A Roadmap for Policy Dialogue and Economic Surveillance in East Asia

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Abstract
This paper deals with the forward-looking framework of policy dialogue and economic surveillance in East Asia, based on analysis of the necessities, constraints and difficulties, together with criteria for effective surveillance. It proposes a roadmap for strengthening the mechanism for surveillance in East Asia, with the emphases on defining different phases, designing possible approaches and identifying the key elements for better surveillance in the region. The study suggests that there should be three phases for forming strong institutionalized regional surveillance. It also discusses possible moves in the second phase with focus on the importance of specifying surveillance coverage and improving statistical infrastructure. The paper points out that the success of establishing a firmly institutionalized surveillance mechanism in East Asia, to a large extent, relies on a common understanding among the countries in the region on the following issues: the necessity of a common monetary regime, the vital importance of statistical infrastructure and the essential elements of political consideration.

Key words: economic surveillance policy dialogue East Asia

I. Introduction

On 4th May, 2005, the Association of Southeast Asian Nations, China, Japan and Korea (ASEAN+3) decided to take a significant step toward financial cooperation in East Asia. The Finance Ministers of the 13 ASEAN+3 countries agreed to strengthen the Chiang Mai Initiative (CMI) into a more effective and disciplined framework by: (1) integrating the CMI with an enhanced economic surveillance process for the ASEAN+3 countries; (2) adopting a collective activation and decision making process on the current network of bilateral

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swap arrangements within ASEAN+3; (3) increasing the size of the available swaps by up to 100 percent, from US$1 billion to US$2 billion; and (4) doubling the size of the swaps that could be withdrawn, without them coming under an International Monetary Fund (IMF) program from 10 percent to 20 percent (ADB, 2005). This new agreement is regarded as a firm step to strengthen the current CMI into a regional monetary fund in the medium and long term.

However, one of the key follow-up issues is how to enhance policy dialogue and economic surveillance among ASEAN+3 countries under the CMI. The existing policy dialogue and economic surveillance mechanisms in the East Asia can be roughly divided into three groups: (1) global multilateral institutions, such as the IMF, Organization of Economic Cooperation and Development (OECD), the World Bank and Bank of International Settlement (BIS); (2) trans-regional forums, such as Asia-Pacific Economic Cooperation (APEC), South East Asia, New Zealand, Australia (SEANZA), Executives Meeting of East Asia-Pacific Central Banks and Monetary Authorities (EMEAP), Asia-Europe Meeting (ASEM) and Asian Development Bank (ADB); (3) regional mechanisms, such as ASEAN and ASEAN Plus Three Economic Review and Policy Dialogue Process (ASEAN+3 ERPD). Each arrangement has its own objectives and approaches. It appears that this multi-layered feature provides a broad and flexible platform for East Asian countries to exchange information and carry out policy dialogues. However, many of them are actually overlapping and so far none of them are sufficiently effective in conducting surveillance in East Asia. Therefore it becomes an urgent task for ASEAN+3 countries to work together and develop a more effective surveillance mechanism themselves.

In this paper, the necessities, constraints and difficulties for a strong surveillance mechanism are discussed. A roadmap for strengthening surveillance in East Asia is proposed, followed by our concluding remarks on the necessity of a common monetary regime for successful surveillance.

The implications of this study are twofold. On the one hand, China has been actively involved in the process of strengthening East Asia’s financial cooperation since the successful launch of the CMI. China needs a strong regional economic surveillance mechanism, being aware of that the potential risk of fully opening its domestic financial market in the medium- and long-term can best be dealt with through regional monetary architecture, where policy dialogue and economic surveillance constitutes a key component. On the other hand, in the context of increasing trade and financial integration between China and the other economies of the region, and given that China has the potential to become a huge market in the region, China, as one of the “Plus Three”, will play an important role in the whole process of building up a strong economic surveillance mechanism in East Asia. Strategic thinking is crucial for China’s successful involvement in regional financial
cooperation. In this regard, the roadmap proposed in this paper can provide a reference for China’s policy-makers.

II. Necessities, Constraints and Difficulties for Regional Surveillance in East Asia

The rationale for strengthening policy dialogue and economic surveillance in East Asia has been widely discussed among scholars (Ito, 2002; Kaiwai, 2004; Kuroda, et al., 2002). However, there are constraints on conditions for effective surveillance in the region. Suspicion over the necessities also arises from the fact that the existing global multilateral surveillance mechanisms, such as the IMF, are still functioning well.

1. Necessities

There are a number of viewpoints on a rationale for regional policy dialogue and economic surveillance. According to Wang (2002) and Wang and Woo (2003):

(1) It is commonly recognized that financial instability cannot remain within the national borders of the country of origin, and the spillover effects in the region are insidious. Therefore, there is an increasing need for the countries in East Asia to be involved with regional surveillance.

(2) In the prevention of crisis, various forms of policy dialogue among neighboring countries play different roles. For instance, information exchange can help detect and identify the characteristics of a looming crisis at an early stage, so that proper remedial actions can be taken in a timely manner. A joint exercise based on a region-wide early warning system can facilitate close examination of financial vulnerabilities.

(3) Regional policy dialogue can help to ensure effective implementation of collective policy targets, through peer pressure, and to improve accounting and auditing standards, disclosure requirements, corporate governance and efficiency of credible rating agencies.

(4) Economic surveillance is a warranty for creditworthiness of borrowers. At the same time, regular surveillance would enable quick disbursements in times of crises.

All the above general necessities can be applied to East Asia. Moreover, the financial crisis of 1997-1998 provided a catalyst for the strengthening of regional financial architecture, where policy dialogue and economic surveillance constitute key components. However, one of the tough issues in regard to the need for a stronger form of policy dialogue and economic surveillance is the relationship between the existing global multilateral process and the regional process. From the most provocative point of view, why do we need a regional initiative given the fact that global multilateral processes, such as the IMF, are still
functioning? The answer might rely on a close look at the relationship between the regional process and the IMF and whether they complement or duplicate each other.

2. Relationship with the IMF

Apart from the fact that the IMF carries out an annual review and scrutiny of member economies via Article IV consultations, as well as less frequent assessments of financial sector vulnerability in member countries through the Financial Sector Assessment Program (FSAP), it also regularly examines economic developments and policies pursued under regional arrangements such as the Euro Area and the West African Economic and Monetary Union, providing policy consultations for these regional arrangements. IMF conducts regular discussions with Euro Area, West African Economic and Monetary Union, the Central African Economic and Monetary Community and the Eastern Caribbean Currency Union and Baltic States. The staff report includes detailed discussion of cyclical growth outlook and risks, inflation and monetary policies, fiscal policies, structure polices, trade policy and statistical issues. In Asia, IMF has been invited to offer economic briefings for the ASEAN+3 finance ministers’ meetings and to prepare the background papers for the APEC forum.

The ASEAN+3 work program cuts across some of the core functions of the IMF, especially with respect to developing its own regional policy dialogue and economic surveillance. Given the regionalist motivations of ASEAN+3 and its aspirations for an effective regional architecture, the IMF is unlikely to be the central agency for surveillance in the ASEAN+3 process. This comes to the point that one can ask: do the regional process and the IMF surveillance process complement or duplicate each other?

In general, the IMF is likely to be seen as an outsider to the region. This limits the degree to which the region will want to involve it in regional institutions (de Brouwer, 2004). On the other hand, however, some others believe that being an outsider, the IMF has its own advantage in regional surveillance. For example, “proponents of regional dialogue argue that a regional mechanism boosts country ownership of policy and enables local institutional knowledge to be brought to the analysis and solutions of domestic economic and financial problems. But being local may also make it difficult to be completely frank about the problems a country is facing or to say no when it is right to say no. It can be useful to pass this pressure on to outsiders. Having outsiders with global experience involved in regional debate is also useful because it brings a wider set of insights to bear on problems” (de Brouwer, 2004). Ideally, the regional process should be complementary to the global one.

3. Constraints

More specifically, the regional surveillance process in East Asia has its constraints in regard to a set of conditions for effective surveillance.
Firstly, the certain amounts involved in the Bilateral Swap Agreements (BSAs) and the linkage of their activation to the IMF can be explained by the fact that the IMF maintains a crucial capacity that ASEAN+3 lacks: a credible mechanism for the surveillance of member countries.

Secondly, the IMF has mixed guidelines for policy dialogue and surveillance, being composed of more specific, rule-based and legalistic guidelines, as well as more general ones, like the Article IV process, which covers broader trends, development and issues. It is apparent that East Asia has no such clarified guidelines in its internal surveillance process.

Thirdly, one of the key ingredients of effective surveillance is a well-defined set of objectives for a regional mechanism. If common policy objectives were more clearly spelled out, an informal exchange of views and non-binding policy recommendations would be sufficient. If more specific policy objectives were pursued, such as convergence criteria in the European Monetary Union (EMU), tighter coordination and penalties on violations would be required (Wang and Yoon, 2004). The objective for the ASEAN+3 process at the current stage is crisis prevention. Such an objective is sufficient for current informal processes. It is, however, far less than sufficient for taking further steps towards an institutionalized surveillance mechanism.

Fourthly, another element for effective surveillance is clearly a defined focus, and coverage, of regional surveillance. Obviously, the ASEAN+3 process lacks the definition of adequate breadth of coverage. Surveillance can range from information exchange and dialogue on key issues, to the giving of policy advice. It can vary, depending on given policy objectives and the stage of regional financial and monetary integration. Over the past years, the coverage of surveillance of the IMF has expanded from a relatively narrow focus on fiscal, monetary and exchange rate policies to a broader purview, encompassing external vulnerability assessments, external debt sustainability analysis, financial sector vulnerabilities, and structural and institutional policies. So far, the members of ASEAN+3 have no common view on appropriate coverage of regional surveillance, correspondingly no relevant approach has been designed. For instance, surveillance on macroeconomic issues is different from that on financial sector vulnerabilities, requiring different sets of expertise and knowledge, as well as different degrees of intrusiveness (de Brouwer, 2004). If the region emphasizes the need to strengthen financial sector surveillance, information exchange on capital flows, assessment of vulnerabilities arising from the exchange rate regime, public and external debt, especially the risks of contagion and spillovers within the region, then the relevant tools, such as early warning system (EWS), would be designed and brought into effect.

4. Difficulties

There are many reasons for the lack of progress in developing institutional arrangements
for East Asian financial cooperation in general, and for regional economic surveillance in particular. These constraints present difficulties in forming a stronger policy dialogue and an independent economic surveillance mechanism.

(1) Political factors

Independent surveillance needs domestic support from the member countries. However, it is often seen as politically sensitive if the surveillance activities are conducted by another member, especially for those countries with a lesser degree of political openness. The existence of bilateral surveillance carried out by the IMF in its annual Article IV review of member countries makes the countries involved feel less in need of other independent surveillance from the region. Moreover, if the European experience is any guide, East Asia may take many years to develop effective cooperative arrangements and institutions as the political preconditions for strong regional institutions are not in place in East Asia (Eichengreen, 1997, 2000). Wyplosz (2001) and Wang and Yoon (2004) share the same view. They argue that the most important factor in seeking economic and financial integration for the European countries is the political will. "For over a half century, European countries have worked very hard to develop a wider web of political and diplomatic agreements which encouraged their cooperation on monetary and financial matters. Certainly, such a web does not exist in East Asia" (Wang and Yoon, 2004).

(2) Diversities

Why does East Asia lack political will? East Asian governments hold divergent preferences with respect to the pace, extent and direction of regional financial cooperation. This is mainly due to the fact that East Asian economic systems, patterns of trade and levels of economic development are far more diverse than those manifest in the European Community. Mismatches between interest and demand have slowed the development of institutional arrangements for financial cooperation (Xu, 2003).

The countries of East Asia have a vast range of different social structures and economic systems from mature market economies, such as Japan and Korea, to countries in transition to market economies such as China and Vietnam. As Xu (2003) points out, there are many ways of thinking about economic interests. There is now greater cooperation on security and strategic interests than there has been in the past, but residual Cold War attitudes continue to hold cooperation back, and induce distrust. As a result, political considerations are sometimes the first priority in decision-making. Moreover, countries in the region have very different status in the world political arena and usually have different political orientations. The US strategic interest in East Asia creates ambiguity for those pursuing East Asian regionalism. Some people have doubts that the benefits from regionalism would outweigh globalization and multilateralism in East Asia. Such arguments have influenced many countries in East Asia and have discouraged them from taking the political decisions
III. A Roadmap for Regional Surveillance in East Asia

The history of European experience shows that it takes a fairly long time to develop an effective process of policy dialogue and economic surveillance. European surveillance mechanisms were evolutionary across different exchange rate regimes and institutional arrangements. In this section, we present a roadmap for strengthening the surveillance process in East Asia, in light of the success of Europe, whilst taking into account East Asian countries' own characteristics.

1. A proposed roadmap

The proposed roadmap for strengthening policy dialogue and surveillance in East Asia comprises three phases.

Phase one

Phase one is a non-institutional process with formalized efforts, in which the member countries are in the process of clarifying objectives and missions. There are four-tier organizational arrangements at this stage, namely, the ASEAN+3 Heads of Government Summits, ASEAN+3 Finance Ministers Meetings (AFMM+3), ASEAN+3 Finance Deputies Meetings (AFDM+3) and the fourth tier, including Working Groups (WGs), Research Groups (RGs) and a Focal Group.

More specifically, the ASEAN+3 Heads of Government Summits, on tier one, which plays the political role, will guarantee throughout the whole process of regional integration. The role of AFMM+3, on tier two, is to focus on the policy dialogue, peer review, short-term capital flow monitoring and early warning system modeling. The AFDM+3, on tier three, is directly supervising the six WGs, the RGs and Focal Group and filtering the initiatives raised before they are tabled for adoption by the AFMM+3. The AFDM+3 is to support the AFMM+3 in identifying and implementing important initiatives. It plays a pivot role in the

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1 Six WGs includes: WG1 (Securitization, Chair: Thailand); WG2 (Credit guarantee & investment mechanism, Chair: Korea and PRC); WG3 (Settlement, Chair: Malaysia); WG4 (Issuance of local currency bonds by foreign entities, Chair: PRC); WG5 (Rating system and information dissemination, Chair: Singapore and Japan); and WG6 (Technical assistance, Chair: Indonesia, Philippines and Malaysia). ASEAN+3 Research Group (2003) is a network of 30 think tanks from ASEAN+3 countries. The first set of studies was completed and the second set started on ways to enhance cooperation. Focal Group (FG) to coordinate the work of the six working groups. This would further strengthen the ongoing work of the Asian Bond Market Initiative (ABMI). The FG met for the first time on 19 March 2004 in Manila.
policy dialogue process. The groups, on tier four, act as technical support. For instance, the six WGs were established to address key issues of bond market development, and the Focal Group is to coordinate the work of the six WGs. The RGs were established to study the identified key issues on enhancing regional financial cooperation.

**Phase two**

Phase two aims at setting rules, such as (1) working out the coverage and guidelines for policy dialogue and surveillance; (2) adopting commonly agreed statistical standards and data collecting methods; (3) establishing a commonly accepted EWS; (4) setting up conditions that are commonly agreed for bailout in the region, and so on.

In this phase, a stronger institutionalized mechanism can be established. It is possible to establish a standing secretariat, or we may call it the ASEAN+3 Surveillance Secretariat, to support the ministerial forum. However, whether the Secretariat is functioning actively and effectively depends on several conditions, such as the clarified and commonly accepted objectives and coverage of surveillance, a well-designed EWS, guidelines for surveillance, well-established statistical infrastructure, sufficient financial resources to cope with the outbreak of monetary crisis and conditions associated with the granting of financial assistance.

**Phase three**

In phase three, the institutionalization of policy dialogue and economic surveillance in East Asia is expected to take place. The Policy Dialogue and Economic Surveillance Unit, i.e. the institutionalized Economic Review and Policy Dialogue Process (ERPD) transformed from the standing ASEAN+3 Surveillance Secretariat can be formed at this stage. It is suggested that the Policy Dialogue and Economic Surveillance Unit can conduct timely identification of vulnerabilities and provide policy recommendations to the ministers’ forum.

2. **Where we are and what to do next**

*(1) We are in phase one and ready to move to phase two*

Objectives and approaches for mutual surveillance must go hand in hand. The evolvement of policy dialogue and economic surveillance in East Asia is no exception.

In terms of objectives of surveillance, there is already a consensus among the ASEAN+3 countries that measures must be taken to prevent a recurrence of currency crisis in this region, and to promote regional financial stability.

In terms of institutional framework, although there is no formal institutional arrangement for policy dialogue and surveillance in East Asia, the four-level hierarchical structure in the framework of the ASEAN+3 process, namely, (1) the Heads of Government Summits, (2) AFMM+3, (3) AFDM+3 and (4) WGs, RGs and Focal Group, already exists. Within such a framework, the ADFM+3 mechanism is playing the pivotal role by supervising a set of
working groups directly and supporting the AFMM+3 in identifying and implementing important initiatives.

The current objective of crisis prevention in general terms, with no specific scope and coverage of regional surveillance, is sufficient for the current informal process. It is, however, far less than sufficient for forming a firmer institutionalized surveillance mechanism.

As we analyzed in previous parts, ineffectiveness of policy dialogue and economic surveillance process in East Asia at the current stage is rooted in many reasons, such as the lack of a specified commonly accepted scope of objectives for mutual surveillance, the diversified legal systems across countries and the reluctance to submit data in those countries lacking policy transparency, the lack of mutual EWS, etc. It turns out that effectiveness of policy dialogue and economic surveillance can hardly be enhanced without further effort in solving these shortcomings.

(2) Possible moves in phase two

It is necessary to clarify the specified scope and appropriate coverage of regional surveillance in order to design a relevant approach. We proposed that, in phase two, initially the coverage of surveillance is narrowly focused on the vulnerabilities of balance of payments or currency crisis, with special emphasis on capital account development, external debt issues and financial sector stability. Surveillance on macroeconomic issues is equally important. However, it is more practical to conduct surveillance of broad macroeconomic issues on a more general base initially, due to the complexity associated with macroeconomic issues, such as difficulty in assessing the consistency between the exchange rate policy and the stance of fiscal and monetary policies. The coverage of surveillance can be expanded from a relatively narrow focus to a broader purview encompassing fiscal, monetary and exchange rate policies, structural and institutional policies. Such a wide coverage might be likely in phase three where a stronger institutionalized surveillance process is established.

It is important to create enough motivation for all the countries to work together and to develop an appropriate coverage of surveillance that meets the need of the region itself.

Correspondingly, in phase two, the relevant approaches and tools should be designed and taken into effect. These possibly include:

- **To have better information collection**

Effectiveness in surveillance lies in better statistical infrastructure, and better statistical infrastructure relies on better information collection and data availability. It is especially vital in East Asia to enhance data availability because not all the countries in the region are willing to provide national data. However, the necessity to have better information collection is obvious for an effective surveillance process. Considering that regional cooperation in East Asia is still in an early stage of shaping up, a practical approach for better information collection would include: (a) improving information disclosure, policy transparency and
adoption of internationally acknowledged standards and codes among member countries, and (b) using expertise from both member countries and regional and international institutions.

It is advisable to establish an Expertise Group that comprises experts from both ASEAN+3 countries and regional and international organizations. The main mission of this group is to improve the statistical infrastructure in East Asia.

- To have timely information exchange and better information sharing among member countries

Another aspect of improving statistical infrastructure is to have better information sharing among ASEAN+3 countries. It can be achieved possibly by (a) shifting from the current bilateral basis among some ASEAN+3 countries, to multilateral exchange of capital flow information; (b) designing an appropriate set of indicators for assessment on how and to what extent capital flows can affect the financial and real sectors of an economy, such as the types of flow, the openness of the country's capital account, the exchange rate regime, transparency of the financial markets, the size of the market compared to the magnitude of capital flows and economic fundamental conditions, etc.

It is important to avoid duplicating the roles played by the IMF in this respect in order to create sufficient motivation for ASEAN+3 countries to share information among themselves.

- To set up tools for analysis of crisis vulnerabilities and for assessment on financial sectors

Financial crisis might arise from varying vulnerabilities, such as vulnerability from the exchange rate regime, public and external debt, especially the risks of contagion and spillovers within the region. It becomes an urgent task to set up tools for analysis of crisis vulnerability. Rigor of the analysis relies on a regional EWS and external vulnerability indicators. Tools for assessment on financial sectors are also needed, which can be set up by establishing a set of financial soundness indicators.

In order to fully meet the needs of regional surveillance, it is essential to have a tailored model and a set of indicators suitable for East Asian countries. It is also important to provide a training program in using and adopting the model, for less developed countries in the region.

- To establish a standing secretariat as an institutional arrangement under the direct supervision of AFDM+3

It is necessary to establish a standing secretariat. This can be seen as the first step taken in building up a stronger regional surveillance process. Considering that there are constraints
for having a firm institutionalized arrangement in East Asia, it is suggested that a more practical way for better functioning of the secretariat is to follow a step-by-step approach. At its initial stage, the scope of its functions is suggested to be limited to a relatively narrow focus. It can be gradually expanded to a broader one as conditions change. In the initial stage, the secretariat might focus on how to improve the statistical infrastructure among ASEAN+3 countries. The Expertise Group can be set up within the standing secretariat and assigned with statistical issues specifically.

Ideally, the standing secretariat is expected to play the role of supporting AFDMs, and hence AFMM+3, in the exchange of opinions and possible decision-making by (a) providing regular economic review; (b) facilitating the enforcement of multilateral data exchange among ASEAN+3 countries; (c) conducting analysis of external vulnerability and financial crisis vulnerability and providing frequent assessments on crisis vulnerabilities that are potentially the result of being exposed to sudden shifts in market sentiment; (d) monitoring financial sector development and the soundness of the financial system; and (e) giving policy advice. However, a standing ASEAN+3 secretariat is possibly established and functioning effectively only when the relationship between this new secretariat and other existing regional institutions, such as the ASEAN Surveillance Secretariat, ADB, IMF and others, is well defined. It is also important to have the support of policy-makers and political leaders among ASEAN+3 countries. This is because to establish a regional independent institution is always a sensitive matter to the nations involved. In fact the independent institution can never be independent of the political considerations of nation countries.

IV. Concluding Remarks: The Necessity of a Common Monetary Regime

European experience shows that a common monetary regime, i.e. a common objective of a region-wide stable exchange rate arrangement, has been playing a key role in the evolvement of the process of its policy dialogue and economic surveillance. For instance, during the 1960s, the objectives of its surveillance were twofold: maintaining the Customs Union and the Common Agricultural Policy under the Treaty of Rome; supporting economic integration by securing exchange rate stability. Surveillance during this period was inactive although

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2 There is a lingering suspicion among members that the new standing ASEAN+3 secretariat would duplicate roles of other regional institutions and reduce the significance of the secretariats of ASEAN in Jakarta.
institutional arrangements were already in existence, such as the Monetary Committee, Committee of Governors of the Central Banks of the Member Countries of the European Community, Council of Ministers for Economic and Financial Affairs (ECOFIN). This is because the level of economic integration was low, and more importantly, the IMF took care of the objective of exchange rate stability under the Bretton Woods System. During the 1970s and 1980s, after the breakdown of the Bretton Woods System, the objective of a stable exchange rate regime shifted to internal stability of exchange rate under the European Monetary System (EMS). Since then, although the EMS used the same surveillance institutions, the institutions became more active. The Monetary Committee and the Committee of Central Bank Governors made their consultations on exchange rate matters on the directive of ECOFIN. During the first stage of European Monetary Union (EMU), the objective of surveillance turned into policy convergence. The European System of Central Banks (ESCB) was established in the monetary sphere and the working capacity of the Community has expanded considerably. Since 1999, single currency, single monetary policy and economic convergence, a set of material norms given by the Maastricht Treaty, have become the objectives of the EU.

From the experience of Europe, we can see the importance of a common objective in the monetary sphere. Since the beginning, exchange rate stability has been a core element of the objectives throughout the whole process of European integration.

In East Asia, there is an absence of consensus on common regional monetary arrangement. More importantly, any form of collective exchange rate regime in the region is unlikely to happen in the near future. Although the objectives of mutual surveillance from the monetary perspective are quite clear: to prevent currency crisis and to promote financial stability in the region, surveillance for such a purpose will be satisfactory and fully efficient only when there is a regional monetary regime. If there is no regional monetary regime, incentives for mutual surveillance will be limited. "... if some kind of fixed rate regime can be envisaged region-wide, multilateral surveillance, together with financial means, becomes a prerequisite for establishing and maintaining such a regime" (Tetsuji, 2002). Considering the difficulties in having any form of regional exchange rate arrangement in the foreseeable future in East Asia, it is reasonable to say that the formation of a fully efficient policy dialogue and economic surveillance process in East Asia will take time.

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