Why Was the CMI Possible?
Embedded Domestic Preferences and Internationally Nested Constraints
in Regional Institution Building in East Asia**

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Abstract:

The Asian Financial Crisis motivated East Asian governments to enhance regional autonomy from global financial forces through regional financial cooperation. But institutional building has not progressed evenly across different areas of finance. While the institutionalization of the Chiang Mai Initiative (CMI) in recent years have made scholars and policy makers hail the success, the region is unlikely to achieve some form of monetary cooperation any time soon despite concerns of excessive dollar dependence. Because both issues are negotiated by the same state agents, the central banks and financial ministries, the question is what makes one work relatively smoothly but not the other. Why is some regional institution building easier than others, and why do the state actors behave differently? By tracing the development of regional cooperation in both areas, the paper argues that domestically embedded preferences have largely determined the more favorable conditions for institutional building for CMI than the currency arrangement. Despite the quite substantial nesting of the CMI in the international financial architecture headed by the IMF, the state agents in East Asia have managed to establish CMI with formal structure and legal agreements established among well-defined members in the region.
1. **Introduction**

The Eurozone (or European sovereign-debt) Crisis in the early 2010s has impressed upon the world that regional financial integration and the common currency is not a panacea for avoiding financial crises. Under this precarious global economy, however, the East Asian monetary authorities continue to strive for financial stability through regional cooperation.\(^1\) Since the time of the Asian Financial Crisis (AFC) in 1997, regional financial and monetary cooperation (hereafter, regional financial cooperation for short) has focused on various ways to avoid and prevent recurrence of such crises. Among these efforts, so-called Chiang Mai Initiative (CMI), which provides emergency funding mechanism for the region, stands out as the most institutionalized form of cooperation with a specific “Asians-only” membership, a clearly articulated mandate and a well-defined legal commitment. Unlike the oft-caricaturized East Asia’s low cost “talk shop” variety of forums, the CMI has quickly climbed up the ladder of institutionalization during the ten years of its existence so much so that since 2011, it has its own “brick-and-mortar” headquarter in the form of ASEAN Macroeconomic Research Office (AMRO) in Singapore.

Why has this particular form of regional financial cooperation, CMI, become rapidly institutionalized? It is an intriguing question from at least two standpoints. First, the Japanese government’s proposal to establish the Asian Monetary Fund (AMF) at the time of AFC to help contain the currency and financial meltdown was flatly rejected by the United States, Europe and the IMF, and consequently the proposal was withdrawn (Lee 2006, Katada 2004, Amyx 2004a). Despite some level of tempering, the CMI’s main functions are what the proposed AMF had meant to serve.\(^2\) Second, the region’s monetary cooperation to address excessive dependence on the US dollars, a fundamental factor to the region’s financial vulnerability identified at the time of the AFC, has not engendered a high level of regional cooperation, let alone a formal institution. Even though the experts and officials have often discussed the danger of so-called financial “double mismatch” of currency exchange rate and loan maturity, the dollar dependence of the region has *increased*, rather than decreased, in the last 15 years. Even in the recent years

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\(^1\) “East Asia” in this study is defined to cover both Northeast Asia and Southeast Asia. ASEAN+3 cover most of the countries in this region except Mongolia, North Korea, and Taiwan.

\(^2\) Grimes (2011) discusses that the development and multilateralization of the CMI (discussed later) will not make it a rebirth of the AMF, for the current arrangement relies heavily on the IMF link to secure repayment and supplement for the lack of surveillance capacity.
with the post-Global Financial Crisis (GFC) hype and rhetoric of the Renminbi (RMB) taking over the dollar as the world’s most preferred reserve currency in the medium term, East Asia’s currency arrangement has not generated any regional coordination mechanism. Furthermore and because “defensive regionalism” argument in the aftermath of the AFC (discussed below) has emphasized the importance of comprehensive regional financial cooperation, this stark contrast between the CMI that achieved solid institutional shape with its multilateralization in 2009 (Chey 2009, Ciorciari 2011) and the regional currency arrangement that has not even begun to form any institutional underpinning for regional cooperation (Henning and Katada 2011) is quite curious.

What promotes institution building in some areas of regional financial cooperation but not in others? To examine this question, the paper focuses on the preferences and policies among the creditor countries of East Asia, particularly Japan and China. The creditor governments’ policy stances are crucial in defining the shape of regional financial cooperation considering their large shares of the regional economy in terms of trade volume and financial resources.3 Hence this study examines the sources of the distinctive approaches which arise from preferences for different aspects of finance and monetary affairs in the regional institution building. Since issues of emergency financing and currencies are negotiated by the same state agents, the central banks and financial ministries, I focus on the factors that influence their policy autonomy. I hypothesize, then, that the progress of regional financial cooperation in different issue areas depends on how constrained the creditor governments are in two dimensions of their interactions. The first dimension, embedded domestic preferences, emerges from both the level of domestic politics involved in the government’s decision making and how much certain policy is embedded in the domestic economic structure. Given the first impetus towards regional financial stability and defensive regionalism, the creditor governments are more likely to engage in regional institution building if they are not constrained by opposing domestic forces. The second dimension is international nestedness, which arises from the way in which regional mechanism in certain issue area is constrained by the construct of the global architecture. The more nested a regional arrangement is in an international structure, the harder it becomes to establish an alternative regional institution. After empirical analysis of the forces and process

3 The GDP of three large economies, Japan, China and South Korea, constitute 87 percent of ASEAN+3 GDP (current dollar) in 2009.
that shaped the two sets of regional financial cooperation, the study argues that the constraining domestic preferences have played a larger role in forming regional institutions in the area of finance than the external constraints of nested institutions.

This paper consists of four parts. First, it summarizes the existing discussions on what gave rise to East Asian financial regionalism. After a short discussion on the existing explanations regarding the evolution of regional institutions, I summarize my argument about how the domestically embedded preferences and the internationally nested constraints shape the states’ positions regarding the level of institutionalization in regional financial cooperation. Then, in the third section, the paper gives an overview of institutional developments in the fields of emergency finance and currency cooperation in East Asia in the last ten years. In the fourth section, the study focuses on domestic politics and external constraints surrounding the creditor states’ preferences in East Asia, and analyzes how they contribute to very different types of development of regional institutions. Finally, the last section concludes with the assessment of the influence of these two dimensions and with a discussion of the implications of the political dynamics and state preferences on the regionalism in East Asia.

2. Determinants of Regionalism

(a) The Genesis of Regional Financial Cooperation in East Asia

The AFC is undisputedly the major impetus that gave rise to East Asia’s regional financial cooperation. From a historical institutionalist view, the AFC was the critical juncture that transformed the usually path-dependent regional institutional development (or a lack thereof) in the region (Calder and Ye 2004). In addition, regional cooperation motivated by the financial crisis has led East Asia to take a path distinct from European regional development, where financial cooperation, rather than formalized trade cooperation, became the first step in the “logical roadmap” towards regional integration (Dieter and Higgott 2003). The existing work

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4 The discussion on the utility of analyzing regional institution development in different stages of genesis, design and effects, see Solingen (2008).

5 Region-wide financial cooperation efforts in East Asia were very limited prior to the AFC (Wang 2004). Those existed were a few nascent financial cooperation efforts initiated by Japan (Hayashi 2006, Chapter 2).

6 The seminal work of Balassa (1961) argues that the “logical roadmap” to regional integration starts with a free trade area, then it develops into a customs union, to a common market, followed by an economic union and ultimately to a political union.
on East Asia’s “regional turn” identifies three distinctive sources behind the rapid development of regional financial cooperation.7

The first group of arguments focuses intently on the economic conditions faced by East Asia in the immediate aftermath of the AFC. The ideology-laden debate in relation to the ultimate origin of the AFC aside (discussed below), the region faced a stark challenge of financial globalization and limits to their export-led growth economic model in the 1990s. This post-Cold War period was characterized not only by the increasing protectionism against East Asian products in the United States, the largest market for East Asia’s exports, but also by mounting pressures, directly from the United States and indirectly through other multilateral processes, to liberalize economies of the region both in trade and finance. The economic difficulties from these challenges culminated in the AFC, where the missteps such as premature financial liberalization and chronic trade deficit, (or both, especially, in the case of Thailand) as well as deficiency in the government’s oversight of the private corporations’ financial behaviour (such as the case for South Korea) have ultimately led to the crisis.

In general, East Asian economies of the 1990s exhibited a structural vulnerability not only in terms of heavy extra-regional trade dependence, but also currency and financial exposure to global forces. The financial crisis contagion spread throughout East Asia, and the region’s economists began to experience the financial challenge for the region in the form of “double mismatch” as these economies faced the mismatches in currency and investment time horizon (maturity). The currency mismatch for the region emerged mainly from its dollar dependence, where much of the foreign economic transactions in East Asia were conducted in dollars, and there was no regional coordination of the foreign exchange regimes (Cohen 2008). Meanwhile, the overdependence of bank financing (Wade and Veneroso 1998) and underdevelopment of local bond market (McCauley 2003) created rigidity in their financial market. The crisis has, thus, led to rethinking of domestic and regional financial and monetary architecture.8

In order to recover from the crisis and also protect these economies from financial crises, each government took various national measures including a dramatic increase in exports (Ravenhill 2008) with effective corporate governance (Gourevitch 2008) on the one hand, and

7 The discussion below is the summary of my previously published work (Katada 2011).
8 Under these structural constraints, high savings and current account surplus of many of the countries in the region would also be lent back to the US in dollars, a phenomenon called “conflicted virtues” by McKinnnon (2006).
prudent financial management and (partial) compliance with an international financial standard at the domestic level (Walter 2008, Hamilton-Hart 2008), as well as efforts in nurturing domestic bond markets to reduce excessive dependence on banks (Amyx 2008), on the other. As discussed later, many countries in the region also accumulated a massive amount of foreign exchange reserves to insulate their economies from financial and exchange rate volatilities (Mohanty and Turner 2006).

Regional protection was also necessary, however. Deep interdependence and interconnectedness across East Asian economies, developed over the course of a successful “economic regionalization” that linked the regional economies via regional production networks and ethnic Chinese business networks since the 1980s (Peng 2002) has made the region more prone to contagion, which rattled almost all the open East Asian economies within a few days after the onset of the Thai crisis. Despite variations in the severity of the crisis, it is commonly understood that the region overall (with a possible exception of closed countries such as North Korea) was affected (Noble and Ravenhill 2000). Furthermore, the across-the-board reliance on the external market for final products made the countries more prone to engage in the competitive devaluation against the dollar as each country struggled to “export its way out of the crisis.”

The second group argues that the ideational clash between East Asian leaders and the “IMF-Wall Street-Treasury” complex (Bhagwati 1998, Wade 1998) in the face of the AFC gave rise to active regional financial cooperation. Active debates at the time centred on whether the AFC was a crisis of fundamentals arising from East Asia’s failed economic management or that of a temporary liquidity crisis.9 The “fundamental camp,” rooted in the neoliberal economic view, went further and blamed both the corrupt and often inefficient “crony capitalism” of many Asian economies and demanded those countries engage in a dramatic economic reform in compliance with the international regulatory norms of corporate governance and transparency. On the other hand, East Asia’s “liquidity camp,” popular with Asian economists and policymakers, blamed the premature and excessive liberalization in finance and the global economic environment for the crisis.

9 The similar discussion on the cause of the AFC proceeded in among the economists in the United States. The controversy is best summarized by the contrast between Radelet and Sachs (1998) emphasizing the panic stricken behavior of domestic and international investors and failure of the IMF response on the one hand, and Roubini emphasizing the economic distortions among the countries in Asia and the problems of fundamentals (Corsetti, Pesenti and Roubini 1999) on the other.
financial architecture for allowing the rapid and massive inflow and outflow of foreign capital into Asia, which led to the temporary imbalances and demanded a reform in the international financial architecture in order to regulate those so-called Highly Leveraged Institutions (HLIs) such as hedge funds (Yoshitomi and Ohno 1999, Sakakibara 2000). Moreover, as some of the countries that had to endure the IMF conditionality as a result of the AFC engaged in a so-called “politics of resentment” (Higgott 1998) where the countries’ leaders shifted the blame for the crisis to an outside influence such as the IMF as they scrambled to survive the crisis politically. This ideational conflict against the Washington Consensus established the “common other” and united Asia in the form of “us versus them” dynamics (Terada 2003).

The third group focuses on East Asia’s motivation to acquire, through regional cooperation and institution-building, “voice opportunity” (Grieco 1997) in regards to the global economic governance. First and foremost, at the time of the AFC, the region’s policymakers were shocked to find that they did not have any regional recourse as they faced the task of dealing with the crisis. ASEAN was not strong enough and APEC was too diverse to respond to the crisis with a solution (Webber 2001); the ADB responded only timidly and inconsistently to tackle the task of being the regional lender of last resort (Wesley 1999). Furthermore, the central bankers in the region have set up an Executives’ Meeting of East Asia and Pacific Central Banks (EMEAP) since 1991, but the institution has had limited influence on regional cooperation due to the secrecy of the meetings and lack of institutional commitment to coordinate supervisory influence (Yokoi-Arai 2006; 55). In the end, some East Asian governments had to turn to the IMF, whose available funding was considered not enough to address the crisis, due to relatively small quotas that East Asian countries were assigned (Rapkin and Strand 2003), and the austerity and economic liberalization attached as “conditionality” of the IMF loans were not helpful for these countries. Furthermore, in relation to their relatively small quotas, the voting shares of the Asian countries in the institution were limited (Sohn 2005). In short, East Asia was in a dire need of regional representation in global financial governance.

In short, the AFC and the subsequent actions taken by the “Washington Consensus” camp created a high level of uniting forces for “defensive regionalism” in East Asia (Munakata 2006). All three discussions regarding the AFC’s impact on East Asia’s political economy from material, ideational and power perspectives produced a strong motivation on the part of East Asian leadership to enhance regional financial cooperation. As discussed below, the nascent regional
financial cooperation came in the form of a collection of measures to shore up financial stability through an emergency funding mechanism, currency cooperation to reduce dollar dependence, creation of long-term funding mechanisms along with regional macroeconomic monitoring efforts. In contrast to the argument put forward by Solingen (2008), the “genesis” of a regional financial institution in East Asia did not emerge from the political dynamics of a domestic coalition, but from the region’s interaction with each other and with the main agents of global financial governance. As discussed below, it is only after the dust settled from the crisis and region’s monetary and financial cooperation began to take a concrete institutional form that the domestic politics began to influence the institutional preferences among the major actors.\(^\text{10}\) That is where the CMI started to take a formal institutional shape, while the currency arrangement did not take such turn.

\( (b) \) **Explaining the Evolution of Cooperation in Institutional Building**

Strictly speaking, regional institutions are a construct of sovereign governments through establishment of a charter and its ratification. Historically, East Asia has housed very few “legally embedded, broadly encompassing, and deeply institutionalized regional bodies” (Pempel 2005, 4) that fall in the same categories as the European Union or NAFTA. But a decade of regional financial cooperation efforts have produced the CMI which inches closer to a full-fledged regional institution that is moving to become an international organization (as discussed below), while regional currency arrangement shows no sign of a hard institution.

Quite diverging paths of these two major areas of regional financial cooperation makes it difficult for grand theoretical perspectives to explain. In particular, neither the realists nor scholars focusing on identity have much to say on these diverging modes of regional cooperation. Realists, on the one hand, focus on historical mistrust or power rivalry that should lead to limited regional cooperation (Friedberg 2000) and shallow institutions (Grieco 1997). There is no doubt that rivalry among the three Northeast Asian powers exists. However, the fact that the CMI has shaped up without much resistance from China, although CMI is largely considered as the Japanese initiative, provides counterevidence to such power-based argument. Moreover, ASEAN, which is often seen to be in the driver seat of the regional integration (Siow and Sjoholm 2007),

\(^{10}\) Solingen (2008) uses the term “design” of regional institutions to describe the second stage of institutional development. In this paper, however, I would use a term “evolution” to capture path-dependence of such institutional formation.
does not have much influence in the regional financial matters. Developing a regional identity, on the other hand, is likely the underlying factor towards enhanced cooperation that facilitates regional institution building, but such view falls short of explaining the choice of distinct structures. Neofunctionalists and New Institutional Economists focusing on transaction costs would face difficulty explaining the fragmented developments in each area of regional financial cooperation, and the lack of linkage and sequencing. Given the high and increasing level of regional trade integration and prominence of foreign direct investment that have connected the region for the last few decades through regional production and business networks, one would expect regional institutions converging to address the functional needs connected with political spill overs.

The domestic political forces behind economic policy making are central to the study of international political economy, where state preferences (Haggard 1997) and domestic coalitions (Solingen 2008) are important foundations of regional cooperation and institution building. Domestic politics largely determine the position and preferences of the main agents in regional institution building, the state actors. In such sense, this study takes state-society relations in the regionalism dynamics seriously (Moravcsik 1997), and it takes seriously how the industry demands trigger the state’s action (Mattli 1999). Although state bureaucracy of East Asia is known to be relatively autonomous from societal pressures (Johnson 1982; Amsden 1992), the embedded nature of such autonomy compels states to react to business and economic interests (Evans 1995). It is crucial in this context, however, to recognize that the domestic pressures are not evenly imposed on the state.

Building on the domestic sources of regionalism argument, this study considers various forms of embeddedness of the state in each area of regional cooperation efforts towards regional institution building. As noted, the main agent of financial cooperation and financial institution building are the states; the financial bureaucracy and the central banks within the state apparatus mainly have been the key actors in financial cooperation. On the one hand and despite a certain level of autonomy of these state actors, their policy choices are embedded in the domestic politics and domestic priorities. Domestic politics of finance and foreign exchange rate are,

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11 Many favor the view in explaining the emergence of regional cooperation such as Acharya (2004) and Lee (2006).
however, not very clear cut as that of trade.\textsuperscript{12} Frieden (1991) examines the winners and losers of increased cross-border capital mobility and argues that, as the capital market integration begins to allow mobile and non-sector-specific capital to move, it benefits the owners of such mobile (financial) capital in a capital abundant country, and disadvantages the owners of sector-specific capital in a capital scarce country. Such a broad cleavage argument is not very useful, however, when we focus closely on different areas of regional financial cooperation a state engages.\textsuperscript{13} Instead, one can consider additional ways in which embeddedness takes place to impose political constraints on the state such as through lobbying or relational constraints (Amyx 2004b), and in the form of domestic economic structures and institutions. As discussed below, domestic priorities emerged from existing structure and institutions in support of a long-standing development strategy such as export promotion and financial repression. These institutional setups would make those groups with vested interests in the continuation of the institutions to lobby against changes or alternatives.

On the other hand, one can expect that the state preferences are also influenced by the fact that regional cooperation and regional institution building are often nested in the broader multilateral institutions.\textsuperscript{14} Aggarwal (1998; 3-7) sets the stage by differentiating regional institutions that emerge and reconcile their functions with international ones either in a hierarchical form or in parallel to each other. Scholars of political economy of trade have often discussed the states’ strategies in dealing with the nested and overlapping institutions such as forum shopping for trade liberalization (Pekkanen, Solis and Katada 2007) and trade adjudication (Busch 2007, Alter and Meunier 2006). In a financial and monetary area, however,

\textsuperscript{12} In the area of trade, the negative and positive impact of trade liberalization can be demarcated clearly on the basis of factors of production owner or class (Rogowski 1989), or on the types of industry (Schattschneider 1935). Hence, trade policy of a country tend to produce winner and loser groups, both of which would be motivated to engage in collective action to influence the government policy in pursuit of either protection or further liberalization. As for regional preferential trade liberalization, Milner (1997) argues that the preferences of “increasing returns to scale” industries such as aircraft manufacturers would push strongly in favor of expanding its production and market scope as long as they do not face stiff foreign competition. Policymakers and politicians will balance industry demands with the level of tariff revenues and that of consumer surplus, which would lead to regionalism choice.

\textsuperscript{13} In that sense, I partially disagree with Tsunekawa (2005, 133) when he argues that “Japanese and other East Asian governments have faced fewer domestic and international constraints in the financial/monetary field than they have in the area of trade,” not because of the finance versus trade comparison, but lamping financial and monetary field as one.

\textsuperscript{14} Alter and Meunier (2006; 363) define that “[n]esting’ refers to a situation where regional or issue-specific international institutions are themselves part of multilateral frameworks that involve multiple states or issues.”
the hierarchical relations among currencies (Strange 1971, Cohen 1998a, Helleiner and Kirshner 2009) and the overwhelming monopolistic power of the international financial institutions such as the IMF (Cohen 1998b) are expected. Given the network externalities of currencies (Krugman 1984) and the high transaction costs associated with the shift from using one currency arrangement to another (Kindleberger 1967) the institutional path-dependence in the evolution of regional institutions is quite constraining for the state.³ fifteen

In sum, I hypothesize that the states’ engagement in regional financial institution building is the function of the constraints arising from domestic and international encounters of the state. Given the inclination of defensive regionalism, one can expect that the more accommodating (or at least not resisting) the domestically embedded preferences are, the easier it gets for the state to engage in a hard commitment of formal institutions. On the other hand, one can also presume that the higher level of internationally nested constraints that the state faces in turning regional as opposed to adhering to multilateral or global mechanism, the harder it is to solidify regional institutions. Finally, I argue that the empirical stories of the evolution of regional cooperation in the two financial areas, the importance of the domestic preferences seem to outweigh the international ones.

3. Regional Financial and Monetary Cooperation

(a) Regional Financial Cooperation through the CMI

The CMI is a relatively highly institutionalized regional mechanism in East Asia with a formal structure and legal agreements established among the well-defined members in the region. As early as November 1997, the East Asian governments launched a regional framework in the context of the ASEAN+3 (Japan, China, and South Korea) with the hope of dealing effectively with balance-of-payments crises in the region. This framework became the core of the region’s emergency funding mechanism consisting of a network of mostly bilateral currency swap arrangements. The ASEAN+3 governments arrived at the basic agreement regarding this regional mechanism by May 2002. One component of the CMI is the expanded ASEAN Swap Agreement (ASA), a small regional currency swap facility that has existed among ASEAN members since 1977. The other and new components are the Bilateral Swap Arrangements

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³ Levi (1997, 28) explains “once a country or region has started down a [particular] track, the costs of reversal are very high.”
(BSAs) and repurchase arrangements among each member of the ASEAN+3. The CMI has two basic objectives: one is to provide emergency liquidity at the time of financial crisis such as the AFC; the other and longer-term goal is to enhance regional cooperation both in terms of currency stabilization and financial monitoring and surveillance.

In spite of having raised $90 billion worth of bilateral swap lines committed by the participating monetary authorities by 2009, the ASEAN+3 governments aspired to pool the spider web of bilateral agreements to make the arrangement more effective (better access to more funds) and transparent (explicit criteria for activation). Ultimately, helped by the fear of the GFC spreading to Asia, the decision to “multilateralize (i.e. regionalization)” CMI was finalized in May 2009, where the funds committed to bilateral swap lines were “pooled” together with the potential for a much larger swap volume per use. The CMIM (Chiang Mai Initiative Multilateralized) came into effect on March 24, 2010, which consists of a multilateral swap agreement among the member central banks with a pooled fund of $120 billion (in the US dollars) and expanded to $240 billion in 2012. Through the multilateralization process, not only did it expand the available amount for each swap, but it has also allowed the small ASEAN countries (namely Brunei, Cambodia, Laos and Vietnam) that did not have any BSA swaps to become full members of the CMI process. This self-managed “reserve pooling arrangement” binds the participating central banks through commitment letters with the obligation to transfer funds once a particular country receives green light on the currency swap (Ciorciari 2011, 937).

Furthermore, the member governments agreed on the voting share and voting mechanism on policy issues and currency swap activation.

16 The ASEAN+3 finance ministers made the goal of multilateralization public for the first time in 2007 at the Kyoto Meeting.

17 The multilateralization process started in May 2007 when the monetary authorities of the member countries agreed at the ASEAN+3 Finance Ministers’ meeting in Kyoto to gradually establish “a self-managed reserve pooling arrangement governed by a single contractual agreement.” (Point 6 of the Joint Ministerial Statement of the 10th ASEAN+3 Finance Ministers’ Meeting, available: http://www.mof.go.jp/english/if/as3_070505.htm accessed November 15, 2007). At the 11th ASEAN+3 Finance Ministers’ Meeting in Madrid in May 2008, the 13 members agreed then to move forward with the multilateralization as they commit to discuss specific conditions on “economic surveillance, borrowing accessibility, activation mechanism, decision making rules and lending covenants.” (Point 6 of the Joint Ministerial Statement of the 11th ASEAN+3 Finance Ministers’ Meeting, available: http://www.mof.go.jp/english/if/as3_080504.htm accessed February 1, 2009).

18 The agreement of the amount of contribution between China (32 percent including the contribution from HK) and Japan (32 percent) was the key to settling the multilateralization process. Furthermore, the strong need to financial monitoring was felt as the Korean government refused to acknowledge that it was facing a balance of payment crisis (thus not request to activate the CMI) in the fall of 2008. Interview with an MOF official, June 2009.
The CMIM has come a long way from general observation that most of East Asian regional institutions are ‘institutionally light’ as these arrangements are “characterized by few delegated powers, a lack of permanent secretariats, and a lack of formal rules and legal structure (ADB 2011, xviii).” In addition to a relatively large amount of available funds, regional capability to surveillance and monitoring in support of activation decision of the funds has been bolstered in several ways. First, the swap activation of CMIM, where 80 percent of the CMIM funds was conditioned by so-called IMF-link at the time of multilateralization, will gradually be reduced to 60 percent. As discussed later, the challenge of the CMIM continues as it seeks to check against moral hazard (Siregar and Chabchitrchaidol 2013). The CMIM has insisted on its “complementary” to the IMF-led international framework, as discussed more below. Such principle emerged not only from the lesson of the failed AMF, but also to ensure that repayment on the part of borrowers will be secured through international pressure. Second, the development of AMRO has enhanced regional monitoring and surveillance capacity to prevent financial crises. In May 2011, AMRO, an independent regional surveillance unit, was set up to provide information to allow the “advisory panel” to activate the CMIM swaps. Although independent capacity of the AMRO is still quite limited with only about a dozen economists hired and the Office produces quarterly surveillance reports. The challenges of making AMRO an independent surveillance mechanism are still many. One, it is still closely attached to member governments as the Executive Level Decision Making Body (ELDMB) consisting of deputy directors of ASEAN + 3’s finance ministers and central banks is mandated to oversee its activities and overshadows AMRO’s independent power. Two, AMRO’s current status is a Singaporean think tank (which rents a part of space in the Monetary Authority of Singapore), as it slowly moves to become a full-fledged international organization in the legal sense.

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19 This condition was put in place at the establishment of the CMI (then the IMF-link was higher at 90 percent) due to the lack of surveillance function under the ASEAN +3 framework. Without this link, the decision to activate the swap lines and guarantee repayment becomes difficult.

20 Bi-annual meetings in the form of Economic Review and Policy Dialogue (ERPD), which existed prior to the AMRO has proven to be insufficient, lacking the rigor for the basis of financial commitment through the CMIM.

21 The point 9 of from the summary of the statement at the 12th ASEAN+3 Finance Ministers’ Meeting, Bali Indonesia, 3 May 2009.

22 Interview with an official at AMRO, October 2011. The ASEAN+3 Joint Ministry Statement in 2011 noted that the ASEAN+3 ministry deputies are instructed to study how to “strengthen the legal status of AMRO to constitute an international organization with an international legal personality.” See also Ciorciari (2011, 950).
Despite these concerns, however, CMIM has reached a solid level of institutional form where the member governments are required to abide by certain rules and go through agreed mechanisms in support of a common policy direction laid out through regional financial cooperation.

(b) Regional Monetary Cooperation towards Regional Currency Arrangement

In the aftermath of the AFC, regional leaders considered currency and foreign exchange rate arrangement a necessary component for the construction of a stable regional financial structure in East Asia. The prevalent pegging of East Asian currencies to the US dollars in the pre-AFC Asia, despite high and increasing intra-regional economic interdependence, made the region vulnerable to dollar-yen exchange rate volatility in the 1990s (e.g. the depreciation of the Japanese yen to the US dollars after spring of 1995). After de-pegging of the Thai baht in the summer of 1997, many East Asian currencies were forced to float against the dollar (at least for a while). Nonetheless, being highly dependent on their foreign investment and trade, the East Asian governments were eager to see their exchange rates stabilize once again (Kuroda and Kawai 2004, 21).

The first post-AFC idea towards region’s foreign exchange rate stability promoted by Japan in the late 1990s was the “internationalization of the yen,” which basically meant to increase the use of the yen in East Asia. The Japanese government changed its long-held reluctance towards a wider use of the yen outside of Japan. The shift arose from its government’s concerns on over-dependence on the U.S. dollar and in support of Japan’s liberalization of the financial and capital markets in the form of “Big Bang” to promote Tokyo as an international financial market on par with New York and London.\(^{23}\) To promote an increased use of the yen, the Japanese government took several steps to make Japan’s short-term capital and money market more attractive. The measures included a tax-exemption withholding for non-residents and foreign corporations that earned an interest income from Japanese government bonds, maturity diversification of government bonds, and the improvement of settlement systems.

\(^{23}\) Council on Foreign Exchange and Other Transactions (1999, 1-2). This council and its subcouncil on the internationalization of the yen were given a mandate by the MOF to provide recommendations regarding the issue.
to facilitate cross-border transactions. These attempts to enhance yen internationalization, however, did not bear much fruit.\textsuperscript{24}

In tandem with and in the context of ASEAN+3, East Asia has gradually started to entertain the possibility of regional monetary cooperation, even to discuss a possibility of monetary union. As the first move and with the aim to learn from the European experience, economists and policymakers in the region conducted a joint study with the European Union (the so-called “Kobe Research Group”), whose July 2002 report recommended a monetary integration process for phase one (by 2010); preparation for a single currency for phase two (by 2030); and launching of a single currency in phase three that would start in 2030 (IIMA 2004). The second and visible initiative is related to the idea of Asian Currency Unit (ACU) which floated initially in late 2005 from the newly established Office of Regional Economic Integration at the Asian Development Bank (ADB) under the leadership of its then director Masahiro Kawai, and the new ADB president Haruhiko Kuroda. The proposed ACU models itself after the European Currency Unit that existed as the region’s currency unit before the euro. This ECU constituted a unit of exchange based on the weighted average of values (basket) of currencies. The ACU idea was picked up by the ASEAN+3 at the finance ministers’ meeting in May 2006, where all thirteen participating governments agreed to conduct in-depth research on its feasibility (Nihon Keizai Shimbun, May 5, 2006).

These efforts to establish some kind of regional currency arrangement have not, however, led to any regional institution building in East Asia. On the contrary, it was the uncoordinated policies among most of East Asian monetary authorities to maintain soft peg to the dollar and the Chinese determination to keep its RMB-Dollar rate stable and undervalued that has kept the East Asian currencies quite stable with each other and vis-à-vis the RMB and the US dollar in the 2000s (Katada and Henning 2010). In addition, the accumulation of massive foreign exchange reserves among the East Asian central banks, particularly by the Chinese, provided security of their exchange rate be maintained stable.\textsuperscript{25}

\textsuperscript{24} The use of the Japanese yen as the foreign exchange reserve currency declined from 5.3 percent in 1996 to 4.1 percent in 2001 and 2.6 percent in 2005 (IMF). The invoice currency for Japanese trade with Southeast Asia remained flat between 1998 and 2005 at around 48 percent for Japanese exports to the region and 27 percent for Japanese imports (Japanese Ministry of Finance).

\textsuperscript{25} As of 2014, it is reported that China’s foreign exchange reserves has reached US$4 trillion. Other Asian countries such as Japan (US$1.3 trillion) and South Korea (US$350 billion) also top the list of countries with large foreign exchange reserves.
The financial turmoil and sharp downturn of the US economy following the collapse of Lehman Brothers in September 2008 led the further concerns on East Asia’s dollar dependence. What has become quite visible since the onset of the GFC was the push to curb dollar dependence and hedge against the dollar’s demise. Nonetheless and despite the support from the political heavy-weights for regional currency, 26 the moves to offset such dollar dependence have not taken the form of regional institution building. The first calls came from by the Chinese leaders. President Hu Jintao at the site of the first G20 Summit in November 2008 insisted the establishment of “fair, just, inclusive, and orderly” international financial order (Xinha net, November 16, 2008). Then, the Governor of the People’s Bank of China, Zhou Xiaochuan, advocated the use of Special Drawing Rights (SDRs) instead of USD for international liquidity in spring of 2009. 27 Since then, the Chinese government has engaged in various measures to expand the use of its currency RMB for international transactions ranging from RMB swaps to cover trade transaction with China to expansion of off-shore RMB deposits and RMB-denominated bond issuances in Hong Kong. 28 Both the Japanese and Korean monetary authorities have been thus far supportive of the Chinese move. The Bank of Korea has established a RMB180 billion (US$28 billion) swap with China in December 2008, and the Bank of Japan announced in December 2011 that Japan and China will begin using more of their respective currencies (rather than the US dollars) to settle their trade accounts. The Japanese government also has a plan to start purchasing a substantial amount of RMB-denominated bonds (Financial Times, December 27, 2011). Moreover, RMB has already become an accepted form of payment in countries like Thailand and Vietnam.

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26 The former Prime Minister of Japan, Yasuhiro Nakasone (2009) argues strongly in support of Asian currency, so does the current Prime Minister and DPJ leader Hatoyama (2009).

27 SDR is a unit of account maintained by the IMF that uses the weighted average of the US dollars, euro, pound sterling and the yen. For the political motives of Governor Zhou’s announcement on the day preceding the G20 London Summit, see Chin and Wang (2010).

28 Cheung, Ma and McCauley (2011) document policy changes to internationalize RMB. Mallaby and Wethington (2012) argue that “the dollar trap” concerns in the aftermath of the Global Financial Crisis allowed the Chinese leadership to focus their attention on internationalization of the RMB “even though many of China’s leadership continued to believe in export competitiveness, highly regulated capital markets, and a state-controlled banking system,” which could be jeopardized by the measures implemented to make the RMB attractive reserve currency.
Despite the high expectation (or concern) regarding the RMB replacing the dollar as the world’s reserve currency in the near future, its progress is extremely uneven and its process utterly lacks regional institution building efforts. Any region-wide efforts to manage foreign exchange rate stability in East Asia have taken forms of unilateral actions (internationalization of the yen and the RMB, soft peg and management of respective currencies) without any explicit cooperation or institutions.

4. Comparison of State Constraints

The region’s emergency funding mechanism, the CMI, takes an explicitly institutional form, while regional cooperation efforts in the area of currency coordination have been unilateral without any formal institution. The question, then, is why the institutionalization of CMI was possible and more desired than the regional currency arrangement. Since the main agents engaging in these two areas are the same finance ministry and central bank officials with relatively limited engagement of the electoral politics, their position vis-à-vis the domestically embedded preferences and international nested constrains are the focus of the analysis.

(a) Domestically embedded preferences

Foreign exchange rate politics of each country is embedded in the country’s domestic structure. Particularly for most East Asian countries, the foreign exchange rate regime of maintaining stable and undervalued currency has been an important underpinning of their economic success through export competitiveness (Haggard 1990, Wade 2004, Amsden 1992, World Bank 1993). In the early years of export-led growth strategy, many East Asian countries focused their exports to the US market, the world’s largest. Thus, the stable and undervalued exchange rate to the US dollar was very important. Even as the regional production network (Hatch and Yamamura 1996) and intra-regional trade began to expand in the 1990s, East Asian economies continue to rely on the United States and Europe for the outlet of their final products (ADB 2010). Such preferences for a stable and low-valued currency, particularly vis-à-vis the

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29 The conditions to become the host of the international reserve currency include that the issuing country has (a) political stability, (b) deep, broad and open financial markets, and (c) a large share of world’s exports (Tavlas 1997). Greenwood (2011) discusses nine criteria for reserve currencies. Five met by China are: unit of account, medium of exchange, store of value, economic size and creditor status. Four not met are: availability beyond home boarders, full convertibility, developed financial system and network effects.
US dollar, was good for the countries’ influential tradable goods sectors, and was a part of the economic catch-up strategy and growth mandate of the “developmental states” of East Asia (Liew and Wu 2007, Kojo 1998, Steinberg 2009).

This developmental strategy among East Asian governments came with its financial complements in the form of financial repression. Such repression takes place when, by implementing controls over credit, entry and interest rate, and impeding the development of bond and equity markets, the government directs or influences the allocation of capital in the economy (Lukauskas 2002, 380). It was through these measures that the East Asian governments channeled government credits to the manufacturing sectors that produce export goods (Amsden 1992, Calder 1993 and Shih 2008). Such control has led to limited development in the capital markets, particularly the bond market, in these countries (McCauley 2003), thus having profound implications on their foreign exchange rate preferences.30

Even the most advanced economies of Asia such as Japan, which had long shed most of their developmental state characteristics, the business concerns and Japan’s export dependence on the United States continued to steer Japanese companies to rely on the US dollar. On the business level, we find domestic resistance among important business entities against de-dollarization leading to the failure of yen internationalization efforts. According to the survey research conducted by Keizai Doyukai (Japan Association of Corporate Executives) in 1999, despite relatively high support (73.3 percent) among Japanese companies (both manufacturing and services) for an increased use of the yen instead of the dollars, 80 percent of these same companies see the increased use of the yen either very difficult or impossible. These difficulties for the Japanese businesses are manifold. First, foreign exchange transactions have developed into an important business not only for Japanese banks but also for the central sections of Japan’s leading trading and manufacturing companies. Because those entities make substantial profits in currency trading, hedging and arbitrage, they are at best lukewarm to the idea of the use of the yen. Especially given the very sophisticated foreign currency hedging instruments that had been

30 Lacking broad and deep markets for home-currency bonds -- “original sin” (Eichengreen and Hausmann 1999) – these countries are forced to borrow in foreign currencies. Because the denomination of their external assets and liabilities is therefore mismatched, currency volatility and depreciation gets very expensive. “Fear of floating” (Calvo and Reinhart 2002) on the part of these governments is exacerbated by the absence or underdevelopment of efficient forward markets in foreign exchange, which would otherwise enable traders and investors to cover exchange-rate risk. These governments thus face strong pressure from domestic constituencies to keep the exchange rate stable (McKinnon 2005, 26).
available for large Japanese companies over the years, there is only a limited interest in shifting all transactions into the yen, which itself incurs a one-time high cost. Second, globalized businesses from Japan, the largest creditor in the world, have a high level of foreign investment in the dollar areas in the world. Third, the exporting companies, which tend to price to the market and for the customers, particularly in the United States, have preferred to use the dollars. In addition, these companies would be concerned about appreciation of the yen as a result of an increased use of (thus demand for) the yen. Finally, Japan’s large natural resource import needs lead those importing companies to rely on the dollars, too (Katada 2008).

In a quite stark contrast to strong domestically embedded preferences for the currency regime choices, financial politics have not dampened the states’ moves to establish an emergence funding mechanism (Nesadurai 2008, 172). Due to the lack of political involvement by domestic businesses in this area, Japan’s policies on the CMI have been led by the active position of the Ministry of Finance. Top-down and quite autonomous foreign policy decision making process in the area of finance in general has been further fostered by the fact that Japanese banking sector was, one, cut off from the MOF jurisdiction since 1998, and, two, went through its own massive restructuring process in the last decade after the failure of Takushoku Bank and Yamaichi Securities in 1997 and under the introduction of the “Big Bang” of the late 1990s. All those events have restricted the financial sector’s engagement in the hands of the government (Amyx 2004b; Katada 2009).

China, too, sees the ASEAN+3 process particularly in the field of emergency regional financial an essential system that provides protection for the country’s still fragile financial system as the country slowly moves to inevitable capital account reform (Yu 2007; Chin and Helleiner 2008). The country’s domestic politics also played into allowing the Chinese government to support the regional financial cooperation. In the late 1990s, then-Chinese premier, Zhu Rongji, advanced his plan to centralize financial system in the hands of the central authority (Shih 2008, Chapter 8). The AFC allowed him to politicize China’s mounting nonperforming loans and make the centralization of the country’s reform a priority, taking away from the local governments and major banks their leverage against the central government (Shih 2008, 165). Furthermore, a similar crisis-led reform strengthened the hands of Korea’s state as

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31 Many companies in Japan have had the tendency to invoice in the currency of the final destination of their export products (Iwami 1994, 4).
both a financial sector and a corporate sector went under a massive and partially externally imposed reform under the IMF program in 1998 (Lim 2009; 93-95).

(b) Internationally Nested Constraints

Nested in a currency pyramid (Cohen 2004, 14-16), one of the ways for a region to overcome the weight of the top currency the dollar is to “hang together” (Cohen 2004, Chapter 5). Of course, despite the current challenges, Europe has illustrated the feasibility of monetary union and regional currency that allowed the region to detach from the dollar standard while retaining exchange rate stability. Could the East Asian monetary authorities detach itself from the dollar dominance if they so choose?

The theory of “Optimum Currency Area (OCA)” specified the conditions under which a group of countries could benefit from surrendering the exchange rate as an instrument of balance-of-payments adjustment in the process of creating a monetary union (Mundell 1961). Fortunately for advocates of Asian monetary integration, the region compares reasonably favorably to Europe on the OCA criteria based on economic indicators such as degree of economic diversification, openness, intra-regional trade, labor and capital mobility, response to common shocks. Even before the interest in post-AFC monetary integration heightened, Bayoumi and Eichengreen (1998) concluded that nine East Asian countries would meet those economic criteria for an OCA. A more recent review of literature analyzing the feasibility of East Asian monetary integration by Watanabe and Ogura (2006) notes that the majority (12 out of 14) of those studies identified some groups of countries within East Asia meeting the conditions. Furthermore, Kawai (2007) and Wilson (2006) emphasize the positive economic impact that regional exchange rate arrangement compared to a unilateral exchange rate policy as the region gets exposed to massive inflow and outflow of capital under globalization. However, no regional currency solution emerged.

Instead, East Asia opted to maintain stable foreign exchange rates between the US dollar and East Asian currencies, leading to a currency regime so-called Revived Bretton Woods system). Rather than being forced to turn to the dollar by the hegemonic power of the United States (Kirshner 1997), it was rather most preferred choice for the East Asian governments. To

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32 The major economic obstacles to OCA, as often argued, are the different level of economic development and lack of convergence in income per capita.
maintain competitive exchange rates, East Asian governments even opted in favor of accumulating large dollar reserves, even at a high and increasing cost, because those countries place a much higher priority on compiling an internationally competitive capital stock to expand industrial production and absorb excess labor. The costs of holding dollar reserves – forgone returns on these investments and capital losses resulting from dollar depreciation – are a relatively small price to pay for rapid economic development. These interests are complementary to those of the United States, in the view of this school, and the international monetary system and the resulting constellation of payments imbalances (current account surpluses for Asia and deficits for the United States) are stable over a time period lasting for decades (Dooley, Folkerts-Landau, and Garber 2003).

Quite contrary to the heated debate over the original proposal of the AMF, which was dubbed to have challenged the IMF authority, the East Asian governments supporting the CMI, namely Japan and China, are consistently in agreement to nest the CMI in global financial architecture with the IMF as the guardian of creditor interests. Although the impetus behind creating a regional emergency financial mechanism emerged from the aversion to the IMF (as discussed above) and the borrower countries such as Malaysia are still quite vocal about either reducing or eliminating the IMF link conditions of CMI activation, the creditor governments do not see it that way (Grimes 2006; 358). Because the regional and multilateral institutions want to (a) avoid forum shipping and institutional arbitrage, (b) avoid excessive duplication and redundancy, (c) make the efficient use of additional resources, and (d) establish division of labor and specialization along the lines of comparative advantage, these two tend to cooperate (Henning 2011, 7). Henning further argues that inter-institutional coordination can take place not only on ad hoc basis through negotiation, but also on an ex ante basis though institutional design. The relationship between the IMF and CMI in particular, there are already some explicit coordination mechanisms such as IMF-link and IMF Article IV consultation made available to help region’s monitoring needs (Henning 2011, 15-22).

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33 The AMF, the first regional financial initiative taken by Japan during the AFC, was rejected due importantly to China’s opposition. The early opposition partially came from the fact that the Chinese authority was yet to be convinced of the severity of the regional financial crisis at the time of Japan’s proposal, but it was also due to the fact that the Japanese government consulted with the Hong Kong Authority regarding this proposal before contacting the Chinese government in Beijing (Amyx 2005).
Despite relatively abundant foreign exchange reserves in the coffers of two major regional creditors, China and Japan, which should enhance the sense of regional autonomy, a lack of mechanism both to scrutinize the financial conditions of borrower countries and to force them to repay the borrowed money calls for a need for the CMI to nest itself very tightly in the IMF authority.

5. Assessment and Conclusion

Despite a high level of internationally nested constraints for the CMI, its institution was the most robust of any regional financial cooperation mechanisms that developed in the aftermath of the AFC. Given its external constraints, its institutional design has inevitably been that of compromises seen in the form of the IMF-link and weaknesses in independent surveillance mechanisms. It is quite noteworthy, however, that the mechanism has developed into a regional institution in East Asia that excludes the United States, and allows Japan and China to work quite smoothly together. The institution building was relatively easy in this area because the states were quite eager to engage in “defensive regionalism” by fostering such mechanism after their AFC experience, and embedded domestic preferences did not come in the way of allowing the state to make explicit commitment to the regional efforts.

On the other hand, the regional currency mechanism has not seen any light of the day as a regional institution. The foreign exchange arrangement reverted back to the dollar-based soft peg as the AFC shock subsided despite efforts by the region’s creditor governments to reduce the dominance of the US dollar in the region. It was the domestically embedded preferences that swayed the East Asian governments to continue their reliance of the dollars. Granted that currency mechanism has a high level of stickiness, the region has enough favorable conditions in place to insist on regional currency cooperation if the majority of the governments are on board. Nonetheless, a soft and informal arrangement with the US dollar at the center has persisted,

34 The amounts of foreign exchange reserves held by China and Japan increased rapidly in the late 1990s into the 2000s. The growth of Japan’s reserves slowed since the mid-2000s, while China, with its need to maintain undervalued currency has kept accumulating the reserves. Currently, China reports $3.2 trillion (December 2011), while Japan $1.3 trillion (December 2011).

35 One of the reasons that made Japan reluctant to activate bilateral loans to Thailand without the involvement of the IMF at the time of its crisis in July-August 1997 was Thai’s unwillingness to produce reliable foreign exchange reserve and debt information (Lee 2006).
which reduces the explanatory power of the internationally nested determinants of regional institutional development.

In the realm of regional financial cooperation in East Asia, the genesis and impetus of region’s financial institutions emerged from an outside pressure and East Asia’s position in the global financial architecture, while the design or evolution preferred by the creditor governments has thus far been largely constrained by domestic preferences and structures. Such political dynamics led certain areas of financial cooperation to proceed more smoothly than others, making the regional financial cooperation without coherence or coordination across important dimensions.
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