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Finance and Security in East Asia

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Abstract

What drives the relationship between regional finance and security in East Asia? Overall, I suggest, the relationship may be regarded as mutually endogenous. Financial cooperation in the region, long promoted in principle, is constrained in practice by underlying security tensions. Yet, over time, tentative steps toward financial cooperation could also have the effect of moderating regional strains, as governments become more accustomed to working with each other and as interests become more densely intertwined. Some form of financial regionalism, entailing closer monetary and financial relations, can certainly be anticipated. However, in the absence of a fundamental shift in regional politics, tangible achievements will most likely remain modest for a long time to come.

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What drives the relationship between regional finance and security in East Asia? Overall, I suggest, the relationship may be regarded as mutually endogenous. Financial cooperation in the region, long promoted in principle, is constrained in practice by underlying security tensions. Yet, over time, tentative steps toward financial cooperation could also have the effect of moderating regional strains, as governments become more accustomed to working with each other and as interests become more densely intertwined. Some form of financial regionalism, entailing closer monetary and financial relations, can almost certainly be expected. However, in the absence of a fundamental shift in regional politics, tangible achievements will most likely remain modest for a long time to come.

Proposals promoting financial regionalism have floated around East Asia for decades. But few in a position of authority ever took the idea seriously until the great banking and currency crisis of 1997-98, which profoundly shook most of the region's economies. Seen today as a genuine watershed in Asian economic history, the upheaval triggered active consideration of all kinds of financial initiatives, from more formal coordination of monetary and exchange-rate policies to the possibility of reserve pooling or perhaps even a common currency. Eventually, agreement was reached on a number of proposals, including an Asian Bond Market Initiative (ABMI) and an Asian Bond Fund (ABF), both launched in 2003-04 with the intention of promoting the development of local capital markets. Most notable was the so-called Chiang Mai Initiative (CMI), dating from 2000, which established a basis for mutual liquidity assistance among central banks – now expanded under the label Chiang Mai Initiative Multilateralization (CMIM). All have been announced with great fanfare.

Yet despite all the hype, it is clear that actual achievements so far have fallen far short of

aspirations. Governments continue to operate more or less autonomously, tailoring their monetary and exchange-rate policies to their own particular needs, and the degree of integration of capital markets remains low. Payments financing is still dependent, first and foremost, on hoards of national reserves. As one source delicately puts it: "The direction of regional financial policies remains contested" (Hamilton-Hart 2006: 108).

Why? The main reason, I contend, can be found in underlying security tensions across the region, which lead governments to seek to preserve for themselves as much room for maneuver as possible. East Asia is replete with historical animosities and festering border disputes. There is little sense of community or enduring common interest. There are also the sensitive unresolved issues of Taiwan and the divided Korean peninsula. There is the continuing rivalry between China and Japan, both of which aspire to regional leadership. And hovering over it all is the complicating presence of the United States, with its own multiple interests in the area. With so much at risk, governments are understandably reluctant to commit to far-reaching financial reforms.

But the relationship is not one-way. I would contend that a reverse causation may also be at work – a process by which tentative steps toward financial regionalism could in time have the effect of moderating security tensions by socializing governments to the benefits of cooperation. A kind of self-reinforcing "virtuous circle" is possible, triggered by crises like that of 1997-98 or today's global recession. Crises can raise the appeal of cooperation, at least temporarily, leading to the institutionalization of initiatives like Chiang Mai. Such initiatives cannot go beyond limits set by security concerns. But once some degree of cooperation is institutionalized, a basis for building mutual trust is established which, over time, can serve to ease historical suspicions,

setting the stage for yet more financial initiatives down the road.

THE RECORD TO DATE

For analytical purposes, financial regionalism is understood to encompass public-policy initiatives intended to deepen monetary and financial cooperation between governments. Financial regionalism is typically distinguished from financial "regionalization," by which is meant concentrations of internationally linked private-sector activities. The aim of financial regionalism is to create institutions at the state level and to institutionalize policy practices in support of market integration. Interest in financial regionalism in East Asia has been high since the crisis of 1997-98.

The crisis was traumatic for the region. Confidence in the Asian development model, hitherto seemingly so successful, was severely shaken. Financial openness, it turned out, had left economies painfully vulnerable to the whims of international investors. Worse, the perception took hold that the region had been ill served by key outsiders, especially the United States and the International Monetary Fund (IMF). Henceforth, many concluded, regional players would have to cooperate more closely in order to better defend their collective interests in a global financial architecture that seemed biased against them – "to become *rule makers*," in the pithy phrase of one commentary, "rather than *rule takers*" (Sohn 2005: 488, italics in the original). Summarizes another acute observer:

> The 1997-98 crisis highlighted the financial vulnerability of the open East Asian economies and left an indelible mark on regional financial policymakers. It

> also significantly eroded regional policymakers' confidence that the IMF and the United States had their best interests at heart... Regional solutions to global financial pressures, which were unthinkable (or at least unthought of) until the crisis hit, became a major focus of the East Asian states' efforts to reduce vulnerability (Grimes 2009a: 67).

The result was a flurry of discussions aiming to promote an effective "counterweight strategy" (Sohn 2007) for the region, stressing three issues in particular: (1) currency management; (2) development of regional capital markets; and (3) emergency liquidity assistance. Hardly a month now goes by without some meeting somewhere in East Asia to address one or another of these policy challenges. In practice, however, accomplishments have been modest. As compared with the status quo ante, achievements have not been inconsiderable. But relative to the region's own loftier ambitions, the record to date must be rated as limited at best – no more than "baby steps," in the words of the *Financial Times* (2009).

Currency management

Least progress has been made in the area of currency management. The region has not lacked for proposals. To the contrary, ideas have been a dime a dozen, addressing every aspect of the complex relations among national monetary, fiscal, and exchange-rate policies – from closer coordination of interest rates and spending programs or various forms of mutual exchange-rate stabilization to the creation of an Asian currency unit or even a formal monetary union, complete with a joint central bank and common currency *à la* the euro.[1] It may be true, as one source

suggests, that "a strong case for regional monetary integration tends to be taken for granted in Asia" (Chung and Eichengreen 2007a: 11). But between inspiration and implementation there still lies enormous resistance to change. In practice, as I have noted elsewhere (Cohen 2008), individual monetary regimes have changed little since the crisis and remain remarkably diverse, ranging from currency boards at one extreme to free floating at the other. Governments show little interest in anything that might force them to reconsider their policy preferences. Concludes one recent survey (Hamada et al 2009a: 1): "Deeper integration... is still a ways away."

Capital markets

Progress in the development of regional capital markets has been little better. Two projects have been initiated -- the Asian Bond Market Initiative and the Asian Bond Fund. Both are intended to correct for private-sector vulnerabilities that were thought to have contributed directly to the troubles of 1997-98. Neither, however, has had much impact in actual practice.

At issue was the so-called "double mismatch problem," which had emerged earlier as East Asians borrowed short-term in major foreign currencies, in particular the U.S. dollar, and then invested locally in long-term assets denominated in domestic currency. The mismatch in both length of maturity and choice of currency left banks and other market actors fatally exposed once exchange rates began to fall, following the crash of the Thai baht in July 1997. Defaults by debtors unable to service their foreign debts led to further exchange-rate depreciations and thus further defaults in a cumulative downward spiral. The lesson seemed obvious. The countries of the region needed to create more opportunities for long-term financial intermediation in their own

currencies. What eventually emerged were the ABMI and ABF.

The purpose of the ABMI, first proposed by Japan in 2002, was to promote infrastructural improvements that might foster local financial development, aiming eventually to create one regional capital market for all of East Asia. The ABMI was soon endorsed by the so-called "ASEAN+3" group, comprised of the ten members of the Association of Southeast Asian Nations (ASEAN) plus the three northeast Asian countries of China, Japan, and Korea – the "Plus Three" nations. Working groups were established to examine such questions as the creation of new debt instruments and settlement and rating issues. In 2008, the ABMI was further expanded with a "New ABMI Roadmap," which added to the agenda insurance mechanisms, a facility to increase demand for local-currency bonds, and improvements of regulatory frameworks.

In parallel, the purpose of the ABF was to increase liquidity in Asian capital markets, mainly through purchases of local government bonds by regional central banks. The idea – a brainchild of Thaksin Shinawatra, then prime minister of Thailand – was to encourage greater private investments in Asian debt issues. The ABF was formally launched in 2003 by the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP), a grouping of eleven central banks and monetary authorities in the region first formed as long ago as 1991.[2] In a first iteration of the ABF, a total of some $1 billion worth of dollar-denominated sovereign debt was acquired. Two years later, in a second version dubbed ABF2, the concept was extended to government bonds denominated in local currencies. Some nine new bond funds were created, including a diversified regional fund labeled the PAIF (Pan Asia Bond Index Fund) and eight single-country funds. The PAIF was funded with the EMEAP Group's initial investment of $1 billion. An additional $1 billion was allocated among the eight single-country funds.

Neither initiative can be faulted in principle. The inherent logic of each is unexceptionable. Both are worthy projects that could, in time, result in real improvements in market conditions. The question is: When, if ever? In practice, both have been essentially frozen in place and remain extraordinarily cautious, not to say downright timid. From the beginning the ABMI has relied exclusively on self-assessment and voluntary action, allowing individual states to proceed with liberalization or other reforms at their own chosen pace. Market development, accordingly, has been uneven at best. The amounts of money committed to the ABF, meanwhile, have been laughably small, generating little investor interest.

Not surprisingly, therefore, results have been anything but impressive. Though the volume of new debt issues has grown, turnover rates and market liquidity are still low by international standards and markets remain overly dependent on government bonds of relatively short maturity. "Market participants," reports one informed observer (Park 2007: 103), "believe that [the ABMI and ABF] may have had little effect." More than a decade after the fall of the baht, maturity and currency mismatches are still a problem in the region, and market integration remains a distant dream.

Liquidity assistance

Most progress has been made in the provision of emergency liquidity assistance via the Chiang Mai Initiative, now to be expanded under the label Chiang Mai Initiative Multilateralization. Launched in May 2000 at a meeting of ASEAN+3 finance ministers in the Thai resort town of Chiang Mai, the CMI established the basis for a new network of bilateral swap

arrangements (BSAs) between the Plus Three countries on the one hand and members of ASEAN on the other. The Plus Three countries promised to make dollar resources available to selected ASEAN members, when needed, in exchange for equivalent amounts of local currency. As BSAs have been negotiated and concluded over subsequent years, their number has grown to as many as nineteen.[3] Initially, the total amount of money that could be mobilized under the CMI came to some $33.5 billion. After the start of a "stage two" in 2005, the nominal size of the swaps was roughly doubled to a net total (after eliminating double-counting) of about $60 billion (Henning 2009: 2).[4]

The roots of the CMI go back to Japan's failed proposal for an Asian Monetary Fund (AMF), first mooted in the midst of the region's crisis in September 1997. As nearly every economy in East Asia came under pressure from investor panic and capital flight, Tokyo urged creation of a new $100 billion regional financing facility, quickly dubbed the AMF, to help protect local currencies against speculative attack. Though nothing came of the proposal at the time – owing to the determined opposition of the United States and IMF, backed tacitly by China – the idea of some kind of mutual safety net survived and eventually took shape at Chiang Mai. The projected network of BSAs, negotiators declared, would finally give East Asia a crisis management capacity it could call its own.

Great hopes have been placed in the CMI as the foundation for increasingly close financial and monetary relations in the region. Functions of the scheme would include monitoring, surveillance, and, if possible, coordination of exchange rates and other related policies. Here too, however, tangible achievements have so far been modest at best. Like the ABMI and ABF, the CMI is a worthy project that could, in time, prove significant – but not yet. Until now, the

initiative has not made much of a difference.

For example, all the participating countries understand that if a BSA network is to function effectively, it must be supported by an independent surveillance system. Governments are naturally reluctant to lend to a neighbor in time of crisis unless they can have some degree of confidence that they will eventually be paid back. A firm surveillance mechanism is vital to ensure that borrowers undertake requisite policy adjustments. But nothing of the sort has yet been put into place, despite repeated discussions. Finance ministers regularly reiterate their commitment to enhancing the ASEAN+3's surveillance capacity and have sponsored multiple studies of the feasibility of constructing a regional monitoring institution. But to date their only accomplishment is a vague peer review scheme known as the Economic Review and Policy Dialogue (ERPD), dating from 2000, which has no set format and lacks any sort of enforcement mechanism beyond nonbinding, informal cautions.

Similar timidity has also plagued the BSA network itself, which requires laborious and time-consuming negotiation (and renegotiation). Member countries agreed that participants would be authorized to draw funds only up to 10 percent of the contractual amount of a BSA (raised to 20 percent in 2005). Beyond that limit a government would have to agree to place itself under IMF tutelage, complete with a macroeconomic and structural adjustment program, thus effectively substituting Fund conditionality for a surveillance system of the region's own making. In part, it appears, this was to placate the United States and IMF, which might otherwise have objected to a possible dilution of the Fund's authority. But mainly it was to avoid putting regional governments in the position of having to judge each other's policies. William Grimes (2009b: 12) describes the IMF link as an "elegant solution" since "it allows the lending governments to elide responsibility

for imposing conditions by delegating conditionality to the IMF." In the absence of a regional surveillance mechanism, the link is obviously necessary to protect the credibility of the CMI. But it has also had a significant chilling effect on actual behavior, owing to memories of the 1997-98 experience. No participating country has ever actually drawn on a BSA.

In an attempt to overcome some of these limitations, governments agreed as early as 2005 to seek to "multilateralize" the CMI, pooling funds together to enhance the amounts that any single country might draw when in need. Four years later, in December 2009, agreement was finally struck, transforming the CMI into a new common facility dubbed the CMIM. Beyond the existing BSAs, some of which were to be retained,[5] resources were effectively doubled to $120 billion. Of this total, 80 percent came from the Plus Three countries together with Hong Kong, a new participant, and 20 percent from the ten members of ASEAN, based on a carefully calibrated set of quotas. Japan and China each contributed 32 percent, with Hong Kong contributing 3.5 percent as part of China's share, and Korea put up 16 percent. Indonesia, Malaysia, Singapore, and Thailand contributed 4 percent each, and 4 percent came from the remaining six ASEAN members. Contributions were based on quotas that also determine voting rights and borrowing limits.[6] Formal launching was set for March 2010. In addition, building on the ERPD, a new surveillance unit is at last supposed to be created.

However, it remains to be seen how much further "multilateralization" will actually take the nations of East Asia. Some observers see the CMIM as a critical step toward realizing, at long last, Japan's original idea of an Asian Monetary Fund. Of particular importance, it is said, is the commitment to a joint decision-making process as BSAs are superseded by the common facility, with access to loans to be decided by majority voting. In practice, however, crucial details have

yet to be negotiated, concerning especially issues of borrowing accessibility, lending terms, and oversight.

To date, ministers have described their latest initiative as a “self-managed reserve pooling arrangement” (SRPA), with each government doing no more than earmarking a portion of its own reserves for joint use. That is a far cry from a genuine common fund of the sort envisioned at the time of the Japanese proposal. An SRPA is no AMF. Moreover, the total amount of money involved, while representing a substantial increase from the existing BSA network, is still trivial in relation to potential need or the value of reserves currently hoarded away by the region’s central banks (now totaling more than $3.5 trillion overall for the thirteen ASEAN+3 countries and Hong Kong). And even less consequential is the proposed surveillance unit, which is expected to be very small (10-20 individuals at most) and with responsibilities limited to no more than a sharing of information. Without a truly autonomous monitor, it is understood that the IMF link will have to be retained, still discouraging potential borrowers. Moreover, broad governance of the system will continue to be based on consensus, minimizing any compromise of national sovereignty.

Overall, therefore, one has the impression that the value of the CMIM lies mainly in its symbolism, signaling little more than a minimal spirit of good will and comity. Its practical impact on actual behavior does not promise to be dramatic.

EXPLAINING THE RECORD

What explains the modesty of the record to date? Many factors are undoubtedly involved, both economic and political. Most discussions focus on the economic side, highlighting structural

and institutional differences among the economies of the region. But none of these barriers is necessarily insurmountable, given a sufficient degree of commitment. The real problem lies on the political side, where security tensions dominate. For all the talk of financial regionalism in East Asia, little real progress is possible without a significant moderation of underlying rivalries and animosities.

Economics

On the economic side, the impediments are obvious. The nations of East Asia are a remarkably diverse lot in terms of economic structure and level of development, with little in common other than geographical proximity. At one extreme are industrial giants like China and Japan, two of the biggest economies in the world. At the other extreme are pygmies like Cambodia, Laos, and Myanmar, among the world's poorest nations. In between, the range runs the gamut from modern high-tech Korea and Singapore and emerging manufacturing centers like Malaysia and Thailand to rural and still primarily agrarian economies such as Indonesia and the Philippines. A high degree of heterogeneity, not homogeneity, rules. In some cases, as Natasha Hamilton-Hart (2003) has emphasized, government capacity is simply inadequate to handle the demanding complexities of financial cooperation.

Moreover, financial ties among the economies of the region are generally weak, reinforcing centrifugal forces. In capital markets, little has changed despite the ABMI and ABF. Although a few governments have made progress in deregulating domestic monetary systems and opening up financial services to foreign competition, overall integration, as noted, remains a distant dream.

Apart from Japan, Hong Kong, and Singapore, most states still impose strict exchange controls and other barriers to limit the free flow of funds. Restrictions are particularly tight in China and the poorer members of ASEAN, where financial systems remain underdeveloped and shallow.

Likewise, at the macroeconomic level there are few signs yet of significant convergence in terms of either performance or policy. Business cycles across the region are far from synchronized, and little correlation exists in inflation or growth rates. Fiscal deficits and public debt burdens vary enormously, and monetary policy in most cases remains insular in orientation. Governments continue to look first to their own national resources for defense against external payments pressures.

Yet for all the challenges they pose, such impediments need not be prohibitive. Offsetting the many centrifugal forces in East Asia are also some powerful and growing economic connections. That is especially true in the area of trade, where the pace of activity within the region has grown exponentially over the last third of a century. Among the forces driving the expansion of intra-regional trade are the many "invisible linkages"created by extensive ethnic business networks, encompassing overseas Chinese communities or other groups such as Koreans or Vietnamese (Peng 2002). Equally important are the much more visible linkages created by the direct investments of multinational corporations – initially coming mainly from Japan, Europe, and the United States, but now followed increasingly from within the region itself. The result has been a bourgeoning of tightly organized production networks and supply chains across East Asia, promoting vertical intra-industry trade in capital equipment, parts and components, semi-finished goods, and final products.

Among the ASEAN+3 countries, for example, the share of intra-regional exchanges in total

trade has risen from some 30 percent in 1980 to close to 40 percent in 2007. If Hong Kong and Taiwan are added, the intra-regional share has soared from 37 percent to nearly 55 percent (Kawai 2008). Even allowing for a certain amount of double-counting due to the high proportion of trade in components and the special role of Hong Kong and Singapore as entrepôts, these numbers are impressive. Overall, shares match the scale of commercial integration found in North America today among Canada, Mexico, and the United States, and actually exceed the rate of intra-regional trade within the European Union (Park and Shin 2009).

Among economists, it is common to judge prospects for financial regionalism on the basis of the well-known optimum-currency area (OCA) theory, which highlights the salience to any integration project of such considerations as structural homogeneity, openness, and the degree of convergence among the countries involved. In many respects East Asia scores remarkably well, particularly when compared with the members of Europe's euro zone (Eichengreen and Bayoumi 1999; Zhang et al. 2001; Kawai and Motonishi 2004; Kawai 2008). Econometric analyses, including some 14 studies surveyed by the Bank of Japan (Watanabe and Ogura 2006), confirm that selected subgroups in the region, if not the region as a whole, meet the usual criteria of OCA theory at least as well as did European nations prior to their monetary union (Watanabe and Ogura 2006). Summarizes one knowledgeable source (De Grauwe 2009: 115-117): "The consensus emerging from that literature is that Asian countries do not experience more asymmetry than the members of the Euro area.... It would appear that East Asia comes at least as close as Europe to forming an optimum currency area."

So if Europe could overcome the impediments to financial cooperation, – going so far as to create a common currency – why have results been so limited in Asia? The answer, I submit, must

lie on the political side.

Politics

If history teaches us anything, it is that economic obstacles to cooperation among states – no matter how seemingly prohibitive – can in fact be overcome if the political will is there. We need only remind ourselves of the successful negotiation a half century ago of a new Common Market in Europe, incorporating previously implacable enemies, not much more than a decade after the most destructive war that Europeans had ever seen. We know that the idea of financial regionalism has broad appeal in East Asia; otherwise, how could we explain all the time and effort that has gone into such projects as the ABMI, ABF, and CMI/CMIM? But we also know that, at least until now, the requisite political will has not yet been in evidence. In effect, governments have been unwilling to put their money where their mouth is – at least, not much money. The question is: Why?

In principle, the answer could lie at the domestic level, in the perpetual tug of war among diverse political constituencies. Perhaps key groups with vital interests at stake have successfully mobilized to block closer financial cooperation. In reality, however, there is scant evidence of any such influence at work, as acute observers such as Saori Katada (2008, 2009) have noted. On issues of trade policy, where potential winners and losers are relatively easy to identify, interest cleavages can indeed make a real difference; in most economies, the risk is high that trade officials will find themselves being actively lobbied by enterprises or industries with a specific axe to grind. In matters of money and finance, by contrast, distributional implications of alternative policy

choices tend to be more ambiguous, reducing the likelihood of well organized collective action for or against specific initiatives. The contrast was long ago highlighted by Joanne Gowa (1988) in an analysis of trade and monetary policy processes in the United States. The logic is equally applicable in East Asia. Regional authorities simply have a freer hand when it comes to finance. In Katada's (2009: 8) words, decision makers are "much more autonomous from pressure when it comes to financial and monetary policy making." If governments have been unwilling to put their money where their mouth is, it is not because of domestic politics.

In practice, the answer appears to lie more at the international level, where differences of perceived state interest dominate. For Asian governments, the dilemma is clear. Regional cooperation of any sort involves a degree of *commitment* that is naturally antithetical to the preferences of formally sovereign nations. Involved is what one source (Litfin 1997) calls a "sovereignty bargain" – a voluntary agreement to accept certain limitations on national authority in exchange for anticipated benefits. In effect, sovereignty is pooled. The conditions generally conducive to such a commitment are, to say the least, demanding.

What are those conditions? Previously (Cohen 2001), I have used comparative historical analysis to identify the key conditions that appear to determine the *sustainability* of close financial cooperation among states. The same factors can be assumed to be instrumental in gaining the necessary commitment to regionalism in the first place. Two requisites stand out. One, suggested by traditional realist approaches to international relations theory, is the presence or absence of a powerful state or combination of powerful states committed to using their influence to keep the joint effort functioning effectively on terms agreeable to all. The other, suggested by more institutional approaches to world politics, is the presence or absence of a broad constellation of

related ties and commitments sufficient to make the sacrifice of sovereignty, whatever the costs, basically acceptable to each partner. Judging from the historical record, I conclude that one or the other of these two types of linkage is necessary to sustain the necessary degree of commitment. Where both types have been present, they have been a sufficient condition for success. Where neither was present, cooperation has tended to erode or fail.

The first condition calls for one or more dominant countries – local leaders or "hegemons"– and is a direct reflection of the distribution of state power. Scholars have long recognized the critical role that the leadership of powerful states can play in preserving sovereignty bargains. At issue, as David Lake (1993) has emphasized, is the provision of a type of public good – an essential "infrastructure" that will support both short-term stabilization and longer-term growth. Leaders must be not only able but willing to use their power, via side-payments or sanctions, to lower the costs or raise the benefits of commitment for their partners.

The second condition calls for a well developed set of institutional linkages and reflects, more amorphously, the degree to which a genuine sense of solidarity--of *community* – exists among the countries involved. Scholars have also long recognized the demanding cognitive dimension of sovereignty bargains. Participating states, at a quite fundamental level, must come to accept that individual interests can best be realized through joint undertakings – through what Robert Keohane and Stanley Hoffmann (1991: 13) call a "network" form of organization "in which individual units are defined not by themselves but in relation to other units." Without such a sense of solidarity, governments will be more preoccupied with the costs of commitment than with any benefits.

The underlying logic goes to the heart of what we mean by sovereignty. Governments

need strong incentives to stick to bargains that might, at some point, turn out to be inconvenient. In practice, such incentives may derive either from the encouragement or discipline supplied by powerful states or else from the opportunities and constraints posed by a network of institutional and cognitive linkages. The question of whether economic ties are weak or strong seems to be of secondary importance. What matters more is a convergence of state preferences, supported either by committed local hegemons or by a common sense of community.

The problem for East Asia is that neither of these critical conditions is presently much in evidence. Many in the region like to think that Asia is different; that unlike Europe, formal sovereignty bargains are unnecessary. They like to boast of the "ASEAN way" – the principle of non-interference in the internal affairs of member countries and a reliance on accommodation and consensus – which has long guided relations in ASEAN and has now been extended to the ASEAN+3 as well. The ASEAN way (or "Asian way"), it is said, combines cooperation with deference, allowing states sufficient autonomy to safeguard domestic priorities (Khong and Nesadurai 2007). But could this just be another way of avoiding real commitment? It is hard not to see celebration of the ASEAN way as simply an excuse for inaction. As the *Economist* (2010) has commented: "Prickly nation-states are loth to cede sovereignty to any regional body. The flip side of Asia's famous taste for consensus is an allergy to enforceable rules and obligations."

The reality is that prevailing circumstances give governments in the region little incentive to go beyond the most minimal sort of joint financial initiatives.

Leadership?

On the one hand is a dearth of coherent leadership. East Asia does not lack for plausible leaders. As everyone knows, there are in fact two of them, Japan and China, potentially not unlike the duopoly of France and Germany in post-World War II Europe that provided the decisive impetus for the early Common Market. But there is a distinct lack of comity between the Japanese and Chinese that makes it difficult for them to jointly lead the way.

In retrospect it is clear that Europe's Common Market, now the 27-member European Union, could never have come into being without the historic reconciliation of France and Germany after 1945 – two long-time adversaries who decided to join together to promote a common regional project. Nothing comparable has emerged in relations between Japan and China, who still regard themselves more as rivals than partners. The lack of trust between East Asia's two giants is palpable, fraught with bitterness and mutual suspicion. Japan, once the dominant economic power of the region, fears falling under China's lengthening shadow – what the Japanese call the "China economic threat theory" (Samuels 2007: 144). The Chinese, meanwhile, continue to harbor acute resentments toward the Japanese for their military and colonial activities from 1895 to 1945 – the so-called "history problem" (Grimes 2009a: 8). Neither country is willing to commit to any collective initiative that might cede a greater measure of influence or prestige to the other. Rather, as Kent Calder (2006) has suggested, "the stage is now set for a struggle between a mature power and a rising one." Moreover, in the background there is also the United States, still a major presence in the region with lingering leadership aspirations of its own.

At the broadest geopolitical level East Asia is dominated by a "strategic triangle" involving Washington as well as Beijing and Tokyo, each with its own distinct interests and preferences that color every effort to promote financial cooperation in the region. For Japan, a once dominant

power fearful of losing its traditional pre-eminence, the key goal is to lock in as much influence as possible while not jeopardizing its close political and military ties with the United States – in the words of one observer, "to exist securely without being either too dependent on the United States or too vulnerable to China" (Samuels 2007: 9). Conversely, for China -- the once and future Middle Kingdom -- the objective must be to support institutional initiatives that will allow it to continue to grow rapidly while avoiding commitments that could contain its anticipated world role. All the while the United States can be expected to seek to do what it can to preserve the historical role of the dollar and U.S. financial enterprises in the region. Washington has never been enthusiastic about the development of multilateral initiatives in the region, preferring instead to promote its own bilateral relationships with individual East Asian states.

The complex dynamics of what one source (Emmott 2008) calls "Asia's new power game" were on vivid display as far back as 1997 when both China and the United States, each for its own reasons, resisted Tokyo's proposal for an Asian Monetary Fund. Apart from their concern about the possible dilution of IMF authority, the Americans evidently feared that the AMF might consolidate a dominant regional role for the yen, thus undermining U.S. interests and influence. Washington actively lobbied Beijing to join in opposition to the plan by emphasizing the threat of Japanese hegemony. The Chinese, meanwhile, always suspicious of Japanese motivations, were piqued by Tokyo's failure to consult with them before the plan was announced and agreed to maintain a passive stance, tacitly backing the United States. And behind both nations was the IMF, which had its own reasons for concern about the advent of a new institutional rival. Without Chinese support, Tokyo was unable to prevail over the combined forces of the United States and the Fund (Chey 2009).

Since then, the three governments have persistently jockeyed for position in a wary *pas de trois*. Though stung by the failure of its AMF proposal, Tokyo has remained out front, pushing one idea after another for new regional ventures. In 1998 came the so-called New Miyazawa Initiative (named after then Finance Minister Kiichi Miyazawa), a plan for some $30 billion of fresh aid for the region, which laid the groundwork for eventual agreement on the CMI in 2000. Japan played a key role as arbitrator in the negotiation of the CMI as countries in the region bargained over terms for the network of BSAs. Two years later came the ABMI, also, as noted, a Japanese initiative. And since 2005 Tokyo has been an eager advocate of CMI multilateralization, obviously hoping to consolidate its position as regional leader while there is still time. Yet simultaneously, in a delicate balancing act, Tokyo has carefully sought to avoid any move that might jeopardize the broader security relationship that it has long enjoyed with the United States. By backing the CMI's IMF link, for example, Tokyo has sought to keep the Fund – and thus, indirectly, the United States, the IMF's most influential member – fully engaged in the region.

In turn, Beijing has gradually shifted toward a more pro-active stance concerning financial regionalism, consistent with a broader embrace of multilateralism in Chinese grand strategy that has been evident since the 1990s (Goldstein 2005). The turn was first evident in the negotiation of the CMI in 2000. Though not the inspiration for the initiative, China was able quickly to join Japan in a leadership capacity because of the size of its foreign reserves. Japan and China were the only two states at the time whose role would clearly be limited to that of lender, should the BSA network be activated. (So soon after the region's financial crisis, prospects for Korea – the third of the Plus Three countries – were less certain.) Subsequently, China became an enthusiastic supporter of the ABMI and ABF and also played a prominent part in the CMI multilateralization.

In part, Beijing's conversion to regionalism appears to have been motivated by a desire to calm concerns about the country's rapid development and incipient power – to signal, as Avery Goldstein (2005: 129) puts it, a "responsible internationalism." But there seems little doubt that paramount in the minds of policy makers was a desire to avoid ceding leadership in regional finance to their rivals, the Japanese.

The rivalry was perhaps best illustrated by the intense bargaining that took place in 2009 over the two countries' quotas in the CMIM. Tokyo was determined to gain the largest quota, reflecting its past dominance in regional finance. China, however, insisted that its own growth and size entitled it to an equal share of the total – an "equal firsts" policy. The compromise that was finally reached, giving China (with 28.5 percent) together with Hong Kong (3.5 percent) a quota equal to Japan's 32 percent, would have been laughable had the stakes not been so serious. With this arcane formula, the Japanese could claim – truthfully – that they were the biggest single contributor. Yet the Chinese could make an equally valid claim that they had now attained parity with Japan, since Hong Kong -- though technically an autonomous region -- is formally a part of the People's Democratic Republic ("two systems, one country"). Both sides could go home as winners.

Significantly, in the period since the CMIM was announced,, both Japan and China have been energetically negotiating or expanding their own bilateral local-currency swaps in the region even while planning to incorporate their existing bilateral dollar swaps into the CMIM. Each government, in effect, appears to be competing to line up as many regional clients as possible, offering access to the yen or yuan as bait.

All of this is a far cry from the kind of historic reconciliation that enabled France and

Germany to provide leadership for Europe after World War II. Some form of reconciliation is not impossible, of course. Tokyo, faced with the prospect of economic stagnation and long-term demographic decline, could well be tempted at some point to bandwagon rather than balance with China, becoming in effect Beijing's junior partner – the equivalent of France to China's Germany. Concerns about the "China economic threat theory" might simply be allowed to fade away. Or conversely, the Chinese economic model could conceivably begin to falter, leading Beijing to turn to Tokyo as an ally in hard times. China's "history problem" with the Japanese might be conveniently forgotten. But what are the chances of either scenario materializing? The odds are long. Few specialists in Asian security anticipate a genuine easing of Asia's power game anytime soon.

Is it any wonder, then, that achievements to date have been so modest? I would not go as far as does Jonathan Kirshner (2003) to predict outright monetary conflict in the region. Neither Japan nor China gives any indication of an appetite for direct confrontation over financial relations. But that is hardly the same thing as a warm embrace. The security tensions between the two cannot be denied. It is understandable, therefore, that others in the region might hesitate to commit to anything too demanding. Without coherent joint leadership, putative followers are naturally reluctant to take any steps that might, in effect, compel them to "choose sides" between mutually mistrustful rivals.

Solidarity?

On the other hand is a dearth of genuine solidarity. Put simply, East Asia lacks any sense

of common identity. As Grimes (2009a: 41) has noted, a "defining characteristic of East Asia has been regional fragmentation... a lack of centripetal forces." Other than geography, little binds the countries of the area together, while many factors work to keep them apart. These include stubborn legacies of World War II and the Cold War, such as Taiwan's contested status and the division of the Korean peninsula, as well as unresolved territorial disputes and deep differences of language, religion, ideology, and social organization. Security tensions are not limited to Japan and China alone.

For all their protestations of amity, all the region's governments remain noticeably distrustful of one another and place a high premium on preservation of as much national sovereignty as possible. Unlike Europeans, East Asians are as yet unwilling to pay even lip service to the notion of "an ever closer union" among their peoples. Most, having only recently emerged from colonial status, are more intent on individual state-building than on promoting regional solidarity. Few demonstrate much inclination to define themselves in relation to one another rather than in their own terms. As one Asian observer (Kim 2009: 49) puts it, "one of the driving forces behind European integration was the desire for a united Europe. This idea of a common citizenship is lacking in East Asia."

Nor is there even any natural core of states on which to build a regional project, as there was in Europe's original "inner six." The requisite like-mindedness is just not there. More or less by default, ASEAN+3 has come to be the main forum for regional financial initiatives. But the group is a wholly artificial construct, in terms of both who is included (Myanmar?) and who is excluded (Taiwan?). The advantage of such a broad grouping is that it includes the two states, China and Japan, who separately or together could play the role of supportive local hegemon. But

even apart from the animosities that divide the two potential leaders, there is the problem that suspicions of both powers remain widespread throughout the region. Wariness about the Japanese goes back to Tokyo's attempts during the interwar period to create a Greater East Asia Co-Prosperity Sphere, which most Asians remember as an exploitative and demeaning relationship. Fears of future domination by a huge, rapidly growing China are equally strong. Governments are not particularly eager to commit to the leadership of either of the two.

Should we be surprised, then, that the results of financial regionalism have until now been so unimpressive? The conditions needed to attain a successful sovereignty bargain have been most conspicuous by their absence. The lack of political will is by no means an accident.

REVERSE CAUSATION?

Political will is not written in stone, however. Attitudes can change. In particular, we cannot dismiss the possibility of reverse causation – a relationship of mutual endogeneity. Though security tensions may cause East Asians to hesitate over a commitment to financial regionalism today, tomorrow could be different. Over time, tentative steps toward financial cooperation could actually have the effect of moderating those same regional strains. Governments might be led to reconsider their security concerns, thus paving the way for additional cooperation on initiatives like the ABMI, ABF, and CMI/CMIM in a kind of self-reinforcing "virtuous circle."

The idea is not new. Other analysts have also suggested the possibility of mutual endogeneity in situations like this. Both David Bearce (2003) and Yoram Haftel (2007), for example, have spoken of the way that frequent contacts through regional economic institutions

may help to create the trust needed to reduce security tensions and overcome commitment problems. Social psychologists label this the "contact hypothesis." But in neither analysis is an explanation provided for the precise mechanism that propels the process forward. A growth of trust may be a necessary condition for further cooperation, but it is hardly sufficient.

What else is needed? In practice, I would argue, the dynamic of a self-reinforcing virtuous circle requires not one but two ingredients – not just regular contacts, to foster mutual confidence, but also a trigger of some kind, to overcome resistance to change. First comes a slow-moving process of socialization that works gradually to erode the foundations of prevailing attitudes. Then, at unpredictable intervals, come occasional fast-moving crises, sharp breaks in the environment that alter incentives enough to overcome inertia and set off a new round of initiatives. Both ingredients are necessary to maintain the momentum of a virtuous circle. It is in the interaction of the two that we find the key to the prospect of any further progress in Asian financial cooperation.

Punctuated equilibrium

I have spoken of the reasons why a successful sovereignty bargain is so difficult to attain. For the same reasons sovereignty bargains, once struck, are also hard to change in any significant way. Typically a certain degree of inertia sets in – an acceptance of the status quo and a resistance to fresh initiatives – that can be overcome only with considerable and determined effort. The progress of cooperation among states, therefore, tends to be subject to fits and starts: sustained periods of relative quiescence alternating with short bursts of reforming zeal.

In the political science literature, the process was once likened by Stephen Krasner (1983)

to the movement of tectonic plates under the surface of the earth. One plate could be envisioned as the terms of a sovereignty bargain; the other, related to underlying economic and political conditions. Change is equated with the tremors that are generated by a release of the frictions that grow up between plates. As Krasner (1983: 357) wrote: "Pressures between the plates vary over time. [At first] there is little pressure. Over time pressure develops at the interface of the plates as they move at different rates. These pressures may be relieved by imperceptible incremental movements, but often the pressures build. The higher the level of incongruity, the more dramatic the ultimate earthquake that finally realigns the plates."

Today the more favored metaphor is *punctuated equilibrium*, a concept borrowed from evolutionary biology and now widely employed in various branches of social theory. First popularized by the paleontologist Stephen Jay Gould, following publication of a landmark paper in 1972 (Eldredge and Gould 1972), punctuated equilibrium was defined as "a model for discontinuous tempos of change [in] the process of speciation and the deployment of species in geological time" (Eldredge and Gould 1972: 83). In social theory, the notion of punctuated equilibrium has been co-opted as a model to help explain discontinuities in public policy behavior, beginning with a seminal book by political scientists Frank Baumgartner and Bryan Jones (1993). The model assumes that policy generally changes only incrementally due to a variety of constraints, such as the "stickiness" of institutional cultures, vested interests, and the bounded rationality of individual decision makers. The policy process, accordingly, tends to be characterized by long periods of stability, punctuated only on occasion by large, though less frequent, changes caused by major shifts in society or government. In recent years, the punctuated equilibrium model has been used to shed light on everything from the specifics of U.S. tobacco policy (Givel 2006) to the

general incidence of war (Levento lu and Slantchev 2007).

Even Krasner (1988) soon came to abandon his tectonic-plates image in favor of punctuated equilibrium, which he concluded was a more suitable model for thinking about institutional change in international relations. From punctuated equilibrium, he contended, we learn that prospects for change are dependent on both existing institutional structures and environmental incentives. Existing structures make new initiatives difficult, owing to path dependency. Features selected at one point of time impose limits on future possibilities. Hence once a particular structure is established, it tends to maintain itself indefinitely – or, at a minimum, to channel future adaptation. Resistance to change can be overcome only by a radical shift of incentives – some modification of the environment sufficient to induce decision makers to recalibrate their estimation of potential benefits and risks of alternative options.

In the East Asian context, a pattern of punctuated equilibrium does seem to have been in evidence since the 1990s. After decades of inaction in the region, the energy that suddenly went into negotiating the ABMI, ABF, and CMI at the start of the new century was striking. Then a renewed period of comparative stasis followed until interrupted by the much celebrated multilateralization of the CMI in 2010. The stop-go quality of the pattern is unmistakable. What drives the pattern, I suggest, is the dynamic interaction of the two ingredients of socialization and crisis.

Socialization

Start with the first ingredient. In the absence of coherent leadership from Japan and China,

a growing sense of solidarity in the region is essential to provide the political will needed to deepen monetary and financial ties. That is where socialization comes in, which has been defined as "a process of inducting actors into the norms and rules of a given community" (Checkel 2005: 804). Socialization occurs naturally when cooperation between states becomes institutionalized in initiatives like the CMI/CMIM. The more actors learn to work together, finding joint solutions to common problems, the less reason they may find to cling to ancient suspicions and animosities. Gradually, bitterness and fear can yield to an accumulation of the mutual trust needed for more far-reaching initiatives – "peaceful change through socialization," as one source describes it (Acharya 2009: 20).

The mechanics of the process were described long ago by Robert Keohane and Joseph Nye (1974), stressing the development of what later came to be known as epistemic communities. From regularized cooperation over a period of time, they wrote, changes of attitude may result, creating "transgovernmental elite networks" linking decision makers to one another by ties of common interest, professional orientation, and even personal friendship. In Keohane and Nye's words (1974: 45): "When the same officials meet recurrently, they sometimes develop a sense of collegiality, which may be reinforced by their membership in a common profession.... Regularized patterns of policy coordination can therefore create attitudes and relationships that will at least marginally change policy." Today, in the language of constructivism, that would be described as a reconstitution of actor identities and interests. Initiatives like the CMI/CMIM can create new "social facts" (inter-subjective understandings) which, in turn, may lead to yet deeper forms of cooperation.

That some kind of socialization has been taking place in East Asia can hardly be questioned.

Many have written of the socializing role of Asian financial institutions (Acharya 2009). Indeed, how could attitudes not be affected, given the frequency of meetings across the region dealing with one financial issue or another? Some positive influence must be at work, quietly building a sense of common destiny. It is true, of course, that the actors most directly involved – central bankers, treasury officials, banking regulators, and the like – normally are not the same as the personnel responsible for security policy. The two issue areas are typically managed by different elite networks that only occasionally overlap in daily operation. But that caveat applies mostly to the lower levels of bureaucracy, which deal mainly with matters of a routine or technical nature. At higher levels of decision making, where grand strategy is involved, contacts among officials are bound to be broader and more intimate. It is hard to believe that finance and foreign ministers do not talk to one another on occasion, sharing their impressions on relations with regional neighbors.

On its own, however, socialization is unlikely to be decisive, precisely because it is such a gradual process. It takes time to shift inter-subjective understandings. Peter Aykens (2005) distinguishes three stages in the process of trust development: (1) "momentary trust," based on calculations of risk resting solely on immediately available information; (2) "reputational trust," derived from growing familiarity and experience; and finally (3) "affective trust," representing stable and unquestioned sets of expectations. Only when the final stage of affective trust is attained – the end-product of a long process of social interaction and learning -- can a really serious sovereignty bargain be struck as a result of socialization alone. Short of that stage, which could take decades to attain, some trigger is needed to overcome resistance to change. The most obvious candidate to play that role is an unexpected crisis of some kind.

Crisis

Enter the second ingredient. Scholars of international relations have long noted the potentially positive role of crises. The classical definition of a crisis is usually attributed to Charles Hermann (1972), who equated the phenomenon with three critical dimensions: high threat, short decision time, and an element of surprise. In such circumstances, it is not at all surprising that actors might be spurred to jump to a new level of cooperation – to use the well worn analogy, much like a frog thrown into the proverbial pot of boiling water. The motivation for joining together may be fear, a defense against the unknown. But it could also be a matter of ambition, a determination to strike while the iron is hot. Many point to the Chinese symbol depicting crisis, *wei-ji*, which combines the two words danger and opportunity. As Rahm Emanuel, chief of staff to President Barack Obama, has said: "Never allow a crisis to go to waste.... They are opportunities to do big things" (as quoted by Ward 2009).

For all the damage they may do, therefore, crises have frequently been cited favorably for their potentially powerful influence as a catalyst for new initiatives. In the words of one recent analysis (Praet and Nguyen 2008: 368): "It is a well known fact that some major institutional changes have been devised in response to crises. Crises do tend to highlight weaknesses of systems as well as raise the collective consciousness that is necessary to give an impetus to major reforms." Or as economist Philip Lane puts it: "It takes a crisis to learn a lesson.... What does not kill you often makes you stronger" (as quoted by Thomas 2009). Crises represent a "critical juncture" (Calder and Ye 2004) that creates a "tipping point" or "window of opportunity" for strategic experimentation and policy adaptation.

Stephan Haggard and Sylvia Maxfield (1996), for example, have cited the key part played by balance-of-payments crises in encouraging financial liberalization in developing countries. Though it might seem counterintuitive, they found that governments faced with the threat of a run on their currency have often found it expedient to increase rather than decrease financial openness, in order to cultivate credibility with market actors. Liberalization in the face of crisis, Haggard and Maxfield write (1996: 211), "signals foreign investors that they will be able to liquidate their investments, indicates government intentions to maintain fiscal and monetary discipline, and thus ultimately increases capital inflows." Similarly, in an early analysis of my own (Cohen 1993), I have highlighted the effect that crises may have in easing, at least temporarily, resistance to new form of monetary cooperation. Major financial upheavals, I suggested, tend for a time to alter governments' calculations of the costs and benefits of cooperation. The perceived disadvantages of a commitment to common action are reduced when all parties seem threatened by a large systemic shock. As a result cooperation may be ratcheted up a notch or two beyond what previously might have seemed possible. Equilibrium is punctuated.

The dynamic in action

The dynamic interaction of socialization and crisis has certainly seemed to be at work in East Asia – at least, so far. Crisis, we know, clearly played a role a decade ago in first stimulating East Asia's interest in financial regionalism. Observers overwhelmingly agree that the trauma of 1997-98 was a "turning point" for the countries of the region (Chey 2009: 450); an "impetus for many financial cooperation initiatives" (Sussangkarn and Vichyanond 2007: 25); a shock that

"opened the door to significant policy-led integration in East Asia" (Park 2007: 96). Many make use of the word "catalyst" (e.g. Amyx 2004: 98). Indeed, a recent major retrospective on the experience was entitled, simply, *Crisis as Catalyst* (MacIntyre et al. 2008). The burst of energy that followed the crisis, resulting in the ABMI, ABF, and CMI, is easy to understand.

Likewise, crisis plainly provided the impetus needed to complete multilateralization of the CMI. Here the shock was the global financial meltdown that started in 2007-08, bringing with it the deepest downturn in the world economy since the Great Depression. Observers agree that in this instance too the perceived threat was serious enough to prod governments into action. In the words of the *China Daily* (2009): "Ever since the Asian financial turmoil of 1997-98, Asian countries have learned the importance of some kind of regional currency cooperative mechanism.... Now, with a second financial crisis in a decade and prospects still unclear as to when the global market would finally emerge from its shadow, it would be all the more crucial to build a collective protective mechanism." Skeptics may object, pointing out that the idea of multilateralization actually dated as far back as 2005. But it is clear that little of a practical nature was ever accomplished toward that goal, following agreement in principle, until crisis once more loomed. As Reuters commented (Wheatley 2009), "It took a global crisis to inject a sense of urgency into the project."

The question is: Can we expect the pattern to be repeated again? Obviously, there is no certainty about the process. For one thing, it relies on the recurrence of events whose frequency and timing is by definition unknowable. Furthermore, even in the midst of a period of distress, the reach of any new financial commitments will be strictly circumscribed by larger security concerns, which in a threatening world are naturally accorded a higher priority by governments. And finally,

much depends on the characteristics of each specific crisis. The shock in 1997-98 was particularly conducive to cooperation because of two dominant features. First was the fact that just about every economy in the region was seriously affected, making it a *collective* experience. They all felt they were in the same boat. And second was the fact that most found themselves to be especially vulnerable owing the "double-mismatch problem" and low levels of reserves. Few at the time were in a position to resist market speculators or the demands of the United States and IMF. The same two features were also in evidence during the more recent episode, owing to the breadth and gravity of the global recession. Despite higher reserve levels, most governments once again felt vulnerable to events originating outside their region. There is no guarantee, however, that similar circumstances will ever arise again. The dynamic of punctuated equilibrium is real but by no means inevitable.

CONCLUSION

My conclusion, therefore, is positive but temperate. Though limited by security tensions, some form of financial regionalism is possible and could, in time, help to reduce barriers to further cooperation in the future. But the process, I suggest, will at best be both episodic and slow. Cumulative accomplishments will remain modest in the absence of a truly fundamental transformation of regional politics.

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ENDNOTES

1. See e.g., Asian Development Bank 2004; Chung and Eichengreen 2007b, 2009; Hamada et al. 2009b.
2. Participants in EMEAP includes the five founding members of ASEAN – Indonesia, Malaysia, Philippines, Singapore, and Thailand – plus China, Hong Kong, Japan, Korea, Australia, and New Zealand.
3. The number in effect at any one time has varied as arrangements have lapsed and been renegotiated and reinstated.
4. Formally, the CMI also included two other "pillars in addition to the BSA network. One was a set of repurchase agreements totaling $1 billion. The other was an agreement to expand an already existing ASEAN swap arrangement (ASA), first established in 1977 by the five founding members of ASEAN (Indonesia, Malaysia, Philippines, Singapore, and Thailand). ASA was now to include the Plus Three countries as well as other members of ASEAN, and the level of mutual commitments, originally set at $200 million, was raised to $1 billion (further increased to $2 billion in 2005). Since the amounts involved are so small, however, neither of these additional "pillars" is considered to be of particular importance.
5. At time of writing, it was still not clear which BSAs will ultimately be retained and which will be effectively folded into the new common facility.
6. Formally, borrowing rights are defined by "purchasing multipliers"of either 0.5, 1.0, 2.5, or 5.0, inversely related to the size of each country's quota (contribution).