity of AMRO and its strategic partnerships with other international financial institutions (May 2014).

Source: Joint Statement of ASEAN+3 Finance Ministers (and Central Bank Governors) Meetings, various years.

3.1 Economic Review and Policy Dialogue and the Association of South East Asian Nations+3 Macroeconomic Research Office: Launch of the Economic Review and Policy Dialogue Process

The ERPD was introduced in May 2000 as a peer review and policy dialogue process to support regional economic surveillance that would promote macroeconomic and financial stability in the region. It was designed to help prevent financial crises through the early detection of financial irregularities, vulnerabilities, and systemic risks, and the swift implementation of corrective policy actions. Its modality was (and still is) information exchange, policy discussions, and peer reviews, which are the basis for enhancing regional monetary and financial cooperation. The ERPD was intended to facilitate analysis of economic and financial conditions of the global, regional, and individual national economies; monitoring of regional capital flows and financial market developments; identifying and managing vulnerabilities and risks; and making policy recommendations for national policymaking as well as joint actions on issues affecting the regional economies. The expectation was that countries would implement better macroeconomic and financial sector policy at the national level as a result of peer pressure and would pursue policy coordination, if needed, to promote regional macroeconomic and financial stability.

Without strong supporting mechanisms for such surveillance, however, the ERPD process was not as successful as initially expected, though gradual improvements were made over time. Problems included the lack of a competent secretariat that could support the surveillance process in a professional way, and the absence of central bank governors in the process, even though central bank contribution to the process was considered necessary.⁹

Recognizing these problems, the ASEAN+3 authorities began to make efforts to enhance the effectiveness of the ERPD. First, the ERPD was integrated into the CMI in May 2005, as this was considered critical to economies engaged in short-term liquidity support under the CMI. Liquidity support would require close economic and financial surveillance, as well as conditionality-triggering policy adjustments in the event of a currency crisis. Without such surveillance, it might be difficult for potential creditors to identify emerging risks in potential borrowing countries, to formulate effective conditionality, and to monitor the policies and economic and financial performance of the borrowing countries during the period of liquidity support. For this reason, the ASEAN+3 group decided to enhance the effectiveness of ERPD as an integral part of CMI, and this remains so under the current CMI (now called the CMIM).

Second, central bank governors started to join the ASEAN+3 process, particularly its ERPD and CMIM process in May 2012. Central banks do have comparative advantage over macroeconomic and financial surveillance and play critical roles in the actual disbursements of liquidity once assistance needs arise. The participation of central bank governors can improve the quality of ERPD.

Third, a new surveillance unit, AMRO, was established in Singapore in May 2011 to support ERPD and the decision making of CMIM. AMRO was tasked to monitor and analyze regional economies, with a view to enhance the effectiveness of the surveillance mechanism through the

⁹ Nonetheless central bank deputies participated in the ASEAN+3 Finance Deputies' Meetings from the beginning. Central bank governors in the region have formed the Executives' Meeting of East Asia-Pacific Central Banks as a completely separate forum from the ASEAN+3 finance ministers' process. Its activities include annual meetings of the governors of the Executives' Meeting of East Asia-Pacific Central Banks, semiannual meetings of the deputy governors, and three working groups concerned with bank supervision, financial markets, and payments and settlement systems. This forum is considered the most influential for regional central banks.

early detection of risks, swift implementation of remedial actions, and effective decision making of CMIM. Essentially it lays the surveillance groundwork for CMIM.

Since December 2011, AMRO has submitted a set of surveillance reports on a quarterly basis. It has also conducted country consultations with CMIM member economies and established cordial relationships with member authorities (Siregar and Chabchitrchaidol 2014). It has expanded the scope of its analysis to include sector-level issues and risks stemming from external sources. The ASEAN+3 authorities have encouraged AMRO to further enhance collaboration with relevant international financial institutions and organizations, including the IMF, ADB, the Bank for International Settlements (BIS), and the World Bank, to help enhance AMRO's institutional capacity and establish strategic partnerships with them. AMRO is now in the process of transforming itself into an international organization, which marks an important milestone in enhancing the effectiveness of ASEAN+3 financial cooperation. In this way, AMRO is expected to conduct impartial surveillance as an objective, independent, international organization so that it can meet the high demands and expectations of the members.

Finally, since May 2012 the ASEAN+3 authorities have been developing the "ERPD Matrix," consisting of various economic and financial indicators of all ASEAN+3 members. The matrix is intended to facilitate the assessment of members' qualification for the CMIM crisis prevention facility. The authorities continue to develop the matrix and elaborate the ways the matrix will be used for the smooth implementation of the precautionary facility of the CMIM.

3.2 Chiang Mai Initiative and its Multilateralization

3.2.1 Launch of the Chiang Mai Initiative

The CMI is a landmark liquidity support facility in East Asia introduced in May 2000, intended to reduce the risk of currency crises and manage such crises or crisis contagion. It started as a combination of (i) a network of bilateral swap arrangement (BSAs) among the PRC, Japan, and the Republic of Korea, and between one of these Plus-3 countries and a select ASEAN member; and (ii) the ASEAN Swap Arrangement (ASA).¹⁰ The number of bilateral currency swaps, and their total amount grew over time and, by April 2009, had reached 16 swap agreements with \$90 billion (Table 1). The total ASA stood at \$2 billion just before CMI multilateralization.

¹⁰ In 1977 the original five ASEAN monetary authorities created an ASA with the initial facility of \$100 million, primarily to provide liquidity support for those experiencing balance of payments difficulties. Originally intended to be in effect for just one year, the arrangement has been extended incrementally, and its duration, coverage, and amount have also expanded. At the time of the announcement of the CMI in May 2000, the ASA was expanded to all current ASEAN members. In November 2000, the total amount available under the ASA was raised to \$1 billion. In May 2005, it was decided to double the total amount to \$2 billion (in effect September 2006).

Table 1: Progress on Bilateral Swap Arrangements under the Chiang Mai Initiative, April 2009

(\$ billion)

From:	To:	PRC	Japan	Korea, Rep. of	Indonesia	Malaysia	Philippines	Singapore	Thailand	Total
PRC		--	3.0 ^a	4.0 ^a	4.0	1.5	2.0 ^a		2.0	16.5
Japan		3.0 ^a	--	13.0 ^b	12.0	1.0 ^c	6.0	3.0	6.0	44.0
Korea, Rep. of		4.0 ^a	8.0 ^b	--	2.0	1.5	2.0		1.0	18.5
Indonesia				2.0	--					2.0
Malaysia				1.5		--				1.5
Philippines			0.5	2.0			--			2.5
Singapore			1.0					--		1.0
Thailand			3.0	1.0					--	4.0
Total		7.0	15.5	23.5	18.0	4.0	10.0	3.0	9.0	90.0

PRC = People's Republic of China; Korea, Rep. of = Republic of Korea.

Notes: ^a The agreements were in local currencies, and the amounts are US dollar equivalents.

^b Japan–Republic of Korea BSA included both US dollar swaps (\$10 billion from Japan to the Republic of Korea and \$5 billion from the Republic of Korea to Japan) and local currency swaps (\$3 billion equivalent each from Japan to the Republic of Korea and vice versa). The yen–won BSA was raised from \$3 billion to \$20 billion equivalent in December 2008 until end–April 2009, which was later extended to end–October 2009.

^c There was also a \$2.5 billion commitment (made on 18 August 1999) under the New Miyazawa Initiative.

^d The table does not include the ASEAN Swap Arrangement, which totaled \$2 billion.

Source: Government of Japan, Ministry of Finance website. <http://www.mof.go.jp/english/>

The CMI was introduced as a regional liquidity support facility to provide short-term US dollar liquidity to any of its member countries experiencing a balance of payments crisis. It was intended to supplement the existing international financial arrangements and to be closely linked to the IMF (see below).¹¹ Because of this, the US and the IMF cautiously welcomed the initiative. The representative of the US Treasury at the ADB Annual Meeting in 2000 noted that a regional initiative such as the CMI could be constructive if it were supportive of prompt financial and economic adjustment. An IMF representative also welcomed the CMI's intention to work with the IMF.¹²

An important feature of the CMI was that crisis-affected members requesting short-term liquidity support could immediately obtain financial assistance for the first 10% of the BSA,¹³ and the remaining 90% was provided to the requesting member under an IMF program. The CMI's link to an IMF program and its conditionality was designed to address the concern that the liquidity shortage of a requesting country might be due to fundamental policy problems, rather than a mere panic (i.e., herd behavior) of investors or genuine external shocks, and that the potential problem of moral hazard could be non-negligible in the absence of rigorous conditionality. Essentially the CMI was for crisis lending and hence required conditionality.¹⁴ The perceived

¹¹ Kohlscheen and Taylor (2008) found that the size of BSAs increased with: the size of the sender economy relative to the receiver, the stock of reserves of the sender country (as a ratio of its imports), and the negative correlation of international reserve growth.

¹² See Henning (2002), Chapter 3.

¹³ This IMF-delinked portion was raised to 20% in May 2005 and to 30% in May 2012 (see 3.3).

¹⁴ On the other hand, bilateral local-currency swap agreements between central banks—such as the yen–won swap between the BOJ and the Bank of Korea—which were part of the CMI, were not intended for crisis lending and, hence, not subject to conditionality.

lack of the region's capacity to formulate and enforce effective adjustment programs in times of crisis was a major concern that led to the CMI's linking to IMF programs.¹⁵

Another feature of the CMI was that the BSAs required individual partner countries to carry out their bilateral agreements once a member country faced a crisis situation. In addition, potential creditor countries were not bound to actually lend because of the "opt out" arrangement. That is, the BSAs were bilateral contractual agreements between the monetary authorities, and potential lenders could opt not to lend. In the event of a currency crisis in a member country, some potential creditors might provide liquidity while others might not. This created a degree of uncertainty as to whether the needed liquidity would be fully secured by a potential borrower country in the event of a currency crisis. In addition to the cumbersome multiplicity of bilateral agreements, this added ambiguity to the actual implementation of the CMI.

3.2.2 Multilateralization of the Chiang Mai Initiative

Given the cumbersome nature of the multiplicity of BSA, the finance officials decided to multilateralize the CMI, by first adopting a collective decision-making procedure for CMI swap activation (May 2006) and then adopting a self-managed reserve pooling arrangement governed by a single contractual agreement as a form of CMIM (May 2007). Negotiations to finalize the CMIM were not straightforward, particularly on country contributions and voting weights. However, these were mostly concluded by May 2009 with some final revisions in 2010. The CMIM came into effect, and replaced the CMI, in March 2010.¹⁶ The country contributions, purchasing multiples,¹⁷ borrowing limits, and voting weights were determined. The voting weights were decided by giving each country equal basic votes and the number of votes equal to the number of billions of US dollars that it contributed to the pool. The total size of the CMIM was set at \$120 billion, with 80% contributed by the Plus Three countries and 20% by ASEAN countries.

Consensus would be required for deciding fundamental issues such as size, contribution, purchasing multiples, membership, and terms of swaps. Two-thirds weighted majority votes would be needed for deciding on swap issues, including approval of swaps, renewal, and default.

The allocation of country contributions to the CMIM was a contentious issue, particularly between the PRC and Japan, as financial contributions largely determined the voting powers of member countries. After long and protracted negotiations, the authorities of the PRC and Japan and came to an agreement to contribute equal amounts (32%) on the understanding that the PRC's contribution included 3.5% from Hong Kong, China. Both the PRC (which, together with Hong Kong, China, secured the same share as Japan) and Japan (whose contribution share exceeded the PRC's share of 28.5%, excluding Hong Kong, China) achieved their respective objectives after this remarkable political compromise (Box 2). The Republic of Korea also achieved its objective as the country obtained a 16% contribution share in the CMIM, much larger than its economic weight among the ASEAN+3 countries.¹⁸

¹⁵ The PRC and Japan, as potential creditor countries, argued that the CMI's link to the IMF was essential. In contrast, some potential borrower members, such as Malaysia, believed that the CMI should not be linked to IMF programs. In the end the intent of potential creditor members prevailed.

¹⁶ The ASA component of the CMI remained in force.

¹⁷ A country's contribution multiplied by its purchasing multiple equals the maximum amount that it can draw from the CMIM.

¹⁸ A similar agreement was made in November 2010 in establishing a \$700 million trust fund under ADB, called the Credit Guarantee and Investment Facility. Once again the PRC and Japan agreed to contribute an equal amount, i.e., \$200 million each, to the facility with additional contributions coming from the Republic of Korea (\$100 million), ASEAN member states (\$70 million), and ADB (\$140 million).

Box 2: Chiang Mai Initiative Multilateralization: Status-Driven Negotiations over Contribution Amounts by the People's Republic of China, Japan and the Republic of Korea

- The People's Republic of China (PRC), Japan, and the Republic of Korea each wanted to contribute such large percentages to the Chiang Mai Initiative Multilateralization (CMIM) that the sum exceeded 100%. This led to difficult and protracted negotiations. Japan wanted to have the largest contribution share as it was both the largest economy in Asia and the largest contributor under the Chiang Mai Initiative bilateral swap arrangements (CMI BSA). (Their contributions totaled \$44 billion compared with the Republic of Korea's \$18.5 billion and the PRC's \$16.5 billion). On the other hand, the PRC wanted to have a share as large as Japan's given that it was the largest holder of foreign exchange reserves in the world. (The PRC's holding totaled \$2.4 trillion compared with Japan's \$1.0 trillion and the Republic of Korea's \$265 billion in 2009.) The Republic of Korea wanted to have a share as large as the PRC's, given the country's high degree of development, the depth of Korean capital markets, and its large contribution under the CMI BSA.
- The Association of South East Asian Nations (ASEAN), having earlier agreed on their own individual shares among themselves, apparently urged the Plus-3 countries to agree on shares so that significant progress could be made on CMIM.
- The final decision was an extremely effective compromise. First, the PRC agreed to a share of 28.5% for itself, but was able to convince other ASEAN+3 members that Hong Kong, China should be a new CMIM member and should get a share of 3.5%. So, the PRC's overall share of 32%, including Hong Kong, China, was the same as Japan's. Second, Japan was able to retain a share of 32% which was larger than the share provided by the PRC excluding Hong Kong, China, and thus maintained her status. Finally, the Republic of Korea's share of 16% was half that of Japan and the PRC, but was much larger than its relative economic and financial weight in ASEAN+3, which was approximately 11–12%. So all the Plus-3 countries could enjoy prestige and satisfaction.

Source: Author's assessment.

A few points are noteworthy on the CMIM. First, the CMIM became a US dollar liquidity support arrangement, thereby excluding the local-currency swaps that had been in place in the CMI BSAs, under the same IMF-linked arrangement. Second, the CMIM included all ASEAN+3 members, while Brunei Darussalam and low-income ASEAN members (Cambodia, Lao People's Democratic Republic, Myanmar, and Viet Nam) had not been included in the CMI BSAs. Hong Kong, China also joined the CMIM without becoming a formal member of the ASEAN+3 finance ministers' meeting.¹⁹ So the CMIM became a more inclusive arrangement, and this opened up the possibility for other countries to participate. Third, Indonesia was eligible to borrow a smaller amount (\$11.9 billion) than that provided by CMI BSAs (\$18 billion). Thus Indonesia might have felt that it would require more financial resources to cope with possible currency turmoil and crisis. Finally, voting powers of member countries were adjusted in a way to increase the voice of smaller countries, such as less developed ASEAN members, by giving each member 3.2 basic votes (except for Hong Kong, China which did not receive any basic votes).

3.3 Further Strengthening of the Chiang Mai Initiative Multilateralization

In May 2012, the CMIM was further modified. The size was doubled to \$240 billion, with the same contribution shares, purchasing multiples and voting weights as in Table 2. The IMF-delinked portion was raised from 20% to 30% of a country's maximum swap quota, with the

¹⁹ Hong Kong, China has been a regular participant in ASEAN+3 finance and central bank deputies' meetings and other initiatives such as the Asian Bond Markets Initiative, but always as part of the PRC team.

possibility that it be raised to 40% in 2014 subject to review should conditions warrant. (But no such increase was made in 2014.) The maturity of the swap for the IMF-linked portion was lengthened from 90 days to 1 year and its supporting period lengthened from 2 years to 3 years, i.e., with a maximum two renewals. The maturity for the IMF-delinked portion was lengthened from 90 days to 6 months and its supporting period lengthened from 1 year to 2 years, i.e., with a maximum of three renewals. This swap, called the Chiang Mai Initiative Multilateralization Stability Facility (CMIM-SF), was intended for crisis response.

Table 2: Financial Contributions, Maximum Swap Amount, and Voting Powers under the Chiang Mai Initiative Multilateralization

Members	Financial Contributions		Purchasing Multiple	Maximum Swap Amount (\$ billion)	Voting Powers (\$ billion)			
	(\$ billion)	(%)			Basic Votes	Votes Based on Contributions	Total Voting Powers	
							(\$ billion)	(%)
Plus Three	192.00	80.00	--	117.30	9.60	192.00	201.60	71.59
PRC total	76.80	32.00	--	40.50	3.20	76.80	80.00	28.41
PRC	68.40	28.50	0.5	34.20	3.20	68.40	71.60	25.43
Hong Kong, China	8.40	3.50	2.5	6.30	0.00	8.40	8.40	2.98
Japan	76.80	32.00	0.5	38.40	3.20	76.80	80.00	28.41
Republic of Korea	38.40	16.00	1	38.40	3.20	38.40	41.60	14.77
ASEAN	48.00	20.00	--	126.20	32.0	48.00	80.00	28.41
Brunei Darussalam	0.06	0.025	5	0.30	3.20	0.06	3.26	1.158
Cambodia	0.24	0.100	5	1.20	3.20	0.24	3.44	1.222
Indonesia	9.104	3.793	2.5	22.76	3.20	9.104	12.304	4.369
Lao PDR	0.06	0.025	5	0.30	3.20	0.06	3.26	1.158
Malaysia	9.104	3.793	2.5	22.76	3.20	9.104	12.304	4.369
Myanmar	0.12	0.050	5	0.60	3.20	0.12	3.32	1.179
Philippines	9.104	3.793	2.5	22.76	3.20	9.104	12.304	4.369
Singapore	9.104	3.793	2.5	22.76	3.20	9.104	12.304	4.369
Thailand	9.104	3.793	2.5	22.76	3.20	9.104	12.304	4.369
Viet Nam	2.00	0.833	5	10.00	3.20	2.00	5.20	1.847
ASEAN+3	240.00	100.00	--	243.50	41.60	240.00	281.60	100.00

ASEAN = Association of South East Asian Nations; Lao PDR = Lao People's Democratic Republic; PRC = People's Republic of China.

Source: Government of Japan, Ministry of Foreign Affairs of Japan (1999).

At the same time, a crisis prevention facility, the CMIM-PL, was introduced, again with a maturity of 1 year for the IMF linked portion and 6 months for the IMF-delinked portion, with a maximum duration of 2 years for both cases. The qualification criteria were based on five policy areas: external position and market access, fiscal policy, monetary policy, financial sector soundness and supervision, and data adequacy. A member country cannot draw on CMIM-SF and CMIM-PL at the same time, and the maximum drawing in either case is the country's swap quota. Box 3 summarizes the key features of the new facility in contrast to the existing one.

Box 3: Key Features of Chiang Mai Initiative Multilateralization-Stability Facility and Chiang Mai Initiative Multilateralization-Precautionary Line

1. Crisis Resolution Mechanism: Chiang Mai Initiative Multilateralization Stability Facility (CMIM-SF)
 - (i) Size: \$240 billion
 - (ii) IMF-delinked portion: 30% (could be raised to 40% subject to review should conditions warrant)
 - (iii) Maturity, supporting period and monitoring:
 - IMF linked portion: 1 year with two renewals, totaling up to 3 years in supporting period;
 - IMF-delinked portion: 6 months with three renewals, totaling up to 2 years in supporting period; and
 - To conduct monitoring on a biannual basis.
2. Crisis Prevention Function: Chiang Mai Initiative Multilateralization Precautionary Line (CMIM-PL)
 - (i) Introduction: One simplified crisis prevention facility.
 - (ii) Qualifications and conditionality
 - Executive Level Decision-Making Body (Deputies' Level Meeting) allowed to flexibly apply the five qualification criteria (external position and market access, fiscal policy, monetary policy, financial sector soundness and supervision, and data adequacy), as *ex-ante* qualifications and *ex-post* conditionality after considering the economic reports by the requesting country and analyses by the Association of South East Asian Nations (ASEAN)+3 Macroeconomic Research Office/Asian Development Bank/International Monetary Fund as the basis for the decision
 - (iii) Duration of access, arrangement period, maturity and monitoring:
 - Duration of access set at 6 months with three renewals, totaling 2 years in arrangement period;
 - Maturity set at 6 months for the IMF-delinked portion and 1 year for the IMF linked portion; and
 - Monitoring conducted on a biannual basis.
 - (iv) Commitment fee: 0.15% to CMIM-PL, in principle.
 - (v) Relationship with CMIM-SF:
 - The total amount that can be drawn by each member country, either for prevention or resolution purposes, should be within the maximum swap amount set aside for that country;
 - Dual-drawing from both CMIM-SF and CMIM-PL restricted; and
 - CMIM-PL to be replaced with CMIM-SF if any CMIM-PL recipient party is hit with crisis and needs additional support, depending on the decision made by Executive Level Decision-Making Body.

Source: ASEAN+3 Finance Ministers and Central Bank Governors (2012).

The introduction of the CMIM-PL was partly a response to the concern that the CMI was ineffective in preventing a currency crisis, as in the case of the mini won crisis in late 2008. At that time the Republic of Korea did not choose to go to its ASEAN+3 peers for liquidity support under the CMI, from which it could have obtained a maximum of \$23.5 billion. There were three reasons why the Korean authorities choose to go to the US Fed rather than to the CMI or other arrangements. First, the CMI was intended to be for crisis response and would not have been triggered for precautionary purposes in a near-crisis situation. The Korean authorities did not regard the condition in late 2008 as a crisis situation and thus would not have been eligible for accessing CMI resources. Second, if the Republic of Korea had used the CMI, it would have had to go to the IMF because the CMI required a link with an IMF program since the amount of borrowing would have exceeded 20% of the swap quota. This would, however, have posed a significant political problem for the government of the Republic of Korea, given the stigma associated with the "IMF crisis" during 1997–1998. Third, opting for bilateral local-currency swap lines with the BOJ or the People's Bank of China (PBOC) would not have been attractive because of their limited size (\$3 billion equivalent with the BOJ and \$4 billion equivalent with the PBOC) and the lack of free convertibility of the renminbi into the US dollar.

Thus, if a mini crisis similar to the one observed in the Republic of Korea in late 2008 were to take place once again, CMIM-PL support could be provided. In this sense the new facility is a significant improvement over the existing crisis-lending arrangement of CMIM-SF.

4. AGENDAS FOR STRENGTHENING THE CHIANG MAI INITIATIVE MULTILATERALIZATION, ECONOMIC REVIEW AND POLICY DIALOGUE AND ASSOCIATION OF SOUTH EAST ASIAN NATIONS+3 MACROECONOMIC RESEARCH OFFICE

4.1 Challenges of the Chiang Mai Initiative Multilateralization, Economic Review and Policy Dialogue, and Association of South East Asian Nations+3 Macroeconomic Research Office

Substantial progress has been made on the CMIM, ERPD and AMRO, but the question remains whether the progress made so far has been significant enough to make these institutional arrangements sufficiently effective to prevent and counter liquidity crises. There are four problems: the adequacy of the CMIM resources, the CMIM's IMF link, procedural clarity and certainty in activating the CMIM, and surveillance and AMRO.

4.1.1 Adequacy of Chiang Mai Initiative Multilateralization Resources

First, the maximum amount that a member country can draw from the CMIM equals its contribution times its purchasing multiple. Even with the increase in the total size of CMIM to \$240 billion, the maximum swap quota available to a country is likely to be insufficient for either crisis prevention or response. For example, the maximum swap quotas available for Indonesia, the Republic of Korea, and Thailand would be \$23 billion (Indonesia and Thailand), and \$38 billion (the Republic of Korea). Although the quota available for Thailand exceeds the size of the IMF package arranged for Thailand (\$17.2 billion) during the financial crisis of 1997, the quotas are small compared to the IMF packages for the Republic of Korea (\$58.2 billion), and Indonesia (\$42.3 billion) arranged during the same crisis. Furthermore, the IMF-delinked portion available to a country is insufficient, even if the portion were to be further raised to 40% (Table 3). The delinked portion is small in comparison to the IMF packages for the three countries mentioned, or compared to the bilateral currency swap arrangement that the Republic of Korea secured from the US Fed (\$30 billion) during the global financial crisis in 2008. To counter a liquidity crisis using the CMIM, therefore, its total size—particularly the amount available without an IMF link—should be increased. Given the “IMF stigma” left in many countries affected by the Asian financial crisis (Ito 2012), some redesigning of the CMIM is needed so that the IMF-delinked portion can be expanded and any member country in a crisis or near-crisis situation can go to the CMIM without an IMF program.

Table 3: Available Financial Resources under the International Monetary Fund Rapid Financing Instrument and the Chiang Mai Initiative Multilateralization's International Monetary Fund-Delinked Portion

Members	IMF			CMIM			
	Quotas (\$ billion)	Rapid Financing Instrument (\$ billion)		Financial Contributions (\$ billion)	Maximum Swap Amount (\$ billion)	IMF-Delinked Amount (\$ billion)	
		50% of Quota	100% of Quota			IMF link of 30%	IMF link of 40%
Plus Three	43.066	21.534	43.066	192.00	117.30	39.600	50.700
PRC total	14.384	7.192	14.384	76.80	40.50	16.560	19.980
PRC	14.384	7.192	14.384	68.40	34.20	10.260	13.680
Hong Kong, China	--	--	--	8.40	6.30	6.300	6.300
Japan	23.599	11.800	23.599	76.80	38.40	11.520	15.360
Republic of Korea	5.083	2.542	5.083	38.40	38.40	11.520	15.360
ASEAN	13.282	6.677	13.282	48.00	126.20	37.860	50.480
Brunei Darussalam	0.325	0.162	0.325	0.06	0.30	0.090	0.120
Cambodia	0.132	0.066	0.132	0.24	1.20	0.360	0.480
Indonesia	3.140	1.570	3.140	9.104	22.76	6.828	9.104
Lao PDR	0.080	0.040	0.080	0.06	0.30	0.090	0.120
Malaysia	2.679	1.339	2.679	9.104	22.76	6.828	9.104
Myanmar	0.390	0.195	0.390	0.12	0.60	0.180	0.240
Philippines	1.539	0.770	1.539	9.104	22.76	6.828	9.104
Singapore	2.126	1.063	2.126	9.104	22.76	6.828	9.104
Thailand	2.175	1.088	2.175	9.104	22.76	6.828	9.104
Viet Nam	0.696	0.384	0.696	2.00	10.00	3.000	4.000
ASEAN+3	56.348	28.211	56.348	240.00	243.50	77.460	101.180

\$ = US dollar; ASEAN: Association of South East Asian Nations; ASEAN+3 = Association of South East Asian Nations Plus Three; CMIM = Chiang Mai Initiative Multilateralization; IMF = International Monetary Fund; Lao PDR = Lao People's Democratic Republic; PRC = People's Republic of China.

Source: Modified version of Siregar and Chabchitichaidol (2014).

To secure adequate financing for members in crisis or near-crisis situations within the IMF-delinked portion, several options can be considered. First, the total size of CMIM resources may be increased at least twofold. This would significantly raise both the maximum swap quota and the IMF-delinked portion that each member can obtain at times of crisis or near-crisis. Second purchasing multiples may be increased for ASEAN countries and the Republic of Korea, while those for the PRC and Japan may be reduced as these two countries are unlikely to require CMIM assistance. For example, the purchasing multiples for the PRC and Japan may become zero and those for ASEAN countries and the Republic of Korea may be raised by 45% without changing the total size of CMIM resources. Third, the IMF-delinked portion may be further increased, ultimately to 100%. This would make it easier for members in liquidity crises to have access to CMIM resources without accepting IMF programs. Finally, a combination of these options may be implemented to substantially increase both the maximum swap quota and the IMF-delinked portion available for each member country that would potentially need CMIM assistance.

A more radical approach to securing sufficient financial resources for each member would be to transform the CMIM, which is a reserve pooling arrangement, into a fund where members contribute their capital (or quotas). Once contribution multiples are set for member countries, for example at 500%, members in crises or near-crises can draw adequate financial resources without relying on IMF financing and programs.

4.1.2 Link with the International Monetary Fund

If the IMF link remains for some time, redesigning of the CMIM may be needed to make it more useable and effective for member countries. Following suggestions made by Sussangkarn (2011), CMIM-PL could be made available to a member country facing temporary foreign exchange liquidity shortage, without requiring any IMF link or conditionality, up to the full amount of the country's swap quota, if the country passed the CMIM prequalification criteria. Quick access to a sufficient amount of swap line is important to gain market confidence and stabilize the situation, as happened in the Republic of Korea during the global financial crisis. If, after using the CMIM-PL facility for a prespecified time (for example, 6 months), the problem still persisted, then it would probably be a crisis situation rather than a temporary liquidity shortage, and thus the support may be switched to CMIM-SF, which would require macroeconomic policy adjustments.²⁰ Removing the IMF link at the initial phase would make it much more attractive for member countries to access the full amount of the CMIM-PL swap.

If a country faces a currency crisis rather than a temporary liquidity shortage but the required liquidity support were small and within the swap limit, then even CMIM-SF support could be provided to an eligible country without an IMF program but with independent policy conditions. Only when the crisis required both larger amounts of liquidity support than those provided under the CMIM and also significant macroeconomic policy adjustment would CMIM-SF be advised to work with the IMF since the CMIM resources are unlikely to be sufficient. In this way CMIM would be the first line of defense for temporary foreign exchange liquidity shortage problems (which would mobilize CMIM-PL) and small-scale currency crises requiring macroeconomic policy adjustments (which would mobilize CMIM-SF), with the IMF joining to deal with large-scale crisis situations.

In providing CMIM-PL or CMIM-SF without an IMF program, the CMIM authorities may believe that AMRO's initial capacity could be limited in assessing the borrowing country's macroeconomic conditions and in crafting independent policy conditions. Thus, the IMF may work with AMRO in endorsing macroeconomic policy soundness of the country in question and in formulating macroeconomic policy conditions, while these tasks will be gradually shifted to AMRO alone as it builds its own analytical capacity.

4.1.3 Procedural Clarity

There is a lack of clarity over procedural matters relating to the activation of the CMIM, such as the precise economic information that is required for other CMIM member countries to make decisions and information about contact points for emergency assistance. When a financial crisis or financial turbulence hits a member country, a rapid response is often essential to contain the turbulence or prevent it developing into a crisis. For this purpose, a smooth and well-prepared mechanism of liquidity support is needed. Given the lack of clarity as to whether a detailed procedural system has been effectively put in place for a member country requiring assistance, i.e., what information should be prepared when requesting assistance, what steps should be taken before contacting CMIM chair countries, and to whom they should speak if they need to use the facility very soon, say within a week, due to sudden liquidity shortages (Azis 2012), the CMIM authorities have conducted CMIM test runs under various scenarios to identify any potential gaps in implementing financial assistance in a timely manner. Nonetheless, a crisis can come at any moment without clear indication, and there could still be a delay in action particularly when chair countries are relatively inexperienced.

Part of the problem is that the CMIM lacks a permanent secretariat in charge of its activation. AMRO is a research and surveillance unit for CMIM and supports ERPD and CMIM, but is not a

²⁰ The period before policy adjustments were required could be decided appropriately.

permanent secretariat for all aspects of CMIM including its activation. To ensure that the CMIM can quickly respond to member countries' emergency situations, it would be useful to establish a permanent secretariat in charge of all aspects of CMIM. One option to address this issue would be to locate such a secretariat in AMRO so as to improve procedural certainty and respond to crisis or near-crisis situations without much delay.

4.1.4 Effectiveness of the Economic Review and Policy Dialogue and the Association of South East Asian Nations+3 Macroeconomic Research Office

Even though progress has been made on ERPD and AMRO, experts consider their effectiveness questionable at best, especially for CMIM purposes (Azis 2012). The current ERPD process is still largely a venue for information sharing with weak peer review or policy coordination (Hill and Menon 2014) and has not moved to the more advanced "due diligence" process which would require a rigorous analysis of potential borrower economies from the perspective of potential creditors (Kawai and Houser 2008). AMRO remains a relatively modest organization in terms of budget and personnel. Ideally, the CMIM authorities should be able to rely on its assessments when making decisions about whether to lend, the amount to lend, and the required conditionality associated with it. This means that CMIM needs to be strengthened as a lending facility with, or without, policy conditions depending on the situation, and AMRO needs to be strengthened as a CMIM support organization for economic surveillance and conditionality formulation.

Siregar and Chabchitrchaidol (2014) stress that, following the model of IMF surveillance, AMRO must encompass two areas of work: bilateral and multilateral surveillance, and macroeconomic and financial sector surveillance. Bilateral surveillance focuses on an individual economy, while multilateral surveillance takes global and regional perspectives. One of the advantages of AMRO is its close contact with regional policymakers. Thus, they argue that the nonpublic nature of the current peer review process facilitates the provision of confidential advice and constructive criticism of policies at the highest official levels throughout the year, rather than making publicly open criticism.

Views are divided on the extent to which AMRO should disclose information publicly and work with other institutions, such as the IMF. Takagi (2010) argues that the IMF produces high-quality analyses of global and national economic developments so that AMRO may have a primary role of processing information provided by global and national agencies, to economize on its limited resources. For this purpose, AMRO should be granted full access to all surveillance outputs on the region's economies produced by the IMF and other institutions. Over time, AMRO's surveillance may increasingly focus on regional, rather than national, surveillance, with a clear mandate for addressing policy spillovers and finding scope for collective action.

Henning (2011) asserts that AMRO will be too small to replicate the work of the IMF and that a division of labor should be identified. He suggests that AMRO could provide contrasting assessments of vulnerabilities within the region when it disagrees with the findings of the IMF; update assessments more frequently than the annual cycle for IMF Article IV consultations (which AMRO does by producing quarterly reports); participate in surveillance discussions in which Asian officials might be more candid with one another than in the presence of IMF officials; and provide a greater sense of Asian ownership.

Relying completely on the IMF for surveillance and conditionality formulation on a permanent basis does not make sense as there is a possibility that CMIM can be activated without IMF programs. In activating CMIM without IMF programs, it is still possible to outsource services of surveillance, conditionality formulation, and performance monitoring from the IMF (without IMF financing), but this should be a temporary arrangement. A more realistic approach would be for

AMRO to develop its own capacity to conduct surveillance, craft policy conditions, and monitor economic and policy performance.

Thus, AMRO should work with the IMF but develop its own role as an independent organization supporting CMIM. First, AMRO should continue to focus on bilateral (or national) surveillance, while processing information provided by the IMF and other international organizations. It should accompany the IMF on its bilateral surveillance—such as its Article IV consultation and the Financial Sector Assessment Program (currently done with the World Bank)—and at the same time articulate its own assessment. Second, AMRO could focus more on regional surveillance and spillover issues and provide its own views on regional vulnerabilities. For example, even within the ASEAN+3 region, some common external shocks could affect different groups of regional economies differently. AMRO could analyze such asymmetric impacts of external shocks and provide advice on desired policy responses for different countries. Third, AMRO needs to gradually build its analytical capacity to provide its own assessment as to whether a country requesting CMIM assistance satisfies prequalification criteria and to formulate its own independent conditionality in the event of CMIM activation without an IMF program. Once AMRO acquires adequate capacity, the CMIM's link with the IMF can be substantially reduced and ultimately eliminated. While Europe developed a model for coordination with the IMF in managing the eurozone financial crisis (Lamberte and Morgan 2014), Asia will have to gradually develop its own model for such coordination.

4.1.5 Bilateral Currency Swaps

Japan has established bilateral currency swaps with several emerging Asian economies (Table 4), which could be expanded to other countries in the region. In January 2014, the governments of India and Japan enlarged their bilateral currency swap arrangement from \$15 billion to \$50 billion. The PRC has also forged many bilateral currency swaps to promote renminbi-based trade, but it would be useful if the PRC could allow the swap to be made available in US dollars in the event of acute liquidity shortages in partner countries. These considerations would help those countries that could not arrange bilateral currency swaps with the US Fed in the future, such as Indonesia, Malaysia, the Philippines, and Thailand.

Table 4: Japan's Bilateral Currency Swap Arrangements (as of November 2014)

Country	Contracting Agency	Currency Used	Swap Commitment
Republic of Korea ^a	JMOF and BOK	US dollar versus domestic currency	Japan to Republic of Korea, \$10 billion; Republic of Korea to Japan, \$5 billion
Indonesia ^a	JMOF and BI	US dollar versus rupiah	Japan to Indonesia, \$22.76 billion
Philippines ^a	JMOF and BSP	US dollar versus domestic currency	Japan to the Philippines, \$6 billion; Philippines to Japan, \$0.5 billion
India ^b	JMOF and RBI	US dollar versus domestic currency	Japan to India, \$50 billion; India to Japan, \$50 billion
PRC	BOJ and PBOC	yen versus renminbi	Japan to PRC, \$3 billion equivalent; PRC to Japan \$3 billion equivalent

BI = Bank Indonesia; BOJ = Bank of Japan; BOK = Bank of Korea; BSP = Bangko Sentral ng Pilipinas; JMOF = Japanese Ministry of Finance; PBOC = People's Bank of China; PRC = People's Republic of China; RBI = Reserve Bank of India.

Notes: ^a The BSA with Indonesia, the Republic of Korea, and the Philippines complement the Chiang Mai Initiative, and will require IMF programs if more than 20% of the commitment is to be withdrawn.

^b The BSA with India is subject to the same IMF-link.

Source: Government of Japan, Ministry of Finance, <http://www.mof.go.jp/english/>.

4.2 Asian Currency Unit as a Tool for Exchange Rate Policy Surveillance

4.2.1 Role of Asian Currency Unit for Regional Economic Surveillance

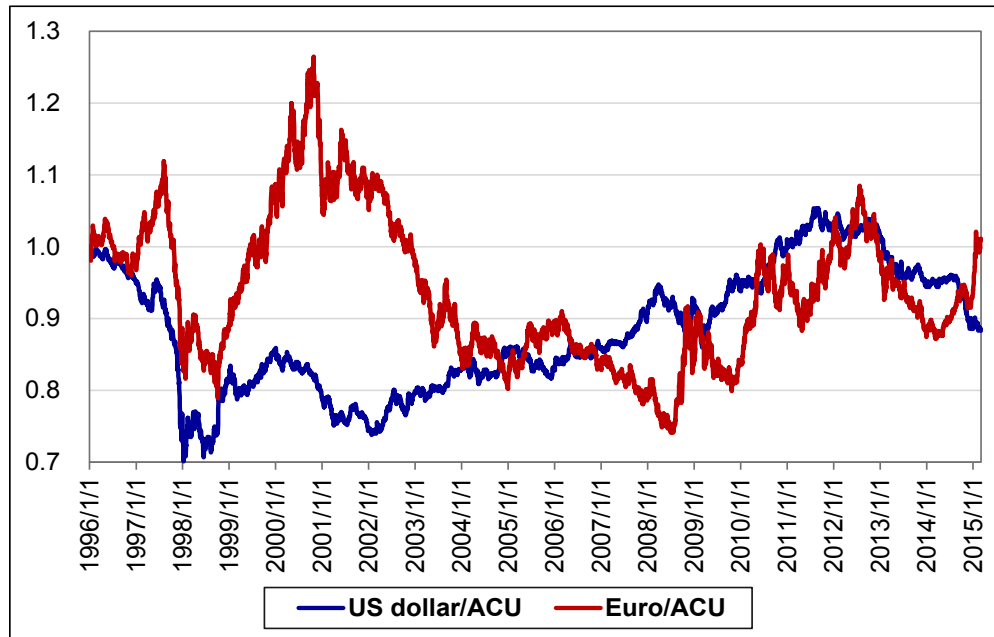
Regional surveillance mechanisms are instrumental to crisis prevention. One of the problems of the current regional surveillance processes is that the policymakers have not developed a systematic framework for monitoring exchange rate movements and for assessing countries' exchange rate policies. This is the case despite recent policy shifts and severe currency market strains. These strains include the Asian financial crisis of 1997–1998, the shift of the renminbi regime in July 2005 from its *de facto* US dollar peg to a gradual crawling appreciation *vis-à-vis* the dollar, the mini crisis of the rupiah in the summer of 2005, the sharp depreciation pressure on the won in the aftermath of the Lehman Brothers shock in the fall of 2008, and currency market turmoil during the taper tantrum in May–September 2013.

Several authors (Kawai 2009; Chai and Yoon 2009; and Moon and Rhee 2009) have argued that an Asian currency unit (ACU) index—an appropriately weighted basket of East Asian currencies—and ACU-based divergence indicators could serve as useful surveillance tools for monitoring currency movements.²¹ An ACU summarizes the collective movement of East Asian currencies, and divergence indicators measure the degree of divergence of each currency movement from the regional average set by the ACU.

Figure 1 depicts ACU exchange rate movements *vis-à-vis* the US dollar and the euro since 1996. The ACU is constructed using the weights provided by CMIM contribution shares for ASEAN+3 currencies and the Hong Kong dollar. The figure demonstrates a sharp depreciation of the ACU in 1997–1998 due to the Asian financial crisis, and a gradual, long recovery over time versus the US dollar until the second half of 2011. From 2013 the ACU value began to decline against the dollar mainly because of yen depreciation under Abenomics. After plunging in value against the euro (or a composite of the major European currencies) during the Asian financial crisis, the ACU made a remarkable recovery against the euro until 2000 but then began to depreciate from early 2001 until the fall of 2008. During the global financial crisis and the subsequent eurozone financial crisis, the ACU appreciated as a trend against the euro.

²¹ However, Adams and Chow (2007) and Watanabe and Ogura (2006) argue that ACU-based divergence indicators are unlikely to be used or monitored by monetary authorities, given the European Currency Unit experience. They note that even the European Currency Unit did not attract attention as a divergence indicator in Europe. In East Asia, potential for ACU as a divergence indicator seems large because the authorities are keen to avoid persistent misalignment in intra-regional exchange rates as well as stemming irregular currency movements and speculative attack on their currency.

**Figure 1: Asian Currency Unit Exchange Rates versus the US Dollar and the Euro
(1 January 1996 = 1.0)**



ACU = Asian currency unit.

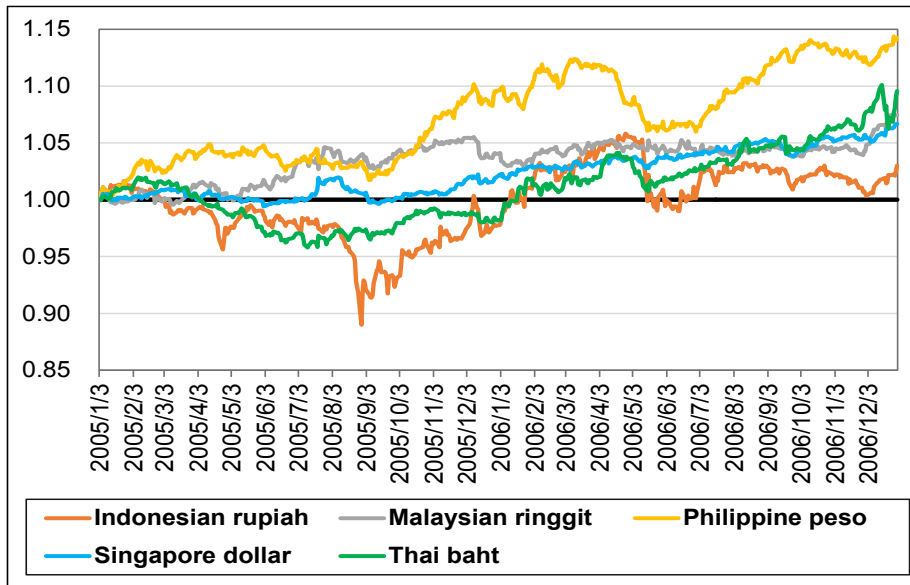
Source: Author's calculations, taken from daily exchange rates of ASEAN+3 countries and Hong Kong, China.

4.2.2 Episodes of Currency Turmoil and Mini Crisis

Figures 2 to 4 illustrate four separate episodes where some East Asian currencies depreciated significantly over relatively short time periods.

Figure 2 shows that Indonesia encountered a “mini currency crisis” in August 2005, when investor confidence suddenly worsened, portfolio capital flows abruptly reversed, and the stock price declined sharply. It was feared that Indonesia might face a repeat of the 1997 currency crisis unless appropriate policy changes were made, and might have to request support under the CMI. Fortunately, the Indonesian markets stabilized after the authorities announced a major cutback in fuel subsidies to help reduce budget deficits and raised policy interest rates to contain inflation. These policy measures helped to calm the markets. In the end, the rupiah depreciated by only 10% relative to the ACU rate, but this episode showed again that an East Asian economy could be vulnerable to sudden changes in investor perceptions and outflows of short-term capital.

Figure 2: Mini Rupiah Crisis (August 2005): Deviations from Asian Currency Unit

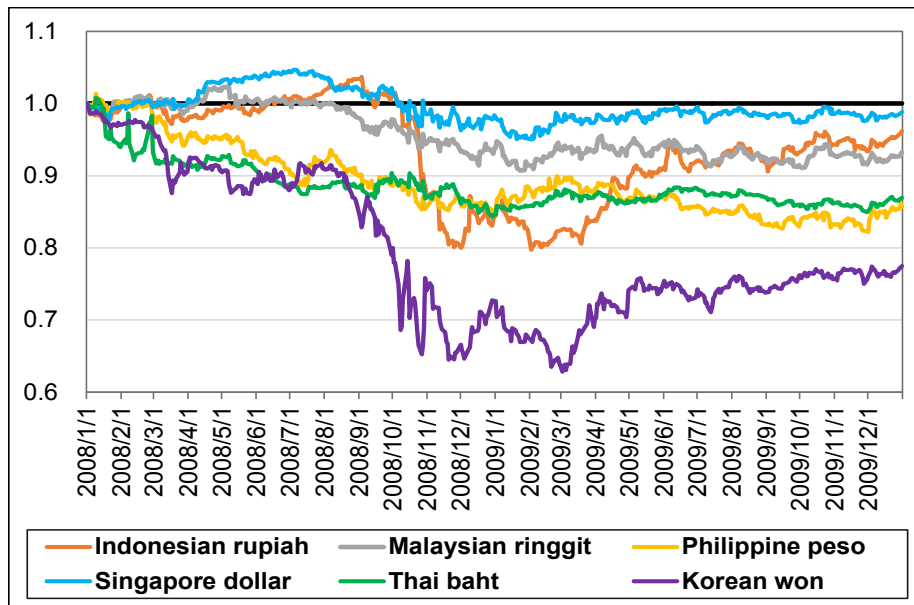


Note: The graphs represent fraction deviations from the Asian currency unit, which is set at 1.

Source: Author's calculations.

Figure 3 demonstrates the significance of the rapid won depreciation during the global financial crisis. Following the collapse of Lehman Brothers in September 2008, the Korean financial market was hit hard by the drying up of international short-term liquidity. As foreign investors withdrew massively from the Korean market, the Bank of Korea lost large amounts of foreign exchange reserves, and the won depreciated sharply. The figure shows that the won depreciation was much sharper than other East Asian currencies.

Figure 3: Mini Won Crisis (late 2008): Deviations from Asian Currency Unit



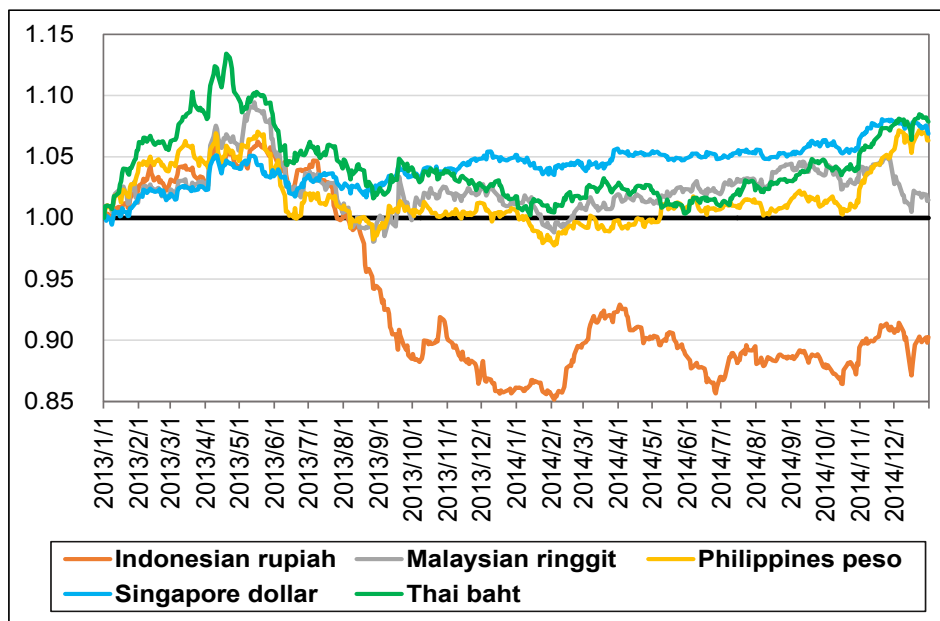
Note: The graphs represent fraction deviations from the Asian currency unit, which is set at 1.

Source: Author's calculations.

As discussed earlier, the Bank of Korea responded swiftly to the crisis by aggressively easing its monetary policy. Its agreement to secure a \$30 billion currency swap arrangement with the US Fed in October 2008 immediately calmed the market, which meant that the turmoil was driven by a liquidity concern. In fact, the low won helped export recovery and reserve accumulation by the second half of 2009, and the won began to gradually restore its value.

On 22 May 2013, US Fed Chairman, Ben Bernanke, indicated a future unwinding of QE3 that had been in place since September 2012. This indication caused global financial markets to react with volatility, raising US long-term yields on Treasuries, triggering capital outflows from a group of major emerging economies—including India and Indonesia—and lowering their stock prices and currency values. Figure 4 shows that the rupiah was most affected in East Asia during the "taper tantrum" period of 2013–2014. Relative to the ACU rate, it declined by about 20% between mid-May and December 2013. Other currencies did not significantly decline in value against the ACU, which depreciated against the US dollar, due mainly to the depreciation of the Japanese yen under quantitative and qualitative monetary easing launched by the BOJ in April 2013.

Figure 4: Taper Tantrum and the Rupiah (mid–2013): Deviations from Asian Currency Unit



Note: The graphs represent fraction deviations from the Asian currency unit, which is set at 1.

Source: Author's calculations.

To summarize, the ACU index and ACU divergence indicators, if properly constructed, can be useful in assisting ASEAN+3 authorities to monitor the trends of regional currencies. The divergence indicators are particularly informative as a market-signaling device and as a measure of a currency's performance with respect to the rest of the regional currencies, and they are easily understood by the authorities and market participants.

4.3 Transforming the Chiang Mai Initiative Multilateralization into an Asian Monetary Fund

An important challenge for ASEAN+3 authorities is to strengthen the effectiveness of regional economic surveillance supported by AMRO in order to reduce, and ultimately eliminate, the CMIM's IMF link so that ASEAN+3 member economies can use the CMIM in both crisis and near-crisis situations without IMF programs. The key is to improve the quality of regional economic surveillance and create conditions to promote further IMF delinking. For this purpose, AMRO should become a credible international organization tasked with regional economic surveillance and liquidity support at times of financial and currency turmoil so that it can assess the economic conditions of countries requesting assistance and formulate lending conditionality, independent of IMF programs, in the event of CMIM-SF activation.

More concretely, this paper recommends the following actions:

- further reduce the CMIM's IMF link over time, ultimately to zero;
- clarify rules and procedures for activating CMIM lending—both the existing crisis resolution facility (CMIM-SF) and the newly introduced precautionary lending facility (CMIM-PL)—and eschew policy conditionality and IMF programs in the event of a small-scale crisis and externally or herd behavior-driven financial turbulence;
- transform AMRO into an independent international organization to function as a secretariat for all aspects of CMIM with adequate resources (staff with the necessary analytical expertise and policy experience) so that it can improve the quality of regional economic surveillance (ERPD), help activate the CMIM smoothly in the event of a need for support, and formulate focused conditionality independent of the IMF;
- further enlarge the total size of the CMIM and/or raise purchasing multiples in order to increase the maximum amount of liquidity available to each member economy in need—other than the PRC and Japan;
- supplement the CMIM by additional bilateral currency swaps, involving sufficiently large amounts, from economies inside and outside the region to make ample resources available for potential needs in the region.
- strengthen economic surveillance by moving beyond the simple “information sharing” stage to a more demanding “peer review and peer pressure” stage, and eventually to a rigorous “due diligence” stage, to improve the quality of economic surveillance;
- contribute financial resources as capital (or quota) to the CMIM in order to physically pool foreign exchange reserves; and
- expand CMIM membership to include Australia, India, and New Zealand.

Once these actions are taken, a new *de facto* AMF would emerge, capable of conducting effective surveillance, providing international liquidity in the event of a crisis or near-crisis, formulating independent policy conditionality when needed, and monitoring performance and policies. It may take some time to achieve all of these. In addition to establishing such a fund, the governance structure of decision-making will have to be improved (Henning 2009), and more power will have to be delegated to AMRO, which is expected to function as the secretariat for the fund.

AMRO/CMIM need to work with the IMF to develop a coordination framework to strengthen complementarities and create synergies. This is because AMRO's capacity is limited, at least for the near future, and the CMIM resources are unlikely to be sufficient to cope with a large-scale or a region wide crisis involving several economies and thus will have to work with the IMF, with or without the formal IMF link. In activating CMIM, the IMF may initially provide endorsement of macroeconomic policy soundness of the country in question and work with AMRO in

conditionality formulation even in the absence of IMF financing and programs and financing, although this task will be gradually shifted to AMRO alone as it builds its own analytical capacity. While the European financial crisis provides a model for coordination between the global and regional financial safety nets—in the form of a troika—Asia will have to develop its own model for crisis management coordination over time.

5. CONCLUSION

East Asia faces three types of risks. The first is a set of large external shocks affecting the region, such as the normalization of US monetary policy, the possible worsening of the eurozone (particularly Greek) crisis, and the eruption of serious geopolitical conflict. The second is a set of internal risks, such as macroeconomic policy mismanagement, a buildup of financial-sector vulnerabilities, and the accumulation of public and private debt. The third risk is the lack of sufficient policy coordination among regional authorities, particularly in the areas of policy dialogue, economic surveillance, and crisis management.

East Asia can contribute to the stability of global finance by achieving balanced, sustainable economic growth; strengthening the resilience of national and regional financial systems; improving regional liquidity (CMIM) and surveillance (ERPD) arrangements; and eventually moving to create an AMF.

The objectives of CMIM are to address short-term liquidity problems in the region and to supplement the existing international financial arrangements. A new AMF will clearly inherit these objectives. To transform the current CMIM into an AMF, significant progress needs to be made in the area of surveillance and institution building. The ERPD process which is in transition from the simple “information sharing” stage to the “peer review” stage, will have to establish more advanced procedures to ensure “due diligence”—a rigorous scrutiny of a potential debtor economy. As this evolution takes place, ASEAN+3 finance ministers and central bank governors need to steadily enhance their policy dialogue and cooperation through ERPD supported by AMRO.

A new AMF could serve as a complementary organization and a building block of the global financial architecture provided by the IMF. For this purpose, an AMF should work closely with the IMF, exchanging information on a routine basis, conducting joint analyses—as for the Financial Sector Assessment Program and Article IV consultation—and intervening in crisis countries together if needed. However, this means that the IMF should also clarify its focus. The IMF as a key global institution has a clear role to ensure global consistency, but this should not imply that the IMF sets all the key agendas, and that regional institutions—such as a new AMF—would simply follow.

In addition, the IMF should reestablish itself as a credible, trustworthy institution. Otherwise it would not be accepted in Asia as a true partner for the region. The IMF needs significant reforms of its operations and governance. On the operational side, the IMF must focus on the surveillance of systemically important economies (such as the US, the eurozone, and the PRC) in an even-handed way and international spillovers of major economies’ policies to ensure global macroeconomic and financial stability. On governance reform, the 2010 IMF reform will have to be implemented in order to increase the voice of rising, emerging economies in the organization and the IMF should further consider prohibiting any single member country to have the power of veto. With such fundamental changes, emerging Asian members would be likely to provide the IMF with an opportunity to regain trust as their partner for macroeconomic and financial stability in Asia.

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