

**Lund University**  
**Centre for East and South-East Asian Studies**  
**Masters Programme in Asian Studies**  
**East & Southeast Asian Track**  
**Fall semester, 2005**

**Master Thesis:**

**“SHOULD EAST ASIA HAVE ITS OWN REGIONAL  
MONETARY FUND?”**

***THE ANALYSIS OF REGIONAL FINANCIAL COOPERATION IN EAST ASIA.***

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## **Abstract**

Certainly, Asian Financial Crisis is a turning point in the history of East Asia, as it has activated regionalization process. One of the regionalist ambitions of East Asians is to set up their regional monetary fund. At the first sight, setting up regional monetary fund seems as an easy process. Nevertheless, in reality there are several factors that make it complicated, especially in East Asia. The purpose of this study was to analyze whether it is necessary and feasible to establish regional monetary fund in East Asia. The analysis includes both economic and political interpretations. Nevertheless, even if my research finds out it necessary and feasible to set up regional financial institution, it might not explain fully why it hasn't been established before or whether there are sufficient political circumstances to set up such institution.

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*I would like to thank my supervisors Turaj Faran and Christer Gunnarsson for their contributions in setting up theoretical framework for my master thesis. I am also grateful to Waseda Research Institute staffs, namely Eriko Sekiguchi, Keiko Koyanagi and Eriko Hayashi for their sincere supports during my fieldwork in Tokyo, Japan in the summer 2005.*

## **INTRODUCTION**

### **The Research Problem of the Master Thesis:**

In 1997, with emergence of Asian Financial Crisis, Ministry of Finance of Japan proposed 100 billion US\$ to establish regional monetary fund namely Asian Monetary Fund (AMF) which would deal with financial crisis and will contribute to the regional development. Nevertheless, IMF and US Treasury initially rejected this proposal and hence Japan postponed its project. The spread of crisis and ineffectiveness of IMF to cope with AFC activated countries in the region to ask Japan to reconsider its project. In 2000, ASEAN countries and Northeast Asian countries namely Japan, China and Republic of Korea met in Thailand to establish trade zone ASEAN+3\* and financial cooperation Chiang Mai Initiatives. Under CMI, ASEAN+3 governments agreed on to set up a system of bilateral swaps to lend foreign exchange reserves between particular countries in the event of a financial crisis. Chiang Mai Initiatives is considered as the first step on the way to financial cooperation in the region. Since 2000, there have been significant achievements in financial cooperation process in East Asia and current trend indicates that there will be gradual progress in this process.

### **Purpose of the Study and Research Questions:**

The purpose of my research would be to analyze the possible future prospects with respect to regional monetary fund in East Asia. The point that I intend to focus on is whether current financial cooperation process will proceed to the establishment of regional monetary fund in Asia Pacific.

The analysis of regional institutions sometimes requires multi-disciplinary study. This might be the case for my research study as well where economic explanation wouldn't be enough and political or sociological interpretations could be required. Thus, this research is going to be within multi-disciplinary framework.

Particularly, I intend to find out whether regional monetary fund such as Asian Monetary Fund is necessary and feasible for East Asia. Moreover, my purpose is to shed the light onto current regional financial arrangements such Chiang Mai Initiatives and ASEAN+3 Policy Dialogue and Surveillance. I would like also to analyze the role of International

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\* ASEAN+3 is a group of countries comprising: Brunei Darussalam, Cambodia, People's Republic of China, Indonesia, Japan, South Korea, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam.

Monetary Fund and Asian Development Bank in Asia Pacific. It is essential to find out whether there is a need for new regional monetary fund that will perform financial activities which are not or can not be performed by IMF and ADB, however, are necessary for ASEAN+3 zone.

The primary research questions would be as such:

- What are the factors that make new regional monetary fund necessary for East Asia?
- Do regional countries indicate interest in forming regional monetary fund?
- Is establishment of regional monetary fund theoretically and practically feasible in East Asia?
- What are the current regional financial arrangements in post Asian Financial Crisis East Asia?
- Could IMF and ADB perform financial activities necessary for coordination of the current regional financial arrangements in ASEAN+3 zone?

#### **Recent Researches about Asian Monetary Fund and their connections to my study:**

Recently, the process of regional financial cooperation in East Asia has become popular topic of research not only in Asia Pacific but also throughout the world. Many respectful economists and political science experts conduct researches about regionalist dynamics in East Asia.

Specifically, I have found the study of Gordon de Brouwer about possible regional monetary fund in East Asia quite interesting and similar to my study. In 'Institutions to promote Financial Stability: Reflections on East Asia and an Asian Monetary Fund' written in July, 2004 Gordon de Brouwer discusses factors that encourage East Asian countries to set up regional monetary fund while in the second half of the paper he suggests what should the appropriate institutional framework for Asian Monetary Fund. Particularly, there are four sections in his paper. In the first section, he starts with discussion of Asian Financial Crisis and how it has activated regional financial cooperation process in East Asia since mid 1997. Later, he emphasizes significant financial potentials in East Asia that makes East Asian countries capable to deal with financial crisis alone, without external support. At the end of section 1, author indicates dissatisfaction of East Asian countries with global financial architecture, where interests of East Asia are not adequately represented, as one of the factors encouraging East Asian policymakers to consider about setting up regional monetary fund. In section 2, Gordon de Brouwer discusses economic and political theories about the importance of institutions and what makes for a 'good' institution. In section 3, author focuses on specific design issues for a possible Asian Monetary Fund where he provides suggestions for

appropriate structure and organizational form of AMF. Section 4 represents conclusion part with summaries of key arguments.

Similar research has been taken by Haruhiko Kuroda and Masahiro Kawai and was documented in ‘Strengthening Regional Financial Cooperation in East Asia’ written in May, 2003. Paper argues that a regional financial architecture needs to be firmly established in East Asia to be able to prevent future crises and provide effective regional financial management. Nevertheless, they believe that regional financial architecture must be also consistent and interactive with global financial architecture. In this paper there are also four sections. Likewise Gordon de Brouwer, they also start section 1 with discussion of Asian Financial Crisis and its consequences on East Asia. In section 2 they analyze the rationale for regional financial cooperation in East Asia by emphasizing increasing economic interdependence among the regional economies specifically indicating growing intra-regional trade and macroeconomic interdependence. In section 3, authors discuss Chiang Mai Initiatives and ASEAN+3 Policy Dialogue and Surveillance. Section 4 (Conclusion part) summaries key points discussed in the paper.

While designing analytical framework for my master thesis, I used above mentioned researches as reference.

### **Theoretical Framework of Master Thesis:**

Since mid 1980s East Asia has experienced gradually growing intra-regional trade and macroeconomic interdependence. For a better comprehension of regionalist trends in East Asia, it is worthwhile to analyze this process from theoretical perspective of Optimum Currency Areas.

In theory of Optimum Currency Areas, Robert Mundell argues that ‘an essential ingredient of a common currency, or a single currency area, is high degree of factor mobility and hence the optimum currency area is the region-defined in terms of internal factor mobility and external factor immobility’. Later, he argues that ‘if factors are mobile across national boundaries, then a flexible exchange system becomes unnecessary, and may even be positively harmful while flexibility of national currencies cannot be expected to perform the stabilization function attributed to it and thus, one could anticipate varying rates of unemployment or inflation within the region.’

From this theoretical point of view, we can conclude that if there is high factor mobility brought by growing intraregional-trade and macroeconomic interdependence, then there is necessity for fixed exchange rate arrangements between countries within the region.

Hence, there is necessity for regional financial cooperation and regional monetary fund which could coordinate exchange rate arrangements within the region.

Nobody would deny that institutions perform crucial role in shaping human behavior and their contributions for preserving stability and sustainability in society are obvious. Goodin (1996:23), for instance, in ``The Theory of Institutional Design`` argues that ‘the basic value of institutions is that they provide stability and reliability by enabling a nested system of rules to govern current and future behavior. With this respect, they can provide more certainty about the future and hence improve predictability and reduce risk’.

On the other hand, Douglas North (1990:107) in “Institutions, Institutional Change, and Economic Performance” claims that ‘institutions are the underlying determinant of the long-run performance of economies’. According to him, institutions exist due to the uncertainties involved in human interaction and they are the constraints devised to shape that interaction. Douglas North believes that the quality of institutions varies according to their consequences for economic performance; while some economies develop institutions that produce growth and development, others develop institutions that produce stagnation.

Thus, not all institutions provide stability and reliability and in many cases they generate instability and chaos within society. Well, then how can we define good institution? According to Goodin (1996) ‘well-designed institutions need to be flexible enough to change as the circumstances change. Particularly, they need to be flexible enough to deal with complexity in terms of agendas and motives and be flexible in dealing with new situations.’

From theoretical explanations of Goodin and North, it becomes clear that depending on their functions and structures, institutions are important determinant of actions in human society. What about setting up new institution? To what extent it might be crucial for society to establish new institution?

Valuable answer comes from Douglas North who argues that ‘the creation of a new institution induces its own responses, a new set of constraints, and persistent informal and formal rules that will govern and influence future behavior’ (North 1990: 83). This is important argument that can facilitate our understanding about necessity of regional monetary fund in East Asia. If existent global and regional financial institutions such as IMF and ADB are not sufficiently flexible and appropriate to coordinate present and future financial arrangements in East Asia, then setting up new regional financial institution could bring about new set of rules that will govern and coordinate such regional financial arrangements in East Asia.



### **Methodology and Selection of Data:**

Methodology for my master thesis would be based on three primary hypotheses.

Hypotheses would be as following:

Hypothesis#1: “If there are factors such as gradually growing intra-regional trade and increasing macroeconomic interdependence, then there is necessity to have deeper monetary cooperation.”

Test of Hypothesis#1: To test this hypothesis it is essential to mention about gradually growing intra-regional trade in East Asia and its impact on financial cooperation. To complete the test of hypothesis#1, I will discuss particular interest of ASEAN+3 countries in forming regional monetary institution. Special focus would be given to the interest of Japan and China, since these two countries most likely will lead the process of financial integration in East Asia.

Hypothesis#2: “If there are conditions that legitimize regional monetary fund practically feasible in East Asia, then there is high possibility for its establishment”

Test of Hypothesis#2: To test hypothesis#2, I will study feasibility of regional monetary institution in East Asia.

Hypothesis#3: If existent global and regional monetary organizations could not perform financial activities necessary for coordination of the current financial arrangements in ASEAN+3 zone, then it is necessary to establish alternative regional monetary institution”

Test of Hypothesis#3: While testing this hypothesis, it is crucial to examine whether IMF and ADB can perform financial activities necessary for coordination of financial arrangements in ASEAN+3 zone such as coordination of Chiang Mai Initiative, and Regional Surveillance.

To support my points while testing hypotheses mentioned above, I am going to use following source of data:

#### **Interview notes and data obtained from Ministry of Finance of Japan:**

During my fieldwork in Tokyo, I had arranged meeting with officials of Ministry of Finance of Japan. I had interview with Mr.Kobayashi, Deputy Director for Regional Financial Cooperation Division of International Finance Bureau. During our meeting, he expressed his personal opinion about regional financial integration in East Asia and role of Japan in this process. He also provided me with useful statistical data on regional financial arrangements among ASEAN+3. Data comprises figures, tables, policies, roadmap for CMI and future strategies of ASEAN+3 countries with respect to financial cooperation.

**Interview notes and data obtained from Professor Kinoshita Toshihiko:**

Professor Kinoshita Toshihiko is a scholar at Waseda University whose field of interest is East Asian regionalism. He has written several articles about current regionalization in Asia Pacific. Via help of Waseda Research Institute staffs, I had arranged meeting with him and got to know his opinion about the subject of my research. At the end of our meeting, he presented me his publications and seminar notes about East Asian regionalism. Personally, I found this source useful and reliable and I am going to use them as a reference.

**Source of Data obtained from Waseda University and Lund University Libraries:**

Primary source of data has been obtained from libraries of Waseda and Lund Universities. Apart from using articles and books relevant with my research, I have also acquired online articles from electronic libraries of above mentioned universities. The full list of articles can be found in Bibliography part of the Master Thesis.

**Interview Notes about Asian Monetary Fund:**

During my fieldwork in July-August 2005 in Tokyo, Japan, I had opportunity to conduct interviews with professor Kinoshita Toshihiko from Waseda University and Mr. Kobayashi Kazuo, Deputy Director for Regional Financial Cooperation Division- International Finance Bureau, Ministry of Finance, Japan. Both interviewers have significant knowledge about ongoing process of regional financial cooperation in East Asia and they provided valuable information during our interview conversations. I would like to present some interview notes from our meetings in order to indicate perspectives of scholar from Japanese university and official from Ministry of Finance about possibility of regional monetary fund in East Asia. Interview notes are written in chronological order.

***Interview Notes from the Meeting with Professor Kinoshita Toshihiko:***

Before having meeting with Professor Kinoshita I decided to search through internet and find out his articles and publications. He has written many articles on East Asian regionalism and his most recent article was ``How East Asians Can Coexist and Prosper`` written in the `Japan Journal` in June 2005.

In that article there are some important points that I would like to share with you. For instance, one of the interesting quote was “ If we push ahead in deepening economic integration, the future direction is likely to become apparent of its own accord, without any need to antagonize countries outside the region” (Prof. Kinoshita). From this statement professor Kinoshita probably tries to emphasize importance of economic interdependence as a crucial prerequisite for economic integration which I find logical.

One of the focus points of my thesis is to analyze which potential country in East Asia will lead the process, in other words, whether it will be China, Japan or both. In that article Mr. Kinoshita claims interesting argument about leadership in East Asian regionalism by saying: “Although Japan is very active in East Asian regionalism, China is also eager to work with Japan as part of the process of regional cooperation and the development of an East Asian Community and has even said that it would like Japan to take the initiative in some areas such as regional financial cooperation” which indicates that China and Japan are ready to cooperate for East Asian integration. Later in the article he makes even more striking argument; “Competition between Asia’s two giants, namely China and Japan actually contributes to the process of regional integration in East Asia”. During my meeting with Prof. Kinoshita I asked him in what sense such competition contributes to the process of regional integration. He replied that “If for instance China takes initiatives and tries to take active role in East Asian cooperation, Japan immediately steps in and introduces new ideas and initiatives in order not to remain back in the leadership race. And this happens vice versa”.

He concludes his article as such: “As a result of factors such as a greater sense of regional unity and consensus in East Asia, it has become increasingly apparent that committing to regionalism is in Japan’s best interest but Japan needs to dedicate itself to the creation of a rational East Asian Community that is open to the rest of the world, whilst at the same time maintaining its trusting relationship with US”.

On the 1<sup>st</sup> August, 2005 Monday at 11:00a.m I and Waseda Research Institute Staff Eriko Sekiguchi visited Prof. Kinoshita at his room. Before proceeding to the interview questions I mentioned professor Kinoshita about his latest article which I have briefly described in above. He was surprised that I could find that article and he replied with smile by saying: “Even I don’t have it yet, where did you get that article?” When I said that I found it from the internet he responded: “Nowadays everything is possible to find on the internet”.

My initial question was about his opinion on his latest article. He made some short comments on that. According to him, in Japan some people are against of East Asian integration where China exists due to communist regime in China. Another problem is the ambiguous attitude of bureaucrats and politicians who have concerns of conflict with USA because of East Asian regionalism. Professor Kinoshita argues that Asia Pacific integration is not appreciated by US government and Japanese authorities try to follow East Asian regionalism policy in the way that will not increase dissatisfaction of US government.

Later in the meeting I asked professor Kinoshita interview questions which he answered with details. I would like to share with you answers of Mr. Kinoshita to some

critical questions. First, I asked him whether there was correlation between Asian Financial Crisis and Asian Monetary Fund proposal, in other words I wanted to know what was the true intention behind AMF proposal, was it proposed to provide rescue package for affected countries or Japan's intention was to establish regional institution. His responded my question by arguing that: "Japan's contribution to deal with financial crisis started many years ago and Japan hasn't only helped East Asian countries but also others especially Latin American countries. However, in 1997 AMF proposal was very special proposal because previous proposals were always in line with US based IMF policies, but this time Japan proposed different conditionality". According to Professor Kinoshita AMF proposal was rejected due to contrasting perception of Asian Financial Crisis. "US and some European countries considered Asian Financial Crisis as the outcome of cronyism and nepotism existing in 'Asian corporate culture' while Japan did not agree with that. Moreover, until Asian Financial Crisis, IMF and World Bank praised Asia Pacific countries by indicating them to other developing countries as the excellent performers. Nevertheless, after crisis, suddenly these institutions started criticizing East Asia with nepotism and cronyism. Needless to mention, in fact, IMF prescriptions made things worse for East Asian countries. When Japan proposed AMF to deal with crisis US government rejected that proposal by claiming that AMF could kill guiding power of IMF and create moral hazard in East Asia. On the other hand, there was strong criticism against IMF especially in Malaysia and Korea." Professor Kinoshita concluded his comments by arguing that rejection of AMF was due to commercial interest of USA.

Although I have discussed several issues with Professor Kinoshita, for the sake of better focus, in this report I would only mention his opinion about AMF and its future prospects. When I asked him whether Asian Monetary Fund would be established he told me that he is not very optimistic about that. He supported his argument as such: "Although USA rejected AMF proposal of Japan in 1997, in 2000 US government tolerated Chiang Mai Initiatives. So, right now to introduce AMF might generate tension between Japan and US government. On the other hand, IMF has also accepted its failure and made some reforms in conditionality. Clearly speaking, 'one size fits all' policy of IMF currently is in the process of revision. Therefore, if IMF introduces necessary reforms and restructuring, then it could be sufficient for the East Asian region. Moreover, if Asian Monetary Fund will have same conditionality with IMF then there will be no sense for establishment of AMF."

Finally I asked Professor Kinoshita what are the possible obstacles that could prevent financial cooperation in East Asia to go further. He replied that there are two main obstacles. "First obstacle is the historical preoccupation between China, Japan and Korea that generates

hostility among young generations. Second obstacle is the poor economic situation in some East Asian countries that requires huge subsidization for bringing those countries to the same level with more advanced Northeast Asian countries. The picture becomes more dramatic when you consider that some Southeast Asian countries like Laos and Cambodia are even poorer than sub-Saharan countries.”

At the end of our meeting, professor Kinoshita offered me some of his publications that could be useful for my master thesis. These were presentation notes on “Economic Integration in East Asia and Japan’s Role” presented by Mr. Kinoshita on the 24<sup>th</sup> of June, 2004 in Washington DC. In return, I highly appreciated his kind offer.

***Interview Notes from the Meeting at the Ministry of Finance of Japan:***

On the 3<sup>rd</sup> of August, 2005 I and Mrs. Keiko Koyanagi from Waseda Research Institute visited Ministry of Finance of Japan. Our meeting was arranged with Mr. Kobayashi Kazuo, Deputy Director for Regional Financial Cooperation Division- International Finance Bureau. The interview meeting was held at the meeting room of Regional Financial Cooperation Division with following officials from Ministry of Finance: Mr. Kobayashi Kazuo and Mrs. Madoka Shinzato.

I would like to mention that Mr. Kobayashi Kazuo had prepared well for our meeting. He brought to the meeting several research reports that could be useful for my master thesis. Moreover he provided me with the copy of declaration of ASEAN+3 Financial Ministers about summit in Istanbul. All these materials contain valuable information and it is possible to find out from them answers to my interview questions.

Generally speaking, I can say that it was very interesting conversation. Although we have discussed wide range of issues, I would like to share with you some important points that Mr. Kobayashi mentioned during the meeting. Right now there are two critical issues in the process of financial cooperation in East Asia. First is the linkage of Chiang Mai Initiatives to the IMF conditionality and the second one is the establishment and location of regional financial institution like Asian Monetary Fund.

Mr. Kobayashi’s comments on these issues were as such: “Linkage of Chiang Mai Initiatives to IMF conditionality is very critical issue and ASEAN+3 financial ministers intensively discuss how to revise that condition. However, there is solid achievement with respect to this issue. At the last meeting of ASEAN+3 financial ministers held in May, 2005 in Istanbul, there was an agreement on increase in the size of swaps that could be withdrawn without the IMF-supported program from the current 10% to 20%. Thus, in the case of financial crisis, ASEAN+3 countries can withdraw 20% of accumulated financial capital

without IMF conditionality. In the future, it is highly possible to see further increase in this percentage.”

On the second issue he argued as such: “Now in Chiang Mai Initiatives there is 39.5 billion USD accumulated and regional surveillance and enforcement mechanism was strengthened by introduction of Economic Review and Policy Dialogue under ASEAN+3. Therefore, current trend indicates that for a better coordination of the regional fund there will be institutionalization of financial cooperation in East Asia. For a sustainable development of financial cooperation it is necessary to establish regional financial institution. However, while ASEAN+3 member countries favor the idea of Asian Monetary Fund, an important obstacle is where to locate AMF, in other words, should it be located in Japan, China or somewhere else in East Asia. Unfortunately, consensus on location hasn’t reached yet.”

**Disposition:**

The Master Thesis would be categorized into four main parts. Part#1 will analyze necessity factors for regional monetary funds which would have following subsections: Asian Financial Crisis, Growing Intra-regional trade in East Asia and particular interest of East Asian countries in forming regional monetary institution.

Part#2 will deal with feasibility of regional monetary organization in Asia Pacific. In this part I am going to indicate financial potentials in East Asia. Later in this part, I intend to study feasibility of regional monetary fund for East Asia. For better understanding of how far it is feasible to have regional cooperation in East Asia, I will provide European Union East Asia comparison. At the end of part#2, I will give some examples from other analogical regional monetary institutions such as Latin American Monetary Fund and Arab Monetary Fund.

In Part#3, I will discuss current regional financial arrangements in ASEAN+3 zone. That would be analysis of Chiang Mai Initiative and Regional Surveillance and future prospects with respect to financial cooperation in East Asia.

Above mentioned financial arrangements require institutional coordination. That is why I am going to analyze the role of IMF and ADB in East Asia and study whether these institutions could coordinate financial arrangements of ASEAN+3. If not, then there is a necessity for new alternative regional monetary organization.

## CHAPTER 1

### **Why Regional Monetary Fund is *Necessary* for East Asian Economies?**

#### **How Asian Financial Crisis has brought loss of confidence to IMF:**

“When the Thai baht collapsed on July 2, 1997, no one knew that this was the beginning of the greatest economic crisis since the Great Depression- one that would spread from Asia to Russia and Latin America and threaten the entire world” that is the first sentence of Joseph Stiglitz in Chapter 4 of “Globalisation and Its Discontents” (J.Stiglitz, 2002: 89). However, Asian Financial Crisis has another importance for East Asian economies, since it is regarded as initiator of regional financial cooperation. If one asks why intensive economic cooperation in East Asia has started since 1997 but not before, the most appropriate answer would be the emergence of awareness among East Asian countries that mutual cooperation is the only way to deal with regional crises. Wrong prescriptions of IMF during and after the crisis have contributed to such belief. In this section, I am going to discuss the series of IMF’s policies that have generated loss of confidence to IMF in Asia Pacific.

IMF responded to AFC by proposing crisis countries to increase interest rates and taxes which in turn would lower aggregate demand. Joseph Stiglitz, however, claims that “given impending recession in East Asia, the problem was not excess demand but insufficient demand. Dampening demand could only make matters worse.” (J.Stiglitz, 2002: 104). IMF’s policy with interest rates also brought many Asian companies to the level of bankruptcy. Many economists agree that IMF must have anticipated that outcome of its policy, since if firms have high levels of indebtedness, imposing high interest rates, even for short periods of time will eventual generate insolvencies problems not only for weak firms but also for stronger ones (J.Stiglitz, 2002: 104).

Another dissatisfaction with IMF’s approach was its inability with controlling sentiments of investors and depositors. ‘Instead of dousing the fire, the IMF in effect screamed fire in the theatre’ that is how Jeffrey Sachs depicts IMF’s approach to Asian Financial Crisis. Robert Wade and Frank Veneroso on the other hand, argue that IMF’s insistence on shuttering many banks despite the absence of deposit insurance caused panicky depositors to withdraw their deposits in return for cash and its push for cutting demand and liquidity has caused the bankruptcy or radical devaluation of the value of firms that were efficient and profitable, as well as those were not (R.Wade and F.Veneroso,2000).

Frequently, IMF is criticized due to its “one size fits all” strategy while it imposes same conditionality for all economies regardless of nature of the crisis. Whether it is relevant or not, in return for financial assistance, IMF always asks not only for immediate market and institutional liberalization but also for ability to repay back foreign debts. That was also case for Asian Financial Crisis, since according to IMF, the solution to financial crisis in East Asia required domestic programs to restore the capacity to repay foreign debt, and radical institutional change, including further liberalization of the financial sector (R.Wade and F.Veneroso,2000). However, IMF’s ‘one size fits all’ strategy made things worse for East Asia economies and almost all commentators have agreed that IMF’s wrong prescriptions occurred partially due to the distinct financial structure of East and Southeast Asian economies, that differs from the kind of case that IMF usually deals with.

In Western financial system, companies normally carry an amount of debt that is not bigger than and generally less than the value of their equity capital; and banks will not lend to companies with higher levels of debt. On the other hand, in East and Southeast Asia, corporate debt to equity ratios of the bigger firms are commonly two to one or more (R.Wade and F.Veneroso,2000). The rationality for such high corporate debt to equity ratios is high savings in East Asian economies. Since households hold their savings mostly in bank deposits, banks have to lend. When neither households nor government are significant net borrowers, the system is biased towards borrowing by firms and in relatively high amount (R.Wade and F.Veneroso,2000). It is crucial to take into account that such financial structure requires cooperation between banks and firms, and considerable government support while restrictions on the freedom of firms and banks to borrow from abroad, and coordination of foreign borrowing by government, are a necessary part of this system. (R.Wade and F.Veneroso,2000).

Over 1990s, with insistence of IMF, OECD and Western governments, banks and firms Asian governments removed controls on companies’ foreign borrowings, abandoned coordination of borrowings and investments, and at the same time failed to strengthen bank supervision (R.Wade and F.Veneroso,2000). By doing so, they violated one of the stability conditions of the Asian high debt model, helping to set the crisis in train. That’s why it seems particularly unwise for the IMF to insist that companies receive even more freedom than before to borrow on international capital markets on their own account, without government coordination, when it was their uncoordinated borrowing that set up the crisis in the first place.



IMF's unclear approach to AFC raised doubts in minds of many people that, IMF's policies are biased to defend the interests of the owners and managers of international capital. The reforms that the Fund requested countries to implement are connected in one way or another with further opening up Asian economies to international capital. Some respectful economists started asking question why is the Fund insisting on capital account opening in countries that are abundant with domestic savings. For instance, Robert Wade and Frank Veneroso claim that in such high saving societies, foreign savings are not needed, since it is already difficult enough to allocate domestic savings to efficient investments at the margin (R.Wade and F.Veneroso,2000). According to them, such reforms might seriously damage developmental state model of Japan, Korea and Taiwan, while future results would be far from the IMF's model of a desirable financial system (R.Wade and F.Veneroso,2000).

Apart from following interest of foreign investors, the role of the US Treasury in shaping the IMF's insistence on radical financial opening in Korea is also documented. The Treasury made it clear that Korean financial opening was a condition of US contributions to the bail-out, on the understanding that financial opening would benefit US firms that would in turn give political support for US contributions (R.Wade and F.Veneroso,2000). Maybe, that is why Asian Financial Crisis was ironically called as "The Second Opium War" in Korean and Southeast Asian media. Another impact of US Treasury on IMF's policies became apparent when US Treasury argued that Japan's proposal of 30 billion USD Miyazawa Initiative should be spent not to stimulate the economy through fiscal expansion, but for corporate and financial restructuring- effectively, to help bail out American and other foreign banks and creditors (J.Stiglitz, 2002: 113).

All these events were perceived negatively by East Asian countries and in order not to experience the same situation they decided to cooperate for mutual benefit without being dependent on external forces. That is why the rationality for economic and financial cooperation in East Asia is based on principle of preventing another regional financial crisis.

### **Gradually Growing Intra Regional Trade in East Asia:**

Since 1985 trade flows among East Asian countries have dramatically increased while after Asian Financial Crisis, ASEAN+3 member countries have realized importance of free trade agreements for regional development. Currently, series of bilateral and multilateral trade negotiations take place in Asia Pacific. Nevertheless, for sustainable regional economic cooperation there is a need for well-organized regional financial governance.

**Table 1.1: Share of Intraregional Trade in East Asia, EU and NAFTA**

	<b>1990</b>	<b>1995</b>	<b>1998</b>	<b>2000</b>	<b>2004</b>
<b>EU</b>	65.4%	65.1%	65.2%	64.6%	65.7%
<b>East Asia</b>	41.4%	49.9%	47.0%	51.1%	53.4%
<b>NAFTA</b>	37.2%	42.0%	45.7%	46.9%	43.9%

- ❖ The trade amount is the sum of imports and exports.
- ❖ East Asia: ASEAN, Japan, China, Korea, Taiwan, and Hong Kong  
EU: 25 European Union countries  
NAFTA: Canada, USA and Mexico

**Source: IMF ``Direction of Trade Statistics``**

As it is indicated in Table 1.1 while EU and NAFTA intraregional trade shares were relatively stable through last decade, intraregional trade in East Asia has performed significant gradual growth since 1990. Despite small decline in 1998 (basically due to Asian Financial Crisis), intraregional trade shares in Asia Pacific reflect upward sloping growth trend.

A China –ASEAN Free Trade Framework Agreement was agreed in November 2001, and now the agreement has become effective. The China-ASEAN tariff will be zero by 2010 while Cambodia, Laos, Myanmar, and Vietnam, four less developed ASEAN countries, will join AFTA by 2015 (Kinoshita, 2004; 4).

As Kinoshita Toshihiko argues `Free Trade Agreements help economic development but can not solve diversity problems among members, income disparity in particular. Proactive actions to correct such discrepancies are necessary for further economic integrations`. Therefore, I would argue that regional monetary fund could be very essential for East Asia, since by allocating regional fund it could implement necessary proactive actions to reduce diversities within the region.

### **Interest of Japan in East Asian Community:**

In last two decades East Asia has become important market to Japan. The share of exports from Japan to other countries in East Asia nearly doubled over the past two decades, rose from 20% in 1980 to 40% in 2001, while during the same period, the share of Japanese import from the rest of East Asia rose from 26% to 40% (A.Nasution, 2005; 426). As a consequence, recent Japanese foreign policy mainly focuses on the development of East Asian community.

At the core of Japan`s interest in forming East Asian Community exists interest of big Japanese companies operating in East Asia. This especially becomes apparent when Keidanren (Japan`s big business lobby) pushed the government to embrace regionalism because it knew that some of its important members, especially automobile and electronics firms operating as multinational corporations (MNCs), could benefit from `deeper integration` that would allow them to operate more freely in host countries (W.Hatch, 2005; 89). Thus, we can conclude that Japanese corporations constitute the `driving force` behind regional economic integration, and their leadership in developing a Japanese strategy for regionalism helps to foster cooperation between related ministries.

However, this is not the only reason why Japan is so passionate about developing East Asian Regionalism. Japan`s challenge with IMF and World Bank in shaping universal ideology for industrial policy might have encouraged Japan to support regional financial cooperation in East Asia. It is well-known that Japan is situated to be the biggest creditor country in the world while it is also quite common that Japanese government has encouraged its recipient governments to think more strategically and in more interventionist terms that can be accommodated by World Bank ideas (R.Wade, 1996; 7). Particularly, Japanese government claims that the potential benefits of the state`s directional thrust are illustrated by the actual benefits from the Sectoral industrial policies of pre- and post- war Japan (R.Wade, 1996; 7).

Robert Wade argues that `Japanese challenge to the World Bank can be seen as part of a wider attempt by the Japanese elite to develop an ideology distinct from free trade and orthodox liberalism` (R.Wade, 1996; 14). Probably not surprisingly, recently Japanese government has started considering `the Japanese approach to industrial policy` as a new export product, and for this aim, it is building up an enormous capacity for teaching Asian bureaucrats, industrialists and scholars about the Japanese approach to industrial policy (R.Wade, 1996; 34).

In my opinion, above mentioned interests of Japan could be sufficient reasons for Japanese government to consider about regional monetary institution through which it would be able to reflect its own ideology about regional financial governance.

### **Interest of People's Republic of China in East Asian Regionalism:**

The process of economic integration in East Asia is of great significance to China, too. According to Z.Hong "China believes that the mechanism of ASEAN+3 should be developed as a primary vehicle for broader regional cooperation in East Asia" (Z.Hong, 2005; 61). It is possible to argue that China's perception from China ASEAN Free Trade Agreement (AFTA) and other forms of sub-regional cooperation in East Asia is that these regional cooperation will bring about a chain reactions from Japan and other countries in the region which may serve as building blocks for an eventual East Asian Community.

Domestic policies also shape China's foreign policy with respect to East Asian Regionalism. Probably, the most influential one is the economic cooperation in the Greater Mekong zone that not only meets the needs of some less-developed ASEAN countries, but also is China's strategic choice for accelerating development in its Western region (Z.Hong, 2005; 62). Hence, sub-regional economic cooperation with ASEAN might be providing a good channel for opening the western region of China to the world and accelerating market economic reform there.

### **China versus Japan:**

Many analysts agree that the destiny of East Asian Regionalism depends basically on Japan and China and on their cooperation in this process. China is becoming more and more active in promoting sub-regional economic cooperation in East Asia while Japan seems to be follower in this process. According to Zhao Hong China has never intended to marginalize Japan's role in regional cooperation, instead it simply wants Japan to join it in playing the role of 'two engines' promoting East Asian economic integration (Z.Hong, 2005; 60).

However, nobody would deny that as the second largest economy in the world and the largest in Asia, Japan's market is important to East Asian countries and if East Asia wants to become the third regional economy after the EU and NAFTA, then Japan's leading role should not be neglected.

It is also crucial to note that there is a common belief that successful collaboration between Japan and China will be a pivotal element in promoting regional integration in East Asia. So far, it seems that while China is leading the process in trade negotiations, Japan takes initiatives in financial cooperation.

### **Interest of Association of Southeast Asian Nations (ASEAN):**

Economic cooperation in East Asia has started with bilateral or/and multilateral Free Trade Agreements and there is a strong expectation that FTAs and sub-regional economic zones will help to revive and develop backward areas. This expectation has been especially keen in ASEAN countries which have inherited excessive corporate debt, non-performing loans and large government budget deficits from Asian Financial Crisis (Zhao Hong, 2005;55).

It is crucial to notice that many East Asian countries do not have sufficient confidence to become involved in, and, to some extent, are reluctant to commit seriously to, multilateral cooperation. Particularly, it seems that they wonder whether regional cooperation may in the long term lead to a loss of sovereignty. As Zhao Hong claims, `most countries in the region fear being dominated by regional powers in the process of regional integration` (Zhao Hong, 2005;58).

This insecurity of East Asian countries mainly arises from the fact that unlike the case of Europe, East Asia lacks a kind of institutional driving force for integration. Regional monetary fund in Asia Pacific could provide egalitarian distribution of power in decision making and hence could increase confidence of ASEAN countries in regional cooperation. That is why regional monetary organization could play leading role for sustainable regional integration.

### **Dissatisfaction of East Asian Countries with Global Financial Governance:**

Some economists such as Gordon de Brouwer and Joseph Stiglitz emphasize the important detail in the global financial system where, despite having a fundamental interest in the global architecture, East Asian interests are not adequately represented in global forums and institutions. As a group East Asia now commands about a fifth of world GDP, a quarter of world trade and nearly a half of world foreign exchange reserves, but only has 15% of the IMF quota and hence voting rights in that organization (A.Nasution, 2005; 426).

The primary dissatisfaction occurs due to the fact that although East Asia is major shareholder in IMF most of East Asia is under-represented in the decision-making of the IMF whereas North America and Europe is over-represented (G.Brouwer, 2004;7).According to Gordon de Brouwer there is concern among East Asian countries that the credibility of the IMF is undermined by its pliability in meeting the short-term strategic objectives of its major shareholder namely East Asia. Particularly, there is concern that the concentration of the IMF's lending to Argentina, Brazil and Turkey increases the Fund's exposure to risk and

creates moral hazard. In fact, these countries are not as strategically important to East Asia as they are to the United States or Europe (G.Brouwer, 2004;7).

It seems that the more the region is dissatisfied with global arrangements and feels that it is marginalized in, or excluded from, international policy debates, the more likely it is to focus on regional solutions. Unless there are remarkable changes in approach of global institutions with regards to East Asian interests, current circumstances will encourage further progress in regional financial cooperation in East Asia.

Another popular debate in East Asia is about what should be the appropriate model for financial cooperation in ASEAN+3 zone. For instance, Kinoshita Toshihiko hopes that East Asia will not adopt the Anglo-American model as it is. He believes that the Anglo-American standard has alien components that are incompatible with East Asia's economic systems, traditions, societies, cultures, and ideals about human relationships. Therefore, if regional monetary fund will be established, it should adopt East Asian standards which would have maximum flexibility to allow for the coexistence of the various East Asian systems, yet still generate the minimum homogeneity necessary to allow for competitive East Asian economic system.

## CHAPTER 2

### **Is Regional Monetary Fund *feasible* in East Asia?**

#### **Significant Financial Potentials in Asia Pacific:**

During Asian Financial Crisis, East Asian countries indicated their power and determination in regional financial cooperation. For instance, besides the IMF, World Bank and ADB, only countries from the region provided direct financial support to Thailand (Gordon de Brouwer, 2004; 3). The psychological impact of the Friends of Thailand was large since it showed that the region itself was able to come together quickly and resolutely to provide support for one of its own. Support to Thailand was not the only case as in subsequent international financing packages, the region committed USD 14 billion to Indonesia (out of a total USD 35.1 billion) and USD 11.1 billion to South Korea (out of a total USD 58.4 billion) (Gordon de Brouwer, 2004; 3).

**Table 2.1: *General Statistical Overview of East Asian Countries***

	Area (1000km <sup>2</sup> )	Population (mil) (2003)	GDP (bln USD) (2003)	Per Capita GNP(\$) (2003)	Real GDP Growth(%) (2004)	Foreign Reserve (bln \$) (2004)
Japan	378	127	4,326.4	34,180	2.6	835.2
S.Korea	99	48	605.3	12,030	4.6	199
China	9,598	1,288	1,409.9	1,100	9.5	615.6
Brunei	5.8	0.4	N.A	N.A	1.1	N.A
Cambodia	181	13	4.3	310	4.3	1.0
Indonesia	1,905	215	208.3	810	5.1	35.1
Laos	237	5.7	2.0	320	6.0	0.2
Malaysia	330	25	103.2	3,780	7.1	66.5
Myanmar	677	49	N.A	N.A	5.0	0,7
Philippines	300	82	80.6	1,080	6.1	13.3
Singapore	0.6	4.3	91.3	21,230	8.4	112.2
Thailand	513	62	143.2	2,190	6.1	48.8
Vietnam	332	81	39.2	480	7.7	6.6

**Source: IMF, World Bank, Ministry of Finance of Japan; 2004.**

**Table 2.2: Regional Comparison Between EU, East Asia and North America**

	EU zone	East Asia	North America
GDP (USD)	9.4 trillion	8.3 trillion	13 trillion
Trade Volume (USD)	5.6 trillion	4.6 trillion	3.2 trillion
USD Reserves	210 billion	2290 billion	175 billion

**Source: IMF `International Financial and Trade Statistics`; 2005.**

From above tables it is possible to see that the East Asian region now has foreign exchange reserves in excess of USD 2.2 trillion, up from USD 715 billion at the end of 1996. While many economies in the region have increased their holdings of foreign exchange, the most spectacular in the past few years are Japan and China, with USD 835 billion and USD 615 billion respectively at the end of March this year.

Reserves of this size naturally lead to the question of how they might be used. Such reserves are not only costly to carry but they also have an opportunity cost which is high for some developing economies. Some countries, therefore, may want to use them for domestic purposes, as China did in January 2004 by allocating USD 45 billion of its reserves to fund bank recapitalization (Gordon de Brouwer, 2004; 5). However, the main holders of these reserves, while probably not wanting to build up reserves further, may keep them on the official balance sheet. As such, some portion of them might be used in some form of financial cooperation. If the region did decide to institutionalize the Chiang Mai Initiatives arrangement, for example, say in the form of an Asian Arrangements to Borrow or central reserve fund, some of these reserves could be channeled to that purpose. Amounts that are talked about in the region range as high as USD 100-200 billion, which is substantially above the aggregate value of the bilateral swaps (Gordon de Brouwer, 2004; 6). In this case, Japan is expected to be the most likely candidate to increase the amount of funds in such an arrangement.

The region certainly now has the financial resources to deal with regional financial crises alone if it so wanted. At the end of 2003, the IMF's total resources were USD 326 billion whereas its one-year forward commitment capacity was a more modest USD 81 billion; supplementary funding of around USD 50 billion is available through the General Arrangements to Borrow and the New Arrangements to Borrow (Gordon de Brouwer, 2004; 6). Therefore, external funding for a country in crisis can now be provided by either the IMF or East Asian financial resources.



### **The role of Institutions and the Analysis of Regional Monetary Fund in East Asia:**

One should take into account that there is no presumption that an institution created for the needs of East Asia at this point in time will necessarily have the attributes of some other similar institution elsewhere (Gordon de Brouwer, 2004; 10). In other words, what suits the region should be informed by insight from elsewhere, however, it does not have to mimic one to one what is done elsewhere.

While setting up their regional institution, East Asian countries should be careful in shaping decision-making mechanism. This is especially important if the region comprises a few very large countries, as does East Asia. Therefore decision-making process should be shared across countries. Otherwise, the region as a whole will be unwilling to choose institutional forms or practices which allow a big country to dominate a regional institution in the same way as the United States is perceived to dominate the IMF.

Since the basic rationale for a regional institution is to ensure stability, the guiding principle for selecting the responsibilities of the regional monetary fund in Asia Pacific should be the promotion of regional financial and economic stability.

As Gordon de Brouwer argues the responsibilities of a regional institution can not mimic those of a global institution since they are regional, not global, by construction (Gordon de Brouwer, 2004; 13). For example, a regional body can not do global surveillance and there are some forms of cooperation that probably can only be done at the global level such as private-sector involvement which requires global coordination to be effective. For instance, it is quite obvious that East Asian governments have no jurisdiction over the activity of US or European banks and other financial institutions outside East Asia. Thus, regional monetary fund should be constructed in such a way that will enable it to solve the problems on the regional level.

To sustain financial stability, regional monetary fund has no choice but to provide effective surveillance. According to Gordon de Brouwer, effective surveillance requires not just the sharing of information about key economic and financial developments but also transparent and open discussion of policy responses to the economic and financial issues in play (Gordon de Brouwer, 2004; 13). This is probably the weakest aspect of regional financial cooperation in East Asia, since due to the fact that much of East Asia comprises developing economies with diverse income levels, the region faces a basic problem of adequate data and information collection and exchange.

Another important aspect with regards to regional monetary institution is its conditionality for financial assistance. Currently, bilateral swap agreements in East Asia are

coordinated under IMF conditionality. Nevertheless, the region might decide to substantially ease or remove the attachment to IMF conditionality. This would then require it to set out its own economic and structural conditions for borrower country to access the region's funds. Although it is widely appreciated in East Asia, to fail to do so could create substantial moral hazard. Some analysts argue that conditionality settled by East Asian regional monetary institution could provide easy access to fund by regional countries while their fundamental problems wouldn't be solved. However, it is not possible to say that conditionality set by a regional body would be weaker than that provided by the IMF, or that a regional body would be less credible than the IMF, since creditor countries in East Asia have no desire to waste public resources. In fact, what really matters is how efficiently economic analysis, policy debate and incentives in the region are elaborated.

Finally, while setting up regional monetary fund, policy makers should clearly define its linkages to the global financial governance. For instance, if a regional entity starts as the 'leader' manager of a financial crisis in the region, there has to be an effective mechanism to pass management of the crisis to the global crisis manager if the crisis becomes unmanageable at the regional level, say, because it extends to many other countries in the region or spread beyond the region. That requires regional institution to be compatible with global mechanism. Therefore, even if East Asian regional fund is independent of the IMF, there have to be effective and strong links between the two institutions.

### **Reflections from EU Integration Experience:**

The basic reflection from European integration is that although initially it concentrated around the integration of regional markets in goods and capital, in subsequent stages growth of intra-regional trade generated interest not only in the reduction of trade barriers but also in currency and monetary stability. Thus, regional market integration could encourage regional policy makers to commit to monetary cooperation, as currency fluctuations can disrupt trade and investment.

In fact, according to market integration approach, growing intra-regional trade and investment in the long run requires financial cooperation. Since intra-Asian trade ratios approach those of Europe in the 1970s, the market integration approach must therefore anticipate that, assuming intra-regional trade and investment continue to grow, some of the current proposals for exchange rate and financial cooperation will be implemented (R. Henning, 2004; 88).

Another distinct feature of European integration is the dense network of Western European regional institutions. As Randall Henning has mentioned in his article, the

institutional network of European Union facilitated the exchange of information, monitoring and enforcement of bargains, and making of side payments among member states (R. Henning, 2004; 88). Thus, regional institutions have performed critical role in successful European integration.

On the other hand, institutions of the Asian region have been relatively weak. General idea about institutions in East Asia is that although regional organizations in Asia have facilitated transnational networks, they haven't developed into policymaking institutions (R. Henning, 2004; 89). As a consequence, unlike the European Commission, no present Asian institution could play the roles of initiator, entrepreneur, broker and enforcer. According to Randall Henning, with present institutions, Asian financial integration will occur through inter governmentalist initiatives or not at all.

From the perspective of spillover approach, the weakness of Asian trade regionalism historically explains the weakness of monetary and financial cooperation compared to Europe (R. Henning, 2004; 90). Nevertheless, current attempts to liberalize trade on a sub-regional basis would encourage further monetary and financial integration as well. Specifically, spillover approach anticipates that close financial cooperation in the form of mutual financial facilities to fight with capital withdrawal will lead to more general monetary cooperation as well (R. Henning, 2004; 90).

#### **Analogical Regional Monetary Funds:**

When the idea of setting up an Asian Monetary Fund was first suggested by Japan during the early stage of the Asian Financial Crisis, the idea was quickly shot down. The main argument was that it would overlap with the IMF and lead to increased moral hazard. My initial impression at that time was that a regional monetary organization is something new, and therefore great care is needed in thinking about setting up such an organization. However, later it turned out that there already exist regional monetary organizations, whose objectives and the scope of their activities do not differ so much from what an AMF might do. These are the Arab Monetary Fund and the Latin American Reserve Fund. Information about Arab Monetary Fund and Latin American Reserve Fund I have obtained from their official website. In bibliography part, you can find their corresponding web-links.

The Arab Monetary Fund was set up by the Economic Council of the League of Arab States in 1976. Its principal aims are to: promote the stability of exchange rates among Arab currencies and render them mutually convertible, correct disequilibria in the balance of payments of member states, coordinate the monetary policies of member countries and the liberalization and promotion of trade and payments, as well as the encouragement of capital

flows among member countries. The Arab Monetary Fund aims to promote the capital markets of the region, and more recently, in 1995, the Inter-Arab Rating Company (IARC) was set up in partnership with Arab Monetary Fund, the International Finance Corporation and Fitch IBCA, in order to promote and set up local rating agencies in various Arab countries. The eventual aim of the Arab Monetary Fund appears to be the promotion of the use of a common currency, the Arab Dinar, and the economic integration of its members.

The Latin American Reserve Fund (LARF), on the other hand, was established in 1991 as the successor to the Andean Reserve Fund (ARF). LARF's aims are to assist in correcting payments imbalances through loans with terms of up to four years and guarantees extended to members; to coordinate their monetary, exchange rate, and financial policies and to promote the liberalization of trade and payments in the Andean sub-region. Latin American Reserve Fund member countries are Bolivia, Ecuador, Venezuela, Colombia and Peru while its headquarters locates in Bogota, Colombia.

It can be seen that the objectives of these regional monetary organizations appear similar to what regional monetary fund in East Asia might perform. The crucial point is that this type of organization already exists and has been functioning for some time.

## CHAPTER 3

### **Financial Cooperation Initiatives Under ASEAN+3<sup>†</sup>**

Currently, there are four main regional projects jointly coordinated by Finance Ministries of ASEAN+3. These are: Economic Review and Policy Dialogue, Chiang Mai Initiatives, Asian Bond Markets Initiative and ASEAN+3 Research Group. Probably the most crucial one is Chiang Mai Initiative since it is not only the first regional financial arrangement among East Asian countries after the Asian Financial Crisis, but also is situated to be the locomotive force driving financial cooperation in Asia Pacific.

#### **Chiang Mai Initiative: (Bilateral Swap Agreement in East Asia)**

The history of Chiang Mai Initiative starts in July, 1997 with devaluation of the Thai baht which was also beginning of Asian Financial Crisis. To discuss financing package for Thailand regional policy-makers met in Tokyo in August 1997 where Japan started developing idea of Asian Monetary Fund. In September 1997, at the IMF- World Bank Annual Meetings in Hong Kong, Japan officially announced its intention to establish regional monetary fund namely Asian Monetary Fund (Yamasaki Tatsuo, 2005). Nevertheless, USA, Australia and China strongly opposed this proposal by arguing that possible establishment of AMF could generate moral hazard in the crisis management.

In November 1999, 10 ASEAN member countries together with People's Republic of China, Japan and Korea met in Manila to set up ASEAN+3 economic summit that covers a wide range of regional cooperation issues, including monetary cooperation (Anwar Nasution, 2005; 430).

It is worthwhile to notice that ASEAN+3 economic forums don't include financially potential economy, Taiwan which is due to lack of being nation state could not participate to regional cooperation. Nevertheless, Taiwan is member of other regional forums of East Asia, such as APEC and SEACEN (Anwar Nasution, 2005; 431). On the other hand, other previously independent economies Hong Kong and Macao participate in ASEAN+3 forums through the People's Republic of China since they are now parts of China (Anwar Nasution, 2005; 431).

In May 2000, finance ministers of ASEAN+3 decided in Chiang Mai, a city in Thailand, to expand existent ASEAN Swap Arrangement (ASA) and include Northeast Asian countries Japan, China and Korea which later adopted the name of "Chiang Mai Initiative" (CMI) (Anwar Nasution, 2005; 431). ASEAN Swap Arrangement was established in August

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<sup>†</sup> Information for this chapter has been obtained from the source provided by Ministry of Finance of Japan. I acquired these data from MOF of Japan during my fieldwork in Tokyo in July, 2005.

1977 by the five original ASEAN member countries (Thailand, Malaysia, Indonesia, Singapore and the Philippines) to provide a network of bilateral swap and repurchase agreement facilities with contribution of 40 million USD by each country which later was increased up to 1 billion by August 2000 with enlargement of membership to other five ASEAN member countries (Anwar Nasution, 2005; 431). Both ASA and Chiang Mai Initiative have an objective to provide systematic collective defense against speculative attacks within the ASEAN+3 zone.

**Table 3.1: Network of Bilateral Swap Arrangements (BSAs) under the CMI**

	<b>BSA</b>	<b>Currencies</b>	<b>Conclusion dates</b>	<b>Amount (USD billion equivalent)</b>
1	Japan-Korea	USD/Won	4.07.2001	2
2	Japan-China	Yen/Renminbi	28.03.2002	3
3	Japan-Philippines	USD/Peso	27.08.2001	3
4	Japan-Indonesia	USD/Rupiah	17.02.2003	3
5	Japan-Singapore	USD/SIN\$	10.10.2003	1
6	Japan-Malaysia	USD/Ringgit	05.10.2001	1
7	Japan-Thailand	USD/Baht	30.07.2001	3
8	China-Korea	Won/Renminbi	24.05.2002	2
9	China-Philippines	Renminbi/Peso	29.08.2003	1
10	China-Indonesia	USD/Rupiah	30.12.2003	1
11	China-Malaysia	USD/Ringgit	09.10.2002	1
12	China-Thailand	USD/Baht	06.12.2001	3
13	Korea-Philippines	USD/Peso	09.08.2002	1
14	Korea-Indonesia	USD/Rupiah	24.12.2003	1
15	Korea-Malaysia	USD/Ringgit	26.07.2002	1
16	Korea-Thailand	USD/Baht	25.06.2002	1

**Source: Ministry of Finance, Japan. April 30, 2005.**

As it is indicated in table 3.1, by April 30, 2005 sixteen bilateral swap arrangements (BSAs) have been concluded with combined total size of USD 39.5 billion. Out of these, seven agreements were signed between Japan and five original member countries of ASEAN (Thailand, Malaysia, Singapore, Indonesia and the Philippines), Korea and China.

Four agreements were between Korea and Thailand, Malaysia, Indonesia and the Philippines. The other five agreements were between China and Korea, Thailand, Malaysia, the Philippines and Indonesia. The largest recipient of the BSA is Thailand with 7 billion USD which is followed by the Philippines and China with 6 billion each, whereas the smallest recipient is Singapore with 1 billion USD (ASEAN+3 Roadmap, 2005).

It is essential to notice that in fact these amounts are far less than external commitments to three crisis countries during AFC. Thailand, Indonesia and Korea have received external commitments \$17.1 billion, \$36.2 billion and \$58.9 billion, respectively, whereas IMF's financial aid packages for these countries were 3.9 USD billion, 11.2 billion and 20.9 USD billion, respectively (Anwar Nasution, 2005; 431).

Currently, the bilateral swap arrangement among ASEAN+3 member countries (CMI) seems just only small step towards regional financial cooperation. Considering financial potentials in East Asia that I have mentioned in chapter 2, the current size of the swap facility has just marginally added to the financial resources available to the countries in this region. To be honest, the size of the Chiang Mai Initiative is inadequate to prevent and manage the financial crisis or large capital outflows as happened during the crisis years in 1997-1998. The amount is also too small compare to the external reserves losses of East Asian central banks during their attempt to defend pegged value of their currencies.

There are some drawbacks that do not let Chiang Mai Initiative to become effective mechanism for crisis management. First of all, bilateral swap arrangements are not centralized and multilaterally administered while for instance swap requesting country requires to get approval from each lender country. Another drawback is linkage of Chiang Mai Initiative to IMF conditionality. Accordingly, swap requesting country can obtain only 10% of fund from CMI immediately without IMF conditionality whereas 90% of fund has to be admitted by IMF (ASEAN+3 Roadmap, 2005). Such linkage to IMF indicates that Chiang Mai Initiative can not act as an independent agent in crisis management.

Probably policymakers of ASEAN+3 are aware of these drawbacks and hence try to make some improvements in the structure of Chiang Mai Initiative. These issues were discussed on the 8<sup>th</sup> ASEAN+3 Finance Ministers' Meeting held on the 4<sup>th</sup> May 2005 in Istanbul, Turkey.

On the 8<sup>th</sup> ASEAN+3 Finance Ministers' Meeting, four important adjustments in the structure of Chiang Mai Initiative were introduced (ASEAN+3 Roadmap, 2005). These are:

- Integration and enhancement of ASEAN+3 economic surveillance into the CMI framework.

- Clear-definition of the swap activation process and the adoption of a collective decision-making mechanism. As a consequence, swap requesting country will not anymore request fund separately from each swap providing country but instead will negotiate with one single pre-appointed coordinating country that will act on the behalf of other member countries. Pre-appointed coordinating country will be circulated within one year term.
- Significant increase in the size of swaps. Member countries are favoring an enhancement of up to 100%.
- According to new swap requesting mechanism, member country can request loan from CMI without IMF conditionality up to 20% from the current 10%.

During my fieldwork in Tokyo, I had interview with official from Ministry of Finance of Japan (Kobayashi Kazuo) and I asked him about future plan of ASEAN+3 with respect to future regional cooperation. He has mentioned four main objectives for future regional cooperation such as collective decision making, enhancement of regional surveillance, utilization of local currencies through Asian Bond Market Initiative and provision of intra-regional exchange rate stability.

It is obvious that for sustainable regional financial cooperation there is a need for institutionalization, otherwise large financial resources of East Asian economies will not be directed to the regional cooperation. However, it is also easy to predict that in the absence of effective regional surveillance and enforcement mechanism countries in East Asia would not commit themselves to more intensive cooperation.

### **Policy Dialogue and Regional Macroeconomic Surveillance in East Asia:**

The regional surveillance provides a venue not only for policy dialogue and discussions for mutual interests but also a venue for regional policymakers to exchange information from each other experiences in managing relatively similar economic and financial structures as well as relatively similar macroeconomic policy regimes. Surveillance mechanism plays also important role in crisis management as it provides warning of crisis and exercise pressure on the vulnerable countries to immediately take appropriate corrective actions. Thus, the regional surveillance mechanism is useful tool to prevent possible future crises in East Asia. Moreover, as Wang and Woo argue ‘monitoring and surveillance is necessary to prevent moral hazard in the use of liquidity provided by the regional institutions and for coordination of exchange rate stability and monetary policies’ (Wang&Woo,2004).

Throughout the history several surveillance mechanisms have been introduced to facilitate information sharing process in East Asia. These are ASEAN+3 Surveillance



Process, Manila Framework Group, SEANZA (South East Asia, New Zealand, Australia), SEACEN (Southeast Asian Central Banks), EMEAP (Executive Meeting of East Asia-Pacific Central Banks) for central banks, APEC and ASEM (Asia-Europe Meeting) for trans-regional policy dialogue, and smaller groups (Haruhiko Kuroda & Masahiro Kawai, 2003; 13). However, the most effective of these mechanisms have been Manila Framework Group and ASEAN+3 Surveillance Process.

Manila Framework Group (MFG) was set up by Fourteen APEC members<sup>†</sup> in November 1997, right after decline of Japan's AMF proposal. The objective of MFG is to perform supplementary role for IMF by providing forum for regional surveillance, economic and technical cooperation (Anwar Nasution, 2005; 435). Nevertheless, MFG fails to provide either additional financial sources or technical advice different from IMF (Anwar Nasution, 2005; 435). Thus, MFG can not be considered as an independent surveillance mechanism that can substitute IMF.

Close linkage of MFG to IMF conditionality dissatisfied ASEAN member countries and encouraged them to consider about establishing their own surveillance mechanism. As a consequence, in October 1998 ASEAN Surveillance mechanism was set up by member countries (Anwar Nasution, 2005; 435). Later, with deepening of ASEAN+3 financial cooperation, in November 1999, ASEAN+3 financial ministers decided to incorporate ASEAN regional surveillance mechanism to Economic Review and Policy Dialogue of ASEAN+3 (Anwar Nasution, 2005; 435). However, it is also difficult to consider ASEAN+3 Surveillance Mechanism as an independent process since it operates under strong influence of IMF surveillance process.

Consequently, it is hard to argue that regional monitoring and surveillance in East Asia is an independent mechanism since as Anwar Nasution claims 'it is limited to complement the analyses that already prepared by international financial institutions, particularly IMF and the World Bank. In fact, there are several factors that need to be improved to make regional surveillance more effective in East Asia. The first factor is the willingness to share information. This is not yet the case for ASEAN since for instance Singapore does not disclose its important statistics such as trade between Singapore and Indonesia and statistics on financial transactions in Singaporean markets'(Anwar Nasution, 2005; 436). As a consequence, the limited transparency and shortage of information reduce the quality of the surveillance not only in Singapore and also throughout East Asia.

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<sup>††</sup> Australia, Brunei, Darussalam, Canada, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore, Thailand and United States.

According to Anwar Nasution, there are three important factors that generate limited transparency and shortage of information in East Asia. These are dominance of family based companies and state-owned enterprises in decision making, weakness in legal and accounting system and lack of corporate culture where management and ownership is not clearly separated (Anwar Nasution, 2005; 436). Another problem to deal with is high level of corruption, collusion and nepotism among state-owned enterprises (Anwar Nasution, 2005; 436). It seems that it is worthwhile to consider about these factors, and in order to set up credible surveillance mechanism in East Asia, regional policymakers should introduce necessary reforms to solve transparency problem.

Apart from problems discussed above, East Asian economies also lack sufficient monitoring capacity to provide effective analysis of data. Particularly, there is problem with inadequacy of technical staff which would be able to analyze the structure and macroeconomic trends of ASEAN+3 member countries (Anwar Nasution, 2005; 436).

Moreover, regional policymakers usually do not sympathize when foreign surveillance agencies monitor their domestic policies. Thus, sometimes monitoring agencies face with difficulties in accessing to data about regional economies.

As I have mentioned before for sustainable regional financial cooperation it is necessary to form regional monetary fund. Nevertheless, without effective surveillance mechanism credibility of such institution would be lower. Therefore, in order to establish effective surveillance mechanism East Asia countries first of all should solve problems that I have emphasized above.

## CHAPTER 4

### **The Role of IMF and ADB in East Asian Financial Cooperation**

International Monetary Fund and Asian Development Bank are taking active role in the current process of regional financial cooperation in East Asia. Both institutions are deeply engaged in East Asian surveillance processes and have particular views on, and interest in, these processes. Both IMF and ADB are strong enough to coordinate financial arrangements in Asia Pacific and actually they have increased their resources to be allocated for East Asian financial arrangements. What really matters is whether these institutions could perform necessary activities for sustainable financial cooperation in East Asia. It is also crucial to analyze how East Asian economies perceive their presence in this process.

#### **IMF's Perspectives on Regional Cooperation in East Asia:**

According to Chris Gilbert and David Vines “one of the core responsibilities of the IMF is to maintain a dialogue with its member countries on the national and international reflections of their economic and financial policies” (IMF 2003:1). Actually, IMF's mandate to conduct surveillance comes from its Articles of Agreement, using surveillance to assess ‘whether a country's economic developments and policies are consistent with the achievement of sustainable growth and domestic and international stability (IMF 2003:1).

Apart from monitoring several countries throughout the world, the IMF is also active in promoting effective monitoring and surveillance in East Asia. Moreover, it closely follows the trend a regional financial architecture in East Asia is developing and how it is likely to evolve over time. IMF basically tries to increase its influence over ASEAN+3 since ASEAN+3 work program includes important financial arrangements such as developing a regional cooperative financing arrangement, improving regional surveillance mechanisms, and exploring options for stronger monetary cooperation in the region (Gordon de Brouwer, 2004; 41). In fact, IMF does have strong impact over ASEAN+3 financial arrangements since for instance, Chiang Mai Initiative requires IMF conditionality for disbursement of 90% of available funds.

Nevertheless, it is ambiguous whether ASEAN+3 member countries would prefer such strong influence of IMF over their regional financial arrangements. Given the regionalist motivations of ASEAN+3 and its aspirations for an effective regional architecture, it is unlikely that the IMF would be the central agency for surveillance in the financial cooperation process of East Asia. Furthermore, there is wide-spread mistrust of East Asians to IMF, especially after Asian Financial Crisis. East Asian economists are also dissatisfied with IMF's

approach to the regional surveillance. In particular, they argue that ‘one visit one week a year’ is not sufficient for IMF staff to understand the complexities of the local economy and institutions and how decisions are made and implemented (Gordon de Brouwer, 2004; 40).

On the other hand, IMF does not seem to give up its strong presence in the region while IMF executives try to persuade East Asian policymakers by arguing that the ‘advantages of global processes should not be ignored in the rush to find regional solutions’ (Gordon de Brouwer, 2004; 42). Particularly, IMF officials claim that: ‘being local may also make it difficult to be completely transparent about problems a country is facing or to say no when it is right to say no. Then, it can be useful to pass this pressure onto the outsiders with global experience involved in the regional debate’ (Gordon de Brouwer, 2004; 42).

### **ADB’s Perspectives on Regional Cooperation in East Asia:**

The Asian Development Bank is also active in promoting and supporting regional cooperation in East Asia. The most apparent ADB’s involvement in East Asian financial cooperation is its coordination of economic surveillance in East Asia which it pursues through its Regional Economic Monitoring Unit (REMU). REMU was established in early 1999 as a result of request of the ASEAN finance ministers to support the ASEAN Surveillance Process (Gordon de Brouwer, 2004; 42). The ADB considers REMU as part of the larger issue of regional monetary cooperation in East Asia which later is expected to include information exchange system, regional reserve pooling, exchange rate coordination and domestic financial sector reforms.

In contrast to IMF, East Asian countries favor Asian Development Bank’s active participation in the regional financial arrangements. The one factor supporting ADB’s position is the popular view in East Asia that international liquidity is insufficient to deal with future crises, so the region needs to build up its own resources. Such belief occurs due to incidents where East Asian countries’ access to international liquidity has not always been fair, especially in the terms and conditions of the IMF support packages (Gordon de Brouwer, 2004; 43). From this perspective, regional mechanism is not just desirable but necessary.

As a consequence, it is more likely that East Asian economies would prefer to engage in coordination of regional financial arrangements with a regional body over which they exercise substantial direct control rather than with a global institution where they will have less influence. Moreover, countries in East Asia might simply find it useful to share information about each other’s economies through a analytical filter different from that of the global institutions, since there have always been significant regional differences in analytical perspectives and in the diagnosis on economic problems (Gordon de Brouwer, 2004; 44).

Probably being aware of such perceptions of East Asians, Asian Development Bank would be willing to play a greater role in examining key aspects of policy reforms in the region. Thus, as East Asia extends and deepens its cooperative financing arrangements, the ADB would like to play a formal role in these regional financial arrangements. Particularly, it volunteers to manage the pooling of regional foreign exchange reserves, including the disbursement of those reserves and the identification and enforcement of associated conditionality for lending (Gordon de Brouwer, 2004; 46).

**Which Institution is Appropriate to Coordinate Regional Financial Cooperation in East Asia: IMF, ADB or New East Asian Financial Institution?:**

With respect to East Asian monetary cooperation, IMF and ADB have different degrees of enthusiasm about regional financial dialogue, with the IMF more guarded and the ADB more enthusiastic supporter. The IMF is the global institution with wealth of experience in surveillance and with remarkable reserve of intellectual talent, whereas ADB is the younger institution and foresees an opportunity to position itself at the core of an East Asian infrastructure (Gordon de Brouwer, 2004; 46).

It is really hard to draw optimistic picture for IMF as one feature of East Asian regionalism is a desire to find Asian solutions to Asian problems. This is itself a product of the tension that emerged during the Asian financial crisis between East Asia on the one hand and IMF on the other. In some quarters, IMF is even seen as part of the problem, not the solution, although this does not seem to be the majority view in East Asia (Gordon de Brouwer, 2004; 46).

There is also negative perception in the region that IMF is more interested in using regional policy dialogue forums to advance the cause of economic reform rather than facilitate dialogue and create mechanisms for regional cooperation (Gordon de Brouwer, 2004; 47). As a result, such perception creates some distance between regional policymakers and IMF because Asian policymakers have suspicions that the aims of two sides are different.

Although ADB seems as more appropriate institution for East Asian financial cooperation, it has also crucial drawbacks. First of all, ADB is a new entrant to the business of regional monitoring and surveillance while Regional Economic Monitoring Unit (REMU) of ADB is small in size and other resources (Gordon de Brouwer, 2004; 47). There is a need for a substantial enlargement of both the professional capacity and other resources devoted for regional monitoring and surveillance.

Secondly, there is a wide-spread concern within the ASEAN+3 zone that the geographic coverage of the ADB is too wide to make it the base for East Asian dialogue and

cooperation as ADB assistance goes to 43 countries (Gordon de Brouwer, 2004; 47). Actually, for an institution which is supposed to service the development needs of the whole Asia, there are some concerns that scarce resources are being diverted from otherwise important development projects, especially in countries outside East Asia. And since it is a development bank, its policy responsibilities should not include surveillance of the region's developed economies, such as Japan.

As you might have understood both institutions have certain constraints. Although IMF has well-established authority in surveillance, it is regarded as an outsider to the region; and hence this limits the degree to which the region will want to involve it into the regional cooperation. ADB, on the other hand, is an "Asian" institution and thus, also has limited appeal as an institution for East Asia. As a regional development bank rather than a regional monetary fund, it is uncertain whether Asian Development Bank is the appropriate institution to provide regional surveillance and financial cooperation.

Therefore, I would argue that due to shortages of ADB and IMF that I have mentioned above, East Asian policymakers might consider establishment of alternative financial institution. Logically, setting up new institution makes sense for East Asia, since ASEAN+3 policymakers will be able to shape its structure and functions in a way that will be appropriate and desirable for regional financial cooperation.

## CONCLUSION

The purpose of this research was to study future prospects with respect to regional monetary fund in East Asia. I have tried to analyze the issue from four different perspectives which are necessity, feasibility, current financial arrangements under ASEAN+3 and the approach of IMF and ADB to financial cooperation process taking place in East Asia.

From necessity perspective, setting up regional monetary fund makes sense due to factors such as loss of confidence of East Asian economies to global financial institutions after Asian Financial Crisis, gradually growing intra-regional trade and particular interest of East Asian economies in forming regional monetary fund. In recent years, bilateral and multilateral trade negotiations have intensified in East Asia while countries in the region are about to sign Free Trade Agreements among each others. Based on experience from elsewhere, especially from EU experience, it is possible to argue that for sustainable regional development, intensified trade interactions should be accompanied with financial cooperation. Regional monetary fund could coordinate such financial cooperation.

From feasibility perspective, it appears that setting up regional monetary institution is not something inevitable for East Asia since it possesses significant financial potentials such as large foreign reserves. Moreover, if it is established, it will not be the first regional monetary fund since there are already analogical examples of it, particularly in Latin America and Middle East.

During Asian Financial Crisis, East Asians became aware that the only way to deal with regional crises is to cooperate without being dependent to external forces. Such perception has encouraged ASEAN+3 countries to form regional financial arrangements like Chiang Mai Initiative and regional surveillance mechanism. East Asian financial cooperation is an ongoing process and it is being gradually intensified. However, intensive financial cooperation requires regional monetary fund that for the sake of durable cooperation will be able to set necessary procedures and implement them.

Finally, I have tried to shed the light on the approach of IMF and ADB to regional financial cooperation in Asia Pacific. Although both IMF and ADB take active role in East Asian financial arrangements, there are certain constraints that prevent these institutions to become key players in ASEAN+3 financial cooperation. Due to past negative experience, East Asian countries do not sympathize IMF's active participation, whereas, being development bank and serve for whole Asia restrict ADB's involvement in East Asian financial arrangements.

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- Kobayashi, Kazuo (Deputy Director for Regional Financial Cooperation Division, International Finance Bureau, Ministry of Finance).Notes taken during the interview, August 3, 2005. Tokyo, Japan.

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