"Laying the Building Blocks for a Regional Financial Architecture," ASEAN-Japan Cooperation: A Foundation for East Asian Community; (ed. Japan Center for International Exchange), Tokyo: Japan Center for International Exchange, 2003, pp. 95-107.

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Laying the Building Blocks for a Regional Financial Architecture

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The financial crisis of 1997–1998 that affected many economies of East Asia—which refers here to ASEAN + 3, that is, the Association of Southeast Asian Nations (ASEAN) plus China, Japan, and South Korea—has spurred new initiatives toward strengthening regional cooperation.

These new initiatives have not been limited to the trade area. In the immediate aftermath of the financial upheaval that sent a few East Asian economies to the negotiating table with the International Monetary Fund (IMF), several initiatives promoting closer cooperation in the financial sector were undertaken. A series of other proposals for regional cooperation in finance have been aired. In addition, there have been proposals and agreements for more comprehensive and much wider cooperation, including some related to building an East Asian Community over the very long term (Wang and Andersen 2002/2003).

These initiatives toward strengthening regional cooperation should be seen in light of the difficult lessons learned from the financial crisis. Among these are the following: (a) trade cannot be neatly separated from finance; (b) economics cannot be fully dissociated from politics; and (c) economic and political cooperation demands much wider-scoped cooperation co-extensive with laying the building blocks for an East Asian Community (Kawai, Newfarmer, and Schmukler 2001).

Even as these lessons overshadow the proposals and agreements on various aspects of regional cooperation, the basic paradigms of the past few decades have barely changed. Virtually all the economies in East Asia have looked upon the region—and the regional agreements being proposed and forged—as a staging ground for promoting their own national interest.

Japan and, more recently, China continue to make the claim of their status as the natural leader of the region. Others—that is, ASEAN economies—have been content to look forward to the benefits that would accrue to them from the regional agreements. But there has been considerable reluctance on the part of most economies to move forward, or at the speed specified by previous agreements, where the demands of regional community building would seriously impinge upon their national interest. Indeed, while the rhetoric has assumed a deepening, maturing spirit of regionalism in East Asia, the actions taken in forging regional agreements, and especially in their implementation, seem to suggest otherwise. This remains a critical challenge for all economies in the region as they continue to lay the foundations for community over the long haul.

The challenge is tall, in large part because the old paradigm of pursuing one's own national interest has been—and continues to be—the norm for taking action. Since that norm is natural and to be expected, few would have the temerity to fault it. So the current situation is likely to be the case for the foreseeable future.

Such self-interested pragmatism forms the backdrop for any regional financial arrangements in East Asia. But it also suggests that in addition to the macroeconomic initiatives that have been undertaken and proposed, microeconomic initiatives are called for as well. Indeed, the complementation of regional agreements on the macroeconomic aspects of finance with similar agreements on reforming microeconomic bases could give more substance to the task of laying the foundation of a regional financial architecture.

Regional Networking for Corporate Governance Reforms

Events immediately before and after the 1997–1998 financial crisis have underscored the imperative for reforms in corporate governance (CG) in East Asia. The business, legal, and regulatory regimes that affect corporate governance differ from country to country, but they all differ markedly from the Anglo-American regime of "best CG practices" that has been held up as a model (Gregory 2000).

While the regimes differ from country to country, the principles that animate CG reforms everywhere are universal: fairness, transparency, and accountability. These are the practices that the more closely interconnected international financial markets demand (OECD Ad Hoc Task Force on

Corporate Governance 1999). And in recent years, even within East Asia, these global standards of practice have been rapidly converging.

Accordingly, institutes of directors have been established in many East Asian economies with the primary challenge of adapting these globally accepted OECD corporate governance principles to local business regimes and cultural circumstances. While each institute of directors is constituted differently, most have felt the need to reach out to institutes in other countries faced with a similar need.

Providing corporate directors with an orientation to modern principles of corporate governance is no mean task for these institutes of directors. So much has to be done in so short a time with limited local expertise and resources! Local cases have to be written. Research into actual corporate governance practices has to be made. Review of local standards in light of globally accepted principles has to be undertaken. And an agenda for corporate governance reform has to be created and adopted. Since the reform agenda may not be broadly embraced, especially by entrenched interests comfortable with the status quo, advocacy for corporate governance reforms has also to be undertaken, as per the particular circumstances of each country (Organization for Economic Cooperation and Development [OECD] 2003).

Most of these institutes of directors have agreed to exchange teaching materials and local cases so as to strengthen their capacity to train corporate directors. Many cases relate to state-owned and family-owned enterprises, which are generally more dependent on bank finance than on capital markets. Because of such similarities, institutes have been working toward a common program, with flexibility for local adaptations, for the regional certification of corporate directors. There has even been discussion of scorecards that would track progress in corporate governance practices—both on the macroeconomic level (for the entire economy) and on the micro-corporate level (for banks and financial institutions as well as public companies) (Pacific Economic Cooperation Council 2003).

Corporate governance reforms, touching as they do upon the microeconomic base of a country, should be among the top priorities of a country. The need is urgent. As the financial upheaval of the late 1990s has demonstrated, strengthening the microeconomic base is critical to securing macroeconomic stability and long-term sustainability of a country. Even as each economy should work toward these goals, the opportunities for regional cooperation in promoting corporate governance reforms should be seized if a regional financial architecture is ever to be achieved.

One point that bears emphasizing in this process is the dynamic and mutually supportive relationship among government, business, and civil society in any country. The institutes of directors that have been established throughout the region were born of this relationship.

Regional Cooperation for Strengthening Banks in the Region

In tandem with corporate governance reforms to strengthen the microeconomic base of East Asian economies, efforts must be made to strengthen the banks and financial institutions in the region (Wang and Andersen 2002/2003). The financial upheaval has also brought attention to the need to modernize the corporate governance regime of banks, cleaning up their books, introducing a modern risk management system, and preparing them for the requirements being agreed upon under Basle 2 (Basel Committee on Banking Supervision 2001).

Banks play a central role in the financial system of each East Asian economy. They are the predominant source of external corporate finance in the region, almost to the same extent (and sometimes more) than are capital markets and the stock exchanges in the United Kingdom and the United States. Thus, in the same way that protection of small shareholders has driven Anglo-American corporate governance reforms, so has the protection of depositors and of the public institutions that provide deposit insurance credit of last resort helped to promote corporate governance reforms in East Asia. In several East Asian economies, improvement in the corporate governance of banks and the financial sector has been given very high priority.

In the aftermath of the financial crisis, banks in the region were faced with the deterioration of their asset portfolios (Miller and Pongsak 1998). The ratio of nonperforming loans (NPLs) had risen to intolerably high levels, and so the challenge has been to bring this NPL ratio down. Some economies took actions that were quick, decisive, and expensive, but the challenge in the region as a whole remains tall. Asset quality in the books of many banks is still in need of improvement, and the work of cleaning up their books has yet to be completed. Asset disposal, NPL management, standards for providing for loan losses, and risk-weighted capital adequacy ratios all still need to be addressed. As they prepare to meet requirements being finalized under Basle 2 (Basel Committee on Banking Supervision

2001), banks have been introducing a modern risk management system. This is as daunting an agenda for banks as it is for the entire financial system of each economy.

The agenda is multifaceted, calling for regionwide cooperation between economies. For example, a scorecard for corporate governance of banks, already in place at the micro level (Estanislao 2002a), may now be scaled up to the macro level of the entire banking sector so that there is monitoring of and adherence to standards of compliance.

As part of the scorecard initiative, there needs to be embedded a provision for training and capacity building. In this regard, government must be involved as much as the banks themselves and civil society. One cannot be effective without the participation of the others, and mutual support and cooperation between these three sectors are vital. In Japan, China, South Korea, and all major ASEAN economies, this is a matter of high priority.

Capital Market Development and a Broader Macroeconomic Forum

With greater regional cooperation in corporate governance and strengthened banking systems, two attendant concerns emerge: capital market development and a regional macroeconomic forum.

Capital market development, as the financial crisis has shown, is an immediate and a long-term necessity for East Asian economies, with the exception of Japan (Park 2003). Developed capital markets, after all, are a vital complement to a solid, stable banking system. They provide long-term alternatives to banks as a source for external corporate finance and as a destination for savings. They also tend to develop alongside banking systems that have credible, effective protection mechanisms for savers and depositors. Where similar protection is extended to bondholders and equity investors, capital markets will thrive.

Faced with this challenge, individual economies in East Asia have strived to develop their capital markets. Stock exchanges are being de-mutualized. Discipline and standards of professional practice are being introduced for brokers, although with varying speed and commitment. Dialogue has been aimed at promoting faster convergence of practices in the regulatory regimes of stock exchanges. In the more open stock exchanges of Hong Kong and Singapore, there has been market pressure to list select shares from other East Asian economies. Overall, there has been a growing acceptance of the close interconnection among the stock exchanges of the region.

In other words, the ground has been prepared for an expanded program of regional cooperation in capital market development. The challenge is how to move to the more productive next step. But if that is to occur, there is need to ensure proper governance of the region's stock exchanges, and through them the companies that publicly list on them (OECD 2003). Furthermore, enforcement mechanisms, aimed at much higher levels of public confidence in the market for bonds and equities, need to be benchmarked against a common high standard that functions effectively throughout the region.

As with capital markets, so with macroeconomics as a whole. Since the financial crisis, there has been a growing consensus on the economic variables that need to be tracked to ensure that economies stay within the band indicated by prudent macroeconomic risk management. The experience with macroeconomic discipline in the 1970s and 1980s in most of East Asia and the lessons learned from the crisis in the 1990s point to the economic variables that need to be monitored (Kawai, Newfarmer, and Schmukler 2001). With new standards of transparency and accountability, a mechanism for tracking these variables has been initiated with a view toward providing early-warning signals and promoting policy dialogue among responsible officials.

In this light, the time has come for institutionalizing a regional macroeconomic scorecard and a regional macroeconomic forum. The scorecard, as with the other items in the regional cooperation agenda, is too important to be left to one sector alone. Instead of limiting responsibility for developing and implementing a regional macroeconomic scorecard to the governments alone, the substantive participation of business and civil society must be secured. Committed, professionally qualified representation from business and civil society in the region needs to be brought into the process (PECC PARNet 2001). Moreover, the process has to be genuinely regional, with all countries in the region jointly taking full and equal ownership of the process in its planning and its implementation.

A regional macroeconomic scorecard would provide a useful, regular venue for a free and open dialogue within a regional macroeconomic forum. Analyses of the scorecard could be assessed. Policy and appropriate action, both individual and joint, to maintain stability could be discussed. Informal peer pressure could be applied where responsibility for action was required. This process has in fact been initiated, but it has been limited to governments alone and the results have been far below expectations. Over time, the dialogue needs to be institutionalized with the participation of independent research institutes and representation from the business community. The dialogue would be further opportunity for pushing the envelope toward genuinely open, sustaining macroeconomic regional cooperation.

Public Governance and Broader Solidarity

While it is tempting to focus on financial issues, if we are to take seriously the lessons learned from the 1997–1998 financial crisis, our perspective must be broader. These lessons suggest that economies are in fact systemic, so over the long term it will no longer be possible to build walls between trade and finance, between economics and politics, and between one aspect of governance and another.

Thus, in promoting reforms affecting the microeconomic base of a country, corporate governance cannot be dissociated from the broader imperative of public governance. Indeed, if the principles of fairness, transparency, and accountability are adopted in the corporate sector, they cannot go far without parallel efforts in the public sector (Estanislao 2002b). Initiatives currently in play in the region should be appreciated and spread with this in mind.

Over time, corporate and public governance reforms should be complementary. They should mutually reinforce each other. Accordingly, initiatives to improve corporate governance should be mirrored by initiatives to improve public governance as well. Orientation programs, governance scorecards, and dissemination of globally accepted benchmarks for local governance, to name a few ideas, should be undertaken for both corporate and public governance. They can also be undertaken at various levels from the small micro-governance units to the much bigger, national, or macro-governance units (Asian Development Bank 1998).

Following the theme above, public governance reforms cannot be limited to government. They must be backed up and fully complemented by responsible citizenship, pitched to the general public through various sectors and professions in the community. The spirit of solidarity needs to be deepened and given new life, adapting itself to the changing needs in each community (Estanislao 2002c). Codes of socially responsible conduct need to be formulated and enforced. Enforcement mechanisms for proper behavior based on ethics and social responsibility need to be instituted and strengthened. The specific challenges posed by responsible citizenship will vary from one polity to another; nonetheless, the sharing of experiences, the dissemination of best practices, and the opportunities for mutual learning among peers should be facilitated.

Toward a Genuine Spirit of Regionalism

Pragmatism has been a guiding principle in formulating and pursuing schemes for regional cooperation, particularly in ASEAN. Not all the schemes have worked, at least from a short-term perspective, as originally envisioned. But there has been flexible adaptation to dynamically changing circumstances, and from a long-term perspective, this has given ASEAN some sense of moving forward.

Similar pragmatism is called for as ASEAN, Japan, South Korea, and China work together to adopt schemes for greater regional cooperation in the financial area. Sometimes, pragmatism calls for putting the horse ahead of the cart.

That is to say, East Asian economies need to establish tri-sectoral networks—involving government, business, and civil society—that would bring together institutions in the region to coordinate corporate governance reforms and the strengthening of banks and banking systems. These networks, as underscored above, need to be informal and open. Moreover, they need to be genuinely regional in spirit—in basic orientation and in actual operation. They should soon be complemented by similar networks that focus on capital market development as well as on a regional macroeconomic scorecard as a prelude to institutionalized dialogue through a regional macroeconomic forum. Similar networks, focused on public governance and responsible citizenship, should be initiated, supported and strengthened.

It is against this backdrop that current proposals and initiatives promoting regional cooperation in finance should be welcomed. The Chiang Mai Initiative (ASEAN + 3 2000a, 2000b) sends the signal that economies in East Asia are prepared to band together—to some extent—as they recover from harsh lessons learned in macroeconomic risk management. A regional monitoring unit has been set up. The framework for reporting and tracking key macroeconomic variables in the region has been agreed upon, including the participation of the IMF. Mechanisms for official dialogue on macroeconomic developments have been instituted. Bilateral agreements, within a common regional program, have been forged to provide liquidity support, under pre-agreed parameters and conditions, to an economy that may come under severe speculative attack from financial markets (Rana 2002).

The significance of the Chiang Mai Initiative cannot be underestimated. It puts a concrete name and a specific amount of money to the common resolve of East Asian economies to cooperate in the area of finance. It represents a first concrete step in a journey of many thousand miles.

For any subsequent steps under the Chiang Mai Initiative, ASEAN and Japan will have to work together so that, in time, the agreements will be less bilateral than regional, reinforcing the notion of a more cohesive ASEAN. They may take a leaf from the book being written in the trade area, where China is negotiating with ASEAN as a whole. Or they may take inspiration from the book written in the mid-1940s, when the U.S. Marshall Plan was instituted with a view toward strengthening dialogue and cooperation among European economies (Marshall 1947). In addition, Japan and ASEAN should jointly look for creative ways to increase significantly the amounts committed under the initiative to levels that markets would find not just symbolic but credible.

At an appropriate time in the future, they should reexamine the process to ensure that it is genuinely open and regional—to the degree that pragmatism indicates essential for the region to progress in the finance area. Indeed, the orientation to such regional monitoring and dialogue should be to prevent difficulties from becoming more serious and from developing into a crisis where IMF intervention would again be inevitable.

Should East Asian economies proceed further along this path of the Chiang Mai Initiative, they would find the entire region, and perhaps even the global financial community, more than politely supportive.

The East Asian bond market initiative has also been pregnant with promise (Asia Cooperation Dialogue 2003). It is now at the point where it has left the conception stage and is beginning to see the full light of day. The modalities have been worked out, and virtually all the "t"s have been crossed and "i"s dotted. Preliminary agreements have been made, and economies should coordinate closely with one another to ensure that the initiative is fully launched and sustained over the long term. Indeed, the bond initiative needs long-term nurturing on the part of all key players in

East Asia. This requires that a country takes the necessary steps—with the encouragement and support of proper practices—to develop its domestic bond market and, therefore, its domestic capital market. Once again, the connection between building a regional superstructure (in this case, for the regional bond initiative) and strengthening a national infrastructure (for the domestic bond market) cannot be overemphasized if there is to be long-term success (Tran and Roldos 2003).

Under the East Asian Forum for Monetary Cooperation—which has yet to be formalized, however—other valuable initiatives can be given shelter for further specification and prudent, pragmatic nurturing. Among these are the "mother ideas" behind an Asian Monetary Fund and the maintenance of reserves in a basket made up of major international currencies. Engendering these ideas is a strategic imperative that may well be spreading across the region—that is, to maintain the region's close links with the U.S. economy, which has been serving as a safe haven for savings from the region. That imperative at the same time calls for developing East Asia as a real alternative to that option.

This imperative presents a challenge to East Asia. It is one that ASEAN countries, China, Japan, and South Korea can rise up to only if they are prepared to promote and foster a genuine spirit of regionalism. For regionalism in East Asia to be genuine, it has to strike a generous balance between the dictates of pursuing an economy's national interests and the discipline of making sacrifices for the regional interest. This spirit is essential and fundamental. Absent that spirit, the region will continue to hear the same initiatives and the same rhetoric as they have for the past three decades.

The countries of East Asia, individually and collectively, should translate their cognizance of the close relationship between corporate governance and public governance into reality. There is much to gain from this: by involving civil society and other sectors of the economy, they foster a spirit of solidarity and responsible citizenship. Once achieved, they might consider the establishment of an East Asian Solidarity Grid, which would connect institutes of similar minds in the region. Opportunities should be provided and gradually expanded where these institutes might cooperate and pursue joint initiatives. Such a grid could be vital in nurturing the spirit of regionalism and giving birth to an actual East Asian Community.

Specifically in the area of finance, the next thirty years could be brilliantly different from the last thirty years. But regional accomplishments ought not to be limited to finance, where the horse must be put before the cart and where building blocks must be placed at the micro base before a macro superstructure can be created. The East Asian Solidarity Grid could betoken cooperation and community on a wider range of regional issues.

In sum, greater regional cooperation in corporate governance and in strengthening the banking and financial sector are critical if East Asia is to embark upon a new financial architecture for the region. This will add effectiveness and power to regional cooperation in the development of capital markets and in institutionalizing a regional macroeconomic forum. Furthermore, given the lessons from the 1997–1998 financial crisis, regional cooperation should extend to improvement in public governance and sharing of positive experiences in responsible citizenship. With this, the stage will be set for a strong, stable East Asian financial architecture based upon a genuine sense of East Asian community.

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