Regional Financial Stability and Economic Growth: The Need for Cooperation in Financial Regulations and Credit Rating

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1. Introduction

Prior to 1998, East Asia had robust growth, which was based on a high investment strategy. This high rate of investment was financed partly by the large inflow of foreign capital, which was needed to meet the shortfall in domestic savings. But this strategy had also created vulnerabilities such as persistent current account deficits, over-leveraged businesses, high level of indebtedness, less flexible exchange rate regimes and a currency mismatched between foreign borrowings and domestic source of revenue.

The 1998 crisis had caused a sharp fall in East Asian growth, severe economic and social hardship including high inflation and unemployment, a steep exchange rate depreciation and a massive outflow of capital. Although East Asia economies have recovered from this deep crisis with some countries achieving a V sharp recovery, East Asia growth rates since 2000 have been moderate and were lower than the rate they had prior to the 1998 crisis. The country that bulked this trend was China, which had continuously notched double digit growth rates. Even though growth was moderate, most of the East Asian countries had registered strong trade surpluses since1998. Consequently, most of them had accumulated a large foreign exchange reserves and these funds were mostly invested in the US treasuries.

One of the most notable developments resulting from the 1998 crisis was that it served as a catalyst for regional integration. The East Asia vulnerability was exposed in the sense that it did not has a regional support mechanism to help the regional countries in time of a crisis. Consequently, much of the post-crisis effort has been devoted to developing regional monetary and financial cooperation, namely the Chiang Mai Initiative (CMI) and the Asian Bond Market Initiative (ABMI). This effort has largely been driven by a defensive logic, namely to avoid the occurrence of a similar crisis. The aim of the CMI is to make available financial support in case where the currency of a member country is been attacked. The ABMI is an effort to develop the regional bond market to recycle East Asia huge foreign exchange reserves that are presently invested outside the region.

The crisis has created a sense of solidarity throughout East Asia. Because they were victims of international financial market volatility, excessive speculation and because they feel that international support is inadequate in many ways, the countries have spontaneously sought to cooperate to develop a common defense system. This need to build a defensive mechanism has an ultimate aim of ensuring that the region can continue to have financial stability that is essential for economic growth. Since many of the regional countries are still at the development stage, they require large capital to advance their economies. East Asia needs sufficient and stable source of capital for investments, financing its import needs as well as for exchange rate stability.

It is important to evaluate the regional financial cooperation that has been built over the last ten years in light of the present circumstances. The question being asked is whether this defense system is useful in the 2008 crisis. Does the regional financial cooperation need to be reviewed in light of the issues raised by the current crisis and if so, what kind of cooperation is needed in the future? The G20 and other global financial forums are debating about the future financial cooperation to minimize the possibility of future crisis. These global issues could be relevant in expanding East Asia's financial cooperation.

2. Development of cooperation in financial regulation and bond market since the 1998 crisis

Two cooperation initiatives namely the Chiang Mai Initiative (CMI) and the Asian Bond Market Initiative (ABMI) were introduced because the East Asian countries believe that they needed a support system to be developed to assist them if they were to ward off attacks on their currencies. These initiatives involved the ten ASEAN countries plus China, Japan and Korea or better known as ASEAN + 3.

2.1 The Chiang Mai Initiative

The CMI was launched on 6 May 2000 by the ASEAN+3 Finance Ministers to provide short-term financial assistance to Member Countries in need of temporary liquidity support and it has two components, as follows:

i. An ASEAN Swap Arrangement (ASA); and
ii. A network of bilateral swap arrangements (BSAs) and repurchase agreements among the ASEAN+3 Member Countries.

The ASA was first signed by five ASEAN central banks (namely, Indonesia, Malaysia, Philippines, Singapore and Thailand) in August 1977, with a total facility of US$100 million in USD, Yen, and Euro. The total amount available was increased to US$200 million in 1978. With the launched of the CMI in 2000, the central banks and monetary authority expanded the ASA to include all 10 ASEAN countries and enlarged the size to US$1 billion from US$200 million. During the 9th ASEAN Finance Ministers Meeting on 6 April 2005 in Vientiane, Lao PDR, the ASA was further enlarged to US$2 billion, to reflect the continued favourable and sound macroeconomic fundamentals in ASEAN, as well as to symbolize the strong commitment among ASEAN Member Countries to cooperate to ensure financial stability in the region.

The BSAs provide for liquidity assistance in the form of swap of US dollars for the domestic currencies of the participating countries. A member country can draw automatically up to 10% of the contractual amount and now this limit is increased to 20%. When exceeding the limit, the member is placed under the IMF surveillance including a macroeconomic and structural adjustment program. The BSA network is thus complementary to the IMF lending facilities. To date, there are 16 BSAs totaling US$83 billion signed between 5 of the ASEAN Member Countries (Indonesia, Malaysia, Philippines, Singapore and Thailand), respectively, with the Plus 3 Member Countries (China, Korea and Japan) as shown in Table 1.

Following the launch of the CMI, Malaysia entered into three BSAs, as follows:

a) **Malaysia-Japan** – commenced in 2001 with a one-way swap arrangement of US$1 billion, which was subsequently renewed in October 2004 for another 3 years (plus a swap arrangement of US$2.5 billion under the New Miyazawa Initiative (NMI)). Malaysia is currently finalizing the agreement with Japan to convert the existing one-way swap arrangement and the NMI into a two-way swap for 3 years (US$6.0 billion from Japan and US$1.5 billion from Malaysia);
b) **Malaysia-Korea** – the first was a two-way swap arrangement of US$1.5 billion, which was renewed in October 2005 and subsequently, expired in October 2008. The BSA was further renewed on 7 January 2009 for another 3 years; and
c) **Malaysia-China** – it began with a one-way swap arrangement of US$1.5 billion, which expired in October 2005. Malaysia is currently

finalizing the agreement with China to convert the one-way swap to a two-way swap for another 3 years.

Table 2: BSA Agreements Entered into by Malaysia

Bilateral Swap Arrangements (BSA)[a]	Currencies	Conclusion dates	Amount as of[b]	
			May 30, 2004	Apr 1. 2008
Japan-Malaysia	US$/Ringgit (one-way)	Oct 042007	US$1 bn.[d]	US$1 bn.[d]
Korea-Malaysia[c]	US$/local (two-way)	Jul26 2002	US$2 bn.	
Korea-Malaysia	US$/local (two-way)	Oct 132008		US$3 bn.
China-Malaysia[c]	US$/Ringgit(one-way)	Oct 082005	US$1 .5 bn.	US$1 .5 bn.

At the ASEAN+3 Finance Ministers Meeting in May 2006, the Finance Ministers set up a new task force to further study various possible options for an advanced framework of regional liquidity support arrangements, or CMI multilateralisation. The Taskforce (TF) on CMI Multilateralisation (CMIM) was established in November 2006 and it discussed the key elements to be addressed, namely, financial arrangements, legal modalities and surveillance. In may 2007, the ASEAN+3 the Finance Ministers agreed, in principle, to **a self-managed reserve pooling arrangement governed by a single contractual agreement** as an appropriate from of multilateralisation. The Finance Ministers also announced in May 2008 that the total size of the multilateralised CMI would be US$80 billion, and that the share of contribution between the ASEAN and the Plus Three countries would be in accordance with the ratio 20:80.

At the side of the 7th Asia-Europe Meeting Summit (ASEM 7) held in Beijing, China, from 24-25 October 2008, the ASEAN+3 Leaders held a meeting to discuss the current global financial crisis and the need to enhance regional financial cooperation, including to expedite the CMIM to assist Members in overcoming liquidity problems. During the Special ASEAN+3 Finance Ministers' Meeting, which was held on the 22 February 2009 in Phuket, Thailand, the size of the CMIM was increased from US$80 billion to US$120 billion.

The TF continues to discuss and work through the key concepts of the various elements of CMIM. While there is some agreement among Members with regard to some of these elements such as the decision-making structure, pooling structure, IMF de-linked portion and credit risk sharing, others issues are still subject to further discussion. The remaining issues include surveillance, borrowing quota, voting rights, decision-making process, and Hong Kong's participation in the CMIM.

In order to advance the CMI and to enhance its effectiveness as a self-help and support mechanism, the ASEAN+3 Finance Ministers agreed, in May 2005, to the integration and enhancement of the ASEAN+3 surveillance process in the CMI framework. The ASEAN+3 Finance Ministers also recognized the important of and the need to strengthen surveillance so that the regional financial cooperation mechanism can properly function because all Members have managed their economies prudently. A Technical Working Group on Economic and Financial Monitoring was established in May 2005 by the ASEAN+3 Finance Ministers to help develop and encourage the use of the Early Warning System (EWS), which will facilitate an early detection of irregularities or vulnerabilities. The Technical Working Group is expected to work as a complementary part of the Economic Report and Policy Dialogue (ERPD) process and constitutes one of the building blocks towards a proper surveillance system to underpin the Chiang Mai Initiative Multilateralisation. Following this, the ASEAN+3 Finance Ministers agreed in May 2006 to explore ways to further strengthen surveillance capacity capacities in East Asia by launching a Group of Experts (GOE). The GOE, comprising several regional professional experts, would serve as an independent economic assessment vehicle for the region. It was established on a two-year trial basis.

2.2 The Asian Bond Market Initiative

The Asian bond market initiative (ABMI) is also a direct response to the currency mismatches that was one of the main causes of the 1998 crisis. During the period of high growth in East Asia (in the 1990s), the private sector had borrowed in foreign currencies to finance domestic investments. The borrowings were done through the purchase of foreign currency denominated bonds to finance mainly infrastructure developments. A large portion of these foreign currency bonds had a short tenure while the revenues needed to repay these bonds were in domestic currencies and they had a long gestation period. This gave raise to the problem of double mismatched – mismatched in terms of currency and timing. This came about because of the region's bond market were either at infancy stage, lack of liquidity or not a very active market the issuance and trade in domestic currency bonds.

Thus, the aim of the ABMI is to create regional markets where assets denominated in regional currencies can be floated. The proponents of the initiatives argue that regional markets could reduce the currency mismatch to which many emerging economies in the region were exposed to and which lay at the root of the crisis. The aim of ABMI is to increase regional borrowings and lendings activities in regional currencies. Ideally, these excess savings should also be lent out in regional currencies. For this to happen, the environment must be conducive for the development of the regional bond markets because these regional markets must compete with other global financial hubs such as New York and London. Funds are liquid and mobile and will seek markets that are efficient and that can give the highest returns.

The development of regional bond markets such as the ABMI has been one of the main objectives of the financial reform and cooperation proposed by the IMF, World Bank, and the Asian Development Bank (ADBI 2002). In line with the ABMI, two bond funds were introduced in the Executive Meetings of the East Asia and Pacific Central Banks (EMEAP) in 2003. They are the Asia Bond Fund 1 (ABF 1) and Asia Bond Fund 2 (ABF 2). The ABF 1, announced in 2003, with a capitalization of US$1 billion, is mandated to invest in dollar-denominated Asian sovereign bonds. The initial subscription had been fully invested in bonds issued by sovereign and quasi-sovereign issuers in eight EMEAP economies (China, Hong Kong, Indonesia, Korea, the Philippinies, Malaysia, Singapore, and Thailand). The ABF 2, introduced in 2004, with a capital of US$2 billion, is mandated to invest in Asian bonds denominated in local currencies. It consists of two components: Pan-Asian Bond Index Fund and Fund of Bond Funds or sub-funds in the eight countries.

Crisis prevention was certainly one of the main reasons behind the ABMI but with the perception of a diminishing risk of a new crisis as well as the difficulties in setting up active and liquid markets, the initiative has been losing public support. But now the issue is back because of the need to diversify the East Asian foreign exchange reserves investment and the need to finance East Asia's growth, in particular for infrastructure projects and technology acquisition.

2.3 Assessment of the regional financial cooperation

The CMI was designed in the aftermath of the crisis to pool foreign exchange reserves at a time of scarcity. While over the years, the amount available through the BSAs has been raised, the accumulation of foreign exchange reserves has reduced the usefulness of these BSAs. The CMI is also facing the challenge of developing an adequate surveillance mechanism and progress of this effort has been slow. In view of these shortcomings the cooperation process may evolve towards a cooperation process through the institutionalization of the Economic Review and Policy Dialogue.

The structure and conditions of the BSAs is such that a member country can draw automatically up to 20% of the contractual amount. If this limit is exceeded, the member is then placed under the IMF surveillance, which may include a macroeconomic and structural adjustment program. Thus, the BSA network is non-exclusive but complementary to the IMF lending facilities. This defeats the purpose of the CMI which was set up to provide financial support to member countries. There is a strong reservation about the IMF-type conditions in CMI and many have raised the possibility of the CMI to be independent of such conditions. From time to time, there is a call for East Asian countries to reconsider the establishment of the Asian Monetary Fund (AMF) which is modeled after the IMF and proposed by Japan during the 1998 crisis. The AMF proposal was strongly objected by the US and the IMF.

The efficacy of CMI in a way was tested during the 2008 global crisis. Although, East Asian economies were not facing speculative pressures on their currencies, they still needed funding support because they were short of dollars to meet foreign debt obligations or the massive outflow of capital due to deleveraging by the private sector. The CMI did not kicked in automatically because members would have to table the issue to their parliament before referring to the regional body. In addition, many regional countries were reluctant to utilize CMI facilities in fear of the conditions imposed. Moreover, the stigma for countries that had to seek IMF help in the 1998 crisis still posed as a major deterrent. As a result, a number of countries had looked for other sources of financing. The US Federal Reserves extended US$30 billion emergency currency swap lines to South Korea and Singapore as well as to Mexico and Brazil to alleviate a dollar shortage caused by the global credit crunch. Korea banks were able to utilize a currency swap deal with the US Federal Reserve aimed at meeting their foreign debt obligations. In March 2009, Indonesia received US$5.5 billion standby budget facility coordinated by the World Bank.

The ABMI has been slow to produce results because of several roadblocks such as limits to capital mobility, heterogeneous regulatory and supervisory frameworks and slow progress in building regional settlement and guarantees. It is expected that the removal of these limitations will allow spontaneous integration of the East Asian markets and countries can issue debt instruments in their own currencies and thus will reduce the dependency on a specific currency or basket of currencies. The ABF 1 has had relatively little effect on the market for East Asia sovereign dollar bonds, since non-EMEAP investors are precluded from investing in it. In addition, between the ABF 1 and the ABF 2, it is expected that ABF 2 would have a greater impact based on the size of the fund.

Since ABF 2 is likely to invest in East Asian sovereign bonds denominated in local currencies, it may serve as a mechanism to finance fiscal deficits of some member countries by other members belonging to EMEAP. In such a case, the investment policy of ABF 2 cannot be dictated by profit motive alone, even though a private institution manages the fund.

The objective of the ABMI is to create regional bond markets (ASEAN+3, 2004) or an international bond market in the region (ASEAN+3, 2006). However, there is confusion in the definition of Asia Bond Markets or Asian regional bond markets. Although the term is used in the ABMI and other documents of ASEAN+3, it does not necessarily refer to off-shore regional bond markets to be created in Asia. Thus, it is a collective term for domestic bond markets of East Asia economies, some of which already serve or have developed into regional financial centers for bond trading and listing. This confusion may hinder the development of the ABMI and the progress for regional financial cooperation.

3. The financial causes of the 2008 global crisis and its impact on East Asia

3.1 Causes of the global financial crisis

Unlike the 1998 Asian crisis, this 2008 global crisis began in the US triggered by defaults in the sub-prime housing loan market. It then quickly impaired major financial institutions in major developed countries. Home prices in the US began to rise rapidly in the late 1990s and home price inflation peaked at 15% per annum in 2005 (Bosworth and Flaaen, 2009). The excesses of the sub-prime mortgage market in the US and the subsequent transformation of those assets into exotic secondary market instruments are, some regarded, as the important factors behind the housing bubble. The bursting of the bubble and the subsequent collapse of the market of sub-prime mortgages initiated a chain-like collapse of markets for securitized assets and a crisis of confidence.

Financial sector liberalization and the growth of financial engineering that created complex investment instruments had spread the network of institutions, players and types of risks involved. The growth and trade of these innovated financial products camouflaged the risks carried by these instruments. Beginning with failures caused by misapplication of risk controls for bad debts, collateralization of debt insurance and fraud, large financial institutions in the United States and Europe faced a credit crisis and a slowdown in economic activity. In these countries, money market mutual funds had begun to experience significant withdrawals of funds by investors. This created a significant risk because money market funds are integral to the ongoing financing of corporations of all types. Individual investors lend money to money market funds, which then provide the funds to corporations in exchange for corporate short-term securities or asset-backed commercial papers. Mounting losses on impaired or illiquid assets had claimed highly-leveraged hedge-funds. Another probable cause of the crisis - and a factor that unquestionably amplified its magnitude - was widespread miscalculation by banks and investors of the level of risk inherent in the unregulated CDOs and Credit Default Swap (CDS) markets. These instruments were evaluated by credit rating agencies, which were supposed to inform the market on the risks carried by these instruments. The credit rating agencies were heavily criticized because the ratings given did not sufficiently reflected the nature risks and did not forewarn of the impending deterioration in the quality of the investment or the rising risks.

Asset bubbles are not uncommon throughout the world's history. These bubbles are however linked with a more fundamental factor, namely the conduct of monetary policy. Prolonged low interest rates and expansionary monetary policy will create cheap source of funds that are translated into investment in a variety of financial asset classes around the world. There also commentators that linked the current global crisis with the large external imbalances that resulted in excess saving by other countries which were invested in the US that helped financial its trade and fiscal deficits. Thus, attention has been given on how to managed or better, reduce these imbalances in particular between the US and East Asia.

The crisis rapidly developed and spread into a global economic shock, resulting in a number of European bank failures, declines in various stock indexes, and large reductions in the market value of equities and commodities. A currency crisis developed, with investors transferring vast capital resources into stronger currencies such as the yen, the dollar and the Swiss franc, leading many emergent economies to seek aid from IMF. The financial panic and the rapid deterioration of the financial institutions is partly attributed to the marked to market accounting policy.

3.2 The impact of the global crisis on East Asia

With the failure of the US financial sector, the crisis accelerated and developed into a global financial crisis, spreading to EU and other selected countries. The crisis also widen from the financial sector to the real economy. World economy had been moderating from 5% in 2007 to 3.9% in 2008. With the crisis, IMF cut its forecast of 2009 world economic growth to 3.0%. But in the most recent IMF forecast announced in March

2009, the world economy is expected to contract by 1.9% in 2009 with all the three major economic centres – US, Japan and EU – in recession.

The most immediate and dramatic impact was the deep fall in many stock markets around the global. Major equity markets around the world had deep falls that were rearly seen before. In 2008, Dow Jones Industrials dropped by 32.7%, UK FTSE 100 by 30.9%, Japan Nikkei 100 by 39.7, Germany Dax by 39.6% and Shanghai by 65.4%.

East Asia's direct exposure to the holdings of structured products such as collateralized debt obligations (CDOs) and asset-backed securities (ABS) is believed to be limited. One estimate places it (excluding Japan) in the range of US$ 20-30 billion. The Bank of China has reported an exposure of about US$12 billion to US sub-prime mortgage-related assets. Other banks that have declared include China Construction Bank (US$1.1 billion) and Industrial and Commercial Bank of China (US$1.2 billion).

In Japan, the country's top three banks are exposed to the US subprime problem. The Bank of Japan Governor Masaaki Shirakawa said "Most lending to Lehman Brothers was made by major Japanese banks, and their possible losses seem to be within the levels that can be covered by their profits," but assured that "There is no concern that the latest events will threaten the stability of Japan's financial system". Singapore and Hong Kong were also affected through the damaged inflicted by financial instruments such as CDOs or losses related to the US subprime housing loan market. .

Commodity prices, which had reached record highs in the first half of 2008, had also tumbled. Crude oil fell from a high of US$147 per barrel to a low of US$40 per barrel. Palm Oil price also plummeted from over RM4,000 per tonne to less than RM2,000 per tonne. Rising oil and commodity prices of resource-rich Asian countries like Indonesia and Malaysia which have pushed growth in the first half of 2008 has reversed its trend as the US and Europe slips into recession.

The de-leveraging of financial institutions further accelerated the liquidity crisis and caused a decrease in international trade. Manufacturing sector in most Asian countries was affected badly by the global crisis and industrial production suffered a large contraction since October 2008. Exports, which used to be the engine of growth for East Asia had became the channel that transmit the global economy slide. Major East Asia countries suffered double digit export fall: for example, Japan exports fall by a massive 45% in January 2009.

Asian currencies have weakened since the global financial crisis as global investors liquidate assets that are perceived to relatively riskier in Asian countries and seek safety in the yen and US dollar. South Korea's won tumbled as much as nearly 29 percent against the dollar in 2008 while the Indian rupee fell to its weakest in almost six years. The ringgit fell to a 13-month low on speculation of deepening turbulence in global financial markets.

4. Proposals for financial cooperation at the global level

The 2008 global crisis has prompted an unprecedented international cooperation among the major multilateral institutions such as the IMF, World Bank and the United Nations. National central banks such as the Federal Reserve Bank, EU Central Bank and Bank of England have also joined in a coordinated response to the crisis. The G20 has emerged as a new and important player in this global response.

The global crisis has seen the IMF reassert its role in the international economy. This include an initial agreement on a US$2.1 billion two-year loan with Iceland, a US$16.5 billion agreement with Ukraine, and a US15.7 billion loan to Hungary. At the IMF annual meeting in 2008, it was announced that the IMF had activated its Emergency Financing Mechanism (EFM) to speed the normal process for loans to crisis-afflicted countries. The IMF has also modified its Exogenous Shock Facility (ESF) to further increase the speed and flexibility of its response to distress economies. The ESF provides policy support and financial assistance to low-income countries facing events that are completely out of the national government's control. These could include commodity price changes (including oil and food), natural disasters, and conflicts and crises in neighbouring countries that disrupt trade.

The IMF has announced that it plans on creating a new three month short-term lending facility aimed at middle income countries such as Mexico, South Korea, and Brazil. It plans to set aside US100 billion for the New Short-Term Liquidity Facility and these loans will have no policy conditionality.

The World Bank Group is helping in the financial rescue but believes that it should remain focus on the human rescue for the many millions left behind. The Bank has called for developed countries to pledge at least 0.7 per cent of their stimulus package to a global vulnerability fund to help developing countries, which cannot afford bailouts and deficits. The fund could speed resources to existing World Bank, United Nations and regional development bank safety-net programs that give the poor access to health, education and nutrition services; build infrastructure such as roads, bridges and low-carbon technology projects; and support small and medium-size businesses and microfinance institutions that lend to the poor.

The World Bank is mobilizing up to US$3.1 billion this year in health financing to help poor countries battle threats to their social services during the global economic crisis. This effectively triples Bank support from US$1.0 billion last year and will be used to strengthen health systems in poor countries, boost their performance in preventing and treating communicable diseases, and improving child and maternal health, hygiene and sanitation. The Bank will be doubling its education financing this year in low- and middle-income countries to US$4.09 billion.

The group of 20 nations (G20) have agreed to increase resources available to the IMF to US$750 billion, to support a new Special Drawing Rights (SDR) allocation of US$250 billion, to support at least US$100 billion of additional lending by the Multilateral Development Banks, to ensure US$250 billion of support is available for trade financing, and to use the additional resources from agreed IMF gold sales for concessional finance for the poorest countries. This constitutes an additional US$1.1 trillion for programmes that support restoration of credit, growth and jobs in the world economy.

With respect to financial regulations, the G-20 agreed to the following initiatives:

- A new Financial Stability Board (FSB) will replace the Financial Stability Forum. The FSB will have a strengthened mandate to promote international financial stability through information exchange, monitoring activities, surveillance and coordination.
- The FSB and the IMF will monitor and warn of macroeconomic and financial risks and take actions needed to address them.
- Each member of the G-20 agreed to reshape its regulatory systems to better identify and take into account "macro-prudential" risks.
- Systemically important financial institutions, instruments and markets will be subject to regulation and oversight. This includes systemically important hedge funds.
- Member states will address pay and compensation for financial sector players, and support sustainable compensation schemes and corporate social responsibility.
- Member states will prohibit excessive leverage on the part of banking institutions and require that cushions be built up in times of growth in order to improve the quality, quantity and international consistency of capital in the banking system.
- Action will be taken against tax havens and jurisdictions not in compliance with the internationally agreed tax standard, which "requires exchange of information on request in all tax matters for the administration and enforcement of domestic tax law without

regard to domestic tax interest requirement or bank secrecy for tax purposes. . . .".

- Accounting standard-setters will be asked to improve valuation and provisioning standards, as well as to present a unitary high-quality global accounting standard.
- Member states will regulate credit rating agencies to prevent harmful conflicts of interest and other violations of international standards.

The G-20 also agreed that all systemically important financial institutions, markets and instruments should be subject to an appropriate degree of regulation and oversight. In particular, the declaration called for the FSB to work with the Bank for International Settlements and other international standard setters to develop the tools necessary to regulate macro-prudential risks across the financial system, including regulated banks, "shadow banks" and private pools of capital (such as hedge funds and private equity funds) to limit the buildup of systemic risk. Further, the leaders declared that they would ensure that national regulators possess the powers for gathering relevant information about all material financial institutions, markets and instruments in order to assess the potential for their failure or severe stress to contribute to systemic risk. Responsibility for actual regulation and oversight of systemically important institutions is to rest with national authorities, but with coordination through the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS) and the Basel Committee on Banking Supervision (BCBS), and with recommendations from the FSB and the IMF.

Of particular importance was the statement that "hedge funds or their managers will be registered and will be required to disclose appropriate information on an ongoing basis to supervisors or regulators, including on their leverage, necessary for assessment of the systemic risks that they pose individually or collectively. Where appropriate, registration should be subject to a minimum size. They will be subject to oversight to ensure that they have adequate risk management." The declaration indicates that responsibility for implementation of this regulation rests with national authorities rather than any supranational body.

The proposals and commitments by the G-20 have expanded the scope of the previous global financial cooperation. G-20 also tried to address the pertinent financial and related issues highlighted by the crisis. The question is now whether East Asia will expand its financial cooperation to be in line with the developments that are taking place globally. In this respect, East Asia is strongly represented by a number of countries such as Japan, China, Korea and Indonesia in the G-20 and these countries may wish to put forward these issues for adoption by the East Asian grouping.

5. Financial cooperation in East Asia: future issues

The East Asia financial cooperation steered by the ASEAN+3 countries has made commendable progress. The CMI has advanced from bilateral swap arrangements into a multilateralised one with larger pool of funds. Similarly the ABMI has established funds to set in motion the regional bond markets, including bonds issued in East Asia domestic currencies. However, the progress of these initiatives are mostly in the setting up the process and in getting financial commitments from member countries. The 2008 Crisis, unfortunately, bares some of the shortcomings of these initiatives because member countries preferred to seek support from outside the established cooperation mechanism. To overcome the shortage of dollars as well as to finance their foreign debt obligations, some countries went into bilateral support arrangements with the US, Japan, China or multilateral institutions.

The 2008 crisis and global financial cooperation efforts especially proposed by the G-20 call for East Asia to step up its cooperation to meet the new financial challenges and to complement the work that are being carried out at the international level. The CMI and ABMI should be improved to ensure that these initiatives will be put in practice and bring real benefits to its member countries. In addition, the regional cooperation should also address the new issues and challenges arising from the present global crisis.

Financial cooperation in East Asia should be enhanced for the following reasons:

i. Stable and increasing capital inflow is important for East Asia's growth. Since many of East Asian countries are small open economies, volatile capital flows would make the management of the economy very challenging. High capital flow volatility can results in excessive gyrations that produce strong reaction both by the government and market, which ultimately erode market confidence.

ii. East Asia also need stable long term capital inflows to develop their economies. Large investments are needed in all areas of economies of East Asian countries such as agriculture, manufacturing, infrastructure, and telecommunication. Foreign investments not only augment economic activities but also bring indirect benefits such as technology, management capability, marketing and skills.

iii. East Asia need to recycle effectively its huge foreign exchange reserves so that these savings can be beneficially used in the region. Since a number of East Asia countries are capital deficit, these surpluses can be gainfully deployed to develop countries and regions that are lagging in terms of development when compared with the high growth areas. In addition, recent experience has indicated the need to diversify the investment of these foreign exchange reserves because the present concentration of investment in dollar dominated asset in the US while bringing benefits, they also have many inherent risks.

iv. The G-20 has highlighted the new issues for financial cooperation at the global level. Among them are the promotion of financial stability through information exchange, monitoring activities, surveillance and coordination, enhancing monitoring of macroeconomic and financial risks and to reshape regulatory system in order to better identify “macro-prudential” risks. The area of cooperation has been expanded to include regulations and oversight of important financial institutions, instruments and markets.

In light of the need to improve existing cooperation mechanism, to continue to attract stable capital inflow into the region and to complement global cooperation initiatives, East Asia financial cooperation should consider the following areas of collaboration:

a) Although many improvements have been made to the CMI, in particular the recent agreement made in Bali on 3 may 2009 for the multilateralisation on CMI, there are areas that need more focused attention:
    - Increasing access to funds by minimizing or removing the condiltionality that member countries had to fulfill to receive financial support from the CMI.
    - The move to multilateralise CMI is laudable but in practice the cooperation mechanism must ensure that the process to access the fund is practical and quick

b) Expand existing cooperation to include matters on regulations for capital flows and prudent management of financial institutions. This cooperation is so essential because presently the task of regulating and oversight of financial institutions rest with national authorities. However, with globalization of finance, national authorities must cooperate so that cross border activities also meet prudent regulations because impairment of financial institutions in one country can have serious implications on other countries.

c) Similarly, cooperation in macroeconomic and financial surveillance should be enhanced. There are already additional initiatives in the region such as:
   - ASEAN is developing a 'Capital Flow Monitoring System' for monitoring short-term capital flow;
   - Asian Development Bank has developed country-specific prototype of the 'Early Warning System'; and
   - Japan has established a fund known as 'Japan-ASEAN Financial Technical Assistance Fund' to enhance the capacity of participating ASEAN countries in generating and compiling accurate and timely data on national income accounts, government finance and monetary statistics.

   However, the areas for surveillance and monitoring should be expanded to include specific "bubbles" in national economies that have regional or global ramifications. A case in point is the housing bubble is the US, which is linked with the financial sector and complex financial products being traded globally. Another area for surveillance is regulating the development and growth of new financial institutions and instruments, in particular ensuring that an effective risk management system is in place and there is transparency in financial market players.

d) Cooperation in developing the regional bond markets and credit rating agencies. Once again, the 2008 global crisis had exposed the short comings of the international credit rating agencies. For East Asia to have a well functioning and active bond market, the establishment of creditable credit rating agencies is critical. It is important that credit rating agencies be able to assess early on bond default risk and prevent financial crises. They must be able to warn of impending difficulties and not to alert investors of bonds risks and weaknesses after the crisis has taken place. In the US, the Senate's Permanent Subcommittee on Investigations is opening a probe into causes of the global financial crisis and is focusing in part on whether bond-ratings firms, driven by conflicts of interest, boosted mortgage investments that have since collapsed. Investigators want to know whether competition among firms led them to issue certain ratings in order to win business from banks. (WSJ, Nov. 20, 2008). Cooperation among national authorities should also hold the private sector accountable for disclosing accurate information in timely manner to ensure that the credit rating agencies' work is effective.

e) East Asia should establish a monetary policy dialogue among its member so that their policies will work towards ensuring a smooth and positive regional development. Expansionary monetary policy of one country may have far-reaching regional or global implications. A dialogue can allow countries in the region to share views on their monetary policies objectives and how these policies can meet each country national objective while at the same time take cognizance of the regional and global developments. This sharing of views can be useful because Asia is still far away from reaching regional integration ala EU. In such a situation sharing of view is essential because East Asia cooperation is based on consensus and informality in keeping with the tradition of non-interference.

Table 1: Progress on the Chiang Mai Initiative in Bilateral Swap Arrangments

Bilateral Swap Arrangements (BSA)[a]	Currencies	Conclusion dates	Amount as of[b]	
			May 30, 2004	Apr 1. 2008
Japan-Korea[c]	US$/Won (one-way)	Jul04 2001	US$2 bn.[d]	
Japan-Korea	US$/local (two-way)	Feb.23 2009		US$15 bn.
Japan- Korea	Yen/Won (two-way)	Jul 3 2010		US$6bn.
Japan-Thailand[c]	US$/Baht(one-way)	Jul30 2001	US$3 bn.	
Japan-Thailand	US$/local (two-way)	Nov 8 2010		US$9 bn.
Japan-Philippines[c]	US$/Peso	Aug 272001	US$3 bn.	
Japan-Philippines	US$/local(two-way)	May 3 2009		US$6.5 bn.
Japan-Malaysia	US$/Ringgit (one-way)	Oct 042007	US$1 bn.[d]	US$1 bn.[d]
Japan-China	Yen/ RMB (two-way)	Sep 202010	US$6 bn.	US$6 bn.
Japan-Indonesia[c]	US$/Rupiah (one-way)	Feb 17 2003	US$3bn.	
Japan-Indonesia	US$/Rupiah (one-way)	Aug 30 2008		US$6bn.
Japan-Singapore[c]	US$/Sing.$ (one-way)	Nov 10 2003	US$1bn.	
Japan-Singapore	US$/local (two-way)	Nov 07 2008		US$4bn.
Korea - China[c]	Won/ RMB (two-way)	Jun 242002	US$4 bn.	
Korea - China	Won/RMB (two-way)	Jun 232010		US$8 bn.
Korea-Thailand	US$/local (two-way)	Dec 112007	US$2 bn.	US$2 bn.
Korea-Malaysia[c]	US$/local (two-way)	Jul26 2002	US$2 bn.	
Korea-Malaysia	US$/local (two-way)	Oct 132008		US$3 bn.
Korea-Philippines[c]	US$/local (two-way)	Aug 09 2002	US$2bn.	
Korea-Philippines	US$/local (two-way)	Oct 162010		US$4 bn.
Korea-Indonesia	US$/local (two-way)	Dec 26 2009	US$2 bn.	US$4 bn.
China-Thailand	US$/Baht (one-way)	Dec 05 2004	US$2 bn.	US$2 bn.
China-Malaysia[c]	US$/Ringgit (one-way)	Oct 082005	US$1.5 bn.	US$1.5 bn.
China-Philippine	RMB/Peso(one-way)	Apr 9 2010	US$1bn.	US$2bn.
China-Indonesia	Rupiah/RMB (one-way)	Dec 03 2003	US$1 bn.	
China-Indonesia	US$/Rupiah (one-way)	Oct 16 2009		US$4bn.

Source: Yung, C.P. and C.Wyplosz (2008), “Monetary and Financial Integration in East Asia: The Relevance of European Experience” *Economic Papers*, European Commission, Brussels.