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Why Asia needs its own monetary fund

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THE ASIAN FINANCIAL CRISIS OF 1997/1998, DEVASTATED THE ECONOMIES OF INDONESIA, KOREA, MALAYSIA AND THAILAND, AND REVEALED SEVERAL IMPORTANT POINTS. FIRST, EAST ASIAN ECONOMIES WERE CLOSELY INTER-CONNECTED; SECOND, A RELIANCE ON THE INTERNATIONAL MONETARY FUND (IMF) ALONE FOR CRISIS MANAGEMENT WAS CLEARLY NOT THE BEST OPTION; AND THIRD, THERE WOULD BE A NEED FOR AN EFFECTIVE REGIONAL SELF-HELP MECHANISM TO PREVENT AND MANAGE CURRENCY AND FINANCIAL CRISES. RECOGNISING THIS, THE ASEAN+3 FINANCE MINISTERS INTRODUCED A REGIONAL LIQUIDITY SUPPORT MECHANISM – THE CHIANG MAI INITIATIVE (CMI) – IN ORDER TO PREVENT FUTURE CRISES.

Even though the current global financial crisis of 2007/2009 did not originate there, it hit many Asian economies hard; some even experienced turbulence in foreign exchange and capital markets as a result of a sudden reversal of capital flows. Korea almost faced a currency crisis in the aftermath of the Lehman Brothers shock, and several ASEAN members – particularly Indonesia – saw a US dollar liquidity squeeze. Luckily no country was forced to go to the IMF. Instead, facing financial turmoil and massive currency speculation, Korea chose to go to the US Fed for liquidity assistance – rather than its ASEAN+3 peers for support through the CMI. For Korea, the CMI turned out not to be such an attractive option. If Indonesia, the Philippines or Thailand had experienced difficulties similar to Korea's, where could it have gone for assistance? What should be done?

Lessons from the Korean experience in the global financial crisis

In Korea, during October and November 2008, both domestic currency and foreign exchange liquidity tightened for wholesale funded banks, and foreign investors

withdrew from the country. As the global financial crisis deepened, short-term capital outflows accelerated due to the need for foreign financial institutions to de-leverage. Korean institutions faced a shrinking foreign currency supply and a severe liquidity crunch, even though they had not been directly exposed to large numbers of sub-prime mortgage-related securities.



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The Bank of Korea used foreign exchange reserves to support the won's value, starting in March 2008; the reserves declined from US\$264bn in March to just below US\$200bn in November. The credit default swap spread on Korea had started to rise in late 2007, reaching a peak of 700 basis points in late October 2008. The won depreciated rapidly, from a strong 907 won per US dollar in October 2007, to 1,483 won per US dollar in November 2008.

In an attempt to calm the panic in the Korean financial markets, the Bank of Korea agreed to a currency swap line of up to US\$30bn with the US Fed in late October 2008, and began to draw dollars from this swap line. This policy action had an immediate significant stabilising impact on the market, as it sent the message that Korean authorities had the resources to stabilise the market. Market confidence was restored and the value of the won recovered.

There were several factors behind the success of the currency swap arrangement with the US Fed. First, it was a pre-emptive measure in that the dollar liquidity support was implemented in the middle of the market turmoil but before a currency crisis emerged. Second, the size was large enough to contain currency speculation. Third, it was done through a bilateral arrangement with the US Fed, as did other countries (Singapore, Brazil, and Mexico), so Korea was not the only recipient of a liquidity support commitment from the US Fed. Finally, the financial turmoil was created not because of fundamental problems, but rather due to a liquidity problem and market anxiety over the shrinking foreign exchange reserves.

During this episode, Korea chose not to go to its ASEAN+3 peers for liquidity support under the CMI, from which it could have obtained a maximum of US\$23.5bn. The most important reason for this decision was that if Korea had done so, it would have been forced to also go to the IMF – because of the CMI requirement linking support with an IMF programme if the amount of borrowing would exceed 20% of the total CMI commitment. This would have posed a significant political problem for the Korean government, given the stigma associated with the 'IMF crisis' in 1997/1998. Further, opting for existing bilateral local-currency swap lines with the Bank of Japan or the People's Bank, as part of the CMI, would not have been attractive even though this

could have been done without an IMF link. These bilateral swap lines were designed for precautionary purposes, but the amounts were limited in size (US\$3bn and US\$4bn equivalent with the respective central banks) and the yuan was (and still is) non-convertible.

There are several lessons to be learned from the Korean experience. Fundamentally, the ASEAN+3 finance ministers need to find ways to be able to use the CMI without triggering the need for IMF links. At the very least, under turbulent circumstances (as in the case of Korea in the autumn of 2008) CMI support should be provided flexibly by: (i) enabling precautionary lending rather than just crisis lending; (ii) delinking the CMI from IMF programmes or requiring that no conditionality be imposed, in a way comparable to the IMF's recently introduced Flexible Credit Line; and (iii) supplementing the CMI by additional bilateral arrangements, involving sufficiently large amounts, from economies inside and outside the region to make ample resources available for potential needs in the region. These actions would help those countries which may not be able to arrange bilateral currency swaps with the US Fed, such as Indonesia, Malaysia, the Philippines, Thailand and other developing ASEAN members.

Challenges of transforming the CMI to an AMF

The ASEAN+3 finance ministers should work hard to transform the multilateralisation process of the CMI into an exercise to build an Asian Monetary Fund (AMF). The key is to create conditions for IMF-delinking, which cannot be done without an enhanced quality of economic surveillance. That is, ASEAN+3 members should improve their ability to conduct high quality regional economic surveillance, and to formulate lending conditionality independent of IMF programmes, in case the CMI is activated by a crisis.

Institutionalising the management of CMI multilateralisation (CMIM) is necessary for this purpose. A 'surveillance unit' for regional economic surveillance and CMIM decision-making – proposed by the ASEAN+3 finance ministers in May 2009 – could become a permanent professional secretariat to deal with financial and currency crises, as well as conduct normal regional surveillance. A

proposed ‘advisory panel of experts’ could function as a *de facto* board of executive directors, making day-to-day decisions, discussing surveillance reports produced by the secretariat, and approving the amount and conditions of crisis lending.

To transform CMIM into an AMF, the following recommendations should be made:

- clarify rules for activating CMIM lending;
- establish a joint forum for finance ministers and central bank governors to intensify policy dialogue among themselves;
- set up a strong professional secretariat, with the required analytical expertise and policy experience, in support of regional economic surveillance, CMIM activation and independent conditionality formulation; and
- move beyond the simple ‘information-sharing’ stage to a more rigorous ‘peer review and peer pressure’ stage, and eventually to a ‘due diligence’ stage, as a means to improve the quality of economic surveillance.

A new AMF would be important for another reason. It would encourage many Asian economies to embark on the rebalancing of sources of economic growth toward domestic and regional demand and to correct payments imbalances. After the Asian financial crisis, many economies in the region saw the high value of building foreign exchange reserves as self-insurance to avoid currency crises. For Asian governments, going to the IMF could be political suicide because of the lingering bad memory of the ‘IMF crisis’ in the public at large. So these governments have had every incentive to accumulate reserves by running large current account surpluses and intervening in the currency markets. The region’s emerging and developing economies would welcome the rebalancing if an AMF could reduce financial turbulence and act as the region’s lender of last resort.

IMF reform

A new AMF would be a complementary organisation, a building-block of the global financial architecture provided by the IMF. This implies that an AMF should work closely with the IMF, exchanging information on a routine basis, often conducting joint analysis – as for the Financial Sector

Assessment Program – and intervening in crisis countries together if needed. However, this also means that the IMF should clarify its roles and focus. While the IMF, as a key global institution, has a clear role of promoting global financial stability, this does not mean that the IMF sets the key global agenda and regional institutions – such as a new AMF – need simply follow it. The process needs to be interactive between the IMF and regional institutions.

Given the loss of trust in the IMF among the Asian policy makers, the institution should re-establish itself as an effective, credible and trustworthy institution. Otherwise the IMF may not be considered in Asia as a legitimate, trusted partner for the region. The IMF needs to significantly reform its operations and governance. On the operational side, the IMF must focus on surveillance of systemically important economies (like the US and the EU) and multilateral consultation (as was done on the issue of global payment imbalances) to foster global macroeconomic and financial stability.

Three major changes to reform IMF governance will have to be made, at least from an Asian perspective. These are: a substantial reduction of Europe’s voting power and representation; the disallowance of any single member country – including the US – to have a veto power; and selection of an Asian as the next managing director. With such fundamental changes, emerging Asian members would be likely to accept the IMF with a sense of trust and ownership, and regard it as their partner for Asian macroeconomic and financial stability.

Note:

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