

The Global Financial Crisis and East Asia: Testing the Regional Financial Architecture

William W. Grimes
Boston University

June 2009



Knowledge-Net for a Better World

The East Asia Institute(EAI) is a nonprofit and independent research organization in Korea, founded in May 2002. The EAI strives to transform East Asia into a society of nations based on liberal democracy, market economy, open society, and peace.

The EAI takes no institutional position on policy issues and has no affiliation with the Korean government. All statements of fact and expressions of opinion contained in its publications are the sole responsibility of the author or authors.

 **EAI** is a registered trademark.

© Copyright 2009 EAI

This electronic publication of EAI intellectual property is provided for non-commercial use only, as long as it is unaltered and complete. Copies may not be duplicated for commercial purposes. Unauthorized posting of EAI documents to a non-EAI website is prohibited. EAI documents are protected under copyright law.

The East Asia Institute
909 Sampoong B/D, 310-68 Euljiro 4-ga
Jung-gu, Seoul 100-786
Republic of Korea
Tel 82 2 2277 1683
Fax 82 2 2277 1684



The Global Financial Crisis and East Asia: Testing the Regional Financial Architecture*

William W. Grimes
Boston University
June 2009

The Asian Financial Crisis had a catalyzing effect on East Asian financial policy makers, as it laid bare both the exposure of regional countries to global finance and the apparent indifference to their plight on the part of the IMF and United States. Whatever else the crisis produced—and it had enormous economic, political, and social ramifications in many countries¹—it clearly raised concerns about the ability and willingness of the guarantors of global financial stability to care about East Asian stability.² Some East Asian policy makers decided early on that the new dynamics of the global financial system called for a regional self-help system, as evidenced in the Asian Monetary Fund proposal and Japan's New Miyazawa Initiative. After some stumbling around, cooperative efforts eventually coalesced around the ASEAN+3—a group that had not formally existed before 1997—in a set of cooperative endeavors that included preeminently the Chiang Mai Initiative, the Asian Bond Markets Initiative, the Asian Bond Fund (actually an initiative of the Executives' Meeting of the Asia-Pacific Central Banks, which is composed mostly of ASEAN+3 central banks), and a rudimentary surveillance mechanism known as Economic Policy Review and Dialogue.³

East Asian financial regionalism developed in response to the lessons of the AFC, and as such was meant to prevent such a crisis from recurring—or, if it did, to prevent its

* Prepared for presentation at the East Asia Institute and Keio University under the auspices of the East Asia Institute's Fellows Program on Peace, Governance, and Development in East Asia. The author wishes to thank the East Asia Institute for its support.

Note: This paper is a draft and will be revised. Please do not quote or cite without permission from the author. All comments, questions, suggestions, and criticisms are welcome.

¹ Haggard 2000.

² Higgott 1998; Narine 2003; Terada 2003; Lee 2008.

³ For details, see Grimes 2009, ch. 3-5.



spread and to rapidly contain its worst effects. Regional cooperation has faced criticism on its economic merits both from those who argued that it had not gone far enough in locking in the lessons of the 1997 crisis and from those who felt that in “fighting the last war,” the East Asian economies were creating new global problems.⁴ There have been political concerns as well, both from advocates who fretted that politics was preventing the establishment of effective regional institutions and from those who doubted the viability of a set of arrangements that depended ultimately on Sino-Japanese cooperation to provide public goods.

Both advocates and critics have built logical arguments based on theoretical and practical assumptions, but any honest evaluation has been left with the basic lingering question: When push comes to shove, what effects would financial regionalism have? With a new financial crisis of global dimensions, this would appear to be a good time to attempt at least an initial appraisal. The thesis of this paper is a paradoxical one. I argue that, while financial regionalism *per se* has had little apparent impact on how the crisis has affected the ASEAN+3 economies, the *regional financial architecture* has effectively insulated these economies from the worst effects of the crisis. The catch is that “regional financial architecture” must be understood as more than simply the official cooperative efforts of ministries of finance and central banks. Rather, it also includes the responses of national authorities and global actors to the political dynamics created by regional and global institutions. And ironically, it is far from obvious that “improvements” in the form of greater institutionalization of regional financial cooperation will improve either the functioning of the regional initiatives themselves or the more broadly defined regional financial architecture.

The East Asian Regional Financial Architecture

The term “architecture” has become a trendy one in the study of regional and global cooperation. One can easily find discussions of regional and global economic or financial or environmental or security architecture in academic and policy journals, often discussed with a sense of great gravity and even urgency. The emphasis on architecture is sensible enough, but like other ambiguously defined concepts in international relations and political economy—from regimes to international organization (as opposed to

⁴ Eichengreen 2004; Goldstein and Wong 2005; Grimes 2009, ch. 4.



international organizations) to institutions—it may obscure more than it reveals about the empirical reality it attempts to summarize.

I will not attempt to parse the various ways in which “architecture” has been or can be construed; instead, I will simply try to clarify here the way in which I use the concept in this paper. Regional architecture is not just about formal rules or institutions; rather, it is the overall structure of rules, actors, interests, and incentives that govern behavior in a given issue-area. Analytically, this may appear to be an uneasy muddle of agency and structure, customary behavior and legal framework, incentive structures and formal organizations. But this is a complex issue-area with a variety of actors and interests, and if we do not think of it as a system (even an ecosystem), our simplifying strategies become a means of misleading ourselves.

The concept is clearer if we use it analytically rather than abstractly and if we break it down by component. I begin with the global level. There are global, regional, national, and subnational sets of rules that affect internationally active financial institutions. So which rules constitute the basis of the global architecture? My answer is an uncomfortable one: all of them. Looking just at the rules that affect internationally active banks, it is clear that some global ones (e.g., the Basel standards or International Accounting Standards Board rules) are of great consequence, but then so are the laws of a bank’s home government (or, in the case of the United States, with its multiplicity of state governmental regulations and regulatory bodies, its choice of home government), the laws of other states in which it operates, and sometimes regional standards such as those promulgated by the European Union. Which ones matter most at any given time depends on the ability of banks to “venue shop” (leading to accusations of a regulatory race to the bottom), the attractiveness of specific market centers at a given time (as evidenced by the attention first to New York and then to London as the *de facto* center for the production of global best practices), and the ability of powerful states to push their agendas on global councils of regulators.⁵

In addition to rules and regulators, financial institutions (banks, securities firms, insurance companies, hedge funds, private equity, exchanges, clearinghouses, rating agencies) and tradable instruments themselves comprise a significant portion of the architecture at each level. Issues include scale (as demonstrated by the many banks that have proven “too big to fail” in the current crisis), the types of business in which financial

⁵ Regarding financial market center competition, see Committee on Capital Markets Regulation 2006, 2009. Regarding the ability of powerful states to direct global regulatory bodies in general, see Singer 2007; an excellent example was the original Basel Agreement—Kapstein 1991.



institutions are engaged, and the ways in which they are interconnected. For example, multinational financial conglomerates in the hyper-globalized markets of the last decade were in a position to directly affect specific markets (and regulators) and to substitute their activities among functionally equivalent investment vehicles and across national boundaries. Moreover, the various trading options even for identical securities—ranging across exchanges, clearinghouses, “dark pools” of liquidity, and OTC trading—complicated price discovery, increased uncertainty about counterparty risk, and reduced liquidity at the worst possible time.

Finally, the financial architecture endogenously creates an ever-evolving set of incentives for investors, lenders, borrowers, and trading platforms of all kinds. For example, the dangerous overreliance on rating agencies witnessed in the run-up to the global financial crisis resulted from a complex set of capabilities, interests and expediencies: Ratings were a useful decision tool for highly-diversified investors; the demand that their usefulness engendered allowed them to grow larger and more sophisticated; their sophistication and authoritative effects on markets made them an attractive third-party arbiter of risk to regulators as those regulators developed and then implemented Basel-2, as well as to financial institutions as they securitized and repackaged ever more derivative products; the profits to be made by both issuers of derivative securities and the credit rating agencies themselves contributed to perverse incentives to create models for innovative products for which adequate credit-risk data did not exist; etc.

Overview of the East Asian Regional Financial Architecture

While I have defined financial architecture very broadly, I focus in this paper on the roles of official actors in describing the East Asian regional financial architecture for the purposes of analytical tractability. These roles can be categorized along three dimensions: regional cooperative efforts, relationship to the global architecture, and “national self-help.” In each dimension, East Asian governments are both components of the regional architecture and agents for change.

The governments of East Asia have been engaged since 1997—and particularly since 2000—in the creation of a series of regional cooperative efforts, mostly situated in the ASEAN+3 and specifically excluding U.S. participation.⁶ These include the Chiang Mai

⁶ Lee 2006, 2008; Grimes 2006, 2009; Dent 2008.



Initiative (CMI), the Asian Bond Markets Initiative (ABMI) and Asian Bond Fund (ABF), Economic Policy Review and Dialogue (EPRD), and a set of arrangements (including the annual ASEAN+3 Research Projects) for discussing further development of formal regional efforts such as currency and macroeconomic policy coordination. The characteristics of these efforts vary considerably. CMI is contractual, with clear obligations for participants to contribute to the collective good under specific conditions. ABMI, in contrast, is based on the principle of self-paced autonomous regulatory change. It operates in the context of regional consensus on long-term goals and standards, but in the absence of substantive collective action by participants or substantial public good provision by leading members. EPRD constitutes a structured process of discussion and recognition of mutual interests, but provides no clear guidelines for behavior or means of promoting cooperation except through moral suasion and peer pressure. Finally, discussions on currency and macroeconomic coordination lack even a generally-agreed notion of goals or timetable.⁷

Nonetheless, we can see at least in CMI, ABMI, and ABF (and arguably in EPRD) a potentially consequential set of components of an East Asian financial architecture. This is particularly true of CMI, which provides assurances to participating governments that they will receive rapid and substantial (if not necessarily sufficient) liquidity support in the event of a currency crisis. In principle, CMI should both reduce the likelihood of currency crises (by assuring investors that macroeconomic authorities will be able to manage their foreign-currency debts in the short-term even if an IMF plan becomes unavoidable) and provide a means of more effectively managing crises that do occur. As I have argued elsewhere, it also creates political pressure on the IMF and outsider donors such as the United States not to impose onerous performance conditions to any bailout that does become necessary.⁸ Meanwhile, the ABMI and ABF provide guidelines and (limited) practical support for developing national financial regulation, as well as a venue for promoting transnational local-currency markets.⁹

The next dimension to note is the relationship between the global and regional architectures. Strikingly, regional cooperative efforts have been almost entirely nested within global structures of cooperation.¹⁰ The ABMI and ABF have operated off of

⁷ For the most detailed description in English, see Grimes 2009.

⁸ Grimes 2009, pp. 97-99; see also Katada 2002, 2004.

⁹ "ASEAN+3 New ABMI Roadmap," 2008, http://asianbondsonline.adb.org/features/abmi_roadmap/080731_ABMI_Roadmap_Publication_Final.pdf.

¹⁰ Grimes 2006.



assumptions that global standards and best practices are the most appropriate way in which to structure financial markets. For example, they have championed acceptance of international accounting standards and the Basel-2 criteria even for domestic financial institutions, have sought to nurture the development of domestic credit rating agencies that utilize methodologies like those of the global credit rating agencies, have supported moves toward capital liberalization, and have promoted the development of asset-based securities markets through the enactment of regulations and creation of infrastructure that meet global standards of transparency and openness to innovation. Even when participants have developed initiatives such as regional credit guarantee mechanisms, they have employed market-based logic in their design efforts. Similarly, CMI has relied on the IMF as a sort of gatekeeper for access to funds, while EPRD has not yet moved beyond standard IMF notions of responsible macroeconomic policy and financial regulation.¹¹

Regional and global elements combine to create a set of incentives for action in our third dimension of the regional architecture, that of national policies.¹² Essentially, regional cooperation has thus far done little to change the basic set of forces that financial globalization has imposed upon national financial systems around the world. Bond market initiatives, in seeking to increase local-currency markets' depth and liquidity, have promoted openness, transparency, and "light-touch" regulatory systems, all of which actually reduce the control of the local authorities and increase the potential role of global financial markets and actors. The Chiang Mai Initiative both maintains a central role for the IMF (at least for the moment) and remains open to challenges to its credibility. The upshot is that national authorities appear to have decided by and large to rely on self-help as their primary insurance against currency crises. This can be seen in two general policy decisions. First, macroeconomic authorities have accumulated massive foreign exchange reserves, despite the promise of both CMI and the IMF (in the form of the Extended Fund Facility) to provide large-scale support as needed. Second, the authorities have abandoned (or at least significantly modified) pegged nominal exchange rates. Both of these sets of efforts predate the current crisis, and both were carried out despite regional or global guidance to the contrary.

¹¹ See Grimes 2009, ch. 3 for CMI and ch. 5 for ABMI and ABF.

¹² Walter 2008.



Financial Regionalism as Insulation and the Limits of a Decoupling Strategy

Before turning to an appraisal of the regional architecture in light of the current crisis, it is important first to discuss the underlying logic of the set of cooperative efforts that I have labeled “financial regionalism.” Financial regionalism can best be understood as a market-oriented strategy of insulating East Asian economies from currency volatility, hot money, and the effects of U.S. macroeconomic policy.¹³ This is most apparent in the case of the Chiang Mai Initiative, whose purpose is to insure economies against sudden drops in the value of their currencies, but can also be seen in bond market development efforts and in discussion of currency cooperation. The purpose of the bond market initiatives has been to reduce the problem of “double mismatch” (borrowing, on net, in dollars for short terms in order to finance long-term projects that would pay back in the local currency), which had contributed to the 1997 crisis.¹⁴ By developing attractive, market-based alternative investment and borrowing opportunities in local currencies, policymakers hoped to reduce their exposure to dollar-based financial intermediation and thus their vulnerability to fluctuations in the dollar value of their currencies. Currency coordination as well (although just a conversation at this point, and not a likely reality in the short-term) seeks to insulate regional economies from the dollar. All of the proposals currently in play are based on currency baskets, whether internal or external to the region;¹⁵ the net effect of any sort of currency coordination would be to reduce the role of the dollar—and possibly dollar-denominated reserves—in the denomination of trade and finance, and thus in the management of East Asian currencies. Overall, therefore, financial regionalism can best be understood as an effort by regional governments to reduce vulnerability to shifts in the U.S. dollar or U.S. economic fortunes through partial decoupling.

While the desire to insulate regional economies from the influence of U.S. macroeconomic shifts is understandable and the policies make sense on their own terms, the actual effects of financial decoupling efforts have been limited. Certainly, currency mismatch measures look much better than they did in 1997,¹⁶ as short-term borrowing by local firms in the emerging markets has been more restrained and—perhaps equally importantly—governments have chosen to effectively socialize the risks of dollar-based intermediation by accumulating their own dollar-based investments. But the mechanism

¹³ Grimes 1999, 2002, 2003, 2006, 2009.

¹⁴ Ito and Park 2004; Asian Development Bank 2004.

¹⁵ Ito 2007; Grimes 2009, pp. 142-145.

¹⁶ See Asian Bonds Online for data, <http://asianbondsonline.adb.org>.



for this transformation has not primarily been development of the local-currency markets that financial regionalism has sought to promote.

Meanwhile, macroeconomic and currency policy coordination among the East Asian economies remains virtually non-existent. ERPD, while useful as a means of ongoing communication and information exchange, has not developed at all as a means of actually coordinating policy. This is not surprising, given that there is no clear mechanism either for disciplining irresponsible macroeconomic behavior or for rewarding responsible behavior, which would essentially require the leading economies to offer or withhold benefits. Neither Japan nor China has shown the stomach for such a role, presumably because the two are simultaneously vying with each other to court the cooperation and trust of other ASEAN+3 governments.

The most practical way to carry out coordination would be through exchange rates—not necessarily through a legalistic and clearly articulated set of obligations analogous to the European Exchange Rate Mechanism and Growth and Stability obligations, but at least by having common expectations of how to manage exchange rates (perhaps relative to a regional or extra-regional basket).¹⁷ This is signally not the case in East Asia, where even discussions of principles of exchange rate management have been considered too sensitive for officials. Indeed, the only effective macroeconomic and exchange rate policy coordination that East Asian economies have experienced in the post-colonial period has been what McKinnon memorably called “the East Asian dollar standard.”¹⁸ The difficulty of creating an attractive alternative to a heavy dollar weighting in exchange rate management is overwhelming, especially since the individual incentives among developmentalist economies for maintaining slightly undervalued currencies (and the lack of meaningful sanctions for currency manipulation) have been so strong.

In the end, the essential problem is a political one. In order to pursue a regional decoupling strategy as envisaged by the ASEAN+3, certain public goods are needed, including providing local-currency liquidity, rewarding cooperative behavior (e.g., market-friendly financial regulation and responsible macroeconomic policies), and punishing defection (e.g., competitive devaluation, favoritism in financial markets). Neither China nor Japan is individually capable or willing to provide the public goods needed to promote a regional decoupling strategy, nor have they been willing to do so cooperatively—indeed, they are each actively competing with each other and with their other ASEAN+3 partners. The result has been self-paced voluntary action in the bond

¹⁷ Rhee 2004; Kawai 2005; Kawai and Takagi 2005; Kuroda 2005, ch. 4.

¹⁸ McKinnon 2005. The East Asian dollar standard may well be breaking down now, with nothing to replace it.



initiatives and a continued major role of the dollar in exchange rate management, despite considerable (and well-founded) unease about the effects of U.S. macroeconomic policies. Looked at this way, the search for institutional solutions is inevitably misguided; only political cooperation by Japan and China, coupled with a fundamental shift within both political economies away from developmentalism and toward openness and a willingness to act as market for regional distressed goods could create effective economic leadership.¹⁹ (Obviously, concerns about financial openness are not as relevant for Japan, despite continuing defects of the financial system.) There seems little likelihood of either condition holding into the medium term.

The Challenge of the Global Crisis

The global financial crisis creates both an opportunity to evaluate the performance of the regional financial architecture and a potential critical juncture at which participants can transform parts of the structure. In principle, the reevaluation should inform the transformation, although this is by no means assured.

Effects of the Crisis in East Asia

The global crisis has had adverse effects throughout East Asia. Nonetheless, it is striking that no economy in the region has yet experienced the kind of currency crisis and capital flight that were so devastating in 1997-98.

Unlike in 1997, the current crisis has affected East Asia mostly through the real economy, as slowdowns in developed country markets have reduced demand for East Asian exports. The toll has been particularly bad in sectors such as consumer electronics, IT hardware, and automobiles, where export production has been dominated by complex regional production networks.²⁰ Since these are the very sectors that have led regional exports and manufacturing growth, the effects on domestic economies have been severe. (In Malaysia and Indonesia, the crash in global commodity prices has further aggravated the problems of the real economy.)

¹⁹ Kindleberger 1981, 1986.

²⁰ See, e.g., "Malaysia's April Exports Slump, Below Forecast," *The Malaysian Insider*, June 4, 2009.



In such a severe economic climate, why have economies escaped currency crises? The main explanation for the resilience of the regional financial systems appears to be the elements of the regional architecture that have been least noted by analysts: national governments' own self-help efforts, which were developed in the context of the incentives created by regional and global institutions. Perhaps most important has been the flexibility of exchange rates, which has allowed for more gradual adjustment to changed economic circumstances. Since 2005, a number of regional currencies—including those of Indonesia, Japan, the Philippines, South Korea, and Thailand, and—have seen substantial shifts both up and down. However, unlike in 1997, there has not been an explicit or implicit government commitment to defend a given nominal value, and so there has been little incentive for speculative attacks. The sheer size of foreign exchange reserves has also reduced fears of speculative attacks or capital flight. It has also provided a substantial cushion that has allowed fiscal and monetary stimulus even for emerging market economies such as Malaysia.

Additionally, domestic financial regulation and supervision in most of East Asia have improved markedly since the 1997 crisis, at least partly due to IMF-imposed plans in Thailand, Indonesia, and South Korea.²¹ But the political will to restrain irresponsible behavior by domestic financial institutions has been buttressed by three elements of the financial architecture. First, officials' lack of confidence in the IMF's ability and willingness to insulate economies from the international effects of domestic financial problems has heightened sensitivity to likely triggers for international attack, even though it has not led to perfect conformity with global standards of regulation and supervision.²² Second, the bond market initiatives have—at least marginally—contributed to increased transparency and prudential regulation as a goal, while also maintaining governments' rhetorical commitment to fair, rule-bound financial intermediation. Third, the basic capital openness of East Asia's emerging market economies (even China, through its Hong Kong proxy), which is a central element of the regional architecture, has created a dynamic of competition among financial market centers to profit from the capital-raising and investing needs of rapidly growing regional economies.²³

For the moment, then, ample foreign exchange reserves and flexible exchange rates have helped to prevent externally-created currency crises in East Asia. Thus, the threat of financial crises is a function of the behavior of national authorities and domestic financial institutions. In this way, the incentives created at both global and regional levels have

²¹ McCauley and Park 2006; Walter 2008.

²² Walter 2008.

²³ Grimes 2009, pp. 194-199.



worked to the benefit of the East Asian economies—although their accumulation of foreign exchange reserves did on net contribute to the rise of the U.S. housing bubble. From a global perspective, the renewed emphasis on sequencing of liberalization rather than deregulation and big-bang liberalization in the post-AFC period has been beneficial to the East Asian emerging markets, as pressure from the United States and IMF to liberalize rapidly has ceased and global guidelines (e.g., the Basel standards) have recognized the need for alternative tracks for regulation of “sophisticated” and “unsophisticated” financial institutions, investors, and systems. The upshot is that East Asian financial institutions were, by and large, not heavily exposed to “toxic assets” and other illiquid or difficult-to-price derivatives and have had good capital cushions, so unlike their U.S. and European counterparts they have not been directly hit by the crisis. Nonetheless, the real economy effects already noted have already led to increased bankruptcies and non-performing loans in East Asian economies, and these problems will inevitably get worse in 2009-10. Whether prudential regulation and bank management are up to the task will be sorely tested; nevertheless, it is hard not to be impressed by the robustness of the East Asian financial systems at this point in the crisis.

Regional Crisis Management

I have argued that the key aspects of the regional financial architecture that have helped East Asian economies avoid financial crisis (despite very real economic challenges) have been the national-level choices. Nonetheless, discussions of regional architecture continue to focus on regional *cooperation*. And in the face of a crisis so severe that for the first time in decades developed economies (albeit small ones, like Iceland) have turned to the IMF, it seems particularly important to reexamine the potential of regional arrangements to manage any crisis that does arise.

From the emergence of the Thai crisis in 1997, emergency management seemed an obvious place to focus regional cooperation. The considerable economic interdependence of the region—and thus potential for contagion—made financial stability in each country a regional public good (and financial crisis a regional public bad). Meanwhile, dissatisfaction with the IMF-led response in 1997-98 has added to the justification for a regional response. Indeed, the first bold stroke in advancing a regional solution to regional financial challenges was Japan’s Asian Monetary Fund proposal. While unsuccessful, the AMF proposal inspired alternatives such as the Asia-Pacific-wide Manila Framework Group and the unilateral Japanese New Miyazawa Agreement before



returning to an East Asia-only regional solution in the form of the Chiang Mai Initiative.²⁴

The Chiang Mai Initiative as it currently stands is definitely *not* the Asian Monetary Fund in new clothes. It is designed such that emergency liquidity is provided bilaterally (albeit on a coordinated basis) through a network of bilateral swap agreements (BSAs).²⁵ States are not obligated to release more than 20% of their agreed swap-lines (the so-called “IMF link”) unless the IMF certifies that crisis economies are engaged in good-faith negotiations for a stand-by agreement, at which point the full amount can be released in order to provide bridge financing while negotiations are ongoing. Thus, the regional arrangements are clearly nested within the global crisis management regime symbolized by the IMF.

The decision to release funds obligated under a BSA is, moreover, not nearly as automatic as often believed. States have complete discretion as to whether to release non-linked funds. And even if the IMF signals its approval of release of linked funds, actual release is still contingent on the willingness of the lending governments (which in some cases may themselves be facing possible currency crises) to part with hard currency. Strangely enough, there is not even a clear definition of what would constitute a crisis severe enough to trigger activation of the network.

From an institutional design perspective, the CMI as of 2008-9 was actually an elegant solution to a number of problems that might otherwise beset a brand-new mechanism for emergency liquidity provision. The IMF link, while much resented by some of the ASEAN+3 governments, has provided a simple decision-making criterion. Moreover, it allows the lending governments to elide responsibility for imposing conditions by delegating conditionality to the IMF (which had earned considerable credibility of threat in the 1997 crisis), thus reducing the potential for moral hazard. Delegating the functions of monitoring and enforcement to the IMF was also attractive to leading participants because of the basic inability of Japan and China to exercise collective leadership in the midst of their own political competition over their position in the region.

Nonetheless, the extraordinary accumulation of foreign exchange reserves by likely borrower countries (not to mention Japan and China, for which reserves could hardly be understood as ammunition for dealing with future crises)—despite the opportunity costs and exchange rate risks they implied—made clear that the credibility of CMI remained in question among participant governments. Meanwhile, the success of the East Asian

²⁴ Katada 2001, ch. 8; Henning 2002; Lee 2006; Grimes 2009, ch. 3.

²⁵ For details, see Grimes 2009, ch. 3.



economies (at least so far) in avoiding financial crisis since 2000 has meant that CMI remains untested.

Testing Chiang Mai

Given that the Chiang Mai Initiative has yet to be triggered, is there anything meaningful we can say about its effectiveness? On the one hand, it is arguable that the lack of disorderly currency depreciations or capital flight in the face of the biggest global financial crisis in seventy years is suggestive of its credibility. On the other hand, I argue that, while the regional financial architecture has been impressively robust in the face of this massive challenge, the most important elements of that architecture have been those at the national level.

While we do not have convincing evidence either that CMI will work as planned or that international speculators have been deterred by its existence, we do have some useful empirical evidence about the way in which *participating states* view its credibility. In the fall of 2008, as credit markets in the United States and other economies ground sickeningly close to a halt, two CMI participants—South Korea and Singapore—swung into action to ensure access to dollar liquidity. They did so not through the ASEAN+3 process or even primarily via enhancement of their bilateral swap agreements with Japan and China. Rather, they turned first to the United States, securing access to significant swap lines (\$30 billion in the case of South Korea, or double the amount committed under CMI to that point) with the Federal Reserve Board to ensure dollar liquidity for their banking systems.²⁶ Although the Bank of Japan and People’s Bank of China followed up soon after with equivalent yen-won and RMB-won swap agreements, the Bank of Korea made clear in a published Action Plan where its priorities lay: “The Korea-US currency swap line will be used prior to other liquidity supplies for funding domestic banks.”²⁷ Technically, the swap lines were meant to ensure dollar liquidity for Korean and Singaporean financial institutions and not to preempt the Chiang Mai Initiative; practically speaking, however, they reflect a reasonable concern on the part of Korean and Singaporean monetary authorities that the funds available to them through CMI were insufficient in terms of either amount or credibility (or both) to prevent a liquidity crisis.

²⁶ “Fed Opens Swaps With South Korea, Brazil, Mexico, Singapore,” *Bloomberg*, October 29, 2008.

²⁷ Republic of Korea Ministry of Strategy and Finance, “Realizing 2009 Policies: Action Plans by the MOSF,” December 18, 2008,

http://english.mofe.go.kr/news/pressrelease_view.php?sect=news_press&sn=6137.



The actions of Korea and Singapore in 2008 demonstrated a basic, albeit consciously hidden, truth at the base of the Chiang Mai Initiative: that CMI had the potential to be an important element in bailing out one (or perhaps two) ASEAN-4 economies in crisis, but no more.

Changes to the Regional Architecture: Improvements or Increasing Hazard?

So far, I have addressed the robustness of the regional financial architecture as if its history began in 2007 and ended in 2008. But that is obviously not the case. The global crisis has thrown many institutions and understandings into turmoil and change is in the air. Much of this is in progress at the global level, where East Asian economies are important players in reenvisioning the role of global institutions, the status of the U.S. dollar, standards for national regulation, and modes of cooperation among regulators and supervisors. It remains to be seen how discussions in the G-20 (where South Korea is co-chair), Financial Stability Board, and elsewhere turn out, but whatever is decided at the global level will have a profound impact on the rules and incentives embodied in the East Asian regional architecture. It is also worth noting that, for the first time, initiative at the global level will not be entirely the province of the United States, United Kingdom, EU, and Japan. Emerging markets, preeminently China, are important new players, although the extent and even direction of their influence is yet to be seen. The changes in global standards that result are likely to have important effects on the East Asian regional financial architecture.

Status of Financial Regionalism

More can be said about ASEAN+3 efforts to reshape the regional architecture. The bond market initiatives are essentially on hold at this point, as national governments seek to address the problems of their own financial institutions, as well as to wait for the changes in global standards and best practices before pursuing further regulatory reform. Meanwhile, uncertainty about macroeconomic and exchange rate issues has done nothing to accelerate the modest efforts at laying the groundwork for macroeconomic



and currency coordination.

Rather, the place to look is the Chiang Mai Initiative. Going back to 2005, well before the crisis, the ASEAN+3 finance ministers had agreed to a roadmap that envisaged the “multilateralization” of CMI, complemented by enhanced surveillance and autonomous decisionmaking procedures. To some observers, this meant that the ungainly CMI would be transformed into a reincarnated AMF; to others (including me), the vagueness of the aspirations and the ambitious preconditions meant that the roadmap was more exhortatory than practical. Even when the finance ministers agreed in 2007 to turn CMI into a reserve pooling agreement, there was some skepticism given that none of the details for decisionmaking had been spelled out, that reserves dedicated to CMI would continue to be held by national governments, and that disbursement of funds would remain at the discretion of national governments.²⁸

My skepticism would seem to have been disproven by the ASEAN+3 finance minister’s agreement in Bali, Indonesia in May 2009, in which the participants committed themselves to expanding by half the total resources available through the initiative and to establishing a reserve pooling arrangement.²⁹ A codicil to the agreement spelled out the contributions of each participant, with Japan and China (in combination with Hong Kong) evenly splitting approximately 80% of the committed funds. Of course, as of this writing, it remains to be seen exactly how the system will be configured, including how monitoring will be implemented, what the criteria will be for identifying a “currency crisis,” how conditionality will be decided and applied, and what “multilateralization” means in practice. Most importantly, it is not yet clear how disbursement decisions will be made. The communiqué notes that, while policy decisions will still be made by consensus, lending decisions will be made by “majority,” but not whether countries votes are equal or weighted. Moreover, it mentions the IMF link and states that the purpose of the fund will be to “to supplement the existing international financial arrangements,” but does not state how the IMF link will work in the new circumstances. It is even possible that there will be little practical change in the way that CMI operates in an emergency, although the likelihood looks lower now than it did a year ago.

²⁸ I base this claim on a variety of conversations with U.S. government officials and other observers. I include myself among the skeptics—see Grimes 2009, pp. 92-94.

²⁹ See “The Joint Media Statement of the 12th ASEAN Plus Three Finance Ministers’ Meeting,” Bali, Indonesia, 3 May 2009, <http://www.aseansec.org/22536.htm>.



A New and Improved Chiang Mai Initiative?

If the reality of the revamped Chiang Mai Initiative does end up matching the rhetoric, it will indeed mean that the initiative will approximate the AMF proposal, as some authors suggest.³⁰ But will the new arrangements contribute to the robustness of the regional financial architecture? My answer is no.

Earlier in this paper, I identified the core political problem of regional cooperation efforts as its dependence on the cooperative leadership of Japan and China. What the Bali agreement envisions is a structure that depends crucially on the ability of the two states to cooperate. In an actual crisis, it is easy to imagine either paralysis or a competitive dynamic in which neither Japan nor China wants to act to discipline a politically important neighbor. Moreover, under the Bali agreement, even routine enhancements and efforts to streamline procedures—which will become much more important if crisis decisionmaking is no longer delegated to the IMF—will be made on a consensus basis. They would thus also be dependent onto Sino-Japanese agreement; again, this could lead either to institutional stasis or moral hazard.

While it is not possible at this point to predict how Japan and China would actually cooperate (as seen in the divergent imaginings in the previous paragraph), that very unpredictability tells us something important about the impact of the proposed institutional “enhancements.” That is, they are unlikely to inspire confidence either among international investors or among potential borrower governments. The likely result on the broader regional architecture (in terms of incentives for government policy and private sector behavior) is thus not positive. For the politically and economically stable emerging economies, we should at least for the time being expect a continued resort to self-help in the form of exchange rate flexibility, large-scale foreign exchange reserves (itself a systemically destabilizing factor even though it may make sense for individual countries), and bilateral liquidity support agreements that circumvent CMI. For less stable economies, a shift away from CMI dependence on the IMF will likely reduce the perceived downside of political business cycles and create moral hazard. It also potentially places them in a rather dependent position vis-à-vis the powerful states of Japan and China. Neither is likely to contribute to regional financial stability.

³⁰ Oh 2009.



Dilemmas of the Regional Financial Architecture in East Asia

A little more than a decade after the Asian Financial Crisis, East Asia has again been faced with a major financial challenge. It has weathered the storm impressively, demonstrating the robustness of the regional financial architecture.

I have made the argument that financial regionalism should not be confused with the regional architecture, of which it is only one part. Nonetheless, financial regionalism is an important political and economic phenomenon. Not only has it grown from nothing twelve years ago to an active agenda and set of obligations, it also logically derives from a set of ideas about the global and regional economies that emphasize regional solutions, insulation through financial and institutional development, and suspicion of wholesale adoption of neoliberal economic policies as the sole principle of economic governance. In the context of the current global financial crisis, East Asian governments seem set to expand the scope and enhance the institutions of financial regionalism.

What are the implications of a renewed commitment to advancing financial regionalism for East Asia's financial stability and prosperity? I identify three key dilemmas going forward.

First, one of the basic goals of financial regionalism has been to insulate the economies of East Asia from U.S. macroeconomic responsibility by reducing the role of the dollar in regional trade, finance, reserves, and currency management and building up attractive regional solutions that depend on local markets and local currencies. This has proved impossible, due to the deep reliance of East Asia as a region on final demand in the United States and the lack of alternative reserve currencies. Meanwhile, in order to improve local-currency intermediation, they have continued to move toward openness, transparency, and market-based reforms, all of which potentially make them more vulnerable to currency movements; effectively, that choice has increased the incentive for prudent macroeconomic policies. In 2008-09, East Asian economies avoided hot money-induced currency crises but were nonetheless hit—hard—by the U.S. downturn. Fortunately, many were able to enact substantial fiscal stimulus packages due to their self-help actions following the AFC, in particular accumulation of foreign exchange reserves, fiscal and monetary stability, and flexible (albeit managed) exchange rate policies. But financial regionalism *per se*—let alone insulation from the dollar—had little or nothing to do with their relatively safe passage through the crisis.

Perhaps more important is the political dilemma that lies at the center of East Asian efforts at financial cooperation: the need for cooperative leadership by Japan and China. Both have the capacity for short-term crisis management in the form of liquidity support,



but their ability create longer-term cooperative institutions is in doubt because they are inevitably in a competitive relationship with each other. Can regional economies count on a framework that is meant to ensure financial stability but that is ultimately dependent on two competing states? Perhaps, but “perhaps” is not good enough in times of crisis, and sensible governments will not pin their policies on it.

The final dilemma is at the level of ideas. To some extent, East Asian financial regionalism has been built on the basis of rejection of the principles of U.S.-led market fundamentalism.³¹ But the East Asian governments have not been able to provide a plausible positive vision of how the regional financial architecture *should* look in terms of role of markets, governments, and foreign participants. Going back to the leadership dilemma, this at least partly reflects the basic differences of interests between Japan and China, whose economies and financial system are at fundamentally different levels of development. With no clear leader or clear positive vision, the likely fallback is exactly where financial regionalism is now—tolerance of a variety of financial systems, but based on global standards and institutions. In the end, regardless of how financial regionalism progresses, the regional architecture is likely to be characterized by the same elements that characterize it now: *ad hoc* self-help and a continued major role for global institutions, standards, and best practices.

³¹ Sakakibara 1998; Lee 2006, 2009.



Bibliography

- Asian Development Bank (ADB), 2004. *Monetary and Financial Integration in East Asia: The Way Ahead*, Vol. 1. New York: Palgrave Macmillan.
- Committee on Capital Markets Regulation, 2006. *Interim Report*. November 30. Available at <http://www.capmksreg.org/pdfs/Summary_11.30interimreport.pdf>.
- Committee on Capital Markets Regulation, 2009. *The Global Financial Crisis: A Plan for Regulatory Reform*. May. Available at <[http://www.capmksreg.org/pdfs/TGFC-CCMR_Report_\(5-26-09\).pdf](http://www.capmksreg.org/pdfs/TGFC-CCMR_Report_(5-26-09).pdf)>.
- Dent, Christopher, 2008. *East Asian Regionalism*. New York: Routledge.
- Eichengreen, Barry, 2004. "The Unintended Consequences of the Asian Bond Fund," address to the annual meeting of the Asian Development Bank, Jeju Island (May). <http://emlab.berkeley.edu/users/eichengr/policy/jejuislandmar29-04.pdf#search=%22Asian%20bond%20fund%22>, accessed October 4, 2006.
- Goldstein, Morris and Anna Wong, 2005. "The Next Emerging-Market Financial Crisis: What Might It Look Like?" in Gerard Caprio, James Hanson, and Robert Litan, eds., *Financial Crises: Lessons from the Past, Preparation for the Future* (Washington, DC: Brookings Institution Press), pp. 121-210.
- Grimes, William W., 1999. "Japan and Globalization: From Opportunity to Constraint," *Asian Perspective*, vol. 23, no. 4, pp. 167-198.
- Grimes, William W., 2002. "Internationalization as Insulation: Dilemmas of the Yen," in Ulrike Schaefer and William W. Grimes, eds., *Japan's Managed Globalization: Adapting to the 21st Century* (Armonk, NY: M.E. Sharpe), pp. 47-76.
- Grimes, William W., 2003. "Internationalization of the Yen and the New Politics of Monetary Insulation," in Jonathan Kirshner, ed., *Monetary Orders: Ambiguous Economics, Ubiquitous Politics*, (Ithaca: Cornell University Press), pp. 172-194.
- Grimes, William W., 2006. "East Asian Financial Regionalism in Support of the Global Financial Architecture? The Political Economy of Regional Nesting," *Journal of East Asian Studies*, vol. 6, no. 3, pp. 353-380.
- Grimes, William W., 2009. *Currency and Contest in East Asia: The Great Power Politics of Financial Regionalism*. Ithaca: Cornell University Press, 2009.
- Haggard, Stephan, 2000. *The Political Economy of the Asian Financial Crisis*. Washington, DC: Institute for International Economics.
- Henning, C. Randall, 2002. *East Asian Financial Cooperation*. Washington, DC: Institute for International Economics.
- Higgott, Richard, 1998. "The Asian Economic Crisis: A Study in the Politics of Resentment,"



- New Political Economy*, vol. 3 no. 3, pp. 333-356.
- Ito, Takatoshi and Yung Chul Park, eds. 2004. *Developing Asian Bondmarkets*. Canberra: Asia Pacific Press.
- Ito, Takatoshi, ed., 2007. *A Basket Currency for Asia*. New York: Routledge.
- Kapstein, Ethan, 1991. "Supervising International Banks: Origins and Implications of the Basle Accord," *Princeton Essays in International Finance*.
- Katada, Saori, 2001. *Banking on Stability*. Ann Arbor: University of Michigan Press.
- Katada, Saori, 2002. "Japan and Asian Monetary Regionalization: Cultivating a New Regional Leadership after the Asian Financial Crisis," *Geopolitics*, vol. 7, no. 1, pp. 85-112.
- Katada, Saori, 2004. "Japan's Counterweight Strategy: U.S.-Japan Cooperation and Competition in International Finance," in Ellis Krauss and T.J. Pempel, eds., *Beyond Bilateralism: U.S.-Japan Relations in the New Asia-Pacific* (Stanford: Stanford University Press) pp. 176-197.
- Kawai, Masahiro, 2005. "East Asian Economic Regionalism: Progress and Challenges," *Journal of Asian Economics*, vol. 16, pp. 29-55.
- Kawai, Masahiro and Shinji Takagi, 2005. "Strategy for a Regional Exchange Rate Arrangement in East Asia: Analysis, Review and Proposal," *Global Economic Review*, vol. 34, no. 1, pp. 21-64.
- Kindleberger, Charles, 1972. "The Benefits of International Money," *Journal of International Economics*, vol. 2, no. 4, pp. 425-442.
- Kindleberger, Charles, 1973. *The World in Depression, 1929-1939*. Berkeley: University of California Press.
- Kindleberger, Charles, 1981. "Dominance and Leadership in the International Economy: Exploitation, Public Goods, and Free Rides," *International Studies Quarterly*, vol. 25, no. 2, pp. 242-254.
- Kindleberger, Charles, 1986. "International Public Goods without International Government," *American Economic Review*, vol. 76, no. 1, pp. 1-13.
- Kuroda, Haruhiko, 2005. *Tsûka no kôbô: En, doru, yûro, jinmingen no yukue* (The Rise and Fall of Currencies: The Fate of the Yen, Dollar, Euro, and Renminbi). Tokyo: Chûô Kôronsha.
- Lee, Yong Wook, 2006. "Japan and the Asian Monetary Fund: An Identity-Intention Approach," *International Studies Quarterly* 50, no. 2, pp. 339-366.
- Lee Young Wook, 2008. *The Japanese Challenge to the American Neoliberal World Order*. Stanford: Stanford University Press.
- McCauley, Robert N and Yung-Chul Park, 2006, "Developing the Bond Market(s) of East Asia: Global, Regional or National?" *BIS Papers*, no. 30, pp. 19-39.



- McKinnon, Ronald, 2005. *Exchange Rates under the East Asian Dollar Standard*. Cambridge: MIT Press.
- Oh, Yong-hyup, 2009. "Asian Monetary Fund Is on the Horizon," *Korea Herald*, May 25.
- Narine, Shaun, 2003. "The Idea of an 'Asian Monetary Fund': The Problems of Financial Institutionalism in the Asia-Pacific," *Asian Perspective*, vol. 27, no. 2, pp. 65-103.
- Rhee, Yeongseop, 2004. "East Asian Monetary Integration: Destined to Fail?" *Social Science Japan Journal*, vol. 7, no. 1, pp. 83-102.
- Sakakibara Eisuke, 1998. *Kokusai kin'yū no genba: Shihonshugi no kiki o koete* (The Arena of International Finance: Moving Beyond the Crisis of Capitalism). Tokyo: PHP Shinsho.
- Singer, David Andrew, 2007. *Regulating Capital: Setting Standards for the International Financial System*. Ithaca: Cornell University Press.
- Terada, Takashi, 2003. "Constructing an 'East Asian' Concept and Growing Regional Identity: From EAEC to ASEAN+3," *Pacific Review*, vol. 16, no. 2, pp. 251-277.
- Walter, Andrew, 2008. *Governing Finance: East Asia's Adoption of International Standards*. Ithaca: Cornell University Press.



Author's Biography

William W. Grimes
Boston University

William W. Grimes is Associate Professor of International Relations and the director of the Center for the Study of Asia (BA, Yale University; MPA, Woodrow Wilson School of Public and International Affairs; PhD, Princeton University). His fields of specialization include Japanese and East Asian Political Economy, Japanese Politics, International Political Economy.

Professor Grimes has taught in the Department of International Relations at Boston University since 1996. He spent 1995-96 as an Advanced Research Fellow at Harvard University's Program on US-Japan Relations, and 1999-2000 as a Reischauer Visiting Assistant Professor at Harvard's Department of Government. He is the founder and coordinator of the Contemporary Japanese Politics Study Group at the Reischauer Institute of Japanese Studies at Harvard University, where he is also an Associate in Research.

Professor Grimes is the author of *Currency and Contest in East Asia: The Great Power Politics of Financial Regionalism* (Cornell University Press, 2009) and *Unmaking the Japanese Miracle: Macroeconomic Politics, 1985-2000* (Cornell University Press, 2001), and was co-editor (with Ulrike Schaeede) of *Japan's Managed Globalization: Adapting to the 21st Century* (M.E. Sharpe, 2002). He has also published articles on the impacts of financial globalization in Japan, monetary policy making in Japan, the prospects for renewed Japanese economic growth, Japanese technology policy, and US-Japan relations.

Professor Grimes has spent time as a visiting researcher at the Japanese Ministry of Finance in 1992-93, 1999, 2000, and 2005 and as a visitor at the Bank of Japan in 2001. He has been the recipient of various fellowships and awards over the years, including two Fulbright fellowships and a book-writing grant from the Japan Foundation Center for Global Partnership. He is an active lecturer in Japan and the United States in both academic and policy venues and has been recognized for his teaching and advising at Boston University.

—from the website of Boston University



Knowledge-Net for a Better World

- This article is the result of the EAI's main academic and educational activity, the EAI Fellows Program. It was presented at the seminars and lectures hosted by member institutions of the program. Subsequently it has been distributed to those audiences. The PDF document of this article can also be viewed via the EAI website by the wider public. Any citation or quotation is prohibited without prior permission of the author and the EAI.
- The EAI Fellows Program seeks to promote understanding of critical issues in East Asia, to encourage intellectual exchange among scholars and experts, and to educate students who will lead the world in the future. For the information about the program, please visit our website, http://www.eai.or.kr/english/fandj/FP01_temp.asp.
- This paper and other EAI reports can be found on our website, <http://www.eai.or.kr/english/publicing/report/booklist.asp>.
The contents of this article do not necessarily reflect the views of the East Asia Institute.
- Young-Hwan Shin, the Executive Director of EAI Fellows Program
Tel. 82 2 2277 1683 (ext. 112) fellowships@eai.or.kr
- Typeset by Young-Hwan Shin and Dae-Gyeong Kim

