Review, Assessment, and Comparison of Economic Surveillance and Policy Dialogue Systems

Report on "Economic Surveillance and Policy Dialogue in East Asia" for the ASEAN Secretariat

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1. Analytical Framework

First part of the paper starts with an overview of the literature on the Asian crisis and on different aspects of cooperation. The Asian crisis is important, because it was the impulse which oriented the ASEAN+3 countries to deepen their cooperation.

The task to review and assess the Economic Surveillance and Policy Dialogue process in the ASEAN+3 and compare it with the Economic Surveillance and Policy Dialogue process of other regional integrations (EU, NAFTA) and international organizations (IMF, BIS, OECD) is very complex. It seemed to be important to identify the most important components of the process and to identify the vertical relationship of the components in the system, which would show the mechanism of the system. The Economic Surveillance and Policy Dialogue process in a flow chart can be expressed as it is shown in Figure 1.

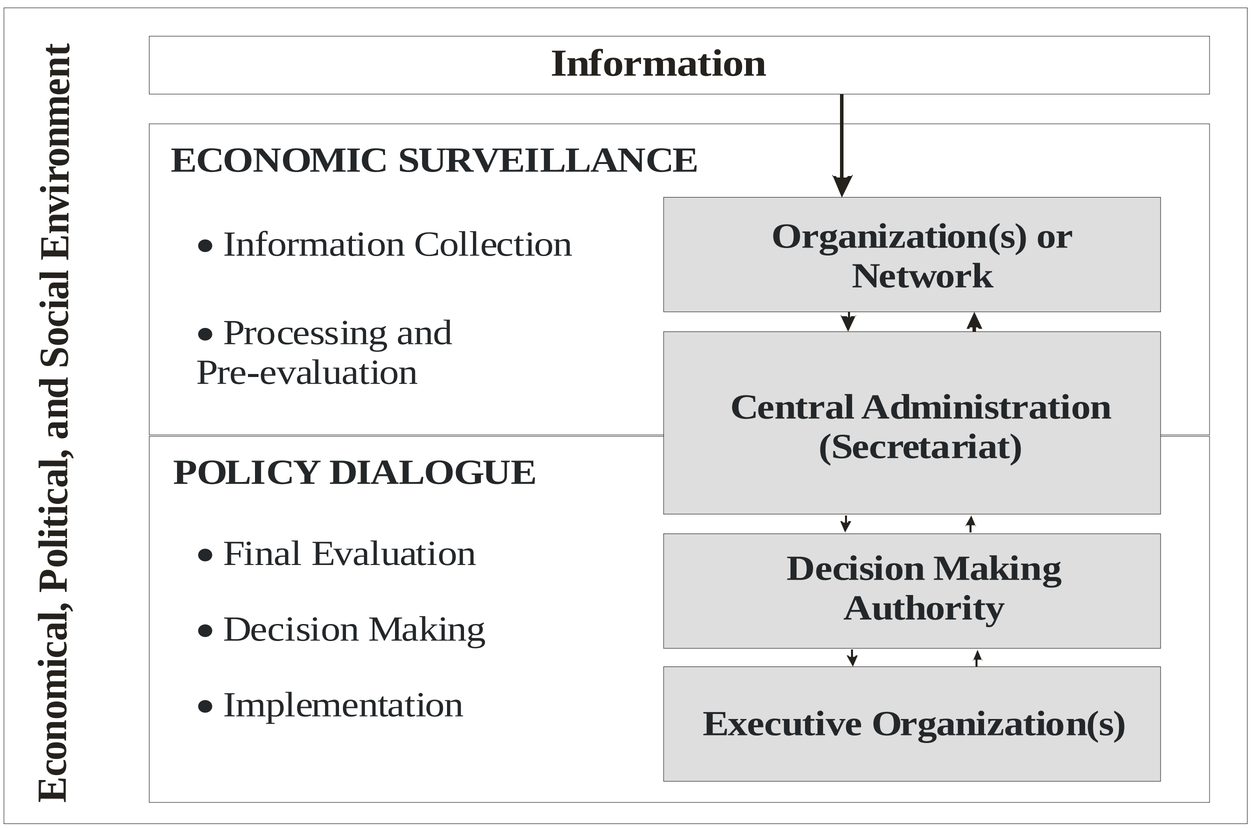

Figure 1 Model of the Economic Surveillance and Policy Dialogue Process

This approach makes it possible not only to identify the vertical relationship but also to compare horizontally the components of the Economic Surveillance and Policy Dialogue process among the regional integrations and international organizations. The horizontal comparison is displayed in an Economic

Surveillance and Policy Dialogue Matrix (Appendix 6). The matrix compares the following components of the process:

1. Objectives,
2. Information
3. Economic Surveillance
   3.1. Information
   3.2. Institutions
   3.3. Mechanism
   3.4. Objective
   3.5. Transparency
4. Policy Dialogue
   4.1. Information
   4.2. Institutions
   4.3. Mechanism
   4.4. Objective
   4.5. Transparency

2. Review of the Literature

2.1. The Asian Crisis

The Asian crisis was a hybrid of structural, and micro-, macroeconomic policy distortion. Fixed exchange rate used by the Asian countries was partly responsible for the crisis. However, flexible exchange rate regimes encounter equally serious problems in case of large capital inflow. Currency pegs are sustainable only if the financial and economic policies are harmonized. Otherwise capital inflow is potentially destabilizing.

Massive short-term capital inflows - key for the crises. At the beginning of 90s FDI was dominant, after 1992 portfolio investment (mainly dept instruments) increased rapidly. Portfolio investors are for short-term profit. The financial system was not developed enough to handle efficiently the huge capital inflow: banks lent very risky projects e.g. real estate investment.

Financial liberalization: reduced credit requirements, lifted entry barriers for new banks and financial institutions, local citizens and businesses were allowed to have foreign currency denominated accounts, private corporations were allowed to borrow from abroad, Asian financial institution became large barrowers from international capital markets, foreign banks entered mainly with short-term credits (mainly USD).

Moral hazard: authorities provide guarantees to public debts, liabilities of most financial institutions had government guarantees, strong political connection of the owners of financial institutions. In Asia moral hazard exhibited three dimensions:

- Corporate: belief that government would intervene for troubled firms.
- Financial: state directed capitalism - “crony capitalism”, ”forced” or “public guaranteed” credit for favored firms, weak system of bank regulations, data inadequacy and lack of transparency.
- International: massive bail-outs to Mexico in 1995, IMF providing bail-outs, International banks believed that Asian financial institutions were implicitly guaranteed by their governments, “instability in beliefs”, ”over-optimism” based on asymmetric or faulty information turned into “over-pessimism”

Asia’s crisis was triggered by private and not sovereign debts. Most of the debt was due to private firms and banks, not government. In contrast 80s African and 94-95 Mexican crises were public sector debts.

Ito (1998) identified three common causes of the East Asian financial crisis:

- The foreign exchange system: crisis-hit Asian countries adopted the dollar peg system which was incompatible with the monetary independence and capital mobility and encouraged capital inflows without regard for risk.
- Vulnerable financial system: prudential regulations and supervision of financial institutions in crisis-hit countries were inadequate to deal with the maturity and currency mismatch.
- Excessive short term foreign depts. of the private sector in the wake of capital account liberalization.

Hausmann et al. (1999) found two factors that constraint emerging market economies from freely floating their exchange rates:

- These economies tend to have a higher pass-through from exchange rates to prices. East Asian countries are particularly concerned about inflation; hence they tend to limit the variability of their exchange rates.
- Emerging market economies tend to have a large portion of liabilities denominated in foreign currency and that most of these are short term. Any depreciation can easily hurt government, banks, and private corporations that have foreign currency denominated liabilities.

2.2. Crises Models

The plethora of currency crises around the world has fueled many theories on the causes of speculative attacks. The **first-generation models** focus on the fiscal and monetary causes of crises. These models were mostly developed to explain the crises in Latin America in the 1960s and 1970s. The **second-generation models** aim at explaining the EMS crises of the early 1990s. Here the focus is mostly on the effects of counter-cyclical policies in mature economies and on self- fulfilling crises, with rumors unrelated to market fundamentals at the core of the crises. The next wave of currency crises, the Tequila crisis in 1994 and the so-called Asian Flu in 1997, fueled a new variety of models –also known as **third-generation models**, which focus on moral hazard and imperfect information. The emphasis here has been on "excessive" booms and busts in international lending and asset price bubbles. With the crisis in Argentina in 2001, academics and economists at international institutions are now dusting off the articles of the 1980s modeling crises of default.

The key finding is that, in fact, crises have not been created equal. Crises are found to be of six varieties. Four of those varieties are associated with domestic economic fragility, with vulnerabilities related to current account deterioration, fiscal imbalances, financial excesses, or unsustainable foreign debt. But crises can also be provoked by just adverse world market conditions, such as the reversal of international capital flows. The so-called sudden-stop phenomenon identifies the fifth variety of crises. Finally, as emphasized by the second-generation models, crises also happen in economies with immaculate fundamentals. Thus, the last variety of crises is labeled self- fulfilling crises.

The second finding is that crises in emerging markets are of a different nature than those in mature markets. Crises triggered exclusively by adverse shocks in international capital markets and crises in economies with immaculate fundamentals are found to be a mature-market phenomenon. In contrast, crises in emerging economies are triggered by multiple vulnerabilities.

The last finding concerns the degree of severity of crises. As it is conventional in the literature, severity is measured by output losses following the crises, the magnitude of the reserve losses of the central bank, and the depreciation of the domestic currency. I also estimate a variety of measures capturing the extent of borrowing constraints/lack of access to international capital markets following crises. Notably, the degree of severity of crises is closely linked to the type of crises, with crises of financial excesses scoring worst in this respect.

More recently, the literature on capital inflows and capital inflow problems has suggested another potential source of instability (see, for example, Calvo, 1998, Calvo and Reinhart, 2000, and Calvo, Izquierdo, and Talvi, 2002), that of liquidity crises due to sudden reversals in capital flows. For example, the debt crisis in 1982, the Mexican crisis in 1994 and the so-called Tequila effect, and the Asian crisis in 1997-1998 show that capital inflows can come to a sudden stop and even can sharply reverse their course and become capital outflows (Kaminsky, 2003)."

2.3. Impossible Trinity Theorem

The Impossible Trinity Theorem states that it is impossible to simultaneously achieve three goals namely exchange rate stability, capital market integration and monetary policy independence. Any pair of goals is achievable by choosing a suitable payments regime but requires abandoning the third. A more detailed explanation to this can be summarized as:

- By adopting a fixed exchange rate, government can combine exchange rate stability and capital market integration but this would require giving up monetary autonomy. Monetary authorities would tend to lose the power to vary domestic interest rates independently of the foreign/international interest rate.
- Monetary autonomy and capital market integration can be combined by floating the exchange rate but this would require giving up exchange rate stability. Monetary authorities have the freedom to choose the domestic interest rate but they must in effect accept any exchange rate that the market dictates.
- Exchange rate stability can be combined with monetary autonomy but this would require giving up capital market integration. In the presence of capital controls, the link between interest rate and exchange rate will be broken.

Therefore, once the capital account is open, and the exchange rate is fixed, monetary policy becomes dogged by the needs of preserving the fixed exchange rate. The theory assumes that capital market integration would mean perfect capital mobility. However, Joshi (2003) posits the need for careful interpretation of the theory for two reasons. First is that capital market integration would mean perfect capital mobility and the absence of policy barriers to capital flows would mean imperfect capital mobility. Joshi (2003) cites that natural barriers to mobility such as due to risk make domestic and foreign assets imperfect substitutes. This would imply that short-run sterilized intervention is possible and hence creates some monetary autonomy even with a fixed exchange rate. Second is the absence of intermediate regimes between fixed and floating exchange rate. This raises the question "Why should a country not enjoy partial exchange stability and partial monetary autonomy consistently with the absence of policy barriers to capital flows.

The “bipolar view” is an extension of the Impossible Trinity answers the questions raised by Joshi. It postulates that no intermediate regime is sustainable in the presence of high capital mobility. It further states that high capital mobility is inevitable because capital controls are not feasible. Thus, the policy choice is reduced to fixed vs. floating rates since all intermediate regimes are unsustainable. The bipolar view predicts that all countries will move to the “fixed” and “floating” exchange rate regimes.

Braga and Reisen (2003) asserts that whatever the exchange-rate regime, the basic requirement for avoiding macroeconomic complications with free capital flows is fiscal control. Unless the government commends fiscal control for stabilization purposes, it has to violate the Mundell assignment and the use of monetary policy acquires a comparative advantage in dealing with external balances, while fiscal policy is assigned to maintain internal balance.

2.4. Theories on Integration, Monetary Agreement and Exchange-rate Regimes

Mundell (2000) argues that free trade areas and currency areas reinforce one another. The costs of not doing so can be seen from the tariff-war between Argentina and Brazil during the nineties which threatened to break the Mercosur apart. The same happened in EU when the Italian lira depreciated sharply vis-à-vis the German DM after it left the ERM in 1992. Germans poured to Italy to buy German cars, prompting the parent companies to revoke those franchises in Italy that sold cars to nonresidents. All this suggests that intra-regional trade and investment can be hampered by exchange rate fluctuation. As East Asia marches towards greater economic integration, it must accept the necessity of establishing a zone of fixed exchange rates in the region.

Lamberte et al (2001) discusses 5 possible monetary agreements for East Asia:

- East Asian Common Currency,
- Dollarization: adoption of a foreign currency as a legal tender and abandonment of the use of national currency,
- Currency Board System: national currencies are jointly fixed to a common external anchor,
- East Asian Dollar Standard: the participating countries mutually link their currencies to the US dollar, which is the nominal anchor for their domestic price levels,

- Regional Currency Basket System: a mutual agreement among countries to fix their currencies to a basket of currencies, consisting of the USD, the Euro and the Yen.

They suggest that in the interim, it is better for East Asia to agree on a regional currency basket system consisting of the USD, Euro, and the Yen. During this transition period, East Asian economies should strive to work on the following preconditions: strengthening central bank independence, enhancing wage and price flexibility, strengthening the financial sector, and harmonizing monetary policy. Success in these arrangements will eventually lead to greater monetary cooperation in the region. In the long term (two to three decades) East Asia can reach its best arrangement: the East Asian common currency union.

Bayoumi et al. (1999) have proposed a transition period that would focus on five objectives:

- Strengthening Central Bank independence,
- Enhancing wage and price flexibility,
- Strengthening the financial sector,
- Harmonizing monetary policy,
- Creating barriers to exit the union.

Primary benefits of a single currency area can be found at microeconomic level and can be summarized in the followings:

- The costs of exchanging one currency to another will disappear due to the elimination of foreign exchange transaction costs.
- The reduction or elimination in information costs due to the disappearance of comparing prices of different currencies will make it harder and difficult for firms to practice price discrimination across international markets.
- The promotion of transparency in pricing will increase competition in the wholesale and retail stage, as consumers will be able to shop and compare prices across national markets of the single currency area.
- Due to fixing of the nominal exchange rate, exchange rate risks and uncertainty disappears. This will raise the volume and improve the allocation of investment.

2.5. Optimum Currency Areas

Because prices and wages are sticky, exchange rates are useful in dealing with shocks. In a currency union, what matters are asymmetric shocks. The OCA theory asks what characteristics may either reduce the incidence of asymmetric shocks or take the edge off asymmetric shocks. It develops criteria which would make the loss of the exchange rate instrument painless.

OCA theory suggests the importance of the following economic characteristics and features:

- Wage flexibility and labor mobility,
- Openness to mutual trade and the level of intraregional trade linkages,
- Diversification and relative importance of asymmetric disturbances,
- Degree of economic convergence.

The theory also suggests two political criteria:

- Homogeneous preferences regarding the aims of macroeconomic policies,
- Shared sense of commonality of destiny.

Greater mobility of factor inputs, especially labor allows economies in a currency area affected by economic shocks, in particular asymmetric shocks, to deal with it through migration to other country or region not affected by the shock. This will lessen the need for an adjustment through the exchange rate. If prices and wages of economies in a currency area are fully flexible, the real exchange rate will be flexible even through the nominal exchange rate is fixed. The flexibility in wages and prices make the nominal exchange redundant, and thus there is no case against fixing the nominal exchange rate (Lamberte et al, 2001).

It is easier to integrate countries in a monetary union when they have similar and converging levels in income per capita and unemployment rates. Wide disparities and differences in economic and financial development are fraught with danger insofar as this will complicate efforts towards financial integration and regional cohesion, which is a necessary prerequisite to a successful monetary union (Bayoumi et al, 2000).

Europe does well on these criteria except: labor mobility and fiscal transfer conditions. The degree to which the OCA criteria are satisfied are endogenous: being in a currency union makes it more likely that the criteria are satisfied.

3. Review and Assessment of Different Economic Surveillance and Policy Dialogue Systems

3.1. ASEAN+3

3.1.1. Nature of Economic Surveillance in ASEAN & ASEAN+3

The ASEAN Surveillance Process (ASP) is a regional economic monitoring mechanism established during the ASEAN finance ministers' meeting in February 1998 in the aftermath of the 1997 Asian Financial Crisis (AFC) to complement the global surveillance function of the IMF, and was later expanded in 1999 as ASEAN+3 Surveillance Process (ASP+3) to include Japan, China, and South Korea.

Objective: Monitor exchange rates, macroeconomic aggregates and sectoral and social policies.

Mechanism: Peer review system to complement the regular IMF surveillance.

The 2 major elements of the ASP are (1) monitoring of global, regional, and national economic and financial developments in order to keep track of the ASEAN countries' recovery process and detect any sign of recurring vulnerability in any member country, and (2) peer review which is the venue for the ASEAN Finance Ministers to exchange views and information on developments in their domestic economies and policies, and if necessary, consider unilateral or collective action to counter potential threats to any member economy.

3.1.2. ASEAN Surveillance Process Flow

ASEAN personnel with the ASEAN Finance and Central Bank Deputies form the core group, which actively manages the ASP. An ASEAN Surveillance Coordinating Unit, based in the ASEAN Secretariat in Jakarta, provides technical and coordination support for the ASP. The Asian Development Bank (ADB) is providing technical assistance in capacity building and training of seconded officials from the ASEAN nations and is now on its Phase IV.

The ASEAN Surveillance Coordinating Unit produces a draft surveillance report which incorporates the economic and financial data of members, other topics relevant to the stability of the region, and inputs from institutions undertaking regular surveillance activities. The IMF lends institutional support to this process by providing the global macroeconomic outlook. After passing through the level of ASEAN Finance and Central Bank Deputies Meeting, the draft is finalized and passed onto the ASEAN Finance Ministers. The end product of the peer review process could be regional or national measures that would find expression in a joint ministerial statement (Manzano 2001).

3.1.3. Recent Activities in ASEAN Surveillance Process

The Finance Ministers conducted their 9th Peer Review in April 2004, with a stronger commitment to keeping the region within a sustainable growth path. While recognizing the increasing resilience of the region's economies, they also recognized the need to broaden and strengthen the recovery. In 2004, the region remained dependent on global growth, which made it vulnerable to fluctuations in global demand. In the light of the urgency to a domestically sourced growth, policy initiatives to strengthen domestic demand have been emphasized.

Among other issues, accelerating domestic investment has become an important issue for the region in 2004. In view of the continued uncertainty in the global economy, most member countries have undertaken measures to promote SME activities and rural enterprises, in addition to policies that aim to strengthen legal and regulatory systems, tighten prudential oversight and improve disclosure and governance in capital markets. Improvement in investment climate has also been addressed by promoting security of property rights, enforcing contracts, business regulation and taxation, and ensuring well-functioning labor and financial markets.

To build capacity of member countries in undertaking surveillance-related matters, two more training programs on regional economic monitoring were conducted by Asian Development Bank (ADB) for ASEAN finance and Central Bank officials. To improve policy analysis and formulation, a study on fiscal sustainability for Cambodia, Indonesia, Laos, and the Philippines was completed by ADB in March 2004.

ASEAN+3 is open to any proposal as to which organization (independent and professional) should be preparing comprehensive papers that covers analysis, assessments, and issues for discussions. Meanwhile, the ADB is currently providing some data on developing member countries.

One conclusion of the initial meeting of ASEAN+3 Research Group 2004-2005 in Tokyo on September 10, 2004 is: "For effective surveillance, setting up a secretariat with effective mandate is most important…The governments in the region should cooperate in setting up the (ASEAN+3) secretariat."

ASEAN is following a Plan of Action on Statistics enunciated during the AHSOM 3.2 Aside from harmonization, AHSOM and their NSOs identify and provide so-

[2] For details, see Appendix A: Plan of Action on Statistics.

called ASEAN Statistical Indicators (ASI) to support the ASEAN Surveillance Process (ASP) and other initiatives.3

3.1.4. Various Initiatives

ASEAN schemes have adopted the principle of “open regionalism” where deepening of economic integration in the region would be pursued parallel to opening of the ASEAN market to the world (Soesastro 2001).

ASEAN initiatives are on track, in accordance with plans and timetables, more concrete and definitive in relation to integration. ASEAN+3 initiatives are important in relation to surveillance and policy dialogue towards prevention of another crisis, but are still far from the integration process.

3.1.4.1. Chiang Mai Initiative (CMI)

Mechanism: ASEAN Swap Arrangement expanded to include ASEAN countries and bilateral swap and repurchase agreement facilities among the ASEAN countries, China, Japan and South Korea. Those experiencing short-term liquidity short-falls, in the event of sudden attacks to their currencies, can swap domestic currency for US dollar with an agreement to buy back the domestic currency at an agreed date in the future, enabling them to borrow funds to address currency problems without having to undertake austerity measures under the IMF.

3.1.4.2. ASEAN-China FTA

ASEAN and China announced their plans to establish a FTA in November 2001, and in November 2002, signed a framework for comprehensive cooperation on the matter.

Goals: progressive elimination of tariffs and non-tariff barriers in substantially all trade in goods; progressive liberalization of services with substantial sectoral coverage; open and competitive regime that facilitates and promotes investment; establishment of effective trade and investment facilitation measures; including but not limited to simplification of customs procedures and development of mutual recognition arrangements (Framework Agreement on Comprehensive Economic Cooperation between the ASEAN and People’s Republic of China, 4 November 2002).

Mechanism: An “Early Harvest Program” is provided, liberalizing tariffs for priority sectors starting January 2004 which include live animals, meat and edible meat, fish, dairy products, other animal products, live trees, edible vegetables and

[3] Initiatives are: ASEAN Surveillance Process (ASP); ASEAN Free Trade Area (AFTA); ASEAN Investment Area (AIA); ASEAN Scheme of Industrial Cooperation (AICO); etc.

edible fruits and nuts. These products will have a zero tariff by January 2006 for China and the ASEAN-Six and by 2010 for the new ASEAN members. Cooperation in five priority sectors will also be strengthened: agriculture, information and communications technology, human resource development; investment and the Mekong River Basin development. Other areas for economic cooperation include banking, finance, industrial cooperation, transport, communication, intellectual property rights, small and medium industries, environment, biotechnology, fishery, forestry and forestry products, mining, energy, and sub-regional development.

3.1.4.3. ASEAN-Japan Comprehensive Economic Partnership

Signed in Bali in October 2003.

Goal: Cooperation in transportation & logistics through efficient cargo transport system, safe and sustainable shipping and safe and efficient air transport.

Mechanism: Beginning 2004, ASEAN and Japan started consultations on facilitation and cooperation in areas related to transport & logistics. Annual Meeting of Transport Ministers with its first meeting on October 25, 2003 endorses Terms of References for various projects in transport and logistics

3.1.4.4. ASEAN Free Trade Area (AFTA)

Goal: increase ASEAN competitiveness as a production base for world market.

Mechanism: CEPT scheme 0-5% intra-regional tariffs after 15 years from 1993.

3.1.4.5. ASEAN Investment Area (AIA)

Goal: promote FDI into ASEAN

Mechanism: binds member countries to gradually eliminate investment barriers, liberalize investment rules and policies, grant national treatment, and open industries to ASEAN investors by 2010 and to all investors by 2020.

3.1.4.6. ASEAN Framework Agreement on Services (AFAS)

Goal:

Mechanism: Negotiations in air transport, maritime transport, telecom, tourism, business services, construction, and financial services.

3.1.4.7. Initiative for ASEAN Integration (IAI)

Endorsed by ASEAN Leaders at their summit on 4 November 2002 at Phnom Penh.

Goal: 6 years from inception, greater economic integration, equitable economic development, and alleviation of poverty in CLMV (Cambodia, Laos, Myanmar, Vietnam).

Mechanism: the Work Plan focuses on the priority areas of infrastructure development (transport and energy), human resource development (public sector capacity building, labor and employment, and higher education), ICT and promoting regional economic integration (trade in goods and services, customs, standards and investments) in the CLMV countries.

3.1.5. Strengths and Weaknesses of ASP and ASP+3 & Various Initiatives

3.1.5.1. Strengths

The financial crisis has not resulted in a slowing down of AFTA's implementation, contrary to popular perceptions (Soesastro 1999).

AFTA's relatively liberal rules of origin (up to 76 % non-ASEAN content) have made it a very open regional trading arrangement, and pursued in parallel with some member's unilateral trade liberalization, resulted in low utilization of AFTA preferences in intra-ASEAN trade. Note that AFTA is not meant to increase intra-ASEAN trade per se. Open regionalism is largely responsible for the region's economic dynamism.

3.1.5.2. Weaknesses

ASP+3 current practices cannot provide effective early warning signals of emerging financial crisis because:

- there is no consensus on the content of the country reports, including the type of indicators of what might bring about a crisis (Austria, 2002);
- there is inadequate exchange of information on the peer review process as discussions during ASEAN+3 meetings tend to focus on recent economic developments of countries on a voluntary basis, while issues of concern and emerging problems are not sufficiently addressed (Wang, 2002).

The ASP itself does not have a deliberate component for building trust and confidence among participants. If the Manila Framework Group (MFG) which was established in 1997 was terminated in December 2004, allegedly due to US and IMF scrutiny of participants "but not the other way around", then this seems to signal unwillingness in any potential ASP+3 to be more transparent.

Issue of leadership is potential set back in any attempt at an ASEAN+3 FTA or a bigger East Asian Free Trade Area, unless China and Japan learn the way by which both Germany and France carried their leadership roles in the EU. The kind of leadership role that the US should be performing in this regard is also still to be determined, considering its significant support and commercial as well as security involvement in the region.

3.1.6. Nature of Policy Dialogue in ASEAN & ASEAN+3

3.1.6.1. ASEAN+3

ASEAN-Japan partnership covers policy dialogue, enhancing human resource development and cooperation in the facilitation of cargo transport, physical distribution and logistics, enhancing safety in maritime transport, enhancing safety and efficiency of international air transport services, and promotion of advanced transport technologies to ensure security and protect the environment.

Human resource development on financial standards and codes of good practice. The ASEAN+3 and APEC should join together in improving corporate governance and developing financial standards and codes of good practice in the region. Given the recent issue on accounting manipulation within the corporate structure of the US, the joint cooperation program could provide a broader perspective on the issues, drawing upon the good and bad experiences of economies from both regions.

There is no provision for a conflict resolution mechanism under present dialogue process. The ASEAN and ASEAN+3 have yet to institutionalize a conflict resolution mechanism (Soesastro 2002). ASEAN economies prefer to settle intra-ASEAN conflicts outside of the ASEAN framework. However, as problems are becoming more complex, the approach will no longer be adequate. Hence, a mechanism where disputes are readily managed should be developed.

3.1.6.2. ASEAN

Policy dialogue towards economic cooperation is a consensus-based decision making process, dubbed as the "ASEAN Way".

The various areas of policy dialogue in ASEAN are:

1. *Development of financial infrastructure to develop alternative sources of long-term financing in the region*. Countries in the region relied heavily on short-term borrowing to finance their investment-savings gap. The accumulation of such debt was a major factor that caused the crisis. To reduce the reliance on short-term debt, and hence the risk of a financial crisis, the region has to develop its bond market where the savings of surplus countries in the region are recycled to the deficit countries of the region. The development of the bond market, however, could be achieved only when the required financial infrastructure is present. Hence, financial cooperation in the region should include strengthening the credit rating capabilities in the region and developing common standards for various credit rating agencies (Sussangkarn 2002, Austria 2003).

2. *Coordination of monetary and exchange rate policies*. Given the high degree of intra-trade and investment flows in the region, there are proposals for an exchange rate arrangement for East Asia, including a Monetary Union for the region. The objective is to promote intra-regional exchange rate stability and regional growth. The volatility of the exchange rates in the region adversely affects the relative competitiveness of the economies, and hence, the flow of trade and investment. The reduction of currency risks in intra-regional transactions, through an exchange rate arrangement, could therefore lead to a more efficient integration of the region (Austria 2003).

One such exchange rate arrangement proposed is the adoption of a regional currency basket consisting of the US$, yen, and euro, which is broadly representative of the diversity of trade and investment structure of the economies of the region (Kawai & Takagi 2000, Austria 2003). A common basket peg would reduce the possibility that changes in one exchange rate would destabilize effective exchange rates (Austria 2003).

3.1.7. Strengths and Weaknesses of ASEAN and ASEAN+3 Policy Dialogue

3.1.7.1. Strengths

A variety of cooperative activities are pursued that enable identification of opportunities for the private sector, such as those under the framework of AEM-MITI Economic and Industrial Cooperation Committee (AMEICC), under ASEAN+3 process, and under the ASEAN-Australia Development Cooperation Programme (AADCP). The US-ASEAN Business Council has also set up an online SME business matchmaking facility (http://www.us-asean.org/bizmatch/index.asp) to assist companies in the United States and Southeast Asia in finding potential business partners.

3.1.7.2. Weaknesses

Present policy dialogue process does not have a conflict resolution mechanism. Thus, whenever a conflict arises, the ability of the private sector to take advantage of potential synergies, such as opportunities for joint ventures, could be disrupted. The Flor Contemplacion controversy between Singapore and the Philippines is a case in point. This event led to postponement, if not outright cancellation, of mergers and joint ventures being discussed between Philippine and Singaporean financial institutions.

The “ASEAN Way” of decision making, consensual and voluntary, is “limiting the growth of ASEAN…The process is slow and time consuming, producing decisions that are neither swift nor drastic” (Austria 2003).

Issue of leadership is potential set back in the Policy dialogue for both ASEAN and ASEAN+3, unless China and Japan learn the way by which both Germany and France carried their leadership roles in the EU. The kind of leadership role that the US should be performing in this regard is also still to be determined, considering its significant support and commercial as well as security involvement in the region.

3.2. European Union

The European Union is the most successful regional integration in the World. Most of the papers discussing the possibility of an East Asian integration refer to the EU as a benchmark. No doubt, that learning from the long evaluation process of the EU from the 1948 Hague Congress till the present level of integration, and studying the structure and operation of the EU can help to evaluate a similarly successful system in East Asia.

However, there are also many differences between the two regions which have to be considered. Such differences are for example the low income level of the ASEAN+3 countries (except Japan, Korea, and Singapore), high income disparities between regions, high unemployment rate, and high dependence on foreign capital in East Asia. These disadvantages hopefully can be reduced by a successful integration.

However, there is at least one more conspicuous difference. During the European integration process, the new members were relatively small compared to the original integration. Even with the 25 members already, the original 6 countries give 32% of the surface area, 50% of the population, and around 58% of the total GDP of the present EU (Appendix 1-4). In contrast, China itself has 2.1 times more surface area and 2.4 times more population than the ASEAN-10 countries. At the same time, Japan has 6.6 times larger total GDP, than the 10 ASEAN countries together.

The framework for the development of the EU has been set out in a series of treaties:

- 1951, the Treaty of Paris,
- 1957, the Treaty of Rome,
- 1986, the Single European Act,
- 1992, the Treaty of Maastricht on European Union,
- 1997, the Treaty of Amsterdam, and
- 2001, the Treaty of Nice
- 2004, the Treaty establishing a Constitution for Europe, Rome

The Treaty of Paris set up the European Coal and Steel Community (ECSC) which together with the European Economic Community (EEC) and the European Atomic Energy Community (EURATOM), set up by the Treaty of Rome, started the official history of the EU (formerly known as EC) in 1957.

The Treaty of Rome also set the following tasks for the new integration:

- Harmonious development of economic activities,
- A continuous and balanced expansion,
- An increase in stability,
- An accelerated raising of the standard of living, and
- Closer relations between the States belonging to it.

These objectives were further evaluated and extended by the new challenges the EU had to face during its historical evaluation. European leaders soon recognized that European solidarity mean taking action to strengthen economic and social cohesion. It means that the gap between regional income and wealth has to be narrowed. In practice, it led to the introduction of regional and social policies and to their increasing importance with every enlargement of the EU.

The EU's regional policy consists essentially of making payments from the EU budget to disadvantaged regions and sections of the population through specific funds: the European Regional Development Fund (ERDF), the European Social Fund (ESF), the Financial Instrument for Fisheries Guidance (FIFG) and the European Agricultural Guidance and Guarantee Fund (EAGGF, commonly known by its French acronym FEOGA). These payments top up or stimulate investment by the private sector and by national and regional governments. The EU has set three priority objectives. Objective 1 is to help develop regions where the GDP per capita is less than 75% of the EU average. Objective 2 is to help other regions in difficulty: declining rural areas, fishing communities in crises or urban areas with serious problems.

Social progress is also supported by legislations that guarantees all EU citizens a solid set of basic rights. The Maastricht European Council adopted the Community Charter of basic social rights, setting out the rights all workers in the EU should enjoy: free movement; fair pay; improved working conditions; social protection; the right to form associations and to undertake collective bargaining; the right to vocational training; equal treatment of women and men; worker information, consultation and participation; health protection and safety at the workplace; protection for children, the elderly and the disabled.

It also has to be mentioned that the Treaty of Amsterdam made job creation a priority for the EU's economic policy. The European Council set a very ambitious goal in March 2000: the Lisbon strategy. It aims to make the EU, within a decade, the most competitive and dynamic knowledge-based economy in the world, capable of sustainable growth with more and better jobs and greater social cohesion.

After reviewing the major goals of the EU, the institutional system and its mechanism have to be discussed. The major decision making authorities in the EU are the Council of the European Union[4] and the European Council representing the member states, and the European Parliament representing the citizens.

The Council of the European Union (‘the Council’, formerly known as the Council of Ministers) is the main decision making institution in the EU. Each EU country in turn takes the presidency of the Council for a six-month period. The Council has nine different configurations covering all the different policy areas, like industry, transport, the environment etc. The Council for Economic and Financial Affairs is commonly known as the ECOFIN Council, or simply ECOFIN.

The councils work as a whole is planned and coordinated by the General Affairs and External Relations Council. The preparatory work for Council meetings is done by the Permanent Representatives Committee (COREPER), made up of the member states' ambassadors to the EU, assisted by officials from the national ministries. The Council's administrative work is handled by its General Secretariat, based in Brussels.

The Council and European Parliament share legislative power as well as responsibility for the budget. The Council also concludes international agreements that have been negotiated by the Commission. It has to take its decisions either unanimously or by a majority or "qualified majority" vote. On important questions such as amending the treaties, launching a new common policy or allowing a new country to join the Union, the Council has to agree unanimously.

In most other cases, qualified majority voting is required. The number of votes roughly reflects the size of the population of the member country. Until 1 May 2004, the minimum number of votes required to reach a qualified majority was 62 out of the total of 87 (i.e. 71.3%). From 1 November 2004, a minimum of 232 votes (72.3%) will be required to reach a qualified majority. In addition, a majority of member states (in some cases two thirds) must approve the decision, and any member state can ask for confirmation that the votes cast in favour represent at least 62% of the EU's total population.

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[4] The Council of the European Union is not equivalent with the Council of Europe. The first one is a EU institution but the second one is not. The Council of Europe includes not only EU member countries, but also non-EU member countries like Russia, Ukraine, and Turkey. It has a total of 45 member countries.

The European Council is the EU's highest-level policy making body. The EU's political leaders started to hold regular meeting in 1974. This practice was made official by the Single European Act in 1987. With the Treaty of Maastricht, the European Council officially became the initiator of the Union's major policies and was empowered to settle difficult issues on which ministers (meeting in the Council of the European Union) fail to agree. The European Council brings together the presidents and prime ministers of all the EU countries plus the President of the European Commission and the President of the European Parliament also addresses every European Council.

The European Parliament is the elected body that represents the EU citizens and takes part in the legislative process. Since 1979, members of the European Parliament (MEPs) have been directly elected, by universal suffrage, every five years. The parliament and the Council share legislative power, and they do so using three different procedures, in addition to simple consultation:

- The "cooperation procedure", where the Parliament gives its opinion on draft directives and regulations proposed by the European Commission.
- The "assent procedure", where the Parliament must give its assent to international agreements negotiated by the Commission, to any proposed enlargement of the EU and to other matters including election rules.
- The "co-decision procedure", where the Parliament has the power to throw out proposed legislations in these fields if an absolute majority of MEPs vote against the Council's common position. However, the matter can be put before a conciliation committee.

Parliament and the Council also share equal responsibility for adopting the EU budget. The European Commission proposes a draft budget, which is then debated by Parliament and the Council. Parliament is the driving force in European politics. It is the EU's primary debating chamber.

Parliament is the body that exercises democratic control over the Union. It has the power to dismiss the Commission by adopting motion of censure. It checks that EU policies are being properly managed and implemented - for example by examining the reports it receives from the Court of Auditors and by putting oral and written questions to the Commission and Council. The current President of the European Council also reports to Parliament.

The European Commission acts with complete political independence. Its job is to uphold the interest of the EU as a whole, so it must not take instructions from any member state government. As "Guardian of the Treaties", it has to ensure that the regulations and directives adopted by the Council and Parliament are being put into effect. If they are not, the Commission can take the offending party to the

Court of Justice to oblige it to comply with EU law. As the EU's executive arm, the Commission carries out the decisions taken by the Council.

The Commission had 20 members until 1 May 2004, 30 members until 1 November 2004, since that the new Commission has 25 members. The members are appointed for a five year period by agreement between member states, subject to approval by Parliament.

The key indicators of the economic surveillance of the Commission and the source of information can be seen in Appendix X.

The Court of Justice is made up of one judge from each EU country, assisted by eight advocates-general. The Court's job is to ensure that EU law is complied with, and that the treaties are correctly interpreted and applied. **The Court of First Instance** is responsible for giving rulings on certain kinds of case, particularly actions brought by firms or private individuals against EU institutions. **The Court of Auditors** has one member from each EU country. It checks that all the EU's revenue has been received and all its expenditure incurred in a lawful and regular manner and that the EU Budget has been managed soundly.

The European Economic and Social Committee (EESC) is the organized civil society of the EU. The EESC has to be consulted before decisions are taken in a great many fields (employment, the European Social Fund, vocational training, etc.). **The Committee of the Regions (CoR)** consists of representatives of regional and local government, proposed by the member states and appointed by the Council. The Council and Commission must consult the CoR on matters of relevance to the regions.

The EU has recognized that aid alone could never solve all the problems caused by economic recession or by regional under development. Social progress springs, first and foremost, from economic growth and is nurtured by both national, and EU policies. The major institutions responsible for the economic and financial development of the EU are the ECOFIN, the European Central Bank (ECB), and the European Investment Bank (EIB).

The ECOFIN Council has many different objectives:

- The development of general economic guidelines and the coordination of economic policy.
- Cooperation on tax policy and on financial market issues.
- Financial control and auditing the EU budget.
- The operations of the EIB.

The ECOFIN Council normally convenes ten times a year, meeting in Brussels or Luxembourg. In addition to the regular ECOFIN meetings, the Council also holds informal meetings once every six months in the country occupying the EU presidency, attended by the President of the ECB an the governors of central banks in the member states. The EU ministers responsible for economic affairs and finance also take part in the meetings of the European Council when issues of importance for the Economic and Monetary Union (EMU) are to be raised, as well as attending other international meetings relevant to their work.

In the case of legislative issues, decisions are prepared in the same way as for the Ministerial Councils: the European Commission presents a set of proposals and the business is drafted by working parties in the Council of Ministers before being passed on to COREPER, which scrutinizes the proposals and arrives at a preliminary agreement acceptable to all, whereupon the ECOFIN Council takes over and reaches a decision or settles the business in some other ways. Must of the economic policy business dealt with by the ECOFIN is prepared by its two drafting bodies, the Economic and Financial Committee (EFC), and the Economic Policy (EPC). These committees are made up of representatives of each country's finance ministry and central bank and they submit their proposals directly to the ECOFIN Council.

The EU also has a special Budget Council responsible for managing the Commission's budget proposals and for budget negotiations with the European Parliament. Each member state is represented by a state secretary or the equivalent from its finance ministry.

The European System of Central Banks (ESCB, see Appendix xxxx) is composed of the newly created ECB and the national central banks (NCBs). **The European Central Bank**, based in Frankfurt, is responsible for managing the EURO and the EU's monetary policy. The Eurosystem implements the monetary policy of the EURO area. It also conducts foreign exchange operations, in agreement with the Finance Ministers of the member countries. It holds and manages the official foreign reserves of the EMU member states. It monitors the payment systems and it is involved in the prudential supervision of credit institutions and the financial system.

The European Investment Bank, based in Luxemburg, finances projects to help the EU's less developed regions and to help make small businesses more competitive.

The European Statistical System (ESS) was built up gradually with the objective of providing comparable statistics at EU level. The ESS comprises Eurostat and the statistical offices, ministries, agencies and central banks that collect official statistics in EU Member States, Iceland, Norway and Liechtenstein. Member States collect data and compile statistics for national and EU purposes. The ESS functions as a network in which Eurostat's role is to lead the way in the harmonization of statistics in close cooperation with the national statistical authorities. The ESS also coordinates its work with international organisations such as OECD, the UN, the International Monetary Fund and the World Bank.

3.2.1. History of the Monetary Integration

Inflation started to rise in Europe during the late 60s. Because of the Vietnam War, the US had large budget deficit and the USD value eroded. The US could not guarantee anymore the gold value of USD:

1. 1971 the US suspended the USD-gold convertibility and devalued the USD by 10%
2. 1973 every country was free to choose its exchange regime, the Bretton Woods system ended

In Europe, the speculation tore the currencies apart. To limit exchange-rate movement the **European Snake** was created, but it was not equipped for the hectic economic environment of the 70s. The collapse of Bretton Woods and the 1973-74 oil shock led to inflation: some controlled successfully (Belgium, Germany, and Netherlands), some could not (UK, Italy). Several countries were forced to leave the snake. The EC kept the snake but more needed to done which led to the EMS.

The heart of **EMS** is the **Exchange Rate Mechanism** (ERM): a system of jointly managed fixed and adjustable exchange rates backed to mutual support. In 1979, all EC countries joined the EMS, but UK stayed out till 1990. New member countries also joined, but some with delay.

During the first 10 years there was significant inflation difference and realignments were frequent. The implicit rule was to observe inflation rates. The system was 'too' transparent, allowing exchange rate markets to foresee the next realignments and speculate accordingly. Inflation difference had to be reduced. Low inflation, largest economy Germany was followed, and the **Bundesbank** emerged as the center of EMS.

After 1986, each country was trying to anchor its currency to the DM and realignments became very rare. Because not every member's inflation declined to German level misalignments kept growing. The attempt to hold the exchange rates unchanged failed in 1992-93 when **speculative attacks** nearly destroyed the EMS.

Italy and Britain left the ERM (Italy back in 1996), Ireland, Portugal and Spain had to devalue their currencies repeatedly. In 1993, the margins of fluctuations were widened to ±15%

By 1990 the capital control was dismantled. As a result unfettered speculative flows could easily overwhelm the central banks. The EMS was doomed. All countries wanted to recover some influence over monetary policy, which was lost by the convergence to the Bundesbank standard. A common central bank had to be created.

The Delors Report was formally adopted in July 1989 at the **Madrid Summit**. Two intergovernmental conferences were convened to study the creation of an economic and monetary union and of a political union. Both conferences reported in time for the Council meeting held in Maastricht at the end of 1991. The **Maastricht Council** decided the replacement of the EC by an economic and political union, the EU, and included a precise schedule to establish the monetary union.

On 4 January 1999, exchange rates of 11 countries were ‘irrevocably” frozen. The power to conduct monetary policy was transferred from each member country to the **European System of Central Banks (ESCB)** headquartered in Frankfurt. On January 2002, euro banknotes and coins replaced the national currencies with few months transition period.

Lessons:

- Misalignments call for protectionism, and inevitably lead to crises.
- Systems need to be built coherently.
- Policy misbehavior must be ruled out. (independent common central bank)
- To be able to cope with a large variety of shocks the system must be robust. The EMU is, so far, untested.
- Any monetary system needs a conductor (Gold Standard - Britain, Bretton Woods - US, EMS-EMU institutions).

3.2.2. European Monetary System

The EMS was adopted in 1979 to preserve as much as possible, exchange rate stability within Europe. All EU members are members of the EMS but the active part of the system, the ERM, was initially optional.

The ERM was based on a grid specifying all bilateral parities and the corresponding margins of fluctuations, normally ±2.25%

ERM members were committed to jointly defend their bilateral parities, if necessary through unlimited interventions and loans. Realignments were possible, but required the consent of all members.

In practice, the EMS went through three phases. During the first period, inflation differed quite widely from one country to another and realignments were frequent. Than, all countries decided to adopt the Bundesbank's low inflation strategy, in effect adopting the DM as an anchor and avoiding further realignments. The 1992-93 crisis ended with the adoption of wide margins, allowing the ERM to nominally survive until the launch of the euro.

The 1992-93 crisis provides an example of the impossible trinity. The liberalization of financial markets and the fixity of exchange rates was incompatible with divergent monetary policies, especially as Germany, the central country, was going through its unification shocks.

With the adoption of a single currency, a new EMS was established. EMS-2 mainly differs from EMS-1 in that the euro is now the reference currency. All EU members are required to take part in this new exchange rate mechanism unless they have derogation, which is the case of the UK and Sweden.

EMS-2 remains a prerequisite for joining the Euro area. The 10 new members will join the mechanism before adopting the euro.

3.2.3. European Monetary Union

The history of the EMU can be summarized in the following steps:

- 1970 Werner Plan
- 1979 EMS starts
- 1989 Delors Committee
- 1991 (93) Maastricht Treaty
- 1994 European Monetary Institute
- 1997 Stability and Growth Pact
- 1998 Decision on membership, conversion rates set, creation of ECB
- 1999 Monetary Union starts
- 2001 Greece joins
- 2002 Euro coins and notes introduced

The EMU was decided upon in 1991 and started on target in 1999. Countries needed time to prepare themselves and to meet the five convergence criteria:

- Inflation should not exceed the average of the three lowest inflation rates by more than 1,5%

- The long-term interest rate (which usually reflects markets' assessment of long-term inflation) should not exceed the average of the three lowest inflation rates by more than 2%
- ERM-2 member for at least two years
- The German "golden rule" considers that public investment typically amounts to some 3% of GDP. Hence the requirement that budget deficits should not exceed 3% of the GDP. (Inflation is typically the result of large budget deficit.)
- The maximum level of public dept was set at 60% of the GDP (average dept level in 1991, Maastricht)

The convergence criteria were designed to ensure that inflation is low, and permanently so, and that public budgets are in surplus or that the deficit are small.

The EMU includes all EU member countries, but only those that have joined the Euro area have their national central banks included in the Eurosystem alongside the ECB. The system's main body is the Governing Council, chaired by the president of the ECB.

The Eurosystem has decided to achieve in the medium term an EMU-wide inflation rate close to 2%.

The Eurosystem sets the euro short-term interest rate through three channels:

- Marginal refinancing facility: sets a ceiling,
- The deposit facility: sets a floor,
- Conducts regular auctions at the main refinancing rate to hit the middle.

The **Eurosystem's strategy** relies on the price stability objective and on two pillars:

- Economic analysis: the medium impact of current conditions on inflation. It consists of a broad review of the recent evolution and likely prospects of economic conditions (growth, employment, prices, exchange rates, foreign conditions).
- Monetary analysis: the long-term impact of monetary aggregates (in particular M3) and credit on inflation.

These two perspectives offer complementary analytical frameworks to support the Governing Council's overall assessment of risks to price stability.

In the monetary union, there is one central bank and one monetary policy. The Eurosystem can only care about the whole Euro area, not about individual member countries. It takes no responsibility for the exchange rate that is freely floating.

The Eurosystem constitutionally enjoys considerable independence, both in defining its objectives and in deciding how to conduct monetary policy. The ECB is only accountable to the European Parliament to which it presents an annual report, with additional hearings of the Chairman and members of the Executive Board.

The first years of the euro have been marked with several shocks (2000 oil-price, 2001 world wide fell of stock markets (financial bubble fed by unrealistic expectations on information technology revolution), recession in the US and after in the EU area, 2002 world wide stock market crash). Fortunately, these shocks have been symmetric.

The **ECB has three governing bodies**: the Executive Board, the Governing Council and the General Council. The Executive Board is responsible for the day-to-day running of the ECB, including implementation of the monetary-policy decisions of the Governing Council. The Governing Council consists of the Executive Board and the central-bank governors of the 11 euro area member states, totaling 17 members. The ECB's third governing body is the General Council, which comprises the governors of all 15 EU countries' central banks and the President and Vice President of the Executive Board. The Governing Council meets around every two weeks and the General Council meets once a quarter. The ECB has furthermore established a number of committees to prepare for the meetings of the governing bodies.

Publications of the ECB:

- Annual Report (to the EP, the Council, and the Commission)
- Convergence Report
- Monthly Bulletin
- a consolidated Weekly Financial Statement
- Occasional Papers
- Working Papers
- Information Brochures
- Other Publications

3.2.4. Fiscal Policy and the Stability Pact

The loss of national monetary policy leaves fiscal policy as the only macroeconomic instrument. Budgets can be seen as a substitute for the absence of intra-EMU transfers.

Fiscal policy operates in two ways:

- Automatic stabilizers come into play without any policy action because deficits increase when the economy slows down and decline or turn surpluses when growth is rapid.
- Discretionary policy results from willing actions taken by government.

One country's fiscal policy affects economic conditions in other EMU countries. The main spillover channels are:

- Income flow via exports and imports,
- The cost of borrowing as there is a single interest rate,
- The impact of possible defaults on the common exchange rate,
- The effect of fiscal indiscipline of the union's credibility.

The theory of fiscal feudalism provides arguments for and against the sharing of policy instruments. The presence of spillovers and increasing returns to scale argue for policy sharing. The existence of national differences in economic conditions and preferences, and asymmetries of information argue against policy sharing. Finally, the quality of government matters.

The Stability and Growth Pact reflects the view that excessive deficits are a matter of common concern in a monetary union. It aims at making permanent the fiscal convergence criteria. It is an application of the excessive deficit procedure envisioned in the Maastricht Treaty.

The pact defines what excessive deficits are. It calls for annual medium-term projections. It monitors the outcomes and calls for the Council to issue warnings. When the warnings are not heeded, sanctions can be applied, including fines. However, all decisions are in the hands of the Council, a highly political body that can exploit many of the 'ifs' included in the pact.

The pact limits the counter-cyclical use of fiscal policy - including the full working of the automatic stabilizers - when the budget is not initially in the safe zone of balance or surplus. This provides an incentive to achieve such a position as soon as possible.

The early implementation of the Stability and Growth Pact has revealed many cracks. Combining budgetary discipline and fiscal policy flexibility is not easy, nor is it easy to find a good compromise between preserving sovereignty and dealing with potentially dangerous spillovers.

The **multilateral surveillance** takes the form of the adoption by the Council of **Broad Economic Policy Guidelines (BEPG)** against which each country's performance can be assessed. In fact, the pact's stability programs are embedded in the BEPG. The procedure takes the form of **annual reports** by each government. These reports are examined by **the Commission** whose conclusions are than submitted to **the ECOFIN Council**. The Council approves country-specific assessments and may issue warnings (**peer pressure**), but fines can only be imposed for violations of the Stability and Growth Pact.

The BEPG and the Stability and Growth Pact - concern all EMU members, whether they are members of the monetary union or not. However, sanctions can only be imposed on monetary union member countries.

Financial Markets and the Euro

Financial markets play a crucial role: they allow savers and borrowers to meet to their mutual benefit. They also set a price on risk and offer ways to reduce exposure via diversification.

Financial markets are also special. They are subject to economies of scale, they operate as networks, and they face important information asymmetries. As a consequence, they do not conform to the perfect market assumption. In particular, they are prone to systemic instability.

This instability, as well as other market failures, explains why financial systems are regulated and supervised. For the most part, **regulation has been fully harmonized** throughout the EU **but supervision remains at the national level**. This is unlikely to be a lasting solution, but further centralization faces stiff opposition.

Banks share these characteristics, which explain why competition does not take the form implied by perfect markets. In particular, large switching costs and information asymmetries explain why the adoption of the euro has not been followed by a deep restructuring of this industry. So far bank mergers and acquisitions have occurred mostly at the national level and few banks have tried to expand across borders. Differences in national regulations and some degree of protectionism on the part of supervisors also seem to limit changes. Plans have been drawn up to break this logjam.

For much of the post-war period, European financial markets were small and largely disconnected with each other. The reasons were limits to capital mobility and exchange risk. Soon after the launch of the euro, bond markets have been unified. Stock markets, on the other hand, remain small.

The euro has the potential for challenging the dollar as an international currency, but old habits die hard and, despite some changes, the dollar's supremacy has not been seriously dented. Some progress has been achieved in trade invoicing, bond issuance, and the periphery of the Euro area, the role as anchor for currencies and a parallel currency. Little change is reported regarding the function of a vehicle currency or foreign exchange reserves holdings (Baldwin, 2004).

3.3. OECD

The Organization for Economic Co-operation and Development is an intergovernmental organization that provides a setting for its 30 Member countries to discuss, develop and enhance policies across a wide range of economic and social issues. Members compare experiences, seek answers to common problems and work to coordinate domestic and international policies that increasingly, in today's globalized world, must form a web of consistent practice across nations. The Organization backs up its policy dialogue with high quality data and analysis. Exchanges may lead to formal agreements, for example, legally binding codes for free flow of capital and services Discussions among policy-makers and experts from Member countries make for better-informed work within their own governments on the spectrum of public policy and clarifies the impact of national policies on the international community. Over the years, the OECD has also established effective “peer review mechanisms” that help governments to further refine their policies.

Pursuant to Article 1 of the Convention signed in Paris on 14th December 1960, and which came into force on 30th September 1961, the Organization for Economic Co-operation and Development (OECD) shall promote policies designed:

- to achieve the highest sustainable economic growth and employment and a rising standard of living in member countries, while maintaining financial stability, and thus to contribute to the development of the world economy;
- to contribute to sound economic expansion in member as well as non-member countries in the process of economic development; and
- to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.

The organization chart of the OECD can be seen in Appendix 6. The OECD Secretariat staff in Paris carries out research and analysis at the request of the OECD’s 30 member countries. Representatives of member countries meet and exchange information in committees devoted to key issues. Decisions are taken by the OECD Council.

Representatives of the 30 member countries meet in specialized **Committees** to advance ideas and review progress in specific policy areas, such as economics, trade, science, employment, education or financial markets. There are about 200 committees, working groups and expert groups in all.

Some 40 000 senior officials from national administrations come to OECD committee meetings each year to request, review and contribute to work undertaken by the OECD Secretariat. Once they return home, they have online access to OECD documents and can exchange information through a special network.

Decision-making power is vested in the OECD's **Council**. It is made up of one representative per member country and the European Commission. The Council meets regularly at the level of ambassadors to the OECD and decisions are taken by consensus. The Council meets at ministerial level once a year to discuss key issues and set priorities for OECD work. The work mandated by the Council is carried out by the OECD Secretariat's various directorates.

Some 2 000 staff of the **OECD Secretariat** in Paris work to support the activities of committees. Some 700 economists, lawyers, scientists and other professional staff, mainly based in a dozen substantive directorates, provide research and analysis.

The Secretariat is headed by a Secretary-General, assisted by four Deputy Secretaries-General. The Secretary-General also chairs the Council, providing the crucial link between national delegations and the Secretariat (OECD: Overview).

OECD countries created forty years ago a balanced framework for gradual progress towards liberalization: the OECD Code of Liberalization of Capital Movements which also covers direct investment and establishment, and the OECD Code of Liberalization of Invisible Operations which covers services.

The OECD Codes of Liberalization are legal instruments which establish rules of behavior for the governments of OECD Member countries. Technically speaking, they are Decisions of the OECD Council. The OECD Council is the supreme organ of the Organization in which each country has one vote. Its Decisions, which must be taken unanimously, are legally binding on Member governments. They are, however, not a treaty or international agreement in the sense of international law, such as for instance the WTO agreements (OECD, 2003).

Transparency means that information on the barriers to capital movements and trade in services in OECD countries should be complete, up-to-date, comprehensible and accessible to everyone. The Codes achieve this goal by:

- Requiring Member countries to notify all measures which affect any of the transactions covered by the Codes.
- Asking for notification of modifications to any of these measures.
- Reflecting these measures as accurately as possible in reservation lists country by country, so that the reader can be confident that no restrictions exist except for those appearing in the reservation lists (this is called the "top-down" approach to 12 defining obligations).
- Placing on the OECD public website and regular hard copy publication of updated versions of the Codes, together with country positions.

The OECD Committee on Capital Movements and Invisible Transactions, known as the "CMIT", is the structure where Member countries meet to discuss application and implementation of the Codes. All OECD countries are entitled to nominate an expert as a member of the Committee. The European Commission is represented. Other representatives, including from non-member countries, may be invited; the IMF and EFTA are also observers.

The CMIT usually meets twice a year for several days, once in spring and once in the fall. It is assisted by staff from the OECD Secretariat, in particular the Division of capital movements, investment and trade in services. The Committee may set up ad hoc working groups to tackle specific issues which need in-depth expertise and analysis, such as foreign direct investment or certain services sectors such as insurance and E-finance. It can also organize more informal conferences and workshops, often with participation from the private sector and/or academics. One example is a series of workshops on liberalization of professional services which has taken place since 1994.

The CMIT conducts regular reviews of each country's position under the Capital Movements Code, seeking to explore together with the country concerned if and how it could advance towards more open markets. Another instrument are horizontal reviews under the Current Invisibles Code which look at a specific sector only but cover all countries. The Committee usually adopts written reports on each of these reviews which are submitted to the OECD Council. These reports are often accompanied by draft recommendations to the country or countries concerned, or by draft decisions to modify the reservation lists. Final decision on these lies with the OECD Council.

In order to do its job properly, the CMIT needs reliable information on any policy measures in Member countries that could affect the Codes. The Codes stipulate that governments shall notify the OECD within 60 days of all measures having a bearing on the Codes. In addition, the Committee, with the help of the OECD

Secretariat, conducts its own regular surveys. Drawing on a multitude of available sources, the CMIT systematically examines and discusses new policy developments in Member countries which affect capital movements, direct investment and trade in services (OECD, 2003).

The OECD increasingly engages in policy dialogue with a wide range of economies beyond its membership. The Centre for Co-operation with Non-Members (CCNM) promotes and co-ordinates the OECD's policy dialogue and co-operation with non-OECD Members. The CCNM operates under the overall guidance of the Committee on Co-operation with Non-Members, a subsidiary, intergovernmental body of the Council. The CCNM ensures that the dialogue with non-Members remains relevant, effective and forward-looking and it serves as a focal point for relations between the OECD and non-Member economies. Essentially, the CCNM brings together reformers from around the world to share policy experience and analysis contributing to global economic growth, social development, and good governance. The form of this co-operation varies, depending on the issues and circumstances, from jointly financed activities or publications, through formal or informal participation in each other's events, to exchange of information and statistics. An important form of co-operation is the participation of other organizations in the OECD policy dialogue, through, inter alia, observerships in OECD bodies. Our partners include the World Bank, regional developments banks, the IMF, the United Nations family of organizations, other regional groupings and organizations.

The OECD Secretariat uses a wide range of fiscal indicators to evaluate the overall fiscal situation of Member countries. No single indicator captures all the information about the fiscal situation but evaluating the situation by looking at a range of them should help to counterbalance the short-comings of each single one. Moreover, any assessment of the fiscal situation must look at the evolution of the indicators over a period of several years since looking at one year alone could give a distorted picture, given changes in economic conditions, one-off factors, etc.

The most widely used indicator is the general government financial balance or net lending. Besides being an indicator of the accumulation of government debt, net lending is also an important summary measure of the extent to which government's budgets contribute to macroeconomic stabilization. The cyclically-adjusted budget balance represents what government revenues and expenditure would be if output were at its potential level. In assessing public finance positions, attention is also paid to the general government's consolidated gross financial liabilities which measures the total debt held outside the government's accounts and provides an indicator of the likely future debt servicing burden of the economy.

For the major economies, monetary policy is assumed to be set so as to achieve stated objectives. This takes into account a range of monetary indicators, policy announcements with respect to the choice of monetary targets, associated target ranges and instruments, by national authorities. Increasingly, this involves a strong interdependent element, given for example the importance of interest rates, exchange rates, output and prices to international transmission mechanisms. Effectively this means that international financial linkages are increasingly important in the overall global assessment, and hence the assumptions for short- and long-term interest rates and/or monetary aggregates for virtually all OECD countries may hinge critically on the assessment of monetary policy in the three largest countries and/or regions (OECD: EO Sources).

3.4. IMF

Under the Articles of Agreement, the main function of IMF is to supervise the international monetary system. This includes (1) surveillance over the monetary and exchange rate policies of the members; (2) issuing policy recommendations; and (3) granting credit to members with temporary balance of payments difficulties subject to certain IMF conditions. Also, IMF has a mechanism to enhance the international supply of liquidity through the allocation of special drawing rights (SDRs). IMF has three broad areas of activity: surveillance, programs supported by financing arrangements, and technical assistance. Given its responsibilities, IMF is tasked to oversee the international monetary system and the code of conduct to which member countries have subscribed. Also, IMF is in charge of promoting dialogues among member countries on different issues ranging from economical to financial policies that would have an effect on the national and international levels.

3.4.1. Economic Surveillance

The IMF has authority under Article IV of its Articles of Agreement to exercise surveillance over the exchange rate polices of its members to ensure the effective operation of the international monetary system. The objective of surveillance is to help member countries achieve financial stability and sustainable economic growth. Although the objectives of surveillance are still the same today, the framework for surveillance has significantly changed to promote the benefits and respond to the expansion of international capital flows. The scope of surveillance covers a wide area of economic policies with differences in accordance with a country's individual circumstances.

IMF collects the information required for surveillance during regular consultation between IMF and regular consultation between the authorities and Fund management and staff. It also collects information through discussions held in connection with its multilateral surveillance activities. IMF perceives surveillance can help prevent or minimize negative externalities as a result of sound policy coordination among members and can potentially benefit both the international community and individual member countries.

The following are considered areas of concern for surveillance of IMF:

- Exchange rate, monetary and fiscal policies – is considered as the heart of IMF surveillance. IMF provides advice on issues ranging from exchange rate regime and the stance of fiscal and monetary policies.
- Structural policies – includes international trade, labor markets, and power sectors
- Financial sector issues – increase in emphasis was brought about the series of banking crises in both industrial and developing countries in the 1990's.
- Institutional issues – such as central bank independence, financial sector regulation, corporate governance, and policy transparency and accountability.
- Assessment of risks and vulnerabilities – due to large and volatile capital flows in industrial and developing countries.

The function of the IMF with regards to surveillance is to supervise the international monetary system. This includes issuing policy recommendations and granting credit to members with temporary balance-of-payments difficulties subject to certain policy conditions.

The specific activities of surveillance can be classified under the broad headings of information, policy advice and policy coordination. The information including economic data is treated as a public good and, as such, may be undersupplied by markets. IMF is considered to be neutral with no conflict of interest so it is perceived as an agency, which can provide information and analysis accurately without government interference. Policy advice on the other hand is a result of the expertise it possesses as well as institutional memory. Lastly, IMF acts as a policy coordinator due to its perceived neutrality. It can also provide information and analysis of the spillover effects of policies that help government internalize spillovers in the economy.

Crow, Arriazu, and Thygesen (1999) summarizes the six main features of IMF surveillance namely:

- Policy advice - Fund offers advice and proposals as well as serves as a sounding board for policy dilemmas facing a country.

- Policy coordination and cooperation – Fund helps policy consultation among groups of countries by providing inputs such as reliable data, forecasts and analysis and the machinery through which policy coordination can take place.
- Information gathering and dissemination – Fund maintains databases that are useful for policy formulation, and disseminates information, which can benefit private market participants and the general public.
- Technical assistance and aid – in many developing countries, surveillance is tantamount to providing technical assistance, owing to the scarcity of expertise in macroeconomic policy-making.
- Identification of vulnerabilities – Early warnings and policy advice including risks in financial sector
- Delivering the message – Fund disseminates, through policy advice, the prevailing consensus of the economics profession to governments and the world.

Generally, The objective of IMF is that macroeconomic policies implemented by member countries should be consistent with a viable and sustainable external payments situation. It must guarantee that countries adjust macroeconomic policies in a timely manner to prevent crisis. On the monetary policy, the main concern of IMF is to keep the level of inflation to a minimum. On fiscal policy, it should make public finances more transparent; make public sector accounts more complete; containing fiscal deficits; developing and clarifying the concept of quasi-fiscal deficit such as central bank operating losses; and analysis of structural and cyclical factors in government finance. In terms of exchange rates policy, surveillance focuses on the appropriate exchange rate system and level. IMF is allowing both fixed and flexible exchange rate systems as long as the country's macroeconomic policy is consistent with the system. Also, IMF has also been tackling structural and institutional issues, especially in labor markets and financial systems.

3.4.2. Economic Surveillance and Policy Dialogue

Traditionally, IMF has two levels of surveillance: bilateral and multilateral. However, with the existence of the European Union, IMF surveillance has grown into regional approach. Bilateral surveillance refers to consultations undertaken by the Fund with individual member countries while multilateral surveillance refers to the systematic analysis and forecasting of the world economy. Regional Surveillance on the other hand was implemented in response to the integration of Europe into a single market, the European Union. Crises in Mexico and Asia have highlighted the need for surveillance at the regional level.

3.4.2.1. Bilateral Surveillance

Bilateral consultation refers to consultations undertaken by the Fund with individual members countries leading to policy advice. The level of surveillance focuses more on policy implementation and monitoring as it aims to gather information and provide policy discussion and advice.

As stipulate in Article IV, consultation process is divided into three parts. First is an internal procedure of preparing the briefing paper before a Fund mission visits a particular country. The briefing paper usually describes the economic situation of the country and includes the views of IMF staff on different policies and changes needed. Senior staff and Fund management reviews the paper to make sure that problems are sorted out before the actual review is conducted.

Second, the mission to the country starts once the briefing paper is cleared. This process usually takes two weeks to complete. Four or five staff members from different departments of the Fund form the mission team. Meetings with senior and mid-level officials from the finance ministry, central bank and other agencies involved in policy formulation are conducted. The Fund staff also meets with private and business community representatives to get their opinion. The purpose of the mission is information-gathering and policy discussion and advice. A concluding meeting with senior officials (Secretary of Finance and Central Bank Governor) is held before the Fund mission completes the report. Once the mission has been completed, a staff report is prepared, reviewed and sent to the Executive Board.

Lastly, after the Executive Board has discussed the staff report, the Chair (either the Managing Director of deputy Managing Director) will sum up the opinion of the Executive Board. The discussion of the Executive Board completes the Article IV consultation process.

After the meeting with the Executive Board, a Public Information Notice (PIN) may already be released to the public upon approval of the concerned national authorities. A PIN consists of factual summary of recent economic developments and a summary of the discussion in the Executive Board.

The following are some of the indicators used by IMF in its Public Information Notice (PIN):

SECTOR	INDICATORS
Real	Real domestic final demand, real exports and imports, growth rate, inflation, unemployment, savings, investments
Public Finance	Budget, revenue, expenditure, public sector balance
Money and credit	Money supply & growth, domestic credit & growth
Interest rates	Short-and Long –term rates
Balance of payments	Trade balance, current account, reserves
Exchange rates	Exchange rate regime, nominal rates, real effective rates
External liabilities	External debt, external liabilities

Source: IMF website (http://www.imf.org)

3.4.3. Bilateral Surveillance Transparency

With regards to bilateral surveillance, IMF through its Executive Board has taken steps to improve transparency of its members' policies through encouraging:

- Release of PIN after Article IV consultations
- Voluntary public release of Article IV staff reports
- Release of a Statement by the Chairman of the Executive Board after discussions on the use of Funds resources
- Publication of letters of intent, memoranda of economic and financial policies, and policy framework paper; as well as of external evaluation of the Funds surveillance and economic research activities.

3.4.3.1. Multilateral surveillance

Multilateral surveillance is geared more towards analysis of recent world developments, projections of future development, identification of risks of instability in the international economic system and the proposing of the ensuing policy recommendations. The primary vehicle for multilateral surveillance is the World Economic Outlook, produced twice a year, which provides a comprehensive set of economic forecasts for the world economy. It usually covers the broad areas of the world economic situation, global economic prospects and related policies issues, especially policy stances in industrial countries. There is also more emphasis on financial and foreign exchange markets and external payments, financing and debt.

The forecasts used by IMF are not produced by a single model of the world economy, but rather compiled from forecasts for individual countries by the Fund's area departments. The country projections are prepared on the basis of internationally consistent assumptions about world activity, exchange rates, and conditions in international financial and commodity markets. Special attention is devoted to developments in exchange rates, trade and capital flows, which are the principal elements of international interaction, as well as the broad range of economic policies underlying them.

3.4.3.2. Multilateral Surveillance Transparency

IMF has developed standards or codes covering a number of economic and financial areas, most of which are covered included in the PIN released by IMF, among which data dissemination and good practices for transparency in the fiscal area and in monetary and financial policies are of particular concern.

Another aspect related to transparency is the establishment of standards and codes web page. This provides information on standards in areas of direct operational relevance to IMF such as fiscal, monetary, and financial policy transparency, and banking supervision.[5] Other code related to transparency is the adoption of IMF the Code of Good Practices on Transparency in Monetary and Financial Policies as a guide to members to increase transparency in its policies. The objective of which is to enhance the accountability and credibility of fiscal policy as a key component of good governance.

3.4.3.3. Regional surveillance

IMF is also involved in surveillance at the regional level in response to the integration of Europe into a single market known as the European Union. Also, crises in Mexico and other Asian countries have highlighted the need for surveillance at the regional level. The framework used for regional surveillance takes place twice a year, which includes policy discussions with European Union institutions responsible for common policies in the euro area, including the European Central Bank. Discussions are focused on the common monetary policy, exchange rate implications and the fiscal position of the euro area as a whole. The

[5] Web site is accessible at http://www.imf.org/external/standards/index.htm

European Central Bank was given an observer status on the IMF Executive Board. Nonetheless, members of the European Union still continue their Article IV consultation on an annual basis.

Also, the Fund has been active in providing inputs to other regional mechanisms for policy considerations such as APEC, ASEAN and currency unions, such as the West African Economic and Monetary Community, and the Eastern Caribbean Currency Board.

3.4.3.4. Statistical Publications of the IMF:

- **Balance of Payments Statistics Yearbook** – balance of payments data for about 160 countries and international investment position data for 48 countries, as well as regional and world totals of major balance-of-payments components.
- **Government Finance Statistics Yearbook** – annual publication providing detailed data on revenue, expenditures, financing and debt of central governments, and when available, data on state and local governments and institutional units of government.
- **International Financial Statistics** – a monthly publication reporting current data on exchange rates, international liquidity, international banking, money and banking, interest rates, prices, production, international transactions, government accounts and national accounts, by country and for regional and world aggregates.

3.4.3.5. Assessment of Surveillance mechanism of IMF:

The surveillance mechanism of IMF relies on the conditionality set in Article IV for bilateral, the World Economic Outlook for the Multilateral and the Euro for its regional surveillance. IMF can be considered as having a comparative advantage in exercising surveillance over financial systems and also with regards to assessment of compliance with international standards. It has relatively greater power to influence policies imposed by governments compared to other institutions because of the loans they grant to member countries. However, there have been criticisms that IMF has traditionally concentrated on macroeconomic and exchange rate policies rather than the structural and financial issues, which are considered as sources of crisis in Asia (Crowe et. al., 2000). Access to global information also is an advantage for IMF as it publishes regularly documents on its multilateral activities, including World Economic Outlook and International Capital Markets. Also access to information related to bilateral surveillance is being made available to the public through the PIN. There is however perception that IMF's regional surveillance is not as effective as its bilateral or multilateral orientation.

3.5. BIS

BIS was created in 1930 as an institution owned and controlled by central banks. Its objective is to promote financial stability through international cooperation on sound bank supervision practices, developing standards relating to risk management, gathering and dissemination data and policy analysis.

BIS serves as an opportunity for forging international monetary and financial cooperation between countries. It provides central banks with a wide range of financial services for organizing its external reserves. It serves as a representative and trustee in the execution of international financial agreements. Lastly, it is a center for monetary and economic research that contributes to better understanding of international banking, national monetary policies and financial market developments. The Bank's Board of Directors has been drawn from eleven (11) countries comprising of the Group of Ten (G-10), with which BIS has a close association. Nine (9) additional central banks were admitted as shareholders. This includes China, Hong Kong, India, Korea, Singapore, Argentina, Chile, Malaysia and Thailand

BIS follows a particular framework for its analyzing information. Variables used by BIS to monitor banks correspond to the different types of risks identified as follows:

- Credit risk – pertains to the risk of default of a borrower. Credit risk concentration owing to large exposures to a single borrower or to a group of related borrowers.
- Country risk – preventing borrowers of a country from fulfilling their foreign obligations. A wide variety of factors, such as economic, social and political environment of the home country are used to analyze such risk.
- Market risk and Foreign exchange risk – risk of experiencing losses from the on-and-off balance-sheet positions arising from movements in market prices[6]. Risk pertaining to interest rate related instruments and equities in the trading book of the bank; and foreign exchange risk and commodities risk throughout the bank.
- Interest rate risk – exposure of a bank's financial condition to adverse movement in interest rates.

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[6] See BIS, Core Principles for Effective Banking Supervision (Basle Core Principles), available at http://www.bis.org/publ/bcbsc102.pdf (January 18, 2000)

- Liquidity risk – when a bank cannot obtain sufficient funds to meet demand, either by increasing liabilities or by converting assets promptly.
- Capital adequacy – pertains to risk weighted assets of a bank.

3.5.1. Economic Surveillance

The main contribution of BIS in fostering international monetary and financial cooperation towards financial stability is its role of analyzing and organizing regular meetings of central bank and other officials on key issue of financial policy. These meetings are organized under three different committees and fall into four categories namely:

- Regular consultations among central bank governors and senior officials on monetary issues and on matters affecting financial stability.
- Meetings of standing committees that formulate standards or recommend the best practices to promote financial stability.
- Meetings involving broader sets of national authorities and international institutions.
- Meetings centered on technical areas of central bank activities.

BIS works using the three pillars of the financial system. This includes financial institutions, financial markets and payment and settlements systems. Thus, three main committees were formed to deal with each namely:

- Basle Committee on Banking Supervision – forum for discussion on handling of specific supervisory problems and the enhancement of standards on supervision, especially with regard to solvency
- Committee on the Global Financial System – focuses on the systematic short-term monitoring of global financial conditions, longer-term analysis of the functioning of the financial markets, and the articulation of policy recommendations for the improvement of market functioning and promotion of stability.
- Committee on Payment and Settlement Systems – concerned with the promotion of robust payment and settlement systems, so as to strengthen financial market infrastructures and reduce systematic risk.

3.5.2. Transparency

BIS data collection started more than 30 years ago with the recognition of the possible monetary implications of the rapid growth of the euro-currency markets. Over the years new issues arose and the need for the reporting of semi-annual international banking data on a fully consolidated basis was established. At the same time the internationalization and growing scale of global financial market activity saw the need for increased statistical monitoring in the fields of both international banking and international securities financing. Also BIS is involved with monitoring activities in the derivatives market.

BIS publishes three different reports as part of its efforts to establish transparency in its reports. The following are the BIS publications:

- Annual Report – includes a discussion on the financial and banking trends of the world. It deals with economic developments in the advanced industrial countries, issues such as trade, labor and unemployment, wages and prices, as well as monetary policies of industrial countries, and recent developments in asset markets, foreign exchange markets and international financial markets.
- Quarterly Review (International Banking and Financial Market Developments) – reports the quarterly developments in international banking and financial markets, particularly the international securities markets and the derivatives markets.
- Consolidated International Banking Statistics – semi-annual consolidated statistics on the maturity, sectoral and nationality distribution of international bank lending

3.5.3. Policy Dialogue

BIS does not normally use its own financial resources to promote or finance particular courses of action by its members, unlike other financial institutions like IMF and World Bank but organizes and facilitates meetings, and produces research. It also supports the setting of standards, codes of best practices with the expectation that individual authorities from different countries will adopt.

The normal procedure for policy dialogue at BIS is as follows:

- Identification of salient issues by a BIS committee such as capital requirements, credit risk, market risk or cross-border banking etc.
- BIS seeks endorsement and commitment for major initiatives and projects from central bank governors (usually the G-10 countries).
- Central Bank Governors of the G-10 countries meet to discuss topical issues as well as receive various reports from the Standing committees.
- A second set of larger meetings, held on the same day as the G-10 meetings, involves the governors of all BIS shareholding central banks and covers monetary and financial policy issues.

- A third forum involving central bank governors of the principal industrial and emerging market economies discusses the more important issues such as current account and exchange rate adjustments.

The international cooperation at BIS rests on the principle of national (state) control. Activities of BIS serve as a venue to exchange information and analysis for crisis prevention. BIS only suggests and advocates policy changes or practices and does not impose conditionalities. Members of the various committees negotiate to find an agreement that is acceptable across countries as well as to public and private sector agents, and which can be implemented through national legislation or regulation. While the members of the committees that meet at BIS are mostly from the G-10 countries, non-G-10 countries often also accept agreements reached. Thus, the general Basle process adheres to the modality that decision-making is left in the hands of each country while international organizations are tasked with information dissemination.

3.5.4. Assessment of Surveillance mechanism and Policy Dialogue of BIS:

BIS is a Basle-based committee, which is more tightly knitted group composed mainly of the representatives of the G-10 countries. It is funded by central banks through purchase of shares. Based on its initiatives and objectives, BIS seems to have a comparative advantage in setting standards and codes for supervision of the banking system. However, the focus of its effort is geared mostly for developed markets. Unlike IMF, BIS lacks the necessary leverage to draw out policy changes from countries, as it has no enforcing capability. BIS relies more on market peer pressure and market pressure for policy changes. With regards to accessibility, most BIS data are available through its web site. Apart from its official sources, BIS gather more specialized data related to banking and capital flow from their members. However, on problem with BIS is its monitoring-type analysis wherein it is confidential to those participating in the meeting.

3.5.5. BIS initiatives on crisis prevention

The importance of BIS was enhanced during the Asian crisis since it highlighted the strong relationship between finance and the real economy. In both the resolution of the crisis and the discussions on the design of a new financial structure, BIS provided important inputs including taking the lead in policy analysis and the construction of standards for fostering financial stability.

The effects of the Asian financial crisis highlighted the need to understand the risk to financial stability better. There seems to be clear that reliance on self-regulation or on market discipline, while necessary, it is not sufficient. By way of responding to this need, there were efforts to discuss in meetings among central bank governors such issues as the containment of the risks facing the global economy and the necessary adjustments needed in the current account, exchange rate and bank restructuring. While BIS meetings have traditionally focused on events in the G-10 countries, an increasing number now focus on macroeconomic developments in emerging markets as well.

BIS makes an important contribution to international financial stability by ensuring that regulators particularly the central banks know each other well and have open lines of communication. Also, the central banks of the G-10 countries have committed to provide bridging loans through BIS to countries in financial difficulties, which are awaiting funds from IMF or World Bank making funds accessible.

The following are the initiatives of BIS with regards to crisis prevention:

3.5.5.1. Enhancing transparency, data collection and dissemination

BIS has taken steps to improve the timeliness, quality and coverage of BIS international consolidated banking statistics. The following were additions to the regular publications of BIS initiative to enhance transparency and improve the quality of data since the Committee on the Global Financial System has often stressed that transparency in data is very important in crisis prevention:

- Joint BIS-IMF-OECD-World Bank Statistics on External Debt – considered as the best international comparative data currently available on external debt.
- The Global OTC Derivatives Market – covers the global over-the-counter derivatives market.
- Central Bank survey of Foreign Exchange and Derivatives Market Activity – focuses on turnovers in traditional foreign exchange market instruments, as well as turnover, notional amounts outstanding and market values of derivative instruments.

3.5.5.2. Establishing standards and best practices

In addition to transparency, BIS has established standards and best practices by revising the Basle Capital Accord. The objectives of the revision are continued promotion of safety and soundness in the financial system wherein the objective is to provide a more comprehensive approach to addressing risks. With its establishment, BIS promotes the full implementation of the Basle Core Principles for Effective Banking Supervision, the BIS committee assesses the extent of current compliance with the principles among countries. This helps identify weaknesses in the existing system of supervision and regulation, and could form as a basis for remedial measures by government authorities and bank supervisors.

3.5.5.3. Establishment of regional and global arrangements

In July 1998, BIS organized the Representative Office for Asia and the Pacific in Hong Kong, China. The objective of the office is to further enhance information exchange and cooperation among central banks in the region, and between and central banks in the rest of the world.

The BIS also established the Financial Stability Institute (FSI) in February 1999 with the objective of strengthening the financial system worldwide through better and more independent supervision of banking and implementation of the Core Principles. In order to achieve such objective, the FSI will promote the interaction of supervisors from emerging markets and industrial countries during its seminars and training programs.

3.6. NAFTA

3.6.1. OBJECTIVES

NAFTA was established in January 1, 1994 “as a rules-based trade and investment regime under which economic openness and the mobility of trade and capital are to be maintained and activated at the trilateral level”.7 The participating countries are the US, Canada and Mexico. Specifically, Article 102 of the NAFTA Agreement elaborates on these objectives as follows:8

eliminate barriers to trade in, and facilitate the cross-border movement of, goods and services between the territories of the Parties;

promote conditions of fair competition in the free trade area;

increase substantially investment opportunities in the territories of the Parties;

provide adequate and effective protection and enforcement of intellectual property rights in each Party's territory;

create effective procedures for the implementation and application of this Agreement, for its joint administration and for the resolution of disputes; and

establish a framework for further trilateral, regional and multilateral cooperation to expand and enhance the benefits of this Agreement.

NAFTA was created in order to increase efficiency, welfare and productivity levels in the areas of commodities, services and capital investments. Information that is crucial to these three areas, as well as those concerning monetary and fiscal

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[7] Morales, Isidro. NAFTA and the Governance of Economic Openness: Assessing Trade Regimes as a Means for Deepening Economic Integration. http://info.pue.udlap.mx~imorales/naftamorales.html

[8] Lifted from The NAFTA Agreement.

policies are maintained by each government. Non-government institutions and private sector information centers also maintain database relevant to NAFTA applications.

3.6.2. ECONOMIC SURVEILLANCE AND POLICY DIALOGUE MECHANISMS

3.6.2.1. Economic Surveillance

The objective of information collection and processing of economic data is geared towards fulfilling the objectives of the free trade agreement. The NAFTA has over 30 Working Groups committees and other subsidiary bodies established to facilitate trade and investment.9 These committees deal with Agreement-related issued on trade in goods, rules of origin, customs, agricultural trade and subsidies, standards, government procurement, investment and services, cross-border movement of business people and alternative dispute resolution.10

The NAFTA Secretariat, composed of the Canadian, US and Mexican Sections, was created by the NAFTA pursuant to Article 2002 of the NAFTA Agreement. It maintains a trinational website on which updated information maybe accessed.

To enhance transparency, accountability and effectiveness of the NAFTA Working Groups and Committees, a comprehensive review of the achievements and priorities of the NAFTA work program was launched in 1998.11

3.6.2.2. Policy Dialogue

Political direction for the NAFTA work program is provided by ministers through the NAFTA Commission. NAFTA Deputy Prime Ministers of Trade meet twice annually to provide high-level oversight of the NAFTA Working Groups and Committees. Daily management of the NAFTA work program is carried out buy the NAFTA Coordinators – three (3) senior trade department officials designated per country.

Article 2001 established the Free Trade Commission which comprises of cabinet-level representatives of the Parties (US, Canada and Mexico) or their designees. The Commission, which convenes at least once a year, is primarily responsible for the implementation of the Agreement and for supervising the work of all the committees and working groups established under the Agreement. It may seek the advice of nongovernmental persons or groups, and establish its rules and

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[9] See Appendix for list of Nafta Working Groups

[10] Taken from the NAFTA Secretariat website. www.dfait-maeci.gc.ca/nafta-alena/nafta5_menu-en.asp.

[11] Taken from the NAFTA Secretariat website.

procedures. All decisions of the Commission are on a consensus basis, except as the Commission may otherwise agree.

As with any free trade body, the accomodation of divergent and/or contending interests is being done at a 2-level game of negotiation: first, via inter-state negotiations; and second, between national bureaucracies and local constituencies.12

The core of NAFTA's governance check and balance is achieved through the Atlernative Dispute Resolution Mechanism (ADRMs) which is provided for in the Agreement. ADRMs function more as facilitators of government-to-government negotiations in dealing with conflicts stemming from most of the issues surrounding economic integration.

One of the ways by which transparency (at least on the internal level) in the arena of policy dialogue is maintained is via Article 1802 of Chapter Eighteen of the Agreement, which states that "each party shall ensure that…any matter covered by this Agreement shall be promptly published or otherwise made available in such a manner as to enable interested persons and parties to become acquainted with them."13 Article 1803 also provides that each Party promptly provide information and respond to questions of another Party.

3.6.2.3. List of NAFTA Working Groups and Committees14

- Committee on Trade in Goods
- Committee on Trade in Worn Clothing
- Working Group on Rules of Origin
- Customs Subgroup
- Committee on Agricultural Trade
- Working Group on Agricultural Grading and marketing Standards
- Working Group on Agricultural Subsidies
- Advisory Committee on Private internation Disputes regarding Agricultural Goods
- Committee on Sanitary and Phytopsanitary Measures

[12] Morales

[13] Taken from Chapter 18 of the NAFTA Agreement

[14] Taken from the NAFTA Secretariat website.

- Working Group on Emergency Action
- Committee on Standards Related Measures
- Land Transportation Standards Subcommittee and its various working groups
- Telecommunications Standards Subcommittee
- Automotive Standards Council
- Subcommittee on Labeling of Textile and Apparel Goods
- Working Group on Government Procurement and Small Business
- Investment and Services Working Group
- Financial Services Committee
- Working Group on Trade and Competition
- Temporary Entry Working Group
- Chapter Nineteen Operation Working Group
- Advisory Committee on Private Commercial Disputes

4. Summary and Recommendations

1. **Democratic accountability** is typically exercised in two ways: reporting and transparency. E.g. ECB:
   - **Reporting:** annual report sent to the Parliament, the Council, and the Commission. The report is debated by the Parliament. The Parliament may request that the ECB (President, Executive Board members) testify to the Parliament's Economic and Monetary Affairs Committee. The President of the EU Council and a member of the Commission may participate in the meetings of the Governing Council without voting rights.
   - **Transparency:** The President holds a press conference immediately after the monthly policy-setting meeting to present its decisions in highly standardized terms. Publications, including the Annual Report, are available for the public e.g. via the internet. However, the Eurosystem is less transparent than many other major central banks. For example, it does not publish individual votes, because they could be interpreted in a nationalistic manner.
2. Fluent, **open dialogue** helps countries: to recognize weaknesses, problems, and challenges; to evaluate solutions and make steps together, which they would not do alone.

3. The EU through its historical development, guided by this kind of dialogue, recognized that the goals targeted in the Treaty of Rome at the establishment of the EU, such as harmonious development of economic activities, continuous and balanced expansion, increased stability, accelerated rising of the living standard, cannot be reached only by forming a custom union, securing free movement of goods, services, and factors of production, and creating a monetary union. **Regional differences, unemployment problems, health (SARS, BSE etc.) and environmental issues** etc. have to be addressed not only at national but also at community level.
4. Economic surveillance and policy dialogue is not only an economic and financial issue but also very much a **legislative issue**.
5. Membership does not necessarily mean that the country will fall under all the legislations. Even in a regional integration countries can opt to **stay out from given agreements** (e.g. EMU: UK, Denmark, and Sweden). However, they might be required to provide the same information what the countries in the agreement provide to maintain the transparency of the region, but they cannot be sanctioned if they do not follow the directives of the agreement.
6. Policy making and competencies can be categorized into three different areas:
   - Where the community institution(s) has exclusive competence.
   - Where the competence is shared among community institution(s) and national, sub-national institutions.
   - Where the community institution(s) has no competence and decisions are made at national or sub-national level.
7. During the allocation of competences the **subsidiarity principle** should be followed. It means that the decisions should be made at the lowest possible level and decisions shall be allocated to community institution(s) only if there is a good reason to do so.
8. **Monetary and Fiscal issues** have to be addressed separately
   - **Monetary decisions** have to be made by an independent institution (a central bank), which have to enjoy considerable independence, both in defining its objectives and in deciding how to conduct monetary policy. Major target of the central bank is price stability, since floating exchange rate is necessary for the regional currency (impossible trinity).
   - It is important, to set a constraint on the **fiscal policies** to secure that national government will not undermine the economic stability of the integration.

9. Intra-regional trade and investment can be hampered by exchange rate fluctuation. As East Asia marches towards greater economic integration, it must accept the necessity of establishing a zone of fixed exchange rates in the region.
10. The number and type of institutions who provide information for the system can be large. It is important to **involve universities and research institutions** via research projects not only for new ideas, but to educate people who will be familiar with the operation of the system and can enter the system as experts.
11. A consensus among the ASEAN+3 must be arrived at as to what type of indicators point to a financial crisis and to the minimum information or substance to be included in the country reports, so as to make the surveillance process effective.
12. To make the ASP+3 more effective in preventing a future crisis, supplement the current ASP+3 in 2 areas: Cross-regional surveillance – direct interaction between countries from various regions; and Non-government surveillance – carried out by think tanks and institutions independent of government.
13. Surveillance carries no assurance of action. Early warning may not always be helpful because political pressure prevents warning to be noticed. There are some cases when IMF has advocated an adjustment of exchange rates but the policy advice was ignored because of the perceived importance of maintaining a peg.
14. The model underlying the surveillance mechanism was not fully relevant. IMF was criticized during the Asian crisis that its surveillance mechanism did not focus on the problems of the financial sector but on macroeconomic policies. It also paid little attention to issues such as volatility of capital inflows, consequences of financial liberalization, and other capital account issues. Thus it was said that IMF surveillance did not provide importance to structural issues such supervision, regulation and corporate governance. The Asian crisis showed the importance of including structural issues and capital account indicators in examining and determining crisis. IMF has made steps to broaden its surveillance to cover all the policies that affect trade, capital movements, external adjustment and the effective functioning of the financial system. Areas include structural policies, financial sector regulations, and other issues such as environment. IMF has started collecting more information on the structure of external debt, the availability of reserves and the contingent liabilities of governments as part of its model on reserves.
15. IMF traditionally does surveillance at two levels, bilateral and multilateral. IMF has been known to concentrate more on the macroeconomic development

which most of the time would tend to overlook regional link or channels for transmission of disturbances. Due to the effects of globalization, insufficient focus on the regional effects tends to diminish the effectiveness of IMF's macroeconomic surveillance. On the other hand, multilateral surveillance can be too wide and could easily miss regional dynamics. The disparity in the form of a lack of a regional perspective is very closely tied up with the phenomenon of contagion, which tends to have strong regional characteristics. Because of contagion and the immediate rise of crisis, there is a need to have a regional or sub regional surveillance and monitoring system as a complement to domestic (bilateral) surveillance by IMF.

16. A number of initiatives have arisen after the Asian crisis from different organizations as to the possible early warning system that can be used. There has been consensus that monitoring mechanisms be focused on (a) financial sector and the capital account and; (b) emphasis on best practices in disclosure, particularly with regards to transparency and the use of standards and codes.

17. Surveillance can fail because countries do not disclose adequate information. This was the experience of IMF before the Asian crisis where member countries do not divulge information in a timely manner unless a country is asking for financial assistance. Transparency is defined as the process by which information about existing conditions, decisions and actions is made accessible, visible and understandable to all stakeholders. It is recognized that transparency is critical in the functioning of markets as well as in instilling discipline in the economy. In the perspective of the Asian crisis, improved transparency might have helped prevent the build-up of financial and economic mismatches, and speedy solution to the problem could have been made.

18. A high level of transparency is proposed to limit the problems of international asymmetries as can be seen in the lack of transparency that prevented the markets from discriminating the increasing vulnerability of the system. If there are high levels of transparency in market, then points of vulnerability can be raised earlier before considerable corrections can occur. Also the availability of good quality data can easily help facilitate the monitoring process. The use of SDDS and GDDS by IMF is one step towards achieving high level of transparency. Although it does not avert an economic and financial crisis, it enhances the transparency of data dissemination to the public and to various authorities, which can make surveillance and assessment easier for the government or monitoring bodies.

19. Establish more informal exchanges in a regional or sub regional level. The exchange of information with other countries can promote more flexible

economic and financial systems in the region by advocating improvements in the capacity of national authorities to formulate sound policies. Regional of sub regional informal exchanges can provide a good venue for comprehensive discussion on the selection of indicators, data collection methods and issues so that countries can acquire a feel for how to develop their early warning indicators better, taking into consideration their own situation as well as being alert to the international or regional scale.

20. Post 1997 saw the increasing importance of regional trading arrangements (RTAs), both in number and degrees of integration, against the backdrop of globalization. Among inter-country unions and trading arrangements, efforts are underway to explore the possibilities of achieving what the EU has reached in terms of level of economic integration. While NAFTA's objectives are centralized to trade in goods, services and investments, and while it has no mechanism to support the existence of supra-national institutions that would harmonize legislation and national policies in the 3 member countries beyond the trade realm, its principle of "subsidiarity" in "keeping governance as local as possible", while maintaining necessary surveillance at the trilateral level, could suggest a corollary framework for the ASEAN+3 to explore.

21. Whereas the economic integration of NAFTA is not as deep as that of the EU, ASEAN+3 should work towards the formation of a multilateral economic structure (with enforcement capabilities) to help the member countries achieve regional integration level at least within a NAFTA-level minimum, and to further economic cooperation and macroeconomic synchronization to achieve a NAFTA-plus degree of integration. This means pursuing regional economic goals alongside the achievement of "common prosperity and peace on the basis of mutual trust among all the countries in East Asia".

22. Economic surveillance mechanisms should not be limited to country trade and investment policies, but include as well macroeconomic agenda, financial, long term industry and development policies organized at the Secretariat level. This will enable intensive policy dialogues and area-wide (sector-specific) policy actions from and within the ASEAN+3 ministerial level, to benefit lower-income member countries, hasten the convergence of income levels among East Asian economies and progress towards a monetary union, and eventually, with the necessary economic impetus, political will and regional discipline, towards an EU-level of regional economic integration.

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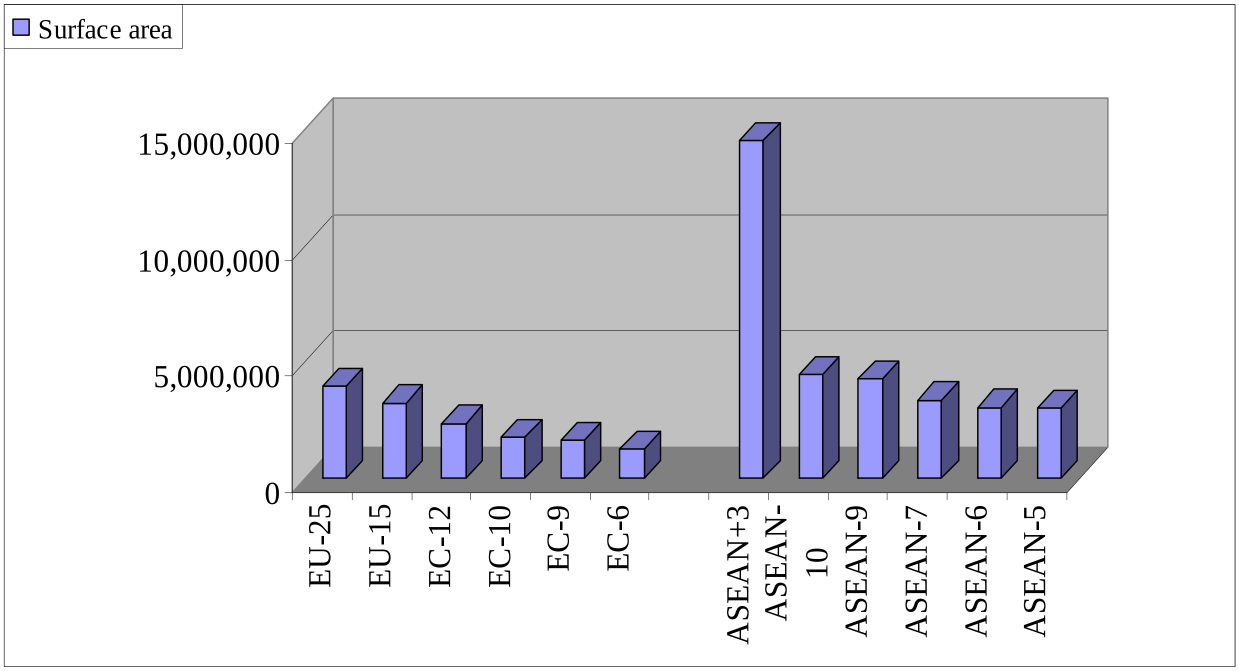
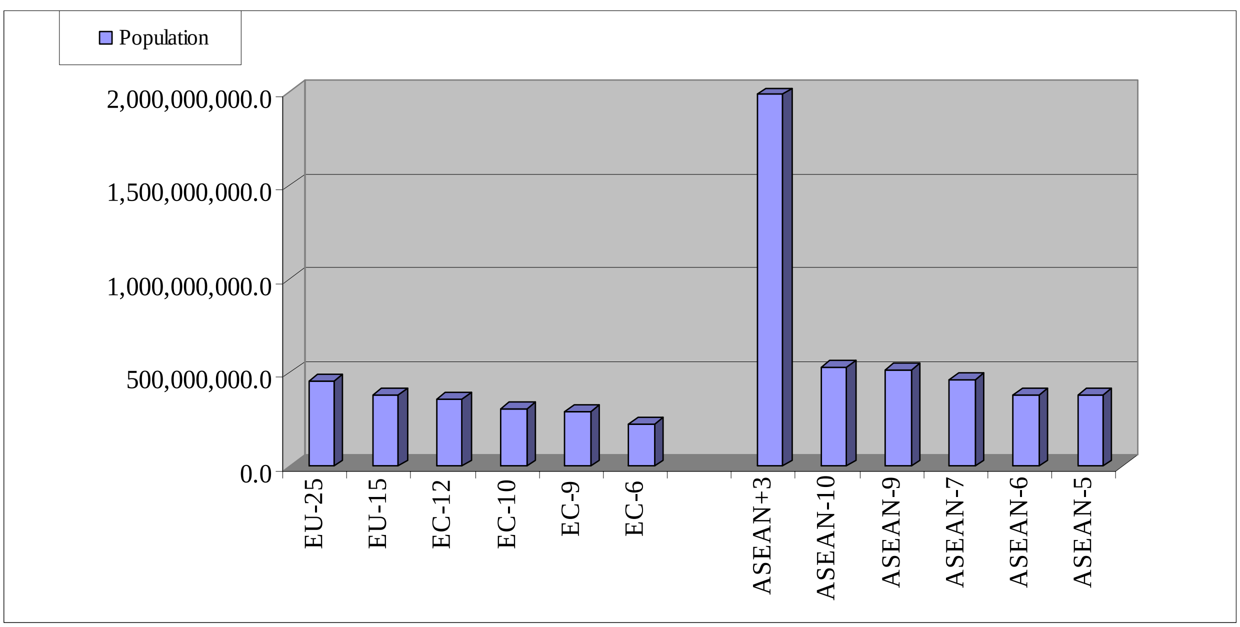
6. APPENDIX

Appendix 1 ASEAN+3 and EU Surface Area Comparison Chart, 2002



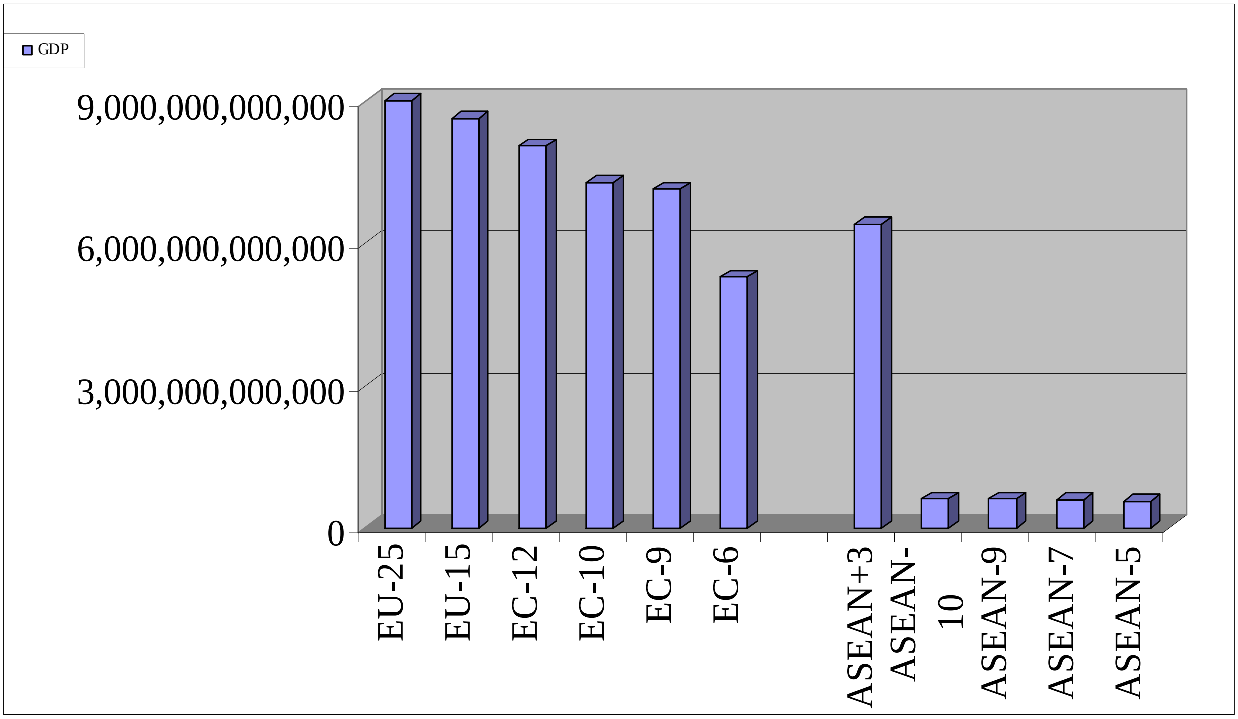
Source: OECD Country Statistics, 2002

Appendix 2 ASEAN+3 and EU Population Comparison Chart, 2002



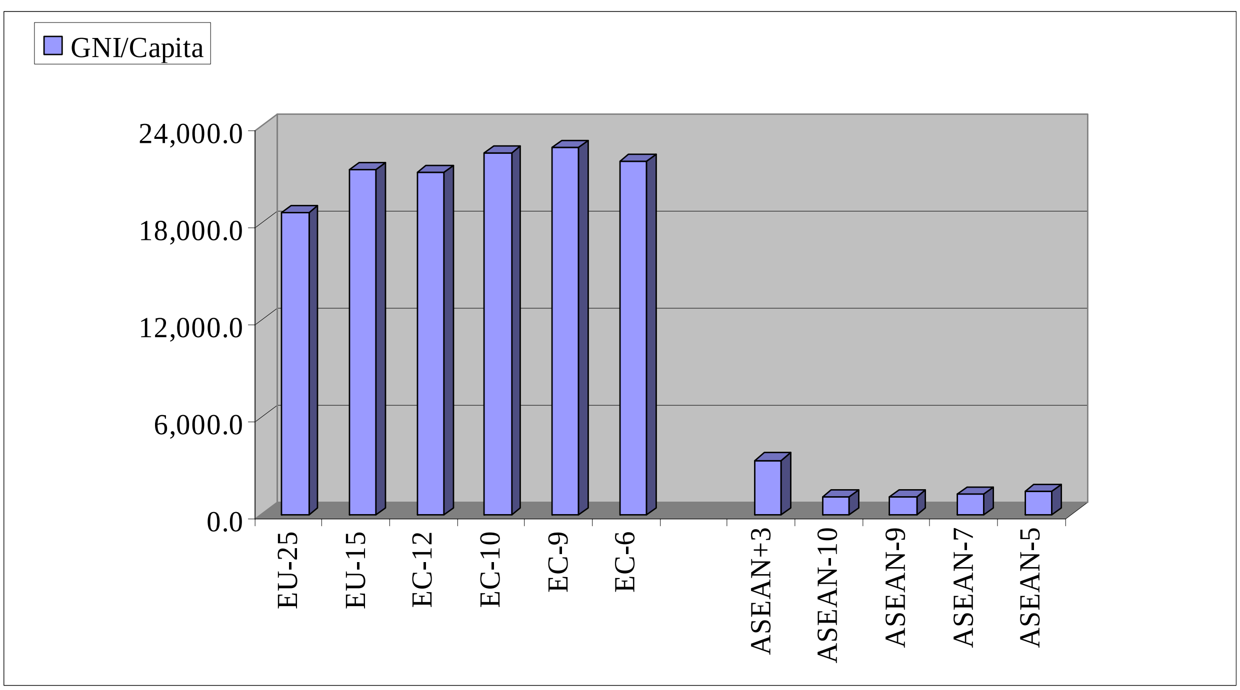
Source: OECD Country Statistics, 2002

Appendix 3 ASEAN+3 and EU GDP Comparison Chart, 2002



Source: OECD Country Statistics, 2002

Appendix 4 ASEAN+3 and EU GNI/Capita Comparison Chart, 2002



Source: OECD Country Statistics, 2002

Appendix 5 List of Key Indicators and the Source of Indicators Used for Economic Surveillance by the European Commission

Key indicators for the euro area

The euro area includes 12 countries (BE, DE, EL, ES, FR, IE, IT, LU, NL, AT, PT, FI)

mom % ch., qoq % ch., yoy % ch.: monthly, quarterly and annual percentage change respectively.

No.	Indicator	Note	Source
1	**Output**		
1.1	Industrial confidence indicator	Industry survey, average of balances to replies on production expectations, order books, and stocks (the latter with inverted sign)	ECFIN
1.2	Industrial production	Volume, excluding construction, working day adjusted	Eurostat
1.3	Gross domestic product	Volume (1995), seasonally adjusted	Eurostat
1.3.1	Gross domestic product & divergence	From 1992 until 1996 the minimum and maximum is based on BE, DE, ES, FR, IT, NL, PT and FI; from 1996 it includes also AT	Eurostat
1.3.2	Gross domestic product and forecast range	Volume (1995), seasonally adjusted; the forecast is based on confidence indicators, real and financial variables (see also ECFIN Economic Papers No 154.	ECFIN / Eurostat
1.3.3	Gross domestic product and standard deviation	From 1992 until 1996 the standard deviation is based on BE, DE, ES, FR, IT, NL, PT and FI; from 1996 it includes also AT	ECFIN / Consensus Forecasts
1.4	Economic sentiment indicator	Composite of indicators for industry, construction, retail trade and consumers (1995 =100)	ECFIN
2	**Private consumption**		
2.1	Consumer confidence indicator	Consumer survey, average of balances to replies to four questions (financial and economic situation, unemployment, savings over next 12 months)	ECFIN
2.2	Retail sales	Volume, excluding motor vehicles, working day adjusted	Eurostat
2.3	Private consumption	Volume (1995 prices), seasonally adjusted	Eurostat
3	**Investment**		
3.1	Capacity utilization	In percent of full capacity, manufacturing, seasonally adjusted, survey data (collected each January, April, July and October).	ECFIN
3.2	Gross fixed capital formation	Volume (1995 prices), seasonally adjusted	Eurostat
3.3	Change in stocks	In percent of GDP, volume (1995 prices), seasonally adjusted	Eurostat
4	**Labour market**		
4.1	Unemployment	In percent of total workforce, ILO definition, seasonally adjusted	Eurostat
4.2	Employment	Number of employees, partially estimated, seasonally adjusted	ECB / Eurostat
4.3	Shortage of labour	Percent of firms in the manufacturing sector reporting a shortage of labour (unfilled job openings) as a constraint to production, seasonally adjusted	ECFIN
4.3.1	Beveridge curve	Relationship between the unemployment rate and shortage of labour as defined in 4.3	ECFIN / Eurostat
4.4	Wages	Not a fully harmonised concept, but representative for each Member State (mostly hourly earnings)	ECFIN
4.4.1	Labour productivity	Difference between GDP growth and employment growth	ECFIN
4.4.2	Hourly earnings industry	Nominal values, seasonally adjusted	Eurostat
5	**International transactions**		
5.1	Export order books	Industry survey; balance of positive and negative replies, seasonally adjusted	ECFIN
5.2	World trade	Volume, 1998=100, seasonally adjusted	CPB**
5.3	Exports of goods	Bn. EUR, excluding intra euro area trade, fob, seasonally and working day adjusted	Eurostat
5.4	Imports of goods	Bn. EUR, excluding intra euro area trade, cif, seasonally and working day adjusted	Eurostat
5.4.1	Intra trade	Bn. EUR, intra euro area trade, seasonally and working day adjusted	Eurostat
5.5	Trade balance	Bn. EUR, excluding intra euro area trade, fob-cif, seasonally and working day adjusted	Eurostat
5.6	Exports of goods and services	Volume (1995 prices), including intra euro area trade, seasonally adjusted	Eurostat
5.7	Imports of goods and services	Volume (1995 prices), including intra euro area trade, seasonally adjusted	Eurostat
5.8	Current account balance	Bn. EUR, excluding intra euro area transactions; before 1997 partly estimated	ECB
5.9	Direct investment (net)	Bn. EUR, excluding intra euro area transactions	ECB
5.10	Portfolio investment (net)	Bn. EUR, excluding intra euro area transactions	ECB

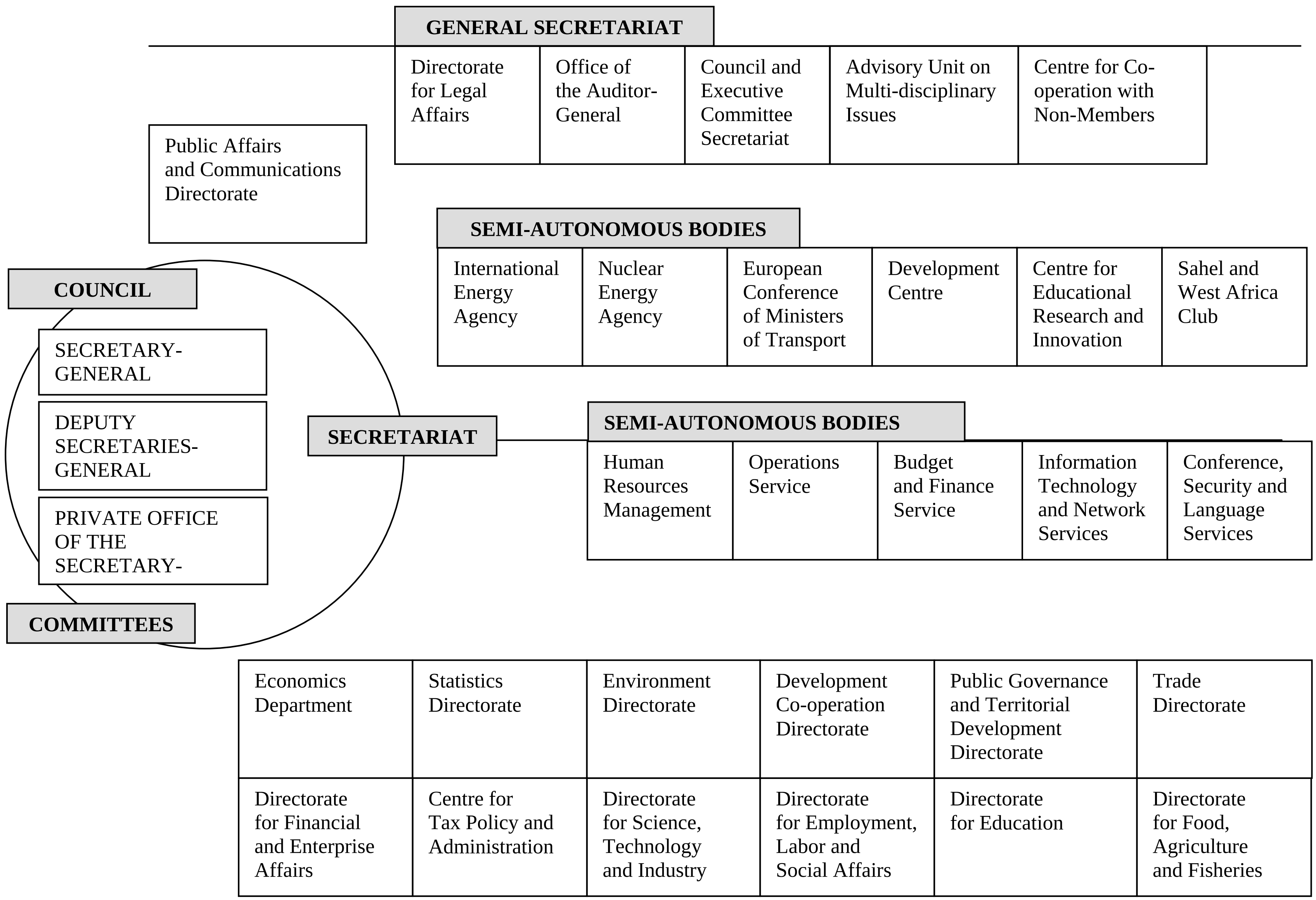
Key indicators for the euro area			
No.	**Indicator**	**Note**	**Source**
6	**Prices**		
6.1	HICP	Harmonised index of consumer prices, national CPI until 1996	Eurostat
6.2	Core HICP	Harmonised index of consumer prices, excluding energy and unprocessed food	Eurostat
6.3	Producer prices	Without construction	Eurostat
6.3.1	Selling price expectation	Industry survey; balance of positive and negative replies, seasonally adjusted	ECFIN
6.4	Import prices	Import unit values index for goods, 2000=100	Eurostat
6.4.1	Oil prices	Brent light; USD/barrel and EUR/barre	Datastream
6.4.2	Non-fuel commodities prices	Index of market prices for non-fuel commodities, 1995=100, in USD terms	IMF
7	**Monetary and financial indicators**		
7.1	Interest rate	Percent p.a., 3-month interbank money market rate, period averages	Datastream
7.1.2	Real short-term interest rates	3-month interbank money market rate (period averages) minus annual percentage change of HICP (CPI before 1996)	Datastream/Eurostat
7.2	ECB repo rate	Percent p.a., minimum bid rate of the ECB, end of period	Datastream
7.3	Bond yield	Percent p.a., 10-year government bond yields (before 1995 long-term bond yield available) lowest level prevailing in the euro area, period averages	Datastream
7.3.1	Real long-term interest rates	10-year government bond yields (lowest level prevailing in the euro area, period averages) minus annual percentage change of HICP (CPI before 1996)	Datastream / Eurostat
7.4	Stock markets	DJ Euro STOXX50 index, period averages	Datastream
7.5	M3	Seasonally adjusted, three-month moving average (attributed to middle month): from 1997 onwards corrected for holdings by non-residents	ECB
7.6	Credit to private sector (loans)	MFI loans to euro area residents excluding MFIs and general government, monthly values: month end values, annual values: annual averages	ECB
7.7	Exchange rate USD/EUR	Period averages, until December 1998: USD/ECU rates	ECB
7.7.1	Exchange rate JPY/EUR	Period averages, until December 1998: JPY/ECU rates	ECB
7.8	Nominal effective exchange rate	Against 13 other industrialized countries, double export weighted, 1995 = 100, increase (decrease): appreciation (depreciation)	ECFIN
8	**Public finance**		
8.1	General government balance	In percent of GDP, net lending (+) or net borrowing (-) general government, ESA 79 up to 1994, ESA 95 as of 1995, 2004 estimates are based on ECFIN Autumn	ECFIN
8.2	Primary balance	In percent of GDP; net lending/borrowing minus interest payment; ESA 79 up to 1994, ESA 95 as of 1995; incl. 2000 and 2001 one-off proceeds relative to UMTS licences, 2004 results are based on ECFIN Autumn 2004 forecasts	ECFIN
8.3	Cyclically adjusted primary balance	In percent of GDP; primary balance corrected for the influence of the cycle; ESA 79 up to 1994, ESA 95 as of 1995, proceeds from UMTS licences excluded, 2003 results are based on ECFIN Autumn 2004 forecasts	ECFIN
8.4	General government expenditure and receipts	In percent of GDP, ESA 79 up to 1994, ESA 95 as of 1995; proceeds from UMTS licences booked as expenditure with negative sign; tax burden: taxes on production and imports (incl. taxed paid to EU) + current taxes on income and wealth + actual social contri	ECFIN
8.5	Cyclically adjusted balance	In percent of GDP, general government balance corrected for the influence of the cycle; ESA 79 up to 1994, ESA 95 as of 1995, proceeds from UMTS licences excluded, 2004 results are based on ECFIN Autumn 2004 forecasts	ECFIN
8.6	General government debt	In percent of GDP, ESA 79 up to 1994, ESA 95 from 1995 ownwards, 2004 results are based on ECFIN Autumn 2004 forecasts	ECFIN

***** ECFIN Autumn 2004 forecasts

****** For further information see: http://www.cpb.nl/eng/general/org/program/ic/trademonitor.html

Source: European Commission, 2005

Appendix 6 OECD Organization Chart



Appendix 7 Economic Surveillance and Policy Dialogue Matrix

	IMF	BIS	NAFTA
Objective	The IMF has authority under Article IV of its Articles of Agreement to exercise surveillance over the exchange rate polices of its members to ensure the effective operation of the international monetary system. The objective of surveillance is to help member countries achieve financial stability and sustainable economic growth.	BIS was created in 1930 as an institution owned and controlled by central banks. Its objective is to promote financial stability through international cooperation on sound bank supervision practices, developing standards relating to risk management, gathering and dissemination data and policy analysis.	To establish the foundations of a free mobility area in the trade of commodities, services and financial flows in order to increase efficiency, productivity and welfare in the economies of the participating countries: United States, Canada and Mexico
Information	Areas of concern: • Policy advice • Policy coordination and cooperation • Information gathering and dissemination • Technical assistance and aid • Identification of vulnerabilities	Areas of concern: • Credit risk • Country risk • Market risk and foreign exchange risk • Interest rate risk • Liquidity risk • Capital adequacy	Areas of Concern: • Trade and barriers to trade in goods and services • Capital movements • Protection and enforcement of intellectual property rights • Resolution of disputes • Further trilateral, regional and multilateral cooperation
Economic Surveillance			
Information Collection	BI- (B) & MULTILATERAL (M): Country level; required to submit information to IMF, REGIONAL (R): regional level specifically for European Union	Country level; countries (usually through its central banks) submit information to BIS.	Country-level economic information is submitted to respective committees at the trilateral level. NAFTA Secretariat maintains a tri-national website on which updated information maybe accessed.
Institutions	B: IMF Mission Team holds meeting with both government and private sector. M: countries submit information among others related to economic, financial and foreign exchange markets and external payments, financing and debt. R: policy discussions with EU institutions responsible for common policies in the euro area, including the ECB.	BIS asks central banks to submit information related to banking sector information.	NAFTA Secretariat with US, Canadian and Mexican sections

Mechanism	B: uses three part procedure M: analysis of recent world developments, projections of future development, identification of risks of instability in the international economic system and the proposing of the ensuing policy recommendations. R: focused on the common monetary policy, exchange rate implications and the fiscal position of the euro area as a whole.	BIS works using the three pillars of the financial system namely financial institutions, financial markets and payment and settlements systems.	NAFTA has over 30 working groups and committees and other subsidiary bodies that facilitates: • Trade in goods covered in the Agreement, • Rules of origin, • Customs, • Agricultural trade and subsidies • Standards • Government procurement • Investment and services • Cross-border movement of business people • Alternative dispute resolution
Transparency	Transparency in the release of reports under Article IV	Transparency in reports such as the Annual report, Quarterly review and Consolidated International Banking Statistics among others.	Comprehensive Review of the achievements and priorities of the NAFTA work program was launched in 1998
Policy Dialogue			
Information Evaluation	B & M: country level; required to submit information to IMF, R: regional level specifically for European Union	Done at the country level; countries (usually through its central banks) submit information to BIS.	
Institutions	B: IMF Mission Team holds meeting with both government and private sector. M: countries submit information among others related to economic, financial and foreign exchange markets and external payments, financing and debt. R: policy discussions with EU institutions responsible for common policies in the euro area, including the ECB.	BIS holds regular meetings and consultations among central bank governors with both government and private sector and senior officials.	• NAFTA Commission • NAFTA Deputy Prime Ministers of Trade meet twice annually • Daily management of NAFTA Work Program

Mechanism	B: uses three part procedure M: analysis of recent world developments, projections of future development, identification of risks of instability in the international economic system and the proposing of the ensuing policy recommendations. R: focused on the common monetary policy, exchange rate implications and the fiscal position of the euro area as a whole.	i) Identification of salient issues by a BIS committee ii) BIS seeks endorsement and commitment for major initiatives and projects from central bank governors (usually the G-10 countries). iii) Central Bank Governors of the G-10 countries meet to discuss topical issues as well as receive various reports from the Standing committees. iv) A second set of larger meetings, held on the same day as the G-10 meetings, involves the governors of all BIS shareholding central banks and covers monetary and financial policy issues. v) A third forum involving central bank governors of the principal industrial and emerging market economies discusses the more important issues such as current account and exchange rate adjustments.	
Transparency	B: Transparency in the release of reports under Article IV M: World Economic Outlook reviews by the Executive Board	i) Joint BIS-IMF-OECD-World Bank Statistics on External Debt ii) The Global OTC Derivatives Market iii) Central Bank survey of Foreign Exchange and Derivatives Market Activity	Article 1802 of the Agreement requires that Parties supply information and all matters covered be promptly published.
Decision Making			Free Trade Commission comprises of cabinet-level representatives (which convenes at least once a year) supervises the work of all working groups and committees.
Implementation			• Free Trade Commission • Alternative Dispute Resolution Mechanisms (ADRMs)