

## Conclusion: post-crisis Asia – economic recovery, September 11, 2001 and the challenges ahead

To the extent that Asia is recovering, no one can claim the credit. The amazing thing to me – if you leave Indonesia out – is how similar the performances are, regardless of the policies. Korea took the IMF's advice and it's bouncing back. Thailand took the IMF's advice and it's starting to come back. Malaysia defied the IMF and did everything the IMF told it not to – it's coming back fast. Everybody's contemplating success for their policies: Mahathir said he did it, the IMF said they did it. The truth is the natural resilience of economies did it (Paul Krugman, August 25, 1999).<sup>1</sup>

In the aftermath of East Asia's spectacular economic collapse in mid-1997 even the most optimistic predictions gave at least a decade before Asia could fully recover.<sup>2</sup> Yet, in early 2000, an IMF study triumphantly noted that “the financial crises that erupted in Asia beginning in mid-1997 are now behind us and the economies are recovering strongly” (IMF 2000a). Indeed, the economic recovery between the second quarter of 1999 and the last quarter of 2000 was simply astounding. South Korea, Thailand, Malaysia and the Philippines notched growth-rates equal to or above those just before the crisis. South Korea made the biggest gain, its GDP growing by a whopping 10.7 per cent in 1999 and 11.2 per cent in the first half of 2000, from a contraction of –6.7 per cent in 1998. Also, by October 2000, Korea had already surpassed its pre-crisis per capita income peak.<sup>3</sup> In September 1999, the IMF-prescribed programs for South Korea (and Thailand) were brought to an end after being in effect for two years. South Korea also stopped drawing from the IMF, and in August 2000 completed repayment of a US\$19.5 billion IMF loan, almost three years ahead of schedule. By March 2000, South Korea had accumulated substantial enough reserves (from US\$9 billion at the end of 1997 to about US\$83 billion) to provide it with reasonable insulation against shocks. In October 2001, Korea's foreign-exchange reserves stood at US\$100.4 billion, and in November 2001, the

international rating agencies restored the country's sovereign rating to investment grade.

The recovery in Hong Kong, China has been equally impressive. The first-quarter growth in 2000 was 14.3 per cent, followed by 10.8 per cent in the second quarter. GDP growth in Singapore of 5.4 per cent in 1999 was partly due to rising productivity levels. Moreover, Singapore experienced a rapid growth of its information technology industry – no doubt benefiting from the government's policy of transforming the island republic into a "wired" economy. Malaysia, the Philippines and Thailand grew at 5.4, 3.2 and 5.2 per cent respectively in the first quarter of 2000 (ADB 2000). Only Indonesia continues to lag behind. However, considering the fact that Indonesia experienced a dramatic output contraction of –13.2 per cent in 1998, its real GDP growth of 0.23 per cent in 1999 was a significant milestone (ADB 2000). Moreover, the rupiah strengthened to about 7,450 per US dollar in mid-2000. Also, inflation, which peaked at 82 per cent in September 1998, has declined to about 1.7 per cent in December 1999.<sup>4</sup> At the end of June 2000, Indonesia's gross external reserves stood at US\$27.4 billion (ADB 2000b, 31). The more recent figures show that in the first quarter of 2000 real GDP growth in Indonesia reached 3.0 per cent.

Other indicators of the region-wide recovery included the steady return of capital. For example, portfolio equity investment flows have stabilized and turned positive with US\$8 billion in aggregate inflows in 1999–2000. FDI flows have been also positive, largely owing to sharply depreciated asset values and exchange rates and also to the relaxation of foreign ownership rules, which has encouraged mergers and acquisitions. The latter factor has been most pronounced in South Korea. In fact, South Korea, almost closed to foreign direct investment before the crisis, received US\$15.5 billion in outside investment in 1999, five times the 1996 inflow. By early 2000, the current accounts of South Korea, Indonesia, Thailand and Malaysia were all positive, foreign-currency liabilities, especially those with short maturities, had fallen, and the exchange-rate misalignments have largely been corrected. By mid-May 2000, the value of local currencies (in nominal terms) had stabilized, although they still bought 20 to 35 per cent fewer US dollars than before the crisis in South Korea, Malaysia, the Philippines and Thailand, and 50 per cent fewer dollars in Indonesia. Overall, these positive developments reduced the region's external vulnerabilities substantially.

What explains this remarkable economic recovery? There are several interrelated factors. *First*, the massive financial injection, totaling some US\$35 billion, provided by the IMF in 1998–99, and some US\$85 billion committed (although not all of this actually materialized) by other multilateral and bilateral sources helped to restore investor confidence and stop any further economic hemorrhage, and in particular the massive currency depreciation. In South Korea, an increase in foreign equity participation in the financial sector has provided an additional source of inflows. Balance-of-payments

surpluses have allowed the crisis-hit countries to accumulate additional international reserves and let currencies appreciate gradually. *Second*, it is important to recognize that financial crises do not necessarily destroy the capacity for economic growth. Although the Asian financial crisis exacted a heavy toll in terms of lost output and socioeconomic dislocations, it did not destroy the industrial and manufacturing infrastructure and the productive capacities of these economies. The significant investments these countries made in physical plant and equipment served them well as the global economy picked up. *Third*, domestic fiscal stimulus and a rebuilding of inventories combined with favorable external developments provided Asia's sagging export sector with a much-needed boost. Specifically, the global output growth of 3 per cent greatly stimulated the initially suppressed demand for goods and services produced in Asia. Most importantly, as the negative effects of the global electronics downturn that occurred from 1996 through to 1998 were gradually reversed, this boosted the South Korean, Malaysian, Thai and Singaporean economies, which depend heavily on the manufacture and exports of electronics, including information-technology-related products. The Korean recovery was also helped substantially by the external demand for cars and semi-conductors. Moreover, in all four countries service-sector output grew strongly, owing to growth in telecommunications, wholesale and retail trade, and financial services.

Prior to the global economic slowdown (which began ostensibly in the last quarter of 2000, compounded by the uncertainty produced by September 11, 2001), the US economy played an important role in supporting global demand – accounting for more than 50 per cent of the growth of global demand. While this was reflected in record US current-account deficits, these deficits proved to be an important buffer against global recession. Japan, on the other hand, has failed to live up to expectations as the engine behind the regional economies. Although positive growth in Japan in the first half of 1999 began to stimulate recovery in the region, it was short-lived.<sup>5</sup> The return to negative growth (0.5 per cent in 2001) weakened the stimulus to regional exports that otherwise would have been created by the stronger yen. Moreover, the Japanese government's growth stimulus from the 1999 fiscal package has petered out. The growth forecast for 2002 has been marked down to 0.5 per cent, reflecting in part the global economic slowdown, but also the continuing weakness of consumer confidence and underlying problems with the financial system. While the Japanese government has the resources to introduce another fiscal stimulus plan, given the high level of public debt, at 125 per cent of GDP, there is little scope for reflationary fiscal policies. Indeed, given Prime Minister Koizumi's plans to curb government spending, the economy is not likely to be stimulated by fiscal policy. Japan is therefore unlikely to provide much support to the regional economies this year through demand for their exports. Although it is expected that the growing intra-Asian trade and

demand from the European Union will help to fill the void, there is little doubt that Japan's recovery is crucial (at least, in the short term) to the region's recovery. Over the long term, Japan's importance as a market for Asian exports and a source of long-term direct capital to the region will gradually diminish.

*Fourth*, the Asian crisis was not a current-account, but a capital-account crisis. Conventional current-account crises are caused by the deterioration of domestic macroeconomic fundamentals, such as price inflation, fiscal deficits and low rates of saving. A capital-account crisis is characterized by massive international capital inflows, usually large enough to surpass the underlying current-account deficit, and composed mainly of short-term borrowing denominated in foreign currencies. This leads to currency and maturity mismatches, which adversely affect the balance-sheets of domestic financial institutions. There is thus a dual financial crisis – a currency crisis due to currency mismatch that leads to international liquidity problems, and a domestic banking crisis resulting in credit contraction. During the Asian crisis, the swing of international capital from inflows to outflows amounted to more than 20 per cent of GDP in Thailand. Currency depreciation further worsened the balance-sheets of corporations by inflating the value of liabilities in domestic currency terms, thereby precipitating a currency and banking crisis. Further, there was an imbalance between high levels of short-term foreign debt and low foreign-exchange reserves. However, as investor panic (both foreign and domestic) that partly triggered the crisis abated, capital once again started to return – with FDI dominating the composition of net private flows, representing about 82 per cent of the total (World Bank 2000c, 154). This allowed the economies to rebuild their official international reserves, reduce their external liabilities, and strengthen their currencies and external current-account positions.

*Fifth*, prudent monetary and fiscal policy – some domestically inspired and some promoted by the IMF – have acted as important catalysts for recovery. For example, in South Korea, Thailand and Malaysia, money-market interest rates have been broadly unchanged since mid-1999, at levels significantly below those observed before the crisis.<sup>6</sup> Lower interest rates helped reduce the pressure on heavily indebted corporations and contain the non-performing loans problem.<sup>7</sup> with regard to fiscal policy, in Korea a supplementary budget adopted in August 1999 provided a much-needed additional stimulus, while targeting a consolidated central government deficit of 5 per cent of GDP for 1999. And *sixth*, luck has played an important role in Asia's recovery, just as it compounded underlying problems in 1997. In particular, while the El Niño and La Niña weather phenomena devastated agricultural production in 1997–98, the favorable weather conditions in 1999 and the first half of 2000 have helped Indonesia and the Philippines to reap bumper crops of rice and other basic agricultural commodities. In addition to creating agricultural employment, this has also eased burdens

on the overstretched social safety nets and enabled vulnerable households better to meet their consumption needs.

### **The global economic slowdown and September 11, 2001**

Most Asian countries experienced a sharp economic slowdown beginning in the last quarter of 2000. The problems of a deteriorating external environment due in large part to the downturn in the US economy were exacerbated by the September 11 terrorist attacks. Countries that are closely linked to the global economy through trade and capital flows were more adversely affected than those where these linkages are weaker. In particular, Asian countries with heavier dependence on manufacturing, in particular the production and export of electronics, saw a larger decline in growth. For example, South Korea's manufacturing sector grew only by 1.5 per cent in the first three quarters of 2001, compared to an average growth of more than 18 per cent between 1999 and 2000. Similarly, in Malaysia the manufacturing sector actually shrank by 4 per cent in the first three quarters of 2001, whereas the average growth rate was 17.4 per cent in the preceding two years. Singapore's manufacturing shrank by 9 per cent in the first three quarters of 2001, from an average growth of more than 14 per cent in the preceding two years (ADB 2001, 4). To varying degrees, the decelerating export demand has been accompanied by softening domestic demand. Indeed, slowing growth and the sharp decline in stock prices have adversely affected both consumer confidence and business investment. The impact of the economic slowdown has been reflected in the growth-rates. In the first three quarters of 2001, Indonesia, South Korea, Malaysia, the Philippines and Thailand taken together grew only by 2.5 per cent. This represents a sharp deceleration from the 7.8 per cent growth they achieved in the first three quarters of 2000 (ADB 2001, 4). Even resilient Singapore saw its GDP decline by 0.6 per cent in the first three quarters of 2001, compared to 9.5 per cent growth in the corresponding period in 2000. The impact of the global slowdown on China has been moderate, partly because of its lower dependence on information technology exports, and partly because of a series of substantial fiscal stimulus measures that have been implemented over the last four years. Thus, China posted a growth of 7.6 per cent in the first three quarters of 2001 (ADB 2001, 4).

Another negative impact was the result of the sharp rise in oil prices in the first six months of 2001. Although prices have since leveled off, the potential oil-price instability (compounded by the uncertainty in the Middle East) remains a major concern. However, the price-rise was something of a mixed blessing. It has worked in favor of net exporters of oil such as Indonesia and Malaysia, but against net importers, such as South Korea, Taiwan, the Philippines and Thailand.<sup>8</sup> Korea is more vulnerable to rising

international crude oil prices than most other Asian countries. Clearly, Korea's current-account balance would deteriorate significantly if oil prices were to rise sharply.

Third, the rebounds in East Asian equity markets in 1999 declined gradually in 2000, but were further sharply eroded following the September 11 attacks. In local currency terms, as of end-September 2000, Korean, Indonesian and Thai equities had fallen by almost 40 per cent, while losses in the Philippines were just under 35 per cent since early 2000 (ADB 2000b, 4). The drop in equity markets has been influenced by external and domestic factors. Externally, rising US interest rates triggered downward adjustments in global equity markets, while increased capital outflows have contributed to the decline in stock prices. Overall, all this has had an adverse impact on regional markets. Another factor that has influenced regional equity markets is the worldwide corrections in prices of information-technology stocks since the second quarter of 2000. Since the information technology sector in the affected Asian countries has expanded in recent years, this has also increased their exposure to fluctuations in information-technology stock prices.<sup>9</sup>

### **The challenges ahead**

The palpable concern that the drop in equity markets and the currency depreciations would trigger another crisis have since subsided – in large part because gross domestic product growth picked up in much of Southeast and East Asia in the first quarter of 2002. Taken together, Indonesia, Malaysia, the Philippines, Singapore, Thailand, the PRC and Korea grew by 5.3 per cent, representing an improvement from the 3.8 per cent growth achieved in the last quarter of 2001 and the 4.3 per cent growth for the entire year 2001. This resurgence in growth is driven primarily by a rise in global demand for the region's exports. This positive development notwithstanding, it is important to recognize that the crisis-affected countries are now more resilient to shocks than before. First, almost all the crisis-affected countries now run current-account surpluses. Second, foreign-exchange reserves have improved significantly, and more than cover the entire short-term external debt. In fact, the short-term to total debt ratios and total external debt to GDP ratios are now lower than those seen at the height of the 1997 crisis. Third, the magnitude of net private capital outflows is nowhere near as large as it was in 1997 and 1998. Fourth, the composition of capital being withdrawn is also different. In 1997–98 the main problem was the non-renewal of short-term credit by banks and investor panic. Now the problem is scheduled debt repayments and slowdown or withdrawal of foreign direct investment and portfolio capital. Fifth, the ratio of money supply to foreign-exchange reserves (another indicator of the vulnerability of a country to a currency crisis) has

improved, and capital adequacy ratios and the profitability of banks are slowly recovering. Finally, as was noted earlier, the 1997 crisis was primarily a capital-account crisis that was exacerbated by pegged – and ultimately unsustainable – exchange rates. Currently, most Southeast and East Asian countries have adopted more flexible exchange-rate regimes. This should enable them to adjust to external shocks more smoothly.

Yet the crisis-affected countries still face some daunting challenges. For example, in order to deal with the social costs of the crisis and then the subsequent economic slowdown, governments responded with a series of fiscal stimuli measures to boost the economy. For example, between August 1998 and August 1999 the Thai government launched three fiscal stimulus packages, including tax and tariff reductions, to boost domestic demand. Consequently, it ran a large deficit which, on a cash-balance basis, reached a cumulative 79.4 billion baht in the first half of fiscal year 1999/2000 (ending September 30). The overall public-sector deficit, including interest costs of financial sector restructuring for the fiscal year 1999/2000 was around 7 per cent of GDP. Total public debt was estimated at about 2.6 trillion baht (US\$67.7 billion) in 1999, equivalent to around 56 per cent of GDP (ADB 2000c, 37–38). Thus rising deficits in combination with very substantial financial sector restructuring costs have contributed to a rapid increase in public-sector debt since the onset of the crisis. Although China, South Korea, Malaysia, Singapore and Thailand introduced the stimuli measures in their 2001 budgets, the sharp downturn following September 11 forced them to announce supplementary spending packages. As a result, fiscal deficits have further increased in each country. Bringing these deficits to a manageable level remains a major challenge.

Since weaknesses in the financial and corporate sectors were at the heart of the crisis, reforming them has been a top priority. There are broadly two phases in resolving financial system distress: containment and restructuring. The containment or distress-resolution phase occurs with the onset of a financial crisis, when there is a major loss of confidence in the financial system. The aim during this phase is quickly to stabilize the financial system and prevent a credit crunch. The usual strategy is to provide large-scale liquidity support to the financial institutions and to limit losses by closing down unviable banks. The countries are now beyond the containment stage. Now in the restructuring and rehabilitation phase, the governments of Indonesia, Korea, Malaysia and Thailand have all intervened in non-viable financial institutions and re-capitalized some of the viable, but weak institutions, and have begun to take steps to improve prudential regulation and supervision. Yet inadequate regulation, weak supervision of financial institutions, poor accounting standards and disclosure rules, outmoded laws, and weak corporate governance continue to pose problems. Moreover, since financial restructuring has involved the governments' injecting a large amount of capital into or nationalizing troubled banks, this has resulted in the state's

owning a high proportion of the banking sector. Although governments are committed to privatizing the nationalized banks and divesting state ownership, the process has been slow – owing in large part to unstable market conditions and political sensitivity in selling bank assets to foreign buyers. Of greater concern is the fact that most banks remain heavily burdened with large volumes of non-performing loans, many of which may ultimately have a relatively low recovery rate.

Governments have pursued various approaches to corporate restructuring. One popular voluntary method has involved mergers and acquisitions (M&As). The number of M&As, particularly those that are cross-border, has increased sharply. That is, total cross-border M&As, defined as acquisitions of more than 50 per cent of equity by foreign investors, increased from some US\$3 billion in 1996 to about US\$22 billion in 1999. The largest rise was in Korea, accounting for roughly US\$13 billion of M&As in 1999 (ADB 2001, 123). While M&As have been triggered by important policy changes, including the liberalization of investment in non-traded sectors and changes in competition policy, it is important to note that much of the M&A activity has been concentrated in such activities as wholesale and retail trade, real estate and financial services. Overall, progress in corporate restructuring has been modest. There are several reasons for this. First, asset disposition has been slow, owing to the difficulty in valuing assets, thin markets for selling assets, and fear of selling them too cheaply. Secondly, many banks not only have insufficient capacity to absorb losses without facing a serious threat of closure, but in most countries operate with a full government guarantee on their liabilities, reducing any real incentive to undertake fundamental restructuring. Third, most banks have a limited technical capacity to restructure, while their long-standing links with corporations have complicated the restructuring process. Finally, the needed restructuring and asset sales have been hampered by disagreement between creditors over loss-sharing, and weak insolvency procedures, including creditors' reluctance to write down losses, have prolonged the liquidation of unviable companies.

Compared to their peak levels during the crisis, non-performing loan ratios have fallen in most of the crisis-hit countries. However, caution should be exercised in interpreting this decline. The reductions in non-performing loan ratios have been brought about by the transfer of such loans from banks' balance sheets to the government-owned asset-management companies (AMCs). While this has enabled banks to resume lending and support recovery, the real test of restructuring also hinges on the progress made in asset-disposal by AMCs.

Finally, the financial crisis left widespread socioeconomic distress in its wake, with massive job losses and bankruptcies. The resultant sharp rise in inflation (in the context of a considerably weakened labor market) exacted a heavy toll in terms of falling real wages and incomes. The combined effects



of higher unemployment, inflation and the absence of a meaningful social safety net pushed hundreds of thousands, if not millions, of people into poverty. While the various social support systems introduced in Thailand, Malaysia, South Korea and Indonesia helped to protect the most vulnerable sectors of society, much more needs to be done. In the immediate term, given that the scope for expansionary macroeconomic policies is greatly limited, it is imperative to develop a means-tested social assistance that provides minimum income support to the most needy. Only Korea has come close to developing such a system. In the long term, sustained economic growth and continuing investments in health, education and social services are a must.

### **A new East Asian regionalism?**

Does East Asia's long-term salvation lie in a new East Asian regionalism? Obviously many East Asian governments think so. The single greatest push for East Asian regionalism has been the Asian financial crisis. The commonly held view in Asia (especially Korea and the ASEAN countries) was that they were let down by the West (in particular, the United States and Japan) during the crisis. In their view, since Western banks and financial institutions from the G-7 countries had created and exacerbated the crisis by suddenly pulling their funds from the region, it was only appropriate for Western governments to provide assistance. The fact that G-7 governments either declined individually to take part in the rescue operations (as was the case of the United States and Japan with Thailand), or required excessively stringent demands through the IMF, only served to aggravate the feelings of let-down and betrayal. At the same time it was widely believed that the United States (through the IMF) was not only dictating flawed policy responses to the crisis, but also that these self-serving policies had worsened the crisis by pushing Asian economies into a deeper economic recession. As Bergsten (2000, 24) notes:

The single greatest catalyst for the new East Asian regionalism, and the reason it is moving most rapidly on the monetary side, is the financial crisis of 1997–98. Most East Asians feel that they were both let down and put upon by the West. In their view, western banks and other lenders created much of the crisis by pulling out. The leading financial powers then either declined to take part in the rescue operations, as the United States did in Thailand, or built the much-bally-hooed “second lines of defense” so deviously that they could never be used. At the same time, the IMF and the United States dictated much of the Asian response to the crisis.

Whatever the merits of such thinking, it is clear that Asian governments now agree that they must reduce their dependence on the G-7 countries and

multilateral financial institutions like the IMF and the World Bank. Perhaps, most significantly, the celebrated APEC (Asia Pacific Economic Cooperation) has been severely compromised. APEC's failure at its Vancouver Leaders' Meeting in November 1997 to support Japan's proposal for an Asian Monetary Fund and its endorsement of the centrality of the IMF to the resolution of the crisis alienated many Asian governments from the organization. However, one cannot conclude that Asian countries are rejecting multilateralism and global economic integration. Rather, it seems that they want their own institutions and a bigger say in regional economic matters. More diplomatically, Asian countries claim that a regionally focused facility might be able to design more appropriate conditionality than the IMF because of the former's presumably superior regional expertise and its closer geographical proximity to its member countries.

### *The Asian Monetary Fund*

The idea of the Asian Monetary Fund (AMF) dates back to August 1997, when Thailand approached the Japanese government for financial assistance. In response, Japan, along with several member countries of ASEAN, proposed setting up a separate monetary fund to provide emergency financing to countries affected by the economic crisis. The proposal was enthusiastically welcomed, as the ASEAN nations were only too eager to see Japan take on a greater leadership role (i.e. in the economic sphere) in the region. Moreover, there was an anticipation that the conditionality attached to AMF resources would not be nearly as strict as that imposed by the IMF. However, in its public relations campaign, ASEAN claimed that the AMF would not only promote regional cooperation and trust, but that there was a real economic rationale for such a body. Specifically, since trade tends to be regional, the affected region loses disproportionately from trade disruptions caused by currency crises. Thus it made sense that the regional governments work in unison to prevent the spread of financial crises. It was also argued that the AMF, like the Arab Monetary Fund and the Latin American Reserve Fund, would complement the IMF (Sussangkarn 2000).

By the end of September 1997, it seemed that the AMF would be a reality. The Japanese government pledged an initial US\$50 billion, while an additional US\$50–60 billion was to be raised through contributions from the PRC, Taiwan, Hong Kong and Singapore (Yoshitomi and Shirai 2000, 67–9). It was argued that the AMF and its financing arm, the Regional Financing Facility, would provide sufficient liquidity that could be quickly mobilized to forestall speculative attacks on the region's currencies. Also, unlike the IMF assistance, funds from the AMF were to be unconditional, taking into account the individual needs of the member countries. As expected, the United States and the European Union were unequivocal in

their objections. First, they argued that unconditional financial assistance would increase the risk of moral hazard, and second, that an independent AMF would undermine the IMF, because of the potential conflicts in their policy guidelines for member states. In the end “Japan decided to give up the proposal in November 1997, owing to the opposition by the United States and the IMF on the grounds that such an arrangement would enhance the problems of moral hazard and double-standards” (Yoshitomi and Shirai 2000, 68). Wade and Veneroso (1998b, 19), more bluntly note that “the United States Treasury pulled out all the stops to kill the proposal, and it died.”

Although the proposal for the AMF did not get off the ground, the ASEAN finance ministers at the November 1997 APEC Summit in Vancouver agreed to establish a cooperative arrangement of regional surveillance (called the Manila Framework Group) through a better coordination between the member states’ finance ministries and central banks. The Framework included the following initiatives: (1) a cooperative financing arrangement that would supplement IMF resources, (2) enhanced economic and technical cooperation, particularly in strengthening domestic financial systems and regulatory capacities, and (3) a mechanism for regional surveillance to complement the IMF’s global surveillance. To enhance cooperation further, the ASEAN finance ministers (on October 4, 1998), formed the ASEAN Surveillance Process (ASP) to promote closer consultations on economic policies. The ASP has two major elements: (1) to monitor global, regional and national economic and financial developments, and (2) to provide a forum where ASEAN finance ministers can share information and jointly develop collective action programs to counter potential threats to any member country and the region.<sup>10</sup>

On October 3, 1998, Japan formally proposed a “New Initiative to Overcome the Asian Currency Crisis.” The most ambitious element was the “Miyazawa Initiative.” Under this initiative, Japan pledged US\$30 billion to support the crisis-hit countries. Half the pledged amount was to be dedicated to short-term capital needs during the process of implementing economic reforms. The rest was earmarked for medium- and long-term reforms. By February 2000, US\$21 billion had been committed, with US\$13.5 billion for medium- and long-term reforms. Korea has been the largest recipient (US\$8.4 billion), followed by Malaysia (US\$4.4 billion), and Indonesia and Thailand with US\$2.9 billion each, and the Philippines (US\$2.5 billion). The initiative has supported economic adjustment, financial and corporate restructuring, social safety nets, infrastructure and export financing. In the second phase of the initiative, Japan has partially guaranteed sovereign debt issues, enabling countries to use limited public resources to mobilize private capital, thereby promoting private debt markets (World Bank 2000b, 152–3).

*The Chiang Mai initiative*

About a decade ago, Malaysian Prime Minister Mahathir Mohamad proposed the creation of an exclusive “East Asian Economic Group” (EAEG) comprising the ASEAN countries, China, Japan and South Korea. Concerned as he was about the emerging trade blocs in Europe and North America, Mahathir’s undeclared objective was to persuade the mentioned countries to shift their economic strategies along the lines of his own “look East” policy – with Japan as the economic focal point. While the EAEG proposal received lukewarm support from Asian countries (including Japan), it was vigorously opposed by the United States, Australia and New Zealand, because they felt that the EAEG would undermine the incipient Asia–Pacific Economic Cooperation (APEC) forum.<sup>11</sup>

However, the organization that actually expanded (with strong American backing) was the broad-based APEC (Asia-Pacific Economic Co-operation). However, in the aftermath of the Asian financial crisis, the ASEAN countries hastily created the “ASEAN+3” (comprising the 10 member countries of ASEAN, plus China, Japan and South Korea) as envisaged earlier by Mahathir. Since December 1997, informal ASEAN+3 summits have been convened on an annual basis. They have already set up a “vision group” to explore ideas for cooperation, and have been holding regular meetings of their finance ministers.

However, the central task of ASEAN+3, besides setting up the vision group, has been to establish a surveillance mechanism to try to anticipate and head off future financial crises. Top-level discussion has also taken place regarding common currency baskets and joint intervention arrangements – to replace both the discredited dollar pegs of the past and the costly free floats imposed by the crisis.<sup>12</sup> Most dramatically, at the thirty-third annual meeting of the Board of Governors of the Asian Development Bank meeting in Chiang Mai, Thailand in June 2000, the finance ministers of ASEAN+3 committed their countries to even greater regional cooperation under the new “Chiang Mai Initiative.” Specifically, they announced their agreement to share foreign-exchange reserves (through a region-wide system of currency swaps and repurchase arrangements) in order to defend their currencies against speculative attacks. The finance ministers reasoned that providing countries under pressure with short-term hard-currency liquidity would act as a firewall against future financial crises. To show their commitment, the ASA (ASEAN Swap Arrangement) was endowed with US\$1 billion effective November 17, 2000. While the repurchase agreements (repos) are designed to allow ASEAN members with collateral like US Treasury Bills to swap them for hard currency, and then repurchase them at a later date, it is hoped that hard-currency lines of credit can be made available to members without strict linkages to repos. Indeed, under the initiative,

ASA is to be made available for two years and is renewable upon the mutual agreement of the members. Each member is allowed to draw a maximum of twice its committed amount from the facility for a period of up to six months, with the possibility of a further extension, which is not to exceed six months. In addition to ASA, members are encouraged to establish bilateral swap arrangements. In April 2001 Japan signed a bilateral swap arrangement with Malaysia, Thailand and Korea totaling some US\$6 billion. While the maximum amount that can be withdrawn under the bilateral swap will be determined by the two countries, in the spirit of regional cooperation all member states will be fully consulted when deciding the size of the disbursements.

Moreover, in keeping with the signed Chiang Mai Initiative, ASEAN+3 have committed themselves to work towards cooperation. In March 2001, the ASEAN Task Force on the ASEAN Currency and Exchange Rate Mechanism was established, with the ambitious task of working towards harmonizing the macroeconomic and exchange-rate policies of the member countries. Moreover, there is agreement to work towards a common market and a single Asian currency unit on the euro model. Even the IMF has given its blessing to this goal. In fact, the fund has expressed support for any regional initiative as long as it is complementary with the policy of the IMF. The IMF recently noted that “regional initiatives can be helpful in supporting sustained economic growth and stable financial relations among participating countries. In this vein, the recent Chiang Mai Initiative among ASEAN members and China, Korea and Japan is an important example of enhanced regional cooperation through which countries in temporary financial difficulties will be able to obtain foreign exchange from their neighbors through swap and repurchase arrangements” (IMF 2000d, 9). In this context, some have argued that the Chiang Mai Initiative is like the European Monetary System (EMS) arrangement. However, this seems to be a bit of an exaggeration. After all, the exchange rate mechanism (ERM) of the EMS provided for automatic and unlimited support of bilateral pegs. That is, the arrangement conveyed an essential message to the markets: any attempt at tearing apart any one currency from the others is bound to face strong official resistance, since the central bank is committed to put up unlimited amounts of its currency as a defense. In contrast, the amounts to be swapped within the Chiang Mai arrangement are limited and unlikely to be commensurate with the amounts that markets can mobilize.

In the end, how all these initiatives will actually work in practice remains to be seen. However, what once seemed a pipe-dream is now no longer that. The growth of cross-border trade is driving Asian economies inexorably towards closer cooperation. Suffice it to note that, the demands for regional arrangements to ensure currency stability and more efficient regional exchange transactions will grow. The Asian financial crisis vividly underscored the fact that Asian countries have a vested interest in cooperating with one another to minimize the systemic risk now inherent under globalization.

**Notes**

- 1 Cited in DeRosa (2001, 186–7).
- 2 The Asian Development Bank (ADB) defines East Asia as the 10 Association of Southeast Asian Nations (ASEAN), including Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam), plus China and South Korea.
- 3 International credit-rating agencies such as Moody's, Standard and Poor and Fitch IBCA have raised their credit ratings for South Korea, Malaysia and Thailand. Most importantly, in all three countries the capital inflows have been mostly non-debt-creating. Thus these countries have been able further to reduce their external liabilities. With short-term liabilities being redeemed, the maturity profile of the external debt has improved significantly.
- 4 Although the rupiah now seems to be less vulnerable and volatile than before, trading levels during the last week of February represent a depreciation of about 67 per cent in US dollar terms from its end-June 1997 level.
- 5 In the second half of 1999, Japan's GDP growth fell to 0.9 per cent and to a negative 0.3 per cent in the third and fourth quarters respectively. For details, see ADB (2000c, 5).
- 6 In Indonesia, a market-led decline in short-term interest rates resumed in the late 1999 as political uncertainty eased, but interest-rate levels continue to exceed those elsewhere in the region.
- 7 Short-term nominal interest rates have come down sharply and are now either below their pre-crisis level or close to it.
- 8 In the case of Indonesia, the net effect of higher oil prices on the government's fiscal position is unlikely to be substantial, as increased government revenues will be partially offset by the higher costs of the government fuel subsidy.
- 9 Prices of IT stocks tend to be more volatile and more closely correlated internationally than those of traditional non-IT stocks.
- 10 In addition to the usual monitoring of exchange rates and macroeconomic aggregates, the ASP also monitors sectoral and social policies, including provisions for capacity-building, institutional strengthening and sharing of information.
- 11 Although some Japanese officials viewed the EAEG proposal favorably, the Japanese government had to oppose it publicly in the face of strong opposition from the United States.
- 12 Although the finance ministers of ASEAN+3 met for the first time in Manila in April 1999, top-level discussions have been taking place since mid-1997.