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Evolving ASEAN+3 ERPD: Towards peer reviews or due diligence?

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**Evolving ASEAN+3 ERPD:
Towards Peer Reviews or Due Diligence?**

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Abstract

The ASEAN+3 finance ministers' group has developed its economic review and policy dialogue (ERPD) process as part of regional financial cooperation efforts. Recently the group has decided to integrate the ERPD process with the regional liquidity support facility, called the Chiang Mai Initiative (CMI), and has taken steps to transform CMI into a multilateral arrangement that is more independent of International Monetary Fund (IMF) programs. This requires a significant strengthening of the effectiveness of ERPD. The issue is how to achieve it—whether to adopt an OECD-type “peer review and peer pressure” approach or an IMF-type “due diligence” approach. The paper argues that ERPD needs to evolve to embrace both approaches by taking appropriate balances between the two.

JEL Classification: F33, F53, F55, O19

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1. INTRODUCTION: REGIONAL FINANCIAL COOPERATION IN EAST ASIA

The Asian financial crisis of 1997–98 caused significant damage to economies in East Asia. The crisis prompted the region's policymakers to realize the importance of economic and financial cooperation among themselves given the region's deepening economic interdependence. Following the crisis, therefore, East Asia embarked on various initiatives to manage such interdependence and achieve stable economic growth. In the monetary and financial area, the finance ministers of ASEAN+3—comprising the ten ASEAN countries,¹ the People's Republic of China (PRC), Japan, and the Republic of Korea (Korea)—undertook three initiatives for regional financial cooperation:

- Establishment of a regional reserve pooling arrangement (Chiang Mai Initiative, CMI);
- Introduction of a regional economic review and policy dialogue process (ERPD); and
- Development of local-currency bond markets (Asian Bond Markets Initiative, ABMI).

The important objectives of these initiatives are to prevent the recurrence of regional financial crises and to contain such crises effectively if and when they occur. The authorities are now studying ways and means to further strengthen the reserve pooling arrangement by going beyond the current Chiang Mai Initiative (CMI) through the multilateralization of bilateral swap arrangements. To function as envisioned, an augmented regional liquidity support facility with a collective decision-making mechanism will require enhanced regional economic surveillance to keep decision-makers fully and accurately informed about the health of potential and prospective users of the facility. Thus, a high priority for ASEAN+3 finance ministers is to make their economic review and policy dialogue (ERPD) exercise an effective support process for an augmented CMI.

In this paper, we focus on ASEAN+3 ERPD as the region's major economic review and policy dialogue process. Although there are several other forums in East Asia, ASEAN+3 ERPD is the most advanced and prominent. We explore the following issues:

- How does the review process in East Asia—particularly that of ASEAN+3 ERPD—work and what are its key features?
- What should be its objectives given the rising importance of CMI?
- How do international financial institutions—such as the Asian Development Bank (ADB) and International Monetary Fund (IMF)—contribute?
- Is there any role for the private sector in East Asia's review process? What are the major challenges for enhancing the effectiveness of ASEAN+3 ERPD? Should ERPD evolve along the line of an OECD-type “peer review and peer pressure” approach or an IMF-type “due diligence” (or “surveillance”) approach?

The remainder of the paper is organized into six sections. In Section 2 we review the ASEAN+3 finance ministers' financial cooperation efforts, arguing that ASEAN+3 ERPD is an integral part of the efforts. In Section 3 we then focus on key features of ASEAN+3 ERPD and discuss its linkage with CMI, which would potentially require ERPD to function as a process beyond a simple economic review process. In Section 4, we discuss three possible modalities of ERPD: *information sharing*, *peer review and peer pressure*, and *due diligence*. In Section 5 we examine the possible role of the private sector in ERPD. In Section 6 we provide some preliminary thoughts on enhancing the effectiveness of ERPD by advancing from *information sharing* to *peer review and peer pressure*, and then to more rigorous “surveillance” with elements of *due diligence*. Section 7 provides concluding remarks.

¹ The ten members of the Association of Southeast Asian Nations are Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam.

2. ASEAN+3 FINANCE MINISTERS' PROCESS

Following the outbreak of the Asian financial crisis, the heads of state/government of the ASEAN+3 countries met for the first time in December 1997 to discuss regional peace, stability, and prosperity, and urged their finance ministers to nurture regional financial cooperation. The first ASEAN+3 finance ministers meeting was held in Manila in April 1999 on the sidelines of the ADB annual meeting, and since then the ministers have met annually, except in 2000 when they met twice.

Table 1 summarizes key decisions and agreements reported in joint ministerial statements of the ASEAN+3 finance ministers' meetings. It is clear that the finance ministers' process has been functioning as a forum for promoting regional financial cooperation and collective policy action to achieve regional financial development and stability. The finance ministers have particularly focused on three major policy initiatives: regional liquidity support facility (CMI); regional economic review and policy dialogue (ERPD); and regional local-currency bond market development (ABMI).² In recent years, the finance ministers have focused on how to improve CMI and ERPD.

Table 1: ASEAN+3 Finance Ministers' Meeting

Date		Place	Key Decisions and Agreements
1 st	30 April 1999	Manila	No statement issued
2 nd	6 May 2000	Chiang Mai	<ul style="list-style-type: none"> • Strengthen policy dialogues and regional cooperation activities in, among others, the areas of capital flow monitoring, self-help and support mechanisms, and international financial reforms • Use the ASEAN+3 framework to facilitate the exchange of consistent and timely data and information on capital flows • Strengthen the existing cooperative frameworks among monetary authorities through the Chiang Mai Initiative (CMI)
3 rd	25 September 2000	Prague	No statement issued
4 th	9 May 2001	Honolulu	<ul style="list-style-type: none"> • Update the capital flow situation in each member country and exchange data on capital flows bilaterally among members on a voluntary basis • Review the current main principles of the bilateral swap arrangement under the CMI in the next three years • Establish a study group to examine ways of enhancing the effectiveness of their economic reviews and policy dialogues • Continue to exchange views on the early warning systems (EWSs) and work towards developing appropriate EWS models for East Asia
5 th	10 May 2002	Shanghai	No significant decision or agreement
6 th	7 August 2003	Makati	<ul style="list-style-type: none"> • Strengthen the current peer review process by implementing the recommendations made by the ASEAN+3 Study Group to Examine Ways of Enhancing the Effectiveness of Economic Reviews and Policy Dialogue • Intensify efforts to develop regional bond markets—through the Asian Bond Markets Initiative (ABMI) • Welcome the deputies' initiative in setting up a voluntary research group—the ASEAN+3 Research Group

² See Kuroda and Kawai (2002), Bird and Rajan (2002), Henning (2002), Montiel (2004), Rajan and Siregar (2004), Girardin (2004a, b) and Kawai (2005a, 2005b) for a review of recent initiatives of ASEAN+3 finance ministers.

7 th	15 May 2004	Jeju	<ul style="list-style-type: none"> • The CMI bilateral swap agreement (BSA) network has reached US\$36.5 with 16 BSAs • Undertake further review of the CMI (known as the “second phase of the CMI review”) to explore ways of enhancing its effectiveness
8 th	4 May 2005	Istanbul	<ul style="list-style-type: none"> • Take measures to enhance effectiveness of CMI through: (i) integration and enhancement of ASEAN+3 economic surveillance into the CMI framework; (ii) clear defining of the swap activation process and the adoption of a collective decision-making mechanism (as a first step of multilateralization); (iii) a significant increase in the size of swaps; and (iv) improvement of the drawdown mechanism (the size of swaps to be withdrawn without the IMF-supported program to be increased from the current 10% to 20%)
9 th	4 May 2006	Hyderabad	<ul style="list-style-type: none"> • The CMI BSA network has reached US\$75.0 billion with 16 BSAs • Successfully complete the strengthening of the regional liquidity support network initiated in Jeju in May 2004 • Adopt the collective decision-making procedure for CMI swap activation • Launch the Group of Experts (GOE) and the Technical Working Group on Economic and Financial Monitoring (ETWG) to explore ways for further strengthening surveillance capacity in East Asia • Task the deputies to set up a “new task force” to further study various possible options towards an advanced framework of the regional liquidity support arrangement (CMI multilateralization or post-CMI)
10 th	5 May 2007	Kyoto	<ul style="list-style-type: none"> • The CMI BSA network has increased to US\$80 billion, consisting of 16 BSAs among 8 countries • Agreement in principle on a self-managed reserve pooling arrangement governed by a single contractual agreement as an appropriate form of CMI multilateralization • Task the deputies to carry out further in-depth studies on the key elements of CMI multilateralization including surveillance, reserve eligibility, commitment size, borrowing quota, and activation mechanism

Source: Joint Ministerial Statement of ASEAN+3 Finance Ministers' Meetings, May 2000–May 2007, aseansec.org

Chiang Mai Initiative. The hallmark liquidity support facility in East Asia is the CMI, which was designed to reduce the risk of liquidity crises and to manage regional currency attacks, contagion, and crises if and when they occur. The 1997–98 Asian financial crisis highlighted the importance of creating an effective financing facility so that governments in the region can prevent or respond effectively to currency crises in an increasingly connected global economy. With the ASEAN+3 leaders' recognition of the need for “enhancing self-help and support mechanisms in East Asia through the ASEAN+3 Framework,”³ the finance ministers of ASEAN+3 agreed in Chiang Mai in May 2000 to establish a regional network of swap arrangements for its members, thus launching the CMI. It consists of two elements: expansion of the existing ASEAN Swap Arrangement (ASA), in both amounts and membership, and the creation of a new network of bilateral swap arrangements (BSAs) among ASEAN+3 members.⁴ By July 2007, sixteen BSAs had been concluded in line with

³ *Joint Statement on East Asia Cooperation*, ASEAN+3 Summit, November 1999, aseansec.org.

⁴ The ASA, established in August 1977 by the members of the original five ASEAN countries, with a total facility of US\$100 million, was augmented to a total of US\$200 million in 1978. Under the CMI, ASA membership was

the main principles, amounting to a total of US\$83 billion—excluding Japan's commitment made for Malaysia under the New Miyazawa Initiative (see Table 2).⁵ As a result CMI now has the total size of US\$85 billion (US\$2 billion for ASA and US\$83 billion for BSAs.)

Table 2. Progress on BSAs under the Chiang Mai Initiative (as of July 2007)

BSAs	Currencies	Effective/Expiration Dates	Size
Japan-PRC	Yen/Renminbi or Renminbi/Yen	28 Mar 2002/27 Mar 2006	US\$ 3.0 billion ^(a) (2-way)
Japan-Korea	USD/Won or USD/Yen	24 Feb 2006/23 Feb 2009	US\$ 10.0 billion (JPN-KOR) US\$ 5.0 billion (KOR-JPN)
	Yen/Won or Won/Yen	27 May 2005/3 July 2007	US\$ 3.0 billion ^(a) (2-way)
Japan-Indonesia	USD/Rupiah	31 Aug 2005/30 Aug 2008	US\$ 6.0 billion (JPN-INO)
Japan-Malaysia	USD/Ringgit	5 Oct 2001/4 Oct 2007	US\$ 1.0 billion ^(b) (JPN-MAL)
Japan-Philippines	USD/Peso or USD/Yen	4 May 2006/3 May 2009	US\$ 6.0 billion (JPN-PHI) US\$ 0.5 billion (PHI-JPN)
Japan-Singapore	USD/Singapore Dollar USD/Yen	8 Nov 2005/7 Nov 2008	US\$ 3.0 billion (JPN-SIN) US\$ 1.0 billion (SIN-JPN)
Japan-Thailand	USD/Baht or USD/Yen	10 July 2007/--	US\$ 6.0 billion (JPN-THA) US\$ 3.0 billion (THA-JPN)
PRC-Korea	Renminbi/Won or Won/Renminbi	27 May 2005/23 June 2007	US\$ 4.0 billion ^(a) (2-way)
PRC-Indonesia	USD/Rupiah	17 Oct 2006/16 Oct 2009	US\$ 4.0 billion (PRC-INO)
PRC-Malaysia	USD/Ringgit	9 Oct 2002/8 Oct 2005	US\$ 1.5 billion (PRC-MAL)
PRC-Philippines	Renminbi/Peso	30 Apr 2007/29 Apr 2010	US\$ 2.0 billion ^(a) (PRC-PHI)
PRC-Thailand	USD/Baht	6 Dec 2001/5 Dec 2004	US\$ 2.0 billion (PRC-THA)
Korea-Indonesia	USD/Rupiah or USD/Won	27 Dec 2006/26 Dec 2009	US\$ 2.0 billion (2-way)
Korea-Malaysia	USD/Ringgit or USD/Won	14 Oct 2005/13 Oct 2008	US\$ 1.5 billion (2-way)
Korea-Philippines	USD/Peso or USD/Won	17 Oct 2005/16 Oct 2007	US\$ 1.5 billion (2-way)
Korea-Thailand	USD/Baht or USD/Won	12 Dec 2005/11 Dec 2007	US\$ 1.0 billion (2-way)

Notes: (a) The amounts are US dollar equivalents.

(b) The amount excludes US\$2.5 billion committed (on 18 August 1999) under the New Miyazawa Initiative.

Source: Update of Table 5 of Kawai (2005a).

One of the important features of the CMI BSA network is that members requesting liquidity support can immediately obtain short-term financial assistance for the first 20 percent of the committed amount. The remaining 80 percent is provided to the requesting member under an IMF program. Linking the CMI liquidity facility to an IMF program—and hence its conditionality—is designed to address the concern that the liquidity shortage of a requesting country may be due to fundamental problems, rather than mere panic and herd behavior by investors, and that the potential moral hazard problem could be non-negligible in the absence of tough IMF conditionality.⁶ The general view is that, with the region's currently

extended to include all ASEAN members, and its facility was further augmented to US\$1 billion. It was agreed in April 2005 to further augment ASA to US\$2 billion. Note the ASA is a multilateral swap arrangement.

⁵ In July 1999, the Japanese Ministry of Finance committed to providing up to US\$ 2.5 billion liquidity to Bank Negara Malaysia, if and when necessary, through swap transactions between the US dollar and the Ringgit, <http://www.mof.go.jp/english/if/kousou.htm>

⁶ The IMF uses "conditionality" in designing its loans and requires borrowers to meet a set of conditions.

limited capacity to produce and enforce effective adjustment programs in times of crisis, linking CMI to IMF programs is prudent, at least for the time being.⁷

ASEAN+3 Economic Review and Policy Dialogue. In May 2000, ASEAN+3 finance ministers agreed to introduce an ASEAN+3 ERPDP, which became the most important information exchange mechanism on economic conditions and policies in East Asia. The purpose of ERPDP is to contribute to the prevention of financial crises through the early detection of irregularities and vulnerabilities and the swift implementation of remedial policy actions. The mechanism is intended to facilitate information sharing, exchanges of views, and collaboration on financial, monetary, and fiscal issues of common interest. The ERPDP process encompasses (i) assessing global, regional, and national economic conditions; (ii) monitoring regional capital flows and currency markets; (iii) analyzing macroeconomic and financial risks; (iv) strengthening banking and financial system conditions; and (v) providing an Asian voice in the reform of the international financial system. Steps have been taken for cooperation in monitoring short-term capital flows and developing a regional early-warning system to assess regional financial vulnerabilities. Many ASEAN+3 members have set up National Surveillance Units for economic and financial monitoring and are developing their own early warning systems. More recently, the Group of Experts (GOE) and the Technical Working Group on Economic and Financial Monitoring (ETWG) were launched to explore ways and means for strengthening the region's economic monitoring capacity. However, there is no single, independent, professional organization which prepares comprehensive assessments of member countries' economic performance (including analyses of risks, vulnerabilities, and appropriate policy options) or identifies key issues for discussion.⁸

There are other forums for regional economic information exchange, analysis and policy dialogue. They include: the ASEAN Surveillance Process for ASEAN finance ministers; the Executives' Meeting of Asia-Pacific Central Banks (EMEAP), South East Asian Central Banks (SEACEN), and South East Asia, New Zealand and Australia (SEANZA) for central bank officials; and the Asia-Pacific Economic Cooperation (APEC) finance ministers and the Asia-Europe Meeting (ASEM) finance ministers for trans-regional processes. See Table 3 for membership of these groups.

⁷ Some ASEAN+3 members, such as Malaysia, believe that the CMI should not be linked to IMF programs.

⁸ The ASEAN Secretariat provides some logistic support to the ASEAN+3 ERPDP process. ADB provides a statement and a paper for discussion at the meetings of finance ministers and of finance and central bank deputies, respectively. The IMF, which formerly played the role of a secretariat for the Manila Framework Group (MFG), has been participating in the ASEAN+3 deputies' process on ERPDP since November 2005.

Table 3: Regional Forums for Finance Ministries and Central Banks^a

	Finance Ministries and/or Central Banks					Central Banks		
	ASEAN (10)	ASEAN+3 (13)	MFG ^b (14)	APEC (21)	ASEM ^c (43)	SEANZA (20)	SEACEN (16)	EMEAP (11)
Year Established	1967.8	1999.4	1997.1 1	1994.3	1997.9	1956	1966.2	1991.2
Japan		○	○	○	○	○		○
PRC		○	○	○	○	○		○
Korea		○	○	○	○	○	○	○
Hong Kong, China			○	○		○		○
Taipei, China				○			○	
Singapore	○	○	○	○	○	○	○	○
Brunei Darussalam	○	○	○	○	○		○	
Cambodia	○	○			○		○	
Indonesia	○	○	○	○	○	○	○	○
Lao PDR	○	○			○			
Malaysia	○	○	○	○	○	○	○	○
Myanmar	○	○			○		○	
Philippines	○	○		○	○	○	○	○
Thailand	○	○	○	○	○	○	○	○
Viet Nam	○	○		○	○		○	
Mongolia					○	○	○	
Macao						○		
Papua New Guinea				○		○	○	
Fiji							○	
Australia, New Zealand			○	○		○		○
India, Pakistan					○	○		
Nepal, Sri Lanka						○	○	
Bangladesh, Iran						○		
USA, Canada			○	○				
Chile, Mexico, Peru				○				
Russia				○				
EU-27					○			

Notes: (a) ASEAN = Association of Southeast Asian Nations; MFG = Manila Framework Group; APEC = Asia-Pacific Economic Cooperation; ASEM = Asia-Europe Meeting; SEANZA = South East Asia, New Zealand, Australia; SEACEN = South East Asian Central Banks; EMEAP = Executives' Meeting of East Asia-Pacific Central Banks.

(b) MFG included the International Monetary Fund, the World Bank, the Asian Development Bank, and the Bank for International Settlements. It was, however, terminated in December 2004.

(c) ASEM includes the ASEAN Secretariat and the European Commission.

Source: Update of Table 2 of Kuroda and Kawai (2002).

Asian Bond Markets Initiative. East Asian policymakers undertook initiatives to develop Asian bond markets in view of the need to channel a vast pool of savings to long-term investment for growth and development within the region. This effort reflects the recognition that the financial system in East Asia has been too dependent on bank financing domestically and on short-term, foreign-currency financing externally, and, hence, needs to become more balanced through the development of national and regional capital, in particular bond, markets. Development of well-functioning, local currency-denominated bond markets is expected to reduce incentives for borrowers to rely on bank financing and/or short-term external financing. It is expected to mitigate the “double mismatch” problem (currency and maturity mismatches) of international capital markets—i.e., borrowing short

term in foreign currency and lending long term in domestic currency—and to make national financial markets more resilient, with sound banking sectors and more developed, deeper capital markets.

The ASEAN+3 finance ministers adopted the ABMI in August 2003 to develop and deepen local currency-denominated bonds through supply-side stimulus. The initiative intends to directly increase the supply of local-currency bonds and strengthen market infrastructure for local-currency bond issuance and trading. The six original voluntary ABMI working groups were revised to four groups focused on developing new securitized instruments (particularly in multi-currency bonds), establishing a regional credit guarantee mechanism, exploring an Asian settlement system, and strengthening Asian credit rating agencies while raising cross-country comparability of their ratings.

In addition to the ABMI, the EMEAP group introduced the Asian Bond Fund (ABF) project. The idea was to help expand the bond market through demand-side stimulus from purchases by central banks of sovereign and quasi-sovereign bonds using foreign exchange reserves. The initial ABF-1 was launched in June 2003, and focused on purchases of US dollar-denominated bonds. ABF-2 was launched in December 2004, involving purchases of sovereign and quasi-sovereign local currency-denominated bonds. ABF-2 consists of two components: a Pan-Asian Bond Index Fund (PAIF) and a Fund of Bond Funds (FoBF). PAIF is a single bond fund index investing in local currency bonds, issued in eight EMEAP emerging economies.⁹ FoBF has a two-tiered structure with a parent fund investing in eight sub-funds, each of which invests in local currency sovereign and quasi-sovereign bonds issued in their respective markets. PAIF and the eight sub-funds are passively managed by private fund managers against a Pan-Asian bond index and predetermined benchmark indexes in local markets. ABF-2 is designed to facilitate investment by public and private sector entities.

ASEAN+3 Research Group. In addition to the three main initiatives outlined above, a research group was set up in August 2003 to explore ways to further strengthen financial cooperation and promote financial stability by soliciting academic inputs from researchers and research think tanks in ASEAN+3 countries. Research projects involved collaboration among major research institutes and think tanks for the ASEAN+3 countries, with funding provided by the governments of the PRC, Japan, and Korea to finance research activities by institutes of their own countries or those of ASEAN countries. Table 4 summarizes the titles of the group's research projects, which have varied over time.

⁹ These economies are: PRC, Hong Kong, Indonesia, Korea, Malaysia, the Philippines, Singapore and Thailand.

Table 4: ASEAN+3 Research Group Activities

Year	Research Projects
2003/ 2004	<ul style="list-style-type: none"> • Towards a Regional Financial Architecture for East Asia • An Exchange Rate Arrangement for East Asia
2004/ 2005	<ul style="list-style-type: none"> • Economic Surveillance and Policy Dialogue in East Asia • Trade, Investment and Financial Integration in East Asia • Exploring Ways to Enhance the Functions of the Chiang Mai Initiative in the Medium Term • The Role of Private Sector Development in Regional Economic Growth and Financial Integration
2005/ 2006	<ul style="list-style-type: none"> • Liberalization of Cross-Border Capital Flows and Effectiveness of Institutional Arrangements against Crisis in East Asia • Fostering the Asset Management Industry for the Development of Capital Markets in the Region • Regional Coordination of Policy Measures Forward: Financial Market Liberalization and Capital Market Development
2006/ 2007	<ul style="list-style-type: none"> • Toward Greater Financial Stability in the Asian Region: Exploring Steps to Create Regional Monetary Units • Financial Conglomeration in the East Asian Region: Recent Trends and Implications for Regional Financial Market Development
2007/ 2008	<ul style="list-style-type: none"> • Development of Database on Corporate Credit Information • Development of Capital Market to Widen and Diversify SME Funding

Source: aseansec.org

3. ASEAN+3 ECONOMIC REVIEW AND POLICY DIALOGUE

Formal processes. The finance ministers’ process began in April 1999, with an annual meeting in which the 13 finance ministers discuss current economic conditions, key policy challenges, and desirable policy actions. The ASEAN Secretary General and the ADB President provide brief statements and engage in policy dialogue with the ministers. Policy dialogue tends to be spontaneous and often focuses on issues touched upon by the two presenters. The finance ministers’ meetings figure prominently in the ASEAN+3 process because of the importance of their decisions on key financial cooperation initiatives, including CMI and ABMI.

ASEAN+3 finance and central bank deputies hold two-day meetings semiannually. At the ERPD session, they exchange their views on global, regional, and individual country economic developments, various types of risks affecting the regional economies, and several policy options. ADB and the IMF provide economic reports, thereby facilitating the deputies’ policy dialogue, information sharing, and exchanges of views. External experts provide their views on certain thematic issues and engage in dialogue with the deputies. Policymakers of individual countries provide only self-assessment of their own countries’ economic conditions. They do not conduct “peer reviews,” that is, they do not assess formally other countries’ economic conditions and vulnerabilities nor do they recommend desirable policy changes of other countries.

The ASEAN+3 ERPD process could be more effective in several ways that would enhance the quality of the dialogue. First, discussions could be more frank, with officials freely debating their own and other countries’ economic problems, vulnerabilities, and policy options to ensure good policies for the region as a whole. Second, there could be an independent, professional organization that prepares comprehensive papers for analyses,

assessments, and discussion to support the process, while the ADB and IMF currently provide their views of the global and regional economy. Third, central bank governors could be more directly involved in the finance ministers' process, not simply and indirectly through their deputies' activities. Fourth, institutions with best knowledge and expertise on particular issues—like the Bank for International Settlements (BIS) on global banking issues, the International Organization of Securities Commissions (IOSCO) on global capital market regulation, global rating agencies on sovereign risks, and other relevant institutions on particular topics—could be invited to the process on an *ad hoc* basis.

Integration of ERPD and CMI. The ASEAN+3 countries began a review of the CMI in May 2004, to consider the adequacy of both the size of the facility and the modality of its operation, as well as the appropriateness of both the IMF linkage and the relationship with ERPD. The total size of swap arrangements covered by CMI was considered to be small in view of the potential size of speculative capital flows and, hence, could provide a more appropriate level of protection if raised substantially. The bilateral nature of CMI was regarded as an impediment to its quick activation and, hence, the facility might be more effective if centralized for prompt joint activation in the event of a crisis.¹⁰ The degree of the CMI's linkage to IMF programs was considered as tight and, hence, the CMI could be more responsive if the linkage were reduced or even eliminated with prudence as the quality of regional ERPD was improved. Thus, for ASEAN+3 policymakers, CMI and ERPD should be linked, both in operation and in evolution.

In May 2005, a set of major agreements was reached to improve the effectiveness of CMI and ERPD. These agreements were:

- Integration and enhancement of ASEAN+3 ERPD into the CMI framework;
- Enunciation of a clear definition of the CMI swap activation process and adoption of a collective decision-making mechanism as a step toward CMI multilateralization;
- Significant increase in the size of bilateral swap arrangements; and
- Increase in the level of BSA disbursement permitted without an IMF program from 10% to 20%.

In May 2006, the finance ministers adopted the collective decision-making procedure for CMI swap activation, as a step toward multilateralizing the CMI. The ministers also tasked their deputies to further study various possible options toward an advanced framework for the regional liquidity support arrangement—that is a multilateral CMI or post-CMI arrangement. In May 2007, the finance ministers agreed in principle on a self-managed reserve pooling arrangement governed by a single contractual arrangement as an appropriate form of CMI multilateralization. They then instructed their deputies to carry out further studies on the key elements of “self-managed reserve pooling”—including surveillance, reserve eligibility, size of commitment, borrowing quota, and activation mechanism.

As ASEAN+3 continues to move towards developing a financing arrangement of large size that is centrally administered and ultimately more independent of the IMF, the nature of regional ERPD must also evolve. That is, the analytical capacity of the ASEAN+3 members to conduct effective economic review must improve substantially as this evolution takes place. Essentially, the region must acquire an ability to accurately assess economic and financial conditions of a country in or near crisis and to draft policy conditions associated with its liquidity support to a crisis country, independently of the IMF. As the capacity to conduct effective ERPD improves, the nature of CMI may also evolve. There is thus a mutually reinforcing relationship between the evolution of ERPD and CMI.

¹⁰ Rajan and Siregar (2004) go one step further and propose to establish a centralized reserve pooling system.

4. POSSIBLE MODALITIES OF ERPД: INFORMATION SHARING, PEER REVIEWS, AND DUE DILIGENCE

Good economic management requires objective assessments of a country's economic conditions and policies, identification of risks and vulnerabilities, analysis of pros and cons of various policy options, and selection and implementation of desirable policies. Any national authority needs to go through these exercises. Such a national effort can be complemented by a joint review mechanism, which involves a group of like-minded countries that are highly economically interdependent. Frank and candid exchanges of views, with mutual trust among these countries and a strong sense of collective action, can induce good policies that are conducive to national, regional, and global economic growth and stability.

There are three different modalities of ERPД depending on the level of commitment on the part of participating countries. These are: *information sharing*; *peer review and peer pressure*; and *due diligence*. These three modalities can be considered as evolutionary stages of ERPД in support of financial cooperation and regional integration as other complementary frameworks—such as regional financing arrangements and exchange rate policy coordination—evolve over time.

Information sharing. The weakest form of ERPД is simple information sharing. Nonetheless, accurate and timely information concerning neighbors' economic conditions, policy options, constraints, and objectives would be valuable; policymakers would be able to make well-informed decisions. In addition, proactive information sharing would provide an opportunity for mutual learning. One country's successful or failed experiences can be useful for others in their policymaking. Finally, frequent contacts and meetings for policy dialogue would nurture a sense of trust and community among participating countries and facilitate future coordination for possible joint action.

Information sharing is part of any higher-level ERPД because it can facilitate more intensive policy dialogue, analyses, assessments, policy advice, peer pressure, and due diligence. The G7 Finance Ministers and Central Bank Governors process, the OECD processes (Economic Policy Committee, the Economic Development Review Committee, and Working Party 3), the European Union's multilateral surveillance process (conducted by Economic and Financial Affairs Council [ECOFIN]), and the global, regional, and national surveillance conducted by the IMF all involve information sharing. The type of economic information to be collected and shared may differ depending on the objectives of ERPД. But generally speaking, they should include: (i) macroeconomic developments and policy changes; (ii) financial market developments involving exchange rates, interest rates, capital flows, foreign exchange reserves, and banking sector performance; and (iii) institutional, legal, and regulatory reforms.

Peer review and peer pressure. The OECD process uses a framework of "peer review and peer pressure." The OECD describes these concepts as follows:

"Peer review can be described as the systematic examination and assessment of the performance of a State by other States, with the ultimate goal of helping the reviewed State improve its policymaking, adopt best practices, and comply with established standards and principles. The examination is conducted on a non-adversarial basis, and it relies heavily on mutual trust among the States involved in the review, as well as their shared confidence in the process. When peer review is undertaken in the framework of an international organization—as is usually the case—the Secretariat of the organization also

plays an important role in supporting and stimulating the process. With these elements in place, peer pressure tends to create, through this reciprocal evaluation process, a system of mutual accountability” (OECD, 2003).

“Peer pressure” can thus be characterized as the “influence and persuasion exercised by the peers” during the peer review process (OECD, 2003). The peer review process can give rise to peer pressure through, for example: (i) a mix of formal recommendations by, and informal dialogue with, the reviewing countries; (ii) public scrutiny, comparisons, and, in some cases, even ranking among countries; and (iii) the impact of all of the above on domestic public opinion, national administrations, and policymakers. It is important to note that peer pressure does not take the form of legally binding acts, sanctions, or other enforcement mechanisms. In essence, the objective of “peer review and peer pressure” is, through a means of soft persuasion, to encourage each country to adopt good policies.

A good “peer review” is expected to have several features (Witherell, 2004). First, it is a “policy dialogue among equals.” It is a “two-way, open, frank, and constructive dialogue” as opposed to a “one-way lecture” or a “hearing by a superior entity” that might deliver a binding judgment or punishment. Second, it aims at “transparency.” While the process is “collegial, informal, and confidential” and can involve sensitive issues, the final outcome is usually made open to the public so that outsiders may understand the nature of, and make comments on, the process. Third, it is a “non legally-binding” process. This feature is particularly suitable in situations where traditional enforcement mechanisms may, on occasion, have the unintended and opposite effect of breeding animosity. Fourth, it requires a high-quality secretariat. An effective peer review process requires a very dedicated and specialized secretariat to conduct professional, objective, and neutral analyses and assessments and to make effective, realistic policy recommendations. The G7 process relies on the IMF, the OECD processes rely on the OECD, and the European Union process (Monetary Committee and ECOFIN) rely on the European Commission, for their respective secretariat functions.

Due diligence. Another form of ERPD is “due diligence.” It involves assessments of a potential borrowing country through the lens of a potential lender. The country’s ability to pay—its solvency and credit worthiness—becomes key issues. If an ASEAN+3 member affected by a currency attack and speculation requests short-term liquidity assistance within the CMI framework, the potential lender countries must agree on whether they should provide liquidity assistance and, if they do, what conditions should be attached to such assistance. As regional financial cooperation moves toward the creation of an enhanced CMI that is more independent of the IMF, a moral hazard issue poses a strong case for the due diligence of potential borrowers, and for a clear need of enforcement mechanisms of necessary policy adjustment.

A good potential reference for “due diligence” would be the IMF’s Article IV surveillance and program conditions. The objective of IMF Article IV surveillance is to “examine all aspects of the member’s economy that cause the exchange value to be what it is and to evaluate the economy’s performance candidly for the entire membership” (Driscoll, 1996).¹¹ This surveillance is based on the “conviction that strong and consistent domestic economic policies will lead to stable exchange rates and a growing and prosperous world economy.” This consultation itself does not involve any enforcement mechanism, but every Article IV staff report is submitted for scrutiny and detailed discussions to the Executive Directors’

¹¹ In the IMF’s early years, periodic Article IV consultations were mandatory only for members with restrictions on currency exchange, but since 1978 the IMF undertakes them with all member countries (Driscoll, 1996).

Board Meeting in Washington, thereby applying peer pressure to the country concerned.¹² When a member country falls suddenly into serious economic difficulty or is believed to be following practices inimical to the interests of other members, the Managing Director may initiate additional consultations, which can involve more intensive assessments of the country. A strong enforcement mechanism sets in once the IMF provides liquidity assistance to a member country in a BOP or currency crisis. The IMF demands extensive flows of information to perform “due diligence” and to intensify the monitoring of the borrower to ensure compliance with the conditionality during the program period.

A “peer review and peer pressure” mechanism alone may not provide an effective incentive for countries to commit themselves to such an intense form of investigation. Possible provision of short-term liquidity assistance at times of difficulties creates incentives for potential lenders to conduct a high level of scrutiny of potential borrowers. The availability of short-term liquidity provides incentives for potential borrowers to subject themselves to such scrutiny. This type of assessment of a potential borrower (i.e., a developing or an emerging market economy) should be performed with the notion that the country in question may be exposed to future difficulties or crises that would require liquidity assistance. This possibility could make ERPD one of “due diligence.” In contrast, ERPD with a highly developed country would not be a “due diligence” type because chances are none or small that they would encounter a BOP or currency crisis and request liquidity assistance. Nonetheless they must be subject to intensive scrutiny and peer pressure so that they pursue good policies that can contribute to regional and global economic stability.

Data requirements. Disclosure of adequate and timely information is essential to any successful ERPD. A country may be reluctant to disclose, even among the ASEAN+3 members, sensitive information on macroeconomic, financial, and external issues. This reluctance must be mitigated. In an early warning system, the provision of timely information is critical in providing lead times for policy corrections to be effective. Information accuracy is critical in formulating appropriate policy responses. Without adequate, accurate, and timely information, the quality of ERPD can be severely damaged.

The IMF has introduced the Special Data Dissemination Standard (SDDS) and the General Data Dissemination System (GDDS), and established the Dissemination Standards Bulletin Board (DSBB).¹³ By participating in these initiatives, countries’ ability to collect and disseminate statistics has substantially improved. However, many low-income ASEAN+3 countries are not SDDS subscribers. It is important for these countries to upgrade capacity to collect important economic statistics. Even among more advanced ASEAN+3 economies, standardizing key economic indicators across the region is a significant challenge.

5. THE ROLE OF PRIVATE SECTOR ASSESSMENTS

The ERPD process is intended to include rigorous mutual review and policy dialogue. How rigorous it will be in practice can be loosely gauged against the risk assessment activities done by the private sector. That is, knowledge of private sector views is a natural credibility test. The private sector viewpoint also matters because it can have an impact on economic performance, especially through its ability to influence borrowing costs and capital flows. Moreover, as regional economic integration proceeds and policy dialogue gradually evolves

¹² The IMF promotes “transparency” by encouraging each member country to agree to placing the Article IV consultation report on the IMF website.

¹³ The SDDS was established in March 1996 to guide countries that have, or that might seek, access to international capital markets in the dissemination of economic and financial data to the public. The GDDS was established in December 1997 to guide countries in the provision to the public of comprehensive, timely, accessible, and reliable economic, financial, and socio-demographic data.

into policy coordination, an independent supranational surveillance unit or professional secretariat may eventually become desirable. That evolution can be guided by a greater understanding of the process by which the private sector formulates views on countries' economic health. At the same time, the limitations on use of private sector information for good policymaking should be recognized.

Common publicly available private sector indicators. Assessments of economic performance are available to clients from a range of private sector providers including those firms that specialize in the provision of economic information and those—such as investment banks—for which it is a service to financial clients. Two widely available and related summary indicators of economic performance provided by the private sector are the pure sovereign risk indicator and the more general country risk indicator.¹⁴ The latter usually includes some assessment of the private business environment. The most widely known sovereign issuer ratings are those done by the major global ratings agencies: Standard & Poor's (S&P), Moody's, and Fitch. Table 5 gives ratings, as of early 2007, for selected East Asian economies from these agencies. These ratings are accompanied by outlook guidance (negative, stable, and positive) that gives some indication of the likelihood and direction of a ratings change.

Table 5. Current Sovereign Risk Ratings on Long-term External Debt

	Investment Grade			Speculative Grade		
	Singapore	Malaysia	Thailand	Philippines	Viet Nam	Indonesia
S&P's	AAA	A-	BBB+	BB-	BB	BB-
Fitch	AAA	A-	BBB+	BB	BB-	BB-
Moody's	Aaa (AAA)	A3 (A-)	Baa1 (BBB+)	B1(B+)	Ba3 (BB-)	B1 (B+)

Notes: S&P and Fitch use similar letter systems. Moody's uses a different system and Moody's ratings are "converted" in parentheses to their S&P equivalents for this table.
Source: Bloomberg

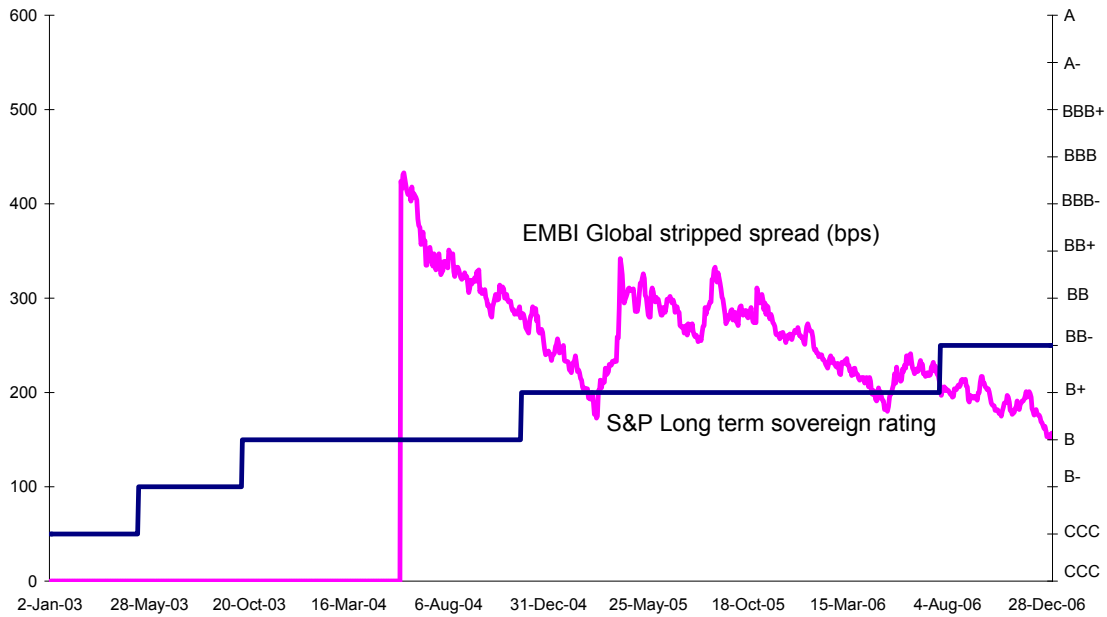
In addition, sovereign risk ratings are commonly maintained for internal purposes by investment banks. Ratings (and rankings) based on an index constructed from semi-annual surveys are reported in the *Institutional Investor*. The September 2006 Institutional Investor Credit Ratings for the countries in Table 1 were Singapore, 91; Malaysia, 68.7; Thailand, 62.0; Philippines, 44.2; Viet Nam, 42.6; and Indonesia, 42.1; with 100 being a perfect credit score. There are several organizations—such as the Economist Intelligence Unit (EIU) and Global Insight—that provide country risk ratings purely as a service for fee. The ratings are usually a part of a larger package of economic data, macroeconomic forecasts, and macroeconomic reports. Industry-specific and other special topic reports are also frequently provided.

Whereas country risk ratings can, in principle, influence direct investment, sovereign risk ratings more closely influence public borrowing costs—especially the sovereign spread on foreign debt, which serves as a benchmark for private sector external borrowing. Of course, other factors also impact the sovereign spread, which is currently noticeably compressed for emerging markets because of strong investor demand for higher yields in a low U.S. long-term interest rate environment. In Figures 1A–D, long-term foreign borrowing sovereign ratings and sovereign spread trends are plotted for four Southeast Asian economies. For Malaysia, both ratings and spreads are relatively stable. For Indonesia, generally declining,

¹⁴ There is also a large and growing list of more specialized indicators including indices of *economic freedom* (e.g., from the Heritage Foundation, heritage.org), *political risk* (e.g., from Political Risk Services, prsonline.com), *competitiveness* (e.g., from the World Economic Forum, weforum.org), *business environment* (e.g., from the World Bank, doingbusiness.org), and *corruption* (e.g., from Transparency International, transparency.org).

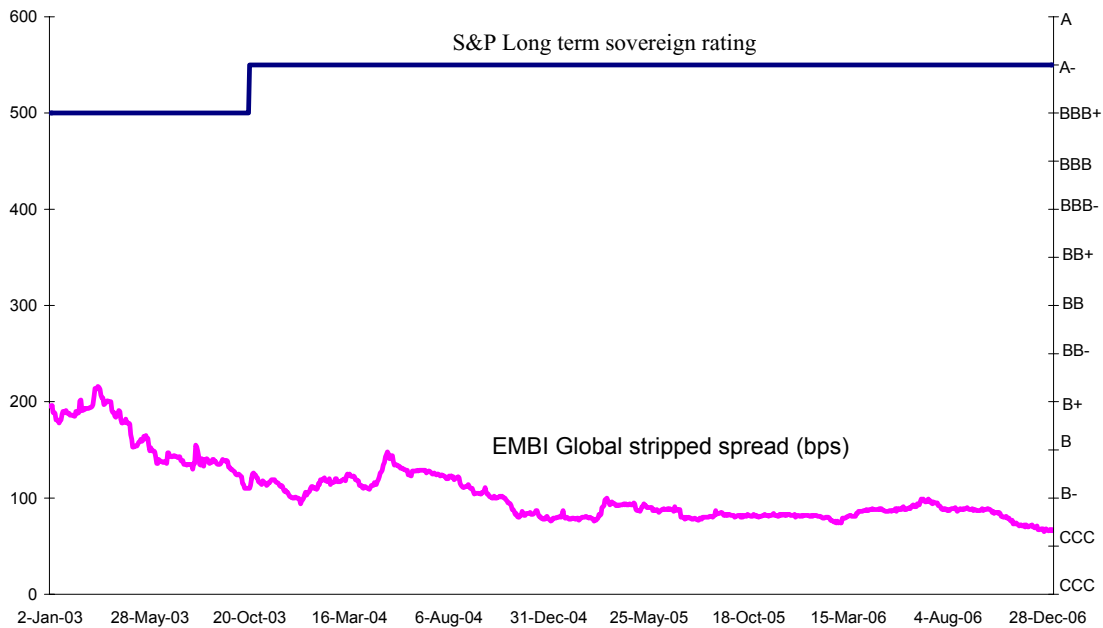
though volatile, spreads are associated with improving ratings. For Thailand, stable spreads have accompanied improving ratings. In contrast, spread compression in the Philippines occurred after a ratings downgrade. Thus, a sharply narrowing spread does not necessarily indicate an upgraded private sector view of country-specific economic fundamentals or sovereign financial health.

Figure 1A: EMBI Global Sovereign Spread vs. Rating (Indonesia)



Source: Morgan Markets and Bloomberg.

Figure 1B: EMBI Global Sovereign Spread vs. Credit Rating (Malaysia)



Source: Morgan Markets and Bloomberg.

Figure 1C: EMBI Global Sovereign Spread vs. Credit Rating: (Philippines)

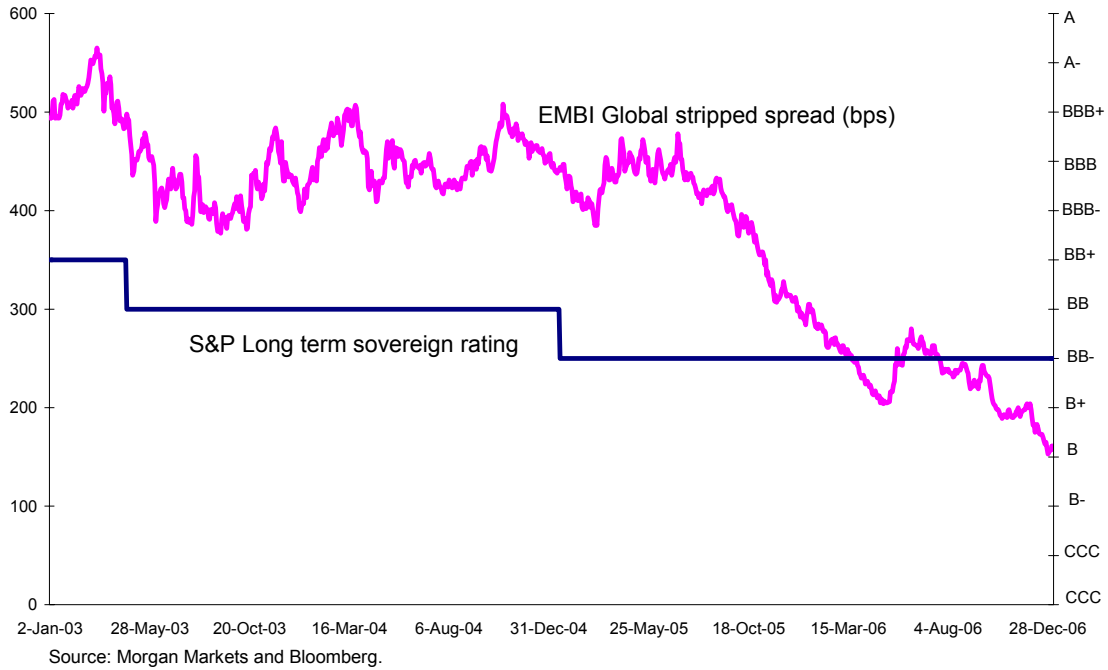
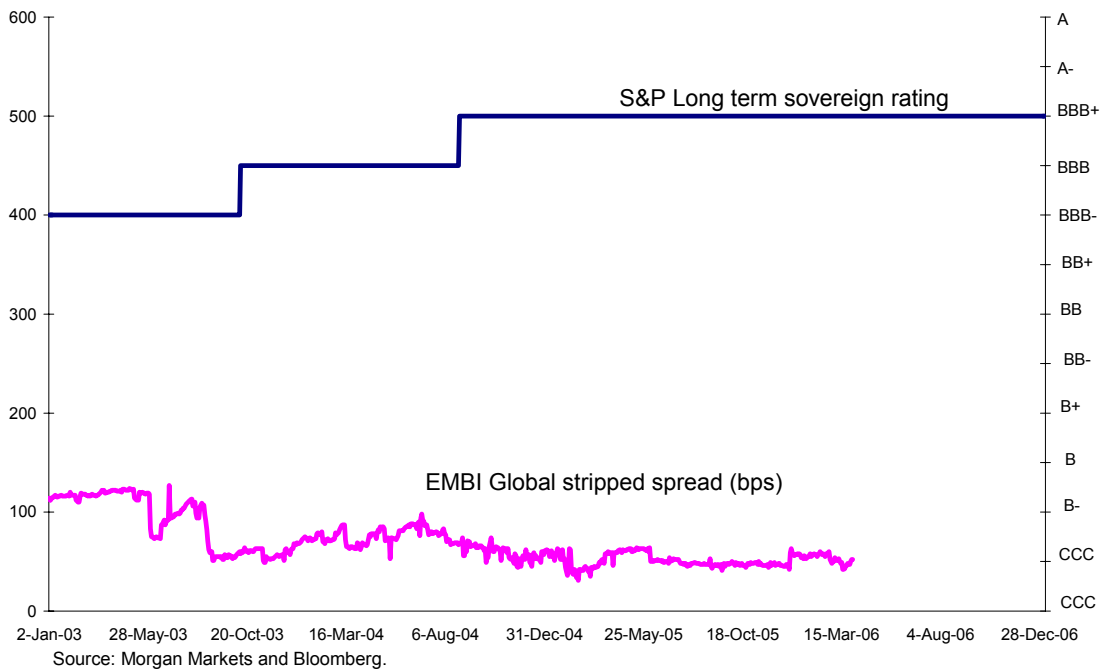


Figure 1D: EMBI Global Sovereign Spread vs. Credit Rating (Thailand)



Private sector assessments. Although approaches vary from institution to institution, there are commonalities. Table 6, which provides a list of indicators used to evaluate sovereign risk by Standard and Poor's, is illustrative.¹⁵

Table 6: Standard and Poor's Sovereign Ratings Methodology Profile

<p>Political Risk</p> <ul style="list-style-type: none"> • Stability and legitimacy of political institutions • Popular participation in political processes • Transparency in economic policy decisions and objectives • Public security • Geopolitical risk <p>Income and Economic Structure</p> <ul style="list-style-type: none"> • Prosperity, diversity, and degree to which economy is market-oriented • Income disparities • Effectiveness of financial sector in intermediating funds; availability of credit • Competitiveness and profitability of non-financial private sector • Efficiency of public sector • Protectionism and other non-market influences • Labor flexibility <p>Economic Growth Prospects</p> <ul style="list-style-type: none"> • Size and composition of savings and investment • Rate and pattern of economic growth <p>Fiscal Flexibility</p> <ul style="list-style-type: none"> • General government revenue, expenditure, and surplus/deficit trends • Revenue-raising flexibility and efficiency • Expenditure effectiveness and pressures • Timeliness, coverage, and transparency in reporting • Pension obligations <p>General Government Debt Burden</p> <ul style="list-style-type: none"> • General government gross and net (of assets) debt as a percent of GDP • Share of revenue devoted to interest • Currency composition and maturity profile • Depth and breadth of local capital markets 	<p>Offshore and Contingent Liabilities</p> <ul style="list-style-type: none"> • Size and health of non-financial public sector enterprises • Robustness of financial sector <p>Monetary Flexibility</p> <ul style="list-style-type: none"> • Price behavior in economic cycles • Monetary and credit expansion • Compatibility of exchange-rate regime and monetary goals • Institutional factors such as central bank independence • Range and efficiency of monetary policy tools <p>External Liquidity</p> <ul style="list-style-type: none"> • Impact of fiscal and monetary policies on external accounts • Structure of the current account • Composition of capital flows • Reserve adequacy <p>Public Sector External Debt Burden</p> <ul style="list-style-type: none"> • Gross and net public sector external debt, including deposits and structured debt as a percent of current account receipts • Maturity profile, currency composition, and sensitivity to interest-rate changes • Access to concessional funding • Debt service burden <p>Private Sector External Debt Burden</p> <ul style="list-style-type: none"> • Gross and net financial sector external debt, including deposits and structured debt, as a percent of current account receipts • Gross and net non-financial private sector external debt, including structured debt as a percent of current account receipts • Maturity profile, currency composition, and sensitivity to interest-rate changes • Access to concessional funding
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Source: standardandpoors.com

Several observations can be made about the general private sector approach: First, if the objective is a risk assessment, then the end result is often a single probabilistic indicator, rating, or ranking. This is by necessity and is in general contrast to economic review or surveillance activities done by international organizations such as the ADB and IMF. This simplicity is both a strength and weakness of the private sector approach to risk assessment. The need for cross-country comparability and demonstrable objectivity imposes such a simple but systematic approach. At the same time, users of the end-result may miss the depth of assessment that was simplified into a single number.

Second, as with the IMF, the depth of the assessment arises from a broad review of economic performance with *several* indicators used to assess performance in each category. In the case of country risk ratings, this also includes a thorough review of the business environment. In any category, a focus on a single indicator could mask vulnerabilities. It is important in considering the strength of public finances, for example, to look at both stock (debt) and flow (deficit) indicators, at contingent as well as explicit liabilities, and at the flexibility or rigidity of the policy options available to policymakers to adjust to unexpected events. Take the cases of Indonesia and Viet Nam, for example, which have similar sovereign risk ratings. Indonesia has a higher debt burden but a lower deficit.

¹⁵ See Standard & Poor's *Sovereign Credit Ratings: A Primer*, available at RatingsDirect. A more comprehensive discussion is available in Bhatia (2002).

Third, the methodology is as standardized as possible but still uses both quantitative and qualitative assessments. Comparators (similarly rated countries) are heavily used to help anchor the qualitative assessment. Nonetheless, the process of internal debate among the staff of the ratings unit is an important component of the final rating. The collective experience of the staff is brought to bear as the relative strengths and weaknesses of an economy are weighed against its comparators. There is no set formula. That the major ratings agencies usually assign very similar rankings to countries is perhaps indicative of systematic approaches but that the ratings can differ shows that individual judgment still matters. Looking back at Table 4, it is the speculative grade economies in which differences in ratings arise. For example, Moody's is apparently more pessimistic and Fitch more optimistic than S&P about macroeconomic fundamentals and the health of public finances in the Philippines. In instances where risks are higher, professional judgment plays a larger role.

Fourth, the focus and emphasis of private sector assessment activities varies. In the case of risk ratings, the analysis is as forward-looking as possible while remaining anchored to underlying fundamentals rather than recent high-frequency trends. Thus, sovereign and country risk ratings seldom change quickly or sharply—unless in a situation of rapidly changing conditions such as a crisis. However, more general assessments conducted for reports and provided to clients by investment banks and information services can be done with monthly, even weekly frequency and are, thus, continuously evolving. As such, they can provide useful real-time market views of economic performance and the expected market impact of events and policy changes. However, these reports can also sometimes become myopically focused on transitory market trends rather than long-term sustainability.

Fifth, there are no taboo subjects in the private sector. Political risks are explicitly evaluated precisely because they can heavily influence economic performance and the probability of default. Perhaps one of the main strengths of private sector assessments is a greater willingness to attempt objective evaluations of political processes and their potential impact on the quality of public policy. Here, too, however, a systematic approach is sought and the empirical link between the political process, policy formation, and macroeconomic stability is stressed. The uncertainty surrounding an impending election, for example, can increase the risk of default, especially if there is a possibility of a sharp adverse change in macroeconomic policy.¹⁶ Conversely, the election of a “market friendly” government with a decisive majority can reduce perceived risks. More subtly, if sound macroeconomic policies are viewed as firmly anchored, ratings can be higher relative to countries with similar economic indicators. This was the case in Eastern Europe for countries that were in the process of joining the European Union. To a lesser extent, Mexico appears to have enjoyed higher ratings and lower external borrowing costs as a result of expectations that NAFTA would lock in a stable policy framework.

Sixth, in common with the IMF, private sector assessors evaluate the quality of information available and quite often supplement it with their own estimates. Two examples where there is particular scrutiny are the estimates of contingent fiscal liabilities and of non-performing loans. Indeed, great uncertainty about the true level of liabilities can increase the perceived risk. In some cases, the private sector may even overestimate the extent of vulnerability. Cady and Pellechio (2006) provide evidence that adherence to the SDDS and participation in the GDDS can reduce sovereign borrowing costs. This can, in turn, reduce corporate borrowing costs. Thus, not only does the private sector compensate for poor provision of data, it provides a payoff to the public sector for disclosing better information.

¹⁶ See, for example, Manasse and Roubini (2005).

Role of private sector in regional ERP. Regional ERP activities can benefit from inputs from the vast experience of multilateral institutions such as the IMF and ADB. These institutions often have access to information and opportunities for dialogue with policymakers unavailable to the private sector. Yet, the private sector contribution to regional ERP is potentially quite large. The systematic approach to assessment, and the importance of both quantitative and qualitative professional assessment, especially where risks are high, can be adapted to regional ERP. Yet, even those elements of private sector assessments that would be more difficult to adopt—such as evaluations of political risk, the use of risk ratings and rankings, and the augmentation of public data—can strengthen the regional ERP process for due diligence. At the same time, the limitations of privately provided assessments should also be recognized. In some instances, the need for concise indicators masks the richness of the analysis. In other cases, the high-frequency nature of the analysis can over-emphasize temporary trends. Moreover, just as the assessments of multilateral institutions are vulnerable to the influence of large members, that of private agencies might be affected by relations with large clients. With these qualifications in mind, regional policymakers would benefit from dialogue with providers of private sector assessments.

6. ENHANCING THE EFFECTIVENESS OF ASEAN+3 ERP

From “information sharing” to “peer reviews” and “due diligence.” Currently the ASEAN+3 ERP process is in transition from the *information sharing* stage to the next stage of a more rigorous scrutiny stage, which must eventually involve some form of *due diligence*. Despite improved financial conditions over the last ten years since the 1997–98 crisis, a speculative currency attack or crisis contagion can take place at any time in the region. Once an ASEAN+3 member faces a liquidity shortage or currency crisis, its authorities are expected to request CMI counterparts for liquidity assistance within the current CMI framework. In order to respond to such an emergency event promptly, the group must have a clearly defined procedure of CMI activation and a capacity to draft necessary policy conditions for liquidity assistance within a short period of time. This requirement will be greater as ASEAN+3 is moving to create an enhanced, multilateralized CMI that is more independent of the IMF. It is thus essential that the ASEAN+3 group begin to consider how to build its capacity and willingness to conduct objective due diligence.

As ASEAN+3 is already past a simple *information sharing* stage, the group's current focus is on strengthening the ERP process. Key elements of an effective ERP are: (i) collection of timely and reliable data—some at high frequency and others at lower frequency; (ii) conducting objective and neutral analyses and assessments of member economy conditions, policies, risks, and vulnerabilities; (iii) identification and assessments of various policy options to reduce risks and vulnerabilities; and (iv) introduction of a mechanism to induce the country in question to take appropriate policy actions. The immediate objective for ASEAN+3 is, in essence, to improve the quality and effectiveness of ERP.

Critically, the ERP process needs to put more emphasis on technical analysis and to create an environment for serious policy debate.¹⁷ This means adopting an appropriate balance between the traditional presumption of non-interference in domestic affairs of another country on the one hand and the new challenge of rigorously scrutinizing economic and financial conditions, risks, and policies of the country on the other. The process must encourage frank and candid discussions on the technical substance without being abrasive and confrontational. The ingredient that will nurture this process is mutual trust.

Linkage between CMI and ERP. Table 7 details the manner in which progress on strengthening CMI and the effectiveness of ERP are linked. If the current CMI—with a

¹⁷ See Grenville (2003).

strong IMF linkage—is expected to remain as is, the ERPD mechanism may not need to go beyond achieving an effective economic review and peer pressure stage. However, if the current CMI is to be transformed into an enhanced CMI—with a centrally administered reserve pooling arrangement that is independent of the IMF—the ERPD process must increasingly contain the element of *due diligence*. The reason is that the ASEAN+3 group must address the generally held concern that a financing arrangement that could lend too generously with too little conditionality might create moral hazard for the government at the receiving end as well as for private investors with stakes in the affected economy. To minimize moral hazard, it is essential to put in place an effective ERPD, improve the capacity to formulate appropriate policy changes in the event of a liquidity crisis, and enforce needed policy adjustment.

Table 7. Linkage between CMI and ERPD

Financing Arrangement	ERPD	Needed Capacity	Recommendations
Current CMI (with a tight IMF linkage)	<ul style="list-style-type: none"> • Information sharing • Economic reviews and peer pressure 	Objective, neutral analyses of country economic conditions, assessments of risks and vulnerabilities, and policy advice	<ul style="list-style-type: none"> • Involve central bank governors • Invite other international institutions and the private sector • Introduce “peer reviews”
Enhanced CMI (with a loose IMF linkage)	<ul style="list-style-type: none"> • Peer review and peer pressure • Elements of due diligence 		<ul style="list-style-type: none"> • Develop capacity to formulate independent policy conditionality • Prepare steps to create an independent secretariat
Independent, centralized reserve pooling arrangement	<ul style="list-style-type: none"> • Peer review and peer pressure at normal times and due diligence at crisis times 	Ability to formulate independent conditionality	<ul style="list-style-type: none"> • Establish a full-fledged secretariat for facilitating ERPD and drafting independent conditionality

Thus, a logical step is to explore the possibility of introducing *due diligence* to the ERPD process. To initiate this, the group should review some key considerations. First, the establishment of an independent secretariat, which may be desirable for an effective ERPD, is perhaps increasingly important for a *due diligence* mechanism. A professional secretariat can produce high-quality country reports, ensuring that all involved with lending decisions have a basic, thorough familiarity with the economic conditions of potential borrowers. In addition, to draft policy conditions in the event of a member requesting CMI support, substantial inputs from an independent, professional secretariat would be indispensable and desirable for political reasons.¹⁸ If charged with regular monitoring of member countries, the secretariat would be better able to guard against the danger of losing sight of long-term fundamental issues in drafting these conditions—intended to ensure short-term macroeconomic stability—in the midst of a crisis.

Second, a better mechanism needs to be introduced to apply peer pressure on each member country so that each country’s policymakers may adopt good policies and, if necessary, change policies to reduce economic and financial vulnerabilities. For this purpose, introducing a “peer review and peer pressure” mechanism should be seriously considered. A key element of a successful “peer review” mechanism is thought to be the ability to engage in frank discussions among equals with mutual respect and trust. It is inherently a symmetric process. At the same time, an effective “peer review and peer

¹⁸ On the other hand, if CMI creditor countries themselves produce “conditionality,” there is a risk that it may be perceived to serve the national interest of particular creditor countries, rather than the financial and economic stability of the crisis-hit country and the region as a whole. “Conditionality” drafted by an independent secretariat can substantially reduce such a risk.

pressure” mechanism built on trust can facilitate the sharing of common views on best practice policies. Such policies that gain legitimacy today may be easier to enforce as elements of a program tomorrow. And, the expectation that a policy package that is needed but is politically difficult to be accepted at normal times may be imposed as lending conditions at a crisis time may spur needed action earlier.

Third, the relationship between the “peer review and peer pressure” and the “due diligence” mechanisms should be carefully considered. While the “peer review” mechanism needs to maintain symmetry among countries, the “due diligence” mechanism introduces possible asymmetry between the potential lender and borrower. If these mechanisms are used at the same time, there is a clear need to take a good balance between the two. The key to ensuring a successful balance between the two is to create an appropriate institutional structure. For example, an independent secretariat would facilitate the “peer review and peer pressure” exercise among member countries at normal times, while it could be directly involved with the “due diligence” function at crisis times.

Greater institutionalization. A technically competent secretariat that supports ASEAN+3 ERPD might be modest in size initially. In normal times, the secretariat would monitor regional and country economic conditions, regional capital flows, and financial and exchange market developments through various tools including early warning indicators. A good “peer review and peer pressure” mechanism should work effectively. At the time of a crisis or contagion, the secretariat, sometimes working closely with the IMF depending on the scale and magnitude of the problem, would make financial needs assessments, produce a policy adjustment package as lending conditionality, encourage the affected country’s authorities to implement needed policies, and monitor policy implementation and progress during its intervention.

If and when the modality of CMI becomes more independent of the IMF, the secretariat will have to perform its own functions with greater independence, including the production of country review papers, provision of liquidity assistance, and drafting of policy conditions associated with financing. If the regional economies can eventually delegate full authority to the secretariat to conduct these tasks effectively and if the secretariat acquires adequate capacity to do so, it is reasonable to completely delink the CMI financing arrangement from the IMF. Thus, although the secretariat would not have to be a highly bureaucratic institution at least initially, it could be expected to become a more structured organization as its tasks become more demanding over time.¹⁹

The ASEAN+3 ERPD process is currently designed for finance ministers, while central banks participate only in preparatory meetings—at the deputies’ level—for ASEAN+3 finance ministers. However, given the important operational role of central banks in extending liquidity support at times of crisis and their potential role in conducting high-quality ERPD, their governors should be fully involved with the ASEAN+3 process, especially the “due diligence” aspects of the process. The experience from European economic integration suggests that analytical expertise and operational knowledge of central banks are essential to financial cooperation. Involving central bank governors is useful not only to ensure coordination between finance ministers and central bank governors but also to strengthen central bank ownership of the process.

While the ADB is the only international financial institution that conducts policy dialogue with the ASEAN+3 Finance Ministers, the IMF, in addition to the ADB, is now a regular policy dialogue partner for the ASEAN+3 deputies’ process. Close dialogue with the IMF is

¹⁹ Such a secretariat should be established in a qualified host country, which is politically and socially stable and is well equipped with social infrastructure. The location should hence be highly attractive to a large number of international experts and professionals in the global community.

particularly important at least initially because of the need to link the CMI disbursement to the IMF at times of crises and contagion (if the disbursement exceeds 20 percent of committed amounts). Even at a later stage, the IMF's input on the global surveillance part is quite useful. In fact, many other institutions and organizations with international best expertise, such as the World Bank, BIS, OECD, IOSCO and others, may be invited, as appropriate, at least to part of the process for discussions with the finance and central bank deputies. In addition, an ASEAN+3 Secretariat may consider having staff join the IMF's annual Article IV consultation mission as well as the IMF-World Bank Financial Sector Assessment Program (FSAP) mission to the regional members.

At the same time, policy dialogue with private sector analysts would be highly recommended. Indeed, participation of the private sector is essential to the success of ASEAN+3 financial cooperation, because it is private sector activity that promotes financial market development and strengthens regional economic and financial integration. For this purpose, the private sector of ASEAN+3 is encouraged to establish a Private Sector Advisory Committee (PSAC), modeling after the Business and Industry Advisory Committee (BIAC) for the OECD. Being located closely to each other, the ASEAN+3 Secretariat and the PSAC can intensify mutual dialogue for greater regional integration.

7. CONCLUSION: CHALLENGES AHEAD

Since the Asian financial crisis, the ASEAN+3 group has developed its finance ministers' process supported by their finance and central bank deputies and various working groups. This process is a forum both for policy dialogue among the ministers and among their deputies to achieve regional financial stability, and for concrete collective action to provide regional public goods—through such initiatives as CMI and ABMI. ASEAN+3 ERPD is an important part of policy dialogue and is increasingly becoming an integral part of the whole financial cooperation process because of its recent integration with the CMI framework. ERPD is intended to encourage good economic policies at the national level through “peer review and peer pressure” and, at the same time, strengthen the regional reserve pooling arrangement.

Over the last few years, the quality and depth of ERPD discussions at the deputies' level has improved partly thanks to the economic reviews provided by international financial institutions—such as the ADB and IMF—and external experts. Nonetheless, ASEAN+3 ERPD is still in its infancy stage in terms of “peer review and peer pressure” in comparison to the renowned “peer review” mechanism developed by the OECD—such as the Economic Development Review Committee (EDRC) and the Economic Policy Committee (EPC). It is also in its infancy in terms of “due diligence” in comparison to “surveillance” mechanisms employed by the IMF through its Article IV consultations.

This paper has argued that the regional ERPD activities must evolve together with the other aspects of regional financial cooperation. Certainly, the region must make a concerted effort to move beyond the “information sharing” stage to a more rigorous review stage, possibly in the form of a formal “peer review and peer pressure” mechanism. Further, if the CMI is to be significantly enhanced, the ERPD process must take an additional step into a “due diligence” mechanism. In this final stage, assessments of a country's economic performance and policies need to be done through the lens of potential creditors—to ensure that the borrowing country will make appropriate policy adjustment, restore financial stability and health, and be able to repay short-term loans provided during a crisis time. A workable balance will thus need to be found between the equality among the “peer review” participants and the asymmetry of the creditor-borrower relationship under “due diligence.” The challenges along the way are both political and technical. Politically, the realization of mutual benefit must bring about greater mutual trust and willingness to participate in a rigorous process that

includes discussing sensitive topics and delegating responsibility and authority to a new institution—a professional secretariat tasked with making independent evaluations. Technically, that institution must develop the professional expertise to accomplish such a mission and inspire confidence in its assessments. It must also be able to enhance the capacity of less developed members to provide the appropriate information required to make adequate assessments and to participate in meaningful dialogues about those assessments.

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