

Henning, C. Randall

**Working Paper**

## Economic Crises and Institutions for Regional Economic Cooperation

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## ADB Working Paper Series on Regional Economic Integration



### Economic Crises and Institutions for Regional Economic Cooperation

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C. Randall Henning

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C. Randall Henning<sup>+</sup>

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<sup>+</sup> Professor, School of International Service, American University, 4400 Massachusetts Avenue, NW, Washington, DC 20016, United States, and Visiting Fellow, Peterson Institute for International Economics, 1750 Massachusetts Avenue, NW, Washington, DC 20036-1903, United States. Tel: (202) 328-9000. [henning@piie.com](mailto:henning@piie.com)

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## **Abstract**

This paper examines the extent to which economic crises facilitate the development of more effective regional institutions and whether such institutions can shield regions from crises. It compares six regional economic crises over the last four decades and the institution building—or decay—that followed. The analysis concludes that five conditions are especially important in generating a constructive regional response: (i) a significant degree of regional economic interdependence; (ii) an independent secretariat or intergovernmental body charged with cooperation; (iii) webs of interlocking economic agreements; and, as elements of the multilateral context, (iv) conflict with the relevant international organization (such as the International Monetary Fund [IMF]); and (v) the support of the United States. The paper then reviews three episodes of crises in Europe, concluding that the Economic and Monetary Union (EMU) has deflected balance of payments and currency crises but not crises of other types, such as sovereign debt crises. Asian regionalism would be well served by heads of government taking the lead and delegating tasks to intergovernmental networks and secretariats, central banks and finance ministries retaining substantial collective autonomy in their fields of responsibility, and the use of concentric circles to accommodate countries with different levels of commitment to regionalism.

*Keywords:* Economic crises; financial crises; regional institutions; Asian regionalism; regional integration

*JEL Classification:* F33, F36, F55, F59

## 1. Introduction

Regionalist movements are intimately connected to economic and financial crises. Most of the financial crises of the last four decades have had a strong regional dimension. We identify them as the Latin American debt crisis, the European currency crisis, or the Asian financial crisis because their impact has been geographically concentrated. Crises call into question the adequacy of multilateral arrangements for prevention and stabilization and, under certain circumstances, galvanize support for proposals to strengthen regional agreements and institutions. Once in place, regional arrangements can in principle shield countries against the adverse effects of global financial turbulence, if they are well designed; but the recent banking and sovereign debt crises in Europe demonstrate that satisfying this proviso is difficult.

Several authors have examined the link between crises and regional institution building. Most treatments to date have addressed specific crises in isolation and have asked different questions of different cases, however. Our understanding of regionalism would benefit from more systematic treatment of the relationship between them. The mandate of this paper is to survey the existing literature for what we know about the connections between economic crises and regional institution-building specifically. The paper thus addresses the two-way relationship:

- (i) the extent to which economic crises help or hinder the development of more effective regional institutions, and
- (ii) the extent to which regional institutions can be designed in ways to help guard against or mitigate future economic crises.

This paper will also supplement the literature with available empirical material on crisis cases, present some of the author's own arguments, and draw out the insights for Asia. Specifically, this paper seeks to address the implications for policies and institutional design in the Asian region.

The study examines previous cases of crises and their impact on regional institutions, employing three methods. First, it conducts an inventory of these crises and the analysis and conclusions about them. Second, to the extent feasible, the paper conducts a structured comparison of the cases. By asking similar questions in each crisis case, relating variables of interest to institutional outcomes, we can draw generalizations about the conditions that are either conducive or adverse to institutional building. Third, the paper will elaborate on aspects of cases that speak to key points in the present Asian discourse on regionalism and institutions. The case treatments, while considering a common set of factors, will thus deviate somewhat from a common template.

One particular caveat is in order: the research design is constrained by the relatively limited number of region-wide crises over the last four decades. Rather than select cases with particular settings on the variables, we must work with the cases that we have, drawing conclusions where doing so is valid, and acknowledging where hypotheses remain open. (On the other hand, this study avoids the trap of selecting on



the dependent variable and considers regions and episodes characterized both by institution building and institutional decay.)

After comparing these crises, the paper concludes that five conditions are especially important in facilitating a constructive regional response to a crisis: (i) a significant degree of regional economic interdependence (market integration), (ii) an independent secretariat or intergovernmental body charged with cooperation, (iii) webs of interlocking economic agreements, and, as elements of the multilateral context, (iv) conflict with the relevant international organization (such as the International Monetary Fund [IMF]), and (v) the blessing of the United States (US) for regional integration. Asian regionalism would be well served, the paper recommends, by the heads of government taking the lead and delegating tasks to intergovernmental networks and secretariats. Within their mandate, central bank and finance ministry officials should have substantial autonomy in order to preserve the confidence of markets.

Note that some matters lie beyond the scope of this paper. First, this treatment focuses specifically on economic, monetary, and financial crises. Crises in health, environment, foreign policy, and natural disasters are beyond this scope. Second, it considers only region-wide cases in the modern era of increasing capital mobility, not crises prior to 1970. Third, an early outline of this paper considered the division of labor among regional and multilateral institutions—that is, what functions are best handled at which levels. Although this is a very important topic, this too must be reserved for treatment elsewhere owing to limited space here.

The paper is organized as follows. The next section discusses the nature and definitions of crisis and institutions, which are both central concepts in this study. The third section addresses the causal links between crises and institution building as well as the factors that condition regional responses to crises. The fourth section presents six crisis cases and draws conclusions from their comparison. The fifth examines how regional institutions form defenses against crises. On the basis of these findings, the final section offers several recommendations for the design of Asian institutions.

## 2. Concepts and Definitions

As the concept of crisis distinguishes this paper from others in the project, it bears some elaboration and clarification. The Oxford English Dictionary's first definition is "a time of intense difficulty or danger." The word derives from the Greek "krisis," meaning decision, and "krinein," meaning decide. Original usage in English thus meant a time of decision and has evolved toward an emergency requiring decision. The concept is employed widely, though inconsistently, in comparative politics, international relations, and political science (see, for example, Graham Allison's analysis of the Cuban Missile Crisis, Allison and Zelikow 1999, as well as Phillips and Rimkunas 1978, Svensson 1986, Goertz 2006). This is consistent with our current usage with respect to economics and finance: an economic or financial emergency that requires a rapid policy response.

In practice, this label applies to major declines in the value of national currencies and financial assets, the bankruptcy of financial institutions, collapse of financial markets,

and macroeconomic recessions or depressions. The Latin American debt crisis of the 1980s, European exchange rate crisis of 1992/93, Mexican peso crisis of 1994/95, and Asian financial crisis of 1997/98 fall under this definition. Also falling under this definition will be major shifts in currency values and conflicts over payments balances and macroeconomic adjustment, such as the “Nixon shock” of 1971, as well as major shifts in commodity prices and supply, such as the “oil shocks” of the last 4 decades. Each of these events forced decisions by the governments with ramifications for international cooperation, sometimes on a regional basis and sometimes not.

Gourevitch expands on the importance of focusing on crises in comparative political economy. “In prosperous times,” he writes, “[s]ocial systems appear stable, and the economy works with sufficient regularity that its rules can be modeled as if they functioned without social referent.” In difficult economic times, by contrast, “[p]atterns unravel, economic models come into conflict, and policy prescriptions diverge. . . .” “Crisis opened [sic] the system of relationships, making politics and policy more fluid.” Societal groups divide and recombine, producing political realignment. “The moments of greatest freedom are crisis points.” (Gourevitch 1983; quotations appear on pp. 17, 32, 22, and 240, respectively). So it is with the political economy of regionalism as well.

In the literature on regional institutions, Calder and Ye (2004) develop the concept of “critical juncture,” which is similar to the concept of crisis. Drawing on Joseph Nye’s early work on regional integration, they specify a critical juncture as an historical episode characterized by crisis, time pressure, and stimulus for collective action to a common problem. Nye (1965) had highlighted the importance of a “catalyst,” which often takes the form of an external shock leading to discontinuities in institution building. For our present purposes, however, it is important to separate the definition of crisis from the effect of institutional change. This paper investigates when and why some crises generate institutional change while others do not. If an event must produce institutional change in order to qualify as a crisis, our analysis would be circular.

The papers in this project examine a variety of types of critical junctures in their analyses of regionalism. Kevin O’Rourke, for example, examines key turning points in postwar European history to explain the establishment of supranational regional institutions during the 1950s and the accession of the United Kingdom and most of the remaining European Free Trade Association (EFTA) countries to the European Community. These turning points, a confluence of fundamental and almost coincidental conditions, differ from crises, which are defined here in relatively narrow economic and financial terms. His and several other papers serve to remind that institutions can arise from circumstances completely unrelated to crises.

Crises are characterized by phases. First, crises are preceded by periods of normality, an equilibrium during which economies and the political relationships among actors and institutions are relatively stable. Tranquility nonetheless masks the gradual buildup of debt, for example, that ultimately becomes unsustainable. Second, the acute phase is initiated by a spark that triggers a cascading series of events, such as a collapse in financial markets. Third, policymakers struggle to respond, during which time they might broker or be subject to realignments in international and domestic politics. Fourth, the crisis is resolved and the political economy returns to a new and usually different

equilibrium—until the next crisis occurs. This formulation compares with Gourevitch's (1983) staging of crises, and Frieden's (1991) stylized evolution of crisis politics. Construction of regional institutions could occur during the response phase or in the new equilibrium.

Consider now the concept of institutions somewhat more carefully. The notion is defined differently across the various subfields of political science and economics.<sup>1</sup> The definition chosen for this paper, guided by the overall purpose of the project, is broad but not all encompassing. The term institution is employed here to include both (i) explicit, formal commitments and organizations; and (ii) common processes and informal networks among governments that facilitate cooperation. The term can thus refer to ASEAN+3, the Chiang Mai Initiative, and the Economic and Monetary Union, as well as regular official meetings, peer review, and surveillance processes. The concept is broader than simply a formal regional bureaucracy, but not so broad as to include norms and expectations. Nor does the term include private-sector networks and transnational political and technocratic alliances.

### 3. How Crises Help Build Regional Institutions

Consider next the reasons we might expect crises to stimulate national governments to construct regional institutions and the background conditions that explain why some regions respond to crises in this way while other regions do not.

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<sup>1</sup> The political economy of international regimes struck a broad and widely used definition of "regime" that has sometimes been used synonymously with the term "institution." Regimes are "sets of implicit or explicit principles, norms, rules and decision making procedures around which actors' expectations converge in a given area of international relations" (Krasner 1983, 1). Goldstein, Kahler, Keohane, and Slaughter (2000, 387) define international institutions as "enduring sets of rules, norms, and decision-making procedures that shape the expectations, interests, and behavior of actors."

- a. The project on the Rational Design of International Institutions defines them somewhat more narrowly as "explicit arrangements, negotiated among international actors, that prescribe, proscribe, and/or authorize behavior" (Koremenos, Lipson, and Snidal 2001; 762). As such they have five key dimensions: membership rules, scope of issues covered, centralization of tasks, rules for controlling the institution, and flexibility of arrangements.
- b. Another meaning, advanced by Milner (1998, 761) is "the means by which the diverse preferences of individuals are aggregated into choices or outcomes for the collective. Institutions here both shape and reflect the strategic interaction among agents." They are mechanisms to aggregate preferences (of individuals or states) and to exercise collective choice. See also Eichengreen (1996, 1998).
- c. Institutionalization is distinct from, but related to, "legalization." Legalization in its hard form refers to a particular variation of institutionalization. Hard legalization entails (i) binding rules of obligation, (ii) precision in those rules, and (iii) delegation to a third party of the interpretation, monitoring and implementation of those rules, dispute settlement, as well as perhaps the promulgation of further rules (Goldstein et al. 2000, 387; Abbott and Snidal 2000). The European Union is often cited as a case of relatively hard legalization (Alter 2000), NAFTA as a case of hardening legalization (Abbott 2000), while cooperation in the Asia-Pacific is described as non-legal (Kahler 2000b).

### 3.1. Causal Links

If crises are exceptional moments of political realignment and policy shift that can be institutionalized in bargains and arrangements that define a new, durable equilibrium, what, precisely, are the mechanisms of the change with respect to regional institutions? In principle, we can posit several causal channels.

1. **Political demand.** Crises give rise to demands for state action to protect corporations, banks, private sector groups, and social groups from economic dislocation. These demands operate through domestic politics, but satisfying them is sometimes more effective when coordinated regionally, which regional institutions facilitate.
2. **Preference clarification.** Crises create new information about the preferences and behavior of regional partners and extra-regional governments. By forcing choices upon governments, crises place their preferences in stark relief. Whereas national preferences between unilateral, regional, or multilateral arrangements might have been ambiguous in periods of tranquility, crises can reveal true allegiances “when the chips are down.”
3. **Preference convergence.** Crises can affect states within regions similarly, creating a common interest in a common response. (They can also affect countries within a region quite differently, such as between creditors and debtors, in which case they can create conflicting interests and preferences regarding the solution.)
4. **Interest re-shuffling.** Crises can change the material basis for domestic and intra-regional coalitions. Destruction of wealth and shifts in competitiveness empowers some firms and sectors and disempowers others. When these shifts motivate or empower transregional groups, they promote cooperation.
5. **Political realignment and regime transformation.** Crises can stimulate the realignment of domestic social groups (Gourevitch 1983) and transform domestic political regimes. Sometimes, such changes can make governments more predisposed to trading off national autonomy for the benefits of regional cooperation. Crises sometimes stimulate transitions to democracy (Haggard 2000) and democracies might be more inclined to international cooperation.
6. **Network reinforcement.** Crises stimulate communication, discourse, and negotiation among government officials and international civil servants within a region, reinforcing elite intergovernmental networks that can support regional integration in a subsequent stage (Calder and Ye 2010).
7. **Leader agency.** Whereas in normal circumstances, heads of government and their ministers will often be beholden to important constituencies and pressure groups, crises alter the constraints upon them. Crises naturally impose strong financial and economic constraints that limit the policy options of governments. By discrediting some ministries and agencies and by forcing quick, unpleasant

choices, however, crises can liberate leaders from interest-group-politics-as-usual and bureaucratic-politics-as-usual, temporarily giving them more room for maneuver politically.<sup>2</sup>

8. **Prioritization.** Crises can raise the issue area to the top of the political agenda, prompting action or agreements that had previously been stifled by apathy, neglect, or lack of political entrepreneurship.

Two frequent candidates have not been included in this list: ideational convergence and power shift. One might be tempted to argue that crises stimulate reassessment of policies and institutions leading to a convergence of analytical beliefs and frameworks that facilitate institutionalization. More often, in my observation, crises generate vigorous debate over causes and widen, rather than narrow, the range of alternative views.

One might also hypothesize that, when they affect countries differently, crises can alter the relative power position of states within a region. The 1997/98 Asian financial crisis shifted influence within East Asia away from Japan and toward the People's Republic of China (PRC), for example (Pempel 1999, 228–232). However, this effect is almost always a temporary acceleration or retardation of an underlying structural trend. Rapid changes in relative power positions can discourage institutionalization because the ascendant state will anticipate a more favorable institutional bargain if it defers agreement.

### 3.2 Background Conditions

Crises are not the only, or necessarily even the primary, determinants of regional institution building. They occur against the background of existing circumstances which configure a region's predilection toward regionalism. Moreover, crises cannot stimulate institution building directly; instead, national officials, international civil servants, and pre-existing regional forums construct them. These officials, in turn, exercise partially independent choice. Whether any given crisis will generate institution building thus depends on a set of third variables.

The set of variables that we might expect to condition the regional response to crises is potentially as broad as the literature on regional integration. Neofunctionalism, institutionalism, realism, constructivism, and domestic politics and epistemic approaches would each advance candidates for this list.<sup>3</sup> These variables include pre-existing regional institutions, intergovernmental and transnational networks, norms, ideas, regional dominance, intra-regional rivalry, linkages to political integration, security externalities, and geopolitics.

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<sup>2</sup> The agency role of executive officials in the domestic context is captured by the aphorism attributed to United States President Barack Obama's Chief of Staff Rahm Emanuel: "You never want a serious crisis to go to waste." Gerald F. Seib. In *Crisis, Opportunity*. Wall Street Journal. 21 November 2008. p. A2.

<sup>3</sup> Reviews of these approaches and how they apply to regional integration can be found, for example, in Wallace, Wallace, and Pollack 2005; Caporaso 2007; Eichengreen 2006; Henning 2006; and the special issue of the *Journal of European Public Policy* devoted to the neofunctionalist legacy (April 2005).

I have stressed the role of institutions and preferences in the context of multilateral arrangements in my work. The source of the shock (whether internal or external to the region) and the response of the multilateral regime strongly condition the regional reaction (Henning 2002 and 2009). US–European conflict over exchange rate policy and the balance of payments preceded each of the European initiatives to strengthen regional monetary integration, for example. The Chiang Mai Initiative (CMI) has similarly depended on the nature of the shock and the response by the IMF. The more disruptive and external the shocks, and the less adequate the IMF's response, the stronger the impetus for the CMI multilateralization.<sup>4</sup>

The treatments of crises in the remainder of the paper will devote particular attention to the following arguments, drawn from several of these theoretical perspectives. We expect that a crisis will stimulate the building of common institutions within a region in the presence of

- (i) a secretariat that is charged with fostering cooperation;
- (ii) substantially integrated markets for goods, services, and capital;<sup>5</sup>
- (iii) functional linkages to pre-existing agreements in related economic areas;<sup>6</sup>
- (iv) a single dominant country within the region;
- (v) preferences that conflict with the relevant multilateral institution; and
- (vi) a benign posture toward regionalism on the part of the US.

Conversely, in the absence of these background conditions, we would not expect crises to produce institution building.

### 3.3 Alternative Outcomes

There is no a priori reason to expect that crises cannot also weaken or destroy regional institutions, just as they might multilateral or national institutions. The 1992/93 crisis in the Exchange Rate Mechanism of the European Monetary System witnessed the ejection of the British pound and the Italian lira from the regime, and a formal widening of the bands of exchange rate fluctuation. A constructive response, though ultimately forthcoming, was by no means inevitable. In the absence of these background conditions, therefore, we might observe crises causing institutional decay.

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<sup>4</sup> During the recent crisis, these indicators were partially offsetting: the shock source was clearly external, but the multilateral response (including direct support from the US) was also much more congruent with Asian preferences than in 1997/98.

<sup>5</sup> Market integration refers to the mutual penetration of national markets as distinct from the adoption of common regional frameworks and regulations to govern markets. It is thus measured, for example, as trade flows relative to gross domestic product (GDP), capital flows relative to domestic market capitalization, and price convergences across borders.

<sup>6</sup> Functional linkages refer to the consequences in one sector of regional cooperation of disturbances in another. For example, drastic shifts in the exchange rates among European currencies created severe problems for the administration of the Common Agricultural Policy owing to the methods used to calculate price supports and compensate producers. A political-economic process distinct from simple cross-border economic effects, such linkages evoke references to spillover in the neofunctionalist literature.

To list the set of possible outcomes comprehensively, we must acknowledge that it is also possible in principle that a crisis might have no effect on regional institutions. One variation on this outcome would be an apparent effect that proves transitory, leaving the degree of institutionalization unchanged in the long term. No effect can be treated as the null hypothesis and the cases of crises can be used to test whether outcomes differ substantially from it and, if so, in which direction.

Finally, in cases where crises do contribute to the creation or strengthening of regional institutions, we would expect this to apply primarily to a specific set of institutions – those that provide defenses against crises or the means to manage them. In response to a balance-of-payments crisis, for example, we might expect states to create balance-of-payments financing facilities and bodies and processes to activate them—not free trade areas, customs unions, or other regional arrangements unrelated to the crisis. We expect the functional form of the crisis to dictate the type of institutional response.

## 4. Cases of Crises and Regional Responses

Consider now the prominent cases of economic and financial crisis in the last 4 decades. We begin with the treatment of Europe and the process of monetary integration, which was punctuated by a number of crises over the span of several decades. We then consider specific crises and responses, beginning with the first oil shock and the nearly forgotten 1975 agreement to create a Financial Stabilization Fund. The section then addresses the Latin American debt crisis of the 1980s, the Mexican peso crisis of 1994/95, the Asian financial crisis of 1997/98, and the Asian dimension of the 2007–09 crisis. It is interesting to observe how the regions in Asia, North America, and Latin America were responding while Europe was grappling with monetary and financial disturbances.

### 4.1 European Monetary Integration

A substantial literature addresses the political economy of exchange rate stabilization, macroeconomic convergence, and the creation of the euro. Authors emphasize various factors as the driving force for European monetary integration: integration of markets,<sup>7</sup> German dominance,<sup>8</sup> domestic politics,<sup>9</sup> intergovernmentalism,<sup>10</sup> linkage politics,<sup>11</sup> institutions,<sup>12</sup> economic ideology,<sup>13</sup> geopolitics,<sup>14</sup> and political integration.<sup>15</sup> My own

<sup>7</sup> Padoa-Schioppa (1990), Delors Report (1989), Commission of the European Communities (1990). See also Eichengreen (1996, 3–12).

<sup>8</sup> Giavazzi and Pagano (1988), Giavazzi and Giovannini (1989). Those opposing the German dominance school included Fratanni and von Hagen (1992). The debate is appraised by Woolley (1992), Gros and Thygesen (1992, 100–160), and Willett and Andrews (1997). See also Cohen (1993), who argues that local hegemony is critical to sustaining monetary unions once created, and Dyson (1994).

<sup>9</sup> See especially Frieden (1994, 2001, 2002, and 2003).

<sup>10</sup> See especially Moravcsik 1991 and 1998.

<sup>11</sup> Martin 1993, Cohen 1993, Pauly 1992.

<sup>12</sup> Sandholtz and Zysman 1989.

<sup>13</sup> McNamara 1998.

<sup>14</sup> See, for example, Sandholtz 1993.

contribution emphasizes the international monetary system and disturbances transmitted through it as the context for monetary integration. This approach gives pride of place to conflicts between Europe and the US over exchange rates, the balance of payments, and macroeconomic adjustment as incentives for European cooperation (Henning 1998). Because several of these episodes were full-blown crises, a review of that approach is suitable here.

International monetary conflict and turbulence provides strong incentives for groupings of vulnerable states to consider regional monetary cooperation in order to create an island of monetary stability. Regional arrangements help countries limit the shifts in intra-regional exchange rates, deflect pressure for policy adjustments, and perhaps even exercise countervailing pressure on a dominant state outside the region. Beginning in the 1960s, the US ran large current account deficits during several episodes, pressured the governments of surplus countries to stimulate their economies, and encouraged depreciation of the dollar in order to persuade them to comply and otherwise achieve adjustment. Confronted by the appreciation of their currencies, the surplus countries, which frequently included Germany, could expect a drop in exports, growth, and employment, which reinforced US demands for macroeconomic stimulus. Elsewhere, I have referred to the use of the exchange rate in this way as the “dollar weapon,” discussed its underpinnings, and described its weakening in the hands of the US during the decade after 2000 (Henning 2006).

In the teeth of the conflict, European governments parried, deflected, but ultimately often accommodated US pressure for macroeconomic adjustment. The recurrence of US pressure and international monetary instability generated sustained interest among targets in developing regional arrangements as defensive mechanisms. After periods of transatlantic monetary conflict, therefore, Europe responded with initiatives for currency cooperation. Conversely, during periods of transatlantic monetary tranquility, the impetus for monetary integration tended to flag.

The narrative, in brief, begins with the Bretton Woods regime, the context for the origins of the European Community. Because that regime stabilized European cross rates at the same time as it stabilized European currencies against the dollar, monetary matters were virtually off the agenda of early European integration. As the Bretton Woods regime experienced a succession of currency crises in the 1960s and then collapsed altogether in the early 1970s, however, the Europeans developed plans for currency cooperation. If the Bretton Woods regime had remained intact, European governments would not have sought regional exchange rate stabilization.

As much of the rest of the world went to flexible exchange rates during the 1970s, Europe experimented with the “snake.” Conflict with the Carter administration during 1977/78 persuaded West German Chancellor Helmut Schmidt and French President Valéry Giscard d’Estaing of the benefits of tightening the European monetary regime. They thus created the European Monetary System (EMS) in 1979. Conflicts with the US during the Plaza and Louvre accords in the mid-1980s and during 1990 and 1991 helped

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<sup>15</sup> Sandholtz 1993, Woolley 1994, Andrews 1993, Garrett 1993. Eichengreen and Frieden (1994) discuss approaches to analyzing the Maastricht treaty commitments.



to reinforce the process leading to the Maastricht treaty.<sup>16</sup> (We consider subsequent episodes in the sections below.) Exchange rate and balance of payments crises were thus integral to the process of European monetary integration.

There were large and sometimes heated conflicts among countries within the region, of course. Member states exhibited considerable variation in their macroeconomic preferences and disagreements over the direction and design of common monetary arrangements. West Germany was famously devoted to monetary orthodoxy and fiscal conservatism to restrain inflation while benefiting from external demand and export-led growth. France and Italy pursued monetary and fiscal activism in efforts to sustain domestic demand and employment. Conflicts with the US served to highlight the benefits to macroeconomic convergence in Europe as a route to monetary integration. Such conflicts placed particularly strong pressure on the outliers in intra-European debates:<sup>17</sup> France in 1973, West Germany in 1978, France in 1983, and West Germany in 1987. France gradually relinquished its attachment to monetary activism and accepted a price-stability orientation. The Bundesbank, hostile to the EMS at the time of the system's creation, became a defender of the system by the mid-1980s, and West Germany gambled on the durability of the stability orientation of its partners when concluding the Maastricht treaty. US-generated disturbances did not extinguish intra-European disputes, but they increased the payoff from intra-European accommodation.

Conflict and crises were not the only important factors, of course. Three background conditions were particularly important also. First, Europe had a substantial degree of intra-regional market integration. In the mid-1970s, intra-European exports were about 45% of total European exports and about 8%–9% of European gross domestic product (GDP). Cross-rate shifts could therefore disrupt a significant amount of trade and investment. Second, Europe had a set of common policies with respect to agriculture, trade, competition, development, and structural cohesion, and was almost continuously negotiating enlargement of its membership. Political and institutional linkages among these policies facilitated a regional response to crises. Third, the institutional structure of the European Community had established forums for ministers and heads of government, regularized meetings among them, a committee of central bank officials responsible for operating currency arrangements, and a Commission with strong bureaucratic incentives to support further integration.

For crises to have a sustained effect on regional integration, member states must not abandon post-crisis monetary arrangements during periods of tranquility. By creating organizational actors and political bargains, governments institutionalize regionally the lessons of earlier conflicts. With institutions in place, and the analytical capacity and

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<sup>16</sup> Treatments of these episodes can be found in Putnam and Henning (1989), Destler and Henning (1989), and Henning (1994), among a number of other places.

<sup>17</sup> Because regional arrangements provide defenses against systemic disruption, the outlier is inherently more exposed and vulnerable to pressure for policy adjustment emanating from the dominant state. The situation is analogous to a herd of cattle on the open range. In fair weather, cattle maximize their grass consumption by grazing apart; when a storm approaches, they gather together for shelter against the wind. The animal that stands aloof will be driven by wind and rain into the fold. It does not lose its appetite for grass but trades off maximizing this commodity for the shelter of the herd. So it is for secondary states buffeted by international monetary storms (Henning 1998, 547).

institutional memory they provide, each successive external shock raises the expectation on the part of vulnerable states that similar shocks will occur in the future. Defensive arrangements set in place after previous episodes, moreover, alter the set of choices available to small states when responding to subsequent episodes, creating path dependency. Within a semi-institutionalized region, states can thus be expected to bolster cooperation after each international monetary crisis more than they allow it to decay between disturbances, producing an upward ratcheting of regional integration.

Three further points, relating to the comparison to East Asia, deserve note. First, while Europe was tightening monetary cooperation over a succession of international monetary conflicts, other regions followed different paths even though they faced a similar external environment. In East Asia, Japan was the target of pressure for macroeconomic stimulus at least as much as West Germany was in Europe, the Republic of Korea; Taipei, China; and the PRC were also subject to US pressure for currency appreciation. So, differences in regional responses should be attributable to differences in the politics and institutions of the regions.

Second, and relatedly, the observations about ratcheting suggest that the central explanatory question can be usefully restated as: What are the necessary preconditions for upward ratcheting to prevail over a succession of crises rather than decay? Market integration, interlocking agreements, and institutions helped to make the European response to conflict and crisis cumulative. But a single case cannot settle arguments over which are the decisive factors. Comparison to the experience of other regions can shed useful light.

Third, while US policy was confrontational during these episodes in terms of exchange rate and macroeconomic policy, US policymakers did not oppose monetary regionalism in Europe. Washington accepted the creation of the snake and the EMS, and supported the Maastricht treaty and the transition to EMU, notwithstanding the fact that Europe was creating a competitor to the US dollar as an international currency. Washington's reaction to the first proposals for regional financial cooperation in East Asia was very different.<sup>18</sup>

## **4.2. Oil Crisis of 1973–74 and OECD Financial Support Fund**

The first oil shock affected the EU, member countries of the Organisation for Economic Co-operation and Development (OECD), as well as the broader membership of multilateral institutions such as the IMF. But the response was different in each case. While the Europeans tentatively pledged themselves to exchange rate cooperation in the snake and deployed short- and medium-term financial assistance facilities, the executives of the governments of the OECD countries agreed to create a new fund, but then allowed the initiative to languish and eventually die from neglect. The OECD's Financial Support Fund (FSF) is thus an episode of failure to strengthen an institution in

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<sup>18</sup> The argument that the multilateral context—the policies of the US and international economic conflict—drives regional cooperation is directly applicable to East Asia after the 1997/98 financial crisis and is discussed below (Henning 2002 and 2008).

the aftermath of a crisis, despite having an international secretariat invested in the proposal and the backing of powerful government bureaucracies.<sup>19</sup>

In response to the oil shock, US Secretary of State Henry A. Kissinger proposed the creation of a financial safety net for OECD countries in order to counter the Organization of the Petroleum Exporting Countries (OPEC) and to help maintain the solidarity of the Atlantic alliance and US–Japan security ties.<sup>20</sup> During a moment of weakness, US Treasury Secretary William E. Simon acceded to and advanced this proposal, designed as an inducement for European states and Japan to take a firm, collective stand in energy talks with oil producers. An agreement was swiftly concluded in the spring of 1975. Under it, the FSF was to be established in the amount of \$25 billion from the contributions of OECD members and lent to members to cover balance of payments needs, which were expected to be large and variable in the new era of high oil prices.

The agreement raised a series of questions, however, about the respective roles of private and official financing and of the IMF and other international organizations. One question was whether the private financial system could recycle petrodollars from oil exporters to deficit countries without the intermediation of the official sector. Even Secretary Simon thought that an official safety net was probably unnecessary. A second question was whether the FSF could in practice be nested within the rules and policies of the IMF. While the new facility was intended to be a backstop to the IMF and impose IMF-like conditions, it would be administered by the OECD secretariat and the modalities of coordination and resolution of any conflicts between the two institutions were ambiguous. Ultimately, the agreement died of inaction in Congress with the assent of the Carter administration.

In his interesting study of this episode, Cohen (1997) emphasizes the influence of ideas and the forceful diplomacy of the US as the main explanations for the initial acceptance and ultimate rejection of the FSF. My reading of this case gives primacy to the triangular relationship among the US State Department, Treasury Department, and the Congress—which he also presents. The State Department preferred the OECD as the locus of efforts to provide payments financing because it had the lead in representing the US in Paris, whereas the Treasury Department preferred the IMF where it had the lead. Although Kissinger had the upper hand in bureaucratic competition with Simon during the acute phase of the crisis, resulting in the advancement of the negotiations, Treasury reasserted itself as the crisis dissipated and petrodollar recycling expanded.

More importantly, the US Congress looked askance at creating a second international financial agency for a purpose for which it thought it had already funded the IMF. Congress is often criticized for its role in international monetary and financial policy. But in this case it played a constructive role, insisting on the rationalization of institutional arrangements that had been made unnecessarily complex by bureaucratic politics.<sup>21</sup> Congress rejected the FSF in favor of a new facility, the Supplementary Financing

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<sup>19</sup> “Region” in this particular case is thus defined by level of development rather than geography. Mistry (1999) argues for defining a region as broadly as the geographical scope of the effects of a crisis.

<sup>20</sup> This section relies on Cohen (1997), the only serious treatment of this interesting case.

<sup>21</sup> For a definitive treatment of the congressional politics of the IMF, see Lavelle (forthcoming).

Facility (SFF, also referred to as the Witteveen facility), within the IMF and, shortly thereafter, expanding the IMF's quotas.

There are a couple of additional observations about this case that resonate with others below. First, the domestic politics of the dominant state was essential to understanding the episode. US officials' interpretation of national interests was shifting and government preferences were unstable. The state was disaggregated, a set of agencies and branches sometimes working at cross purposes. Second, the advocacy and entrepreneurship of an able secretariat was insufficient to secure adoption of the proposal. This was due in part to conflict with an equally capable and better-situated opposing secretariat, the IMF managing director and his staff. Nonetheless, third, the competition between the secretariats of the OECD and the IMF was secondary to interagency conflict in the US. "Nothing was more critical," Cohen (1997, 22) writes, "than the rival institutional ambitions of the State Department and Treasury." Finally, the linkage between security and finance could not be sustained in this instance.

### **4.3. Latin American Debt Crisis of the 1980s**

Without the benefit of hindsight, an analyst might be forgiven for anticipating that a financial crisis of the magnitude that struck Latin America in 1982 would provoke a substantial regional response. Latin America had many of the qualities that might have been expected to favor regionalism. Relative to other regions, including Europe, it had cultural and linguistic homogeneity. Its members largely shared the state-led development strategy of import-substitution industrialization. The Economic Commission for Latin America and the Caribbean (ECLAC), based in Santiago, Chile, had established itself as an informal regional secretariat. Structural economics, developed by Raúl Prebisch as ECLAC's director in the late 1940s and early 1950s, and then dependency theory was widely shared as an economic ideology, one that fostered regional integration as an alternative to market-friendly multilateral trade liberalization. The debt crisis struck nearly all of the members of the region—their interests converged as debtors—and most were similarly antagonized by the policies of the US and the IMF. Yet, the outcome in the region was far different from the response of East Asia after the 1997/98 crisis.

The acute phase of the debt crisis began in August 1982, when the Mexican finance minister announced to the US Treasury Secretary that Mexico could not service its loans to private banks without an emergency financial package. Within a short time, more than forty countries succumbed. Africa was also involved, but in smaller absolute magnitudes. East Asia, while impacted, largely escaped having to reschedule external debt—the one exception being the Philippines. This crisis was thus largely concentrated in Latin America.

The literature on the debt crisis of the 1980s, which preoccupied much of the writing within international finance, international development, and international political economy during the decade, was mainly organized around the normative questions of the policy response: Were Latin American countries illiquid or insolvent? How should the threat to the international banking system be addressed? How should creditor governments respond and what was the proper role of the IMF? Who was bearing and

should bear the cost of stabilizing the financial system? Must debt relief be granted? (See Sachs 1988, Eichengreen and Lindert 1989, Lissakers 1991, Cohen 1992, Cline 1995, and Aggarwal 1996.) Revisiting this literature after more than a decade, one is struck by the relative simplicity of the problems compared to those that confronted the international community in the succession of subsequent crises. (For a comparison of the management of the 1980s debt crisis to the Mexican peso crisis, see Henning 1996.) Comparatively little has been written about the regional response.<sup>22</sup>

Latin America nonetheless had a fairly strong tradition of regionalism prior to the crisis and had constructed a broad range of regional, subregional, and cross-regional institutions. At the broadest level, the Organization of American States (OAS) and the Inter-American Development Bank (IDB) were both headquartered in Washington, DC. At the subregional level, the Central American Common Market, Andean Community, and Caribbean Community, among others, pre-dated the debt crisis.<sup>23</sup> Each subregional group created a development bank to supplement the work of the IDB and World Bank. These supplemented clearing and settlement systems that had been created to facilitate intraregional trade. For liquidity and balance of payments support, the least developed area of regional financial cooperation, the Central American Monetary Stabilization Fund and the Andean Reserve Fund had been established. (The multiplicity of regional and subregional institutions with participation by outsiders loosely compares to the patchwork of regimes in East Asia in later decades.) The crisis thus disrupted a number of agreements that had been previously put in place and secretariats that might have served as the focal point for regional and subregional responses.

As Titelman (2006) reports, the crisis undermined most of these regional institutions, hitting clearing and settlement systems hardest, and the subregional development banks as well. The Andean Reserve Fund (ARF) lent substantially more to the Andean countries during 1983–89 than the IMF lent under exceptional financing arrangements. The ARF, which became the Latin American Reserve Fund (LARF) with the accession of Costa Rica in 1989, thus later inspired proposals for its expansion (Agosin 2001 and Ocampo 2002). While its financing might have been significant among its particular members, the ARF was a small player in the larger debt crisis and in the event did not leverage the crisis into greater capital commitments or institutional strengthening. The debt crisis also weakened most of the subregional trade agreements, with the exception of the creation of an agreement between Brazil and Argentina that laid the basis for Mercosur's establishment in 1991. (For an assessment of the impact at the time of the crisis, see Gauhar 1985.)

A small literature inspired by the prospect of a “debtors’ cartel” was an exception to the general absence of political economy studies of the regional response to the debt crisis. The logic behind a debtors’ cartel was clear: the crisis was not simply a matter of illiquidity, some degree of debt reduction was also necessary; individually, countries would not opt for or demand debt reduction as this would place them at a disadvantage

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<sup>22</sup> The comparative literature on financial systems and policy reform in the wake of the crisis includes Frieden 1991, Williamson 1994, and Haggard and Lee 1995.

<sup>23</sup> Jorge Dominguez (2009) reviews these, emphasizing the trade and political features, in his paper for this project.

in capital markets; but together debtors could have greater bargaining leverage in relation to creditors and would be less likely to be blacklisted from future borrowing. In the event, most debtors did not make true transfers of resources back to creditors; with the exception of Mexico, Venezuela, and Ecuador, debtors made repayments from loan rollovers (Lindert 1989). But each debtor chose to negotiate individually with creditors rather than collectively; debt reduction was effectively accomplished in an ad hoc, uncoordinated, non-transparent fashion across the region.

The failure of the debtors' cartel was due to several factors. First, despite being similarly affected by the crisis, the economic situations of the debtors differed enough to lead some to conclude that they could get better terms by negotiating directly rather than through a cartel. Second, the international banks were implacably hostile to any arrangement that accepted transparent, ex ante debt reduction. Third, low rates of domestic savings and low foreign exchange reserve holdings rendered Latin American debtors crucially dependent on capital inflows and thus on appeasing the banks. Fourth, US policymakers, concerned most for the stability of the banking system, sided firmly with the banks—at least until the threat to systemic stability had passed. (On the failure of the debtors' cartel, see Dietz 1987; Hojman 1987; Kugler 1987; and Lissakers 1991, 198–204. On US policy, see Cohen 1992).

The debtors' cartel concept was a narrow regional proposal, one with clear zero-sum distributional consequences. What explains the failure of other regional initiatives, ones that would not have so obviously harmed the interests of powerful private actors, to emerge? There are several plausible answers. First, regional and subregional institutions, which antedated the crisis, did not have the staff, financial resources, or legal mandate that would have enabled them to leverage the crisis into greater delegation from member states. Second, regional trade agreements were not developed to the point where their disruption could inflict major economic pain in member countries. Regional exports relative to total exports dropped from above 22% in 1980 to less than 12% in 1985—the largest 5-year decline in any of the major regions of the postwar period. But these numbers represented only 3.6% and 1.7% of regional GDP respectively,<sup>24</sup> apparently below the threshold for provoking a regional response. Third, more influential in this region than any other, the US was not particularly inclined toward Latin American regionalism: “US governments have felt deep ambivalence about supporting a more fully institutionalized regionalism that other states might use as a shield against the US,” Katzenstein (2005, 226–7) writes. In addition, “The inter-American system was never based on a congruence of interests that might have supported the growth of regional political institutions.”<sup>25</sup>

<sup>24</sup> Calculated from UNCOMTRADE data.

<sup>25</sup> Note the ambiguity in the logic of regional dominance. Many Latin Americanists, as reported by Katzenstein, argue that US dominance impeded the development of regional institutions because Washington feared constraints. A regional version of the hegemonic stability thesis, on the other hand, would anticipate that dominant powers construct institutions to serve their purposes in the region.

#### 4.4. NAFTA and the Mexican Peso Crisis of 1994/1995

The North American Free Trade Agreement (NAFTA) and the peso crisis of 1994/95 were intimately connected. In anticipation of the entering into force of the agreement, multinational corporations and institutional fund managers invested more into Mexico than any other emerging market country in the early 1990s. But NAFTA did not provide for the policy adjustments that would have been necessary to prevent the crisis nor the financial facilities necessary to deal with it once it occurred. The US responded instead with a large, ad hoc bilateral rescue package through the Exchange Stabilization Fund in concert with financing from the IMF in early 1995.<sup>26</sup> This case is an instance in which a crisis certainly failed to strengthen regional institutions and, if anything, probably weakened the prospects for creating robust ones.

NAFTA is in essence a free trade agreement coupled with some liberalizing investment provisions. It is not a customs union or single market, and it contains little in the way of regulatory cooperation. It has no provision for currency stabilization, monetary cooperation, fiscal coordination, or development assistance. The Federal Reserve negotiated a currency swap agreement with the Bank of Mexico in conjunction with the Bank of Canada as an adjunct to NAFTA, which was quickly overwhelmed during the 1994/95 crisis. NAFTA contained side agreements on labor and the environment, of course, as well as established processes for settling disputes in various issue areas. The agreement also created the North American Development Bank, a NAFTA Commission, and a NAFTA Secretariat. But these institutions exist in name only; they are underfunded and nearly invisible in policymaking surrounding trade and investment in North America.<sup>27</sup> Instead, as Hufbauer and Schott (2005) observe, NAFTA and the EU are “polar opposites” in institutional terms.

NAFTA therefore lacked the surveillance capacity at the regional level to anticipate and head off the financial crisis. There was growing consternation within the US Treasury department about the overvaluation of the Mexican peso and efforts to persuade the Mexican Finance Ministry to address it. But NAFTA placed Mexico under no obligation in this respect and provided no institutional hook for the US administration with respect to the Mexican government. In political terms, this lacuna was important. NAFTA presented the most serious and long-fought debate in the US over trade policy since the Second World War. Though currency matters were missing from the debate, the bilateral exchange rate bore directly on the issues that were discussed: trade, outsourcing, and employment. The depreciation of the peso to half its former value within 15 months of the agreement’s coming into force fundamentally changed the terms of competition between the two countries.<sup>28</sup> As a partial consequence, to this day NAFTA remains controversial in US politics, especially within the Democratic Party, and exercises a

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<sup>26</sup> Lustig 1998, Henning 1999, and Pastor 2001.

<sup>27</sup> The paper by Jorge Domínguez (2009) for this project is a little more generous.

<sup>28</sup> A depreciation of this magnitude would not have been consistent within Europe’s single market in short-run political terms. The far more modest drop of the Italian lira after the 1992 crisis threatened political support for the single market and the monetary union in the partner countries. Eichengreen (1996) examines the relationship between economic and monetary integration. He observes that currency misalignments fan protectionist flames and that currencies can become misaligned under both fixed and flexible exchange rate regimes.

restraining effect on trade liberalization generally and, for present purposes, regional institution building.

Pastor (2001, 5–6), in particular, laments the lack of regional institutions in North America: “The agreement eliminates trade and investment barriers, but it assumes that the social, economic, and political consequences of dismantling those walls will be trivial. . . . Because NAFTA is bereft of institutions, the three countries rarely see—let alone address—the connections between the problems or how implementing different policies may lead to their acting at cross-purposes. . . . The three countries still tend to focus on one problem or one commodity, two countries at a time. . . . We continue to bilateralize and compartmentalize . . . the three governments have not learned the lesson of 1994.” Pastor advocated replication within North America of many of the institutional analogs of the EU. But, as Hufbauer and Schott (2005, 488) observed, “there is no appetite for supranationalism in North America.”<sup>29</sup>

#### **4.5. Asian Financial Crisis of 1997/98 and the Chiang Mai Initiative**

The 1997/98 episode is a clear case of a crisis that produced regional institution building. Key states in East Asia cooperated during the crisis and subsequently launched the Chiang Mai Initiative. This section reviews these events in a nutshell and then examines the role of the six basic background conditions in this case.

If the Mexican peso crisis was the “first crisis of the twenty-first century,” as Michel Camdessus declared, the 1997/98 Asian financial crisis was the second. Beginning with Thailand in July 1997, the crisis quickly spread to most of the rest of Southeast Asia and the Republic of Korea, before infecting the Russian Federation and Brazil, among others, and eventually the US through the collapse of Long-Term Capital Management (LTCM). Stabilizing financial markets involved commitments from the international community summing to hundreds of billions of dollars. Chastened by the Mexican crisis and wary of indulging moral hazard, however, the US and IMF were relatively slow to respond at the outset.

Shortly after the onset of the Thai financial crisis in July 1997, the Japanese Ministry of Finance famously proposed the creation of an Asian Monetary Fund. The PRC government failed to endorse it, however, and the US government opposed it outright, offering to create instead a forum in which East Asian concerns could be addressed, the Manila Framework Agreement. Japan provided significant bilateral financing to its Asian neighbors instead through the New Miyazawa Initiative. The greater share of balance of payments support for Southeast Asian countries and the Republic of Korea during the crisis nonetheless came from the IMF, which imposed policy conditions that cut deeply into the political economy of borrowing countries (IMF 1999a). Such conditionality became the center of controversy within the domestic politics and regional discourse in East Asia.<sup>30</sup> The literature on the political economy of Asian regionalism is virtually

<sup>29</sup> For analysis of the political economy of a prospective monetary union in North America, see Helleiner (2006).

<sup>30</sup> The impact of the crisis and the response of individual states is analyzed in Haggard (2000), Pempel (1999), and Noble and Ravenhill (2000), among others.



united in the assessment that these countries were profoundly alienated from the IMF and that this alienation was principally responsible for their creating the Chiang Mai Initiative.<sup>31</sup>

The CMI was launched at a meeting of ASEAN+3 finance ministers in Thailand in May 2000. They announced a broad set of objectives for financial cooperation, involving policy dialogue, monitoring of capital flows, and reform of international financial institutions. The finance ministers would also later add bond market initiatives and regional bond funds to their agenda for regional cooperation. But at Chiang Mai, their core objective was to establish a network of bilateral swap arrangements (BSAs) between Northeast and Southeast Asian members. As these BSAs were negotiated and concluded over the subsequent years, their number grew to 16.<sup>32</sup>

There are several noteworthy things about these arrangements. First, in principle, Thailand, Malaysia, Indonesia, the Philippines, and Indonesia can borrow several multiples of their IMF quotas through their CMI BSAs. Second, however, their access is linked to their negotiating a program with the IMF with its attendant policy conditionality—except for the first 20% of their allotment. Conceived as such, the CMI is largely a “second” or “parallel line of defense” to IMF financing. The “IMF link,” as this provision is called, helped to secure the accession of the PRC government to the CMI and mollify the US government. Third, ASEAN+3 finance ministries and central banks also launched a regional surveillance mechanism called the Economic Review and Policy Dialogue (ERPD). Many officials within the region hoped to develop the ERPD to the point where it could define regional conditionality in a crisis and thereby permit a diminution, and perhaps eventually elimination, of the IMF link.<sup>33</sup> Finally, partly owing to the IMF link, none of the BSAs has been activated, even during the 2007–2009 crisis.

The ASEAN+3 process has been almost entirely intergovernmental. The leaders of the ASEAN states invited their counterparts from the PRC, Japan, and the Republic of Korea to join them for the first time in the heat of the crisis in November 1997 and have been meeting at least annually since then. The CMI was developed by the ASEAN+3 finance ministries, with their central banks, in meetings of deputy ministers and working groups. The ERPD is conducted through the ASEAN+3 finance deputies meeting, which central bank deputies attend, twice each a year. The Asian Development Bank (ADB) and the ASEAN Secretariat provide input to the ERPD discussions, as well as IMF staff. But much of the surveillance discussion and all of the negotiations surrounding the establishment of the CMI and the individual BSAs took place without the benefit of a collectively appointed secretariat.

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<sup>31</sup> The development of the CMI and associated policy issues are debated in Henning (2002, 2006), Eichengreen (2002), Bergsten and Park (2002), de Brouwer (2004), Kuroda and Kawai (2004), Katada (2001, 2004), Rajan and Sirigar (2004), Amyx (2005, 2008), Lee (2006), Park and Wyplosz (2008), and Grimes (2006, 2009), among others.

<sup>32</sup> The number in effect at any one time varied, as these arrangements lapsed and were renegotiated and reinstated. The CMI rubric and BSAs are described in detail in Henning (2002). See also Kawai and Houser (2007) and Grimes (2009).

<sup>33</sup> Contributions on ASEAN+3 surveillance include Kawai and Houser (2007), Institute for International Monetary Affairs (2005), and Wang and Yoon (2002).

The CMI should be viewed in the context of a multi-pronged strategy by member states with respect to crises and of other developments in regional cooperation. In addition to creating a regional self-help mechanism for crises, countries have embraced self-insurance in the form of unilateral reserve accumulation and have continued to support the IMF, their objections to its role in the 1997/98 crisis notwithstanding. Thus, Southeast Asian governments and the Republic of Korea have not placed all of their crisis-defense eggs in one regional basket; they have diversified.

Member states of the region are also engaged in negotiating multiple, cross-cutting bilateral, subregional, and cross-regional preferential trade agreements.<sup>34</sup> While the pattern of trade liberalization is broadly consistent with regional financial cooperation, there is little or no linkage between the regional initiatives in the trade and financial areas. Measures of the degree of integration of markets in East Asia are sensitive to the choice of group. For the 17 economies,<sup>35</sup> intra-regional trade has exceeded half of their total trade since 2000. But for ASEAN+3 alone, this figure is only about 34%, roughly comparable to the current figure for the six original members of the European Community.

Tension between Japan and the PRC over the pace, direction, and institutionalization of these arrangements has pervaded regional negotiations. The prospective shift in relative influence within the region toward the PRC, as its economic growth outpaces that of Japan by a wide margin, counsels officials in Beijing to bide their time until they might bargain from a more favorable position. Meanwhile, regional initiatives have benefited from the tendency of the two countries to compete for the favor of ASEAN with cooperative measures (Grimes 2009). But more robust institutional arrangements will require transcending or suspending the rivalry. Agreement between the two is a necessary, but not sufficient, condition for deepening institutionalization.

I have argued that the creation and evolution of the CMI can best be explained by the global multilateral context and the Sino–Japanese rivalry. The multilateral context—the stance of the IMF, the modest influence of Asian governments within it, and the posture of US—explains the timing and substantive content of East Asian financial cooperation in the CMI. The intra-regional rivalry explains the choice of the institutional form of that cooperation—characterized by reluctance to delegate to a secretariat, intergovernmentalism, and bilateralism as the defining feature of the network of swap arrangements (Henning 2008).

The posture of the US has evolved substantially over the 12 years since the 1997/98 Asian financial crisis. After working hard to scuttle the AMF proposal in 1997, the US Treasury accepted the creation of the CMI in 2000. Speaking in Chiang Mai, Assistant Secretary Edwin M. Truman reserved judgment on the ultimate merits of the initiative until the details were known.<sup>36</sup> Comforted by the IMF link, however, the

<sup>34</sup> See the papers by John Ravenhill (2009) and Richard Baldwin (2011) for this project, as well as Solis, Stallings, and Katada (2009).

<sup>35</sup> Australia; New Zealand; Hong Kong, China; and Taipei, China; in addition to ASEAN+3.

<sup>36</sup> Truman said that regional initiatives such as these could be constructive in principle and that greater cooperation among Asian countries was “perfectly appropriate.” But he reserved final judgment, cautioning, “The devil is in the details. If they are supportive of prompt financial and economic

administration of George W. Bush did not oppose the further development of the CMI, the other regional financial initiatives, or the surveillance mechanism. In 2006, Undersecretary Timothy D. Adams offered support for the Regional Bond Market Initiative and regional bond funds, professed equanimity with respect to the development of an Asian Currency Unit, but added that the lack of clarity of the CMI gave him pause. Equally important, the US Treasury supported reforms in the IMF that were advocated by many Asian governments, including redistribution of quotas and voting shares, the introduction of quick-disbursing, low-conditionality financial facilities, and reconsideration of policy conditionality on standby loans. Progress was made on several of these fronts when the IMF was enlarged and refitted to combat the 2007–2009 crisis. In addition, the US Federal Reserve extended currency swap arrangements to 14 countries in autumn 2008, including the Republic of Korea and Singapore, in the amount of \$30 billion, and for Japan, in unlimited amounts.<sup>37</sup> The Republic of Korea drew large amounts from this facility to provide dollar liquidity to banks in its successful response to the crisis. Thus, while US policy has not actively opposed regional financial cooperation, American actions made the regional part of the three-pronged strategy less compelling on the margin for some East Asian states.

#### **4.6. 2007–2009 Crisis and CMI Multilateralization**

The importance of crisis as a catalyst for institutionalization of regional cooperation was reinforced by the 2007–2009 crisis. ASEAN+3 finance ministers first articulated the objective of creating a common fund from the bilateral swap arrangements—to which they attached the term multilateralization—at their annual meeting in Istanbul in 2005.<sup>38</sup> A liquidity bubble characterized the global economy during the mid-2000s, however, and East Asian states were accumulating foreign exchange reserves. Although some countries experienced financial tremors, these were isolated events. Creating a common financial facility was thus not a high priority for the region as a whole and progress toward this objective was slow.<sup>39</sup> After it became clear in 2008 that the recession that enveloped the US and Europe owing to the subprime crisis would threaten East Asian economies, however, governments of the region refocused on this objective. Given that the CMI was not activated during the crisis, the relevance and credibility of these arrangements hinged at least in part on ASEAN+3 governments demonstrating progress toward their declared objective of a common fund. The most difficult matter, in addition to several important technical ones, was the relative shares of the three Northeast Asian states in the new arrangement, and those of Japan and the PRC in particular.

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adjustment, then I think they are to be commended, but we don't know what will happen yet" (Scott and Areddy 2000).

<sup>37</sup> US Federal Reserve Board press release. 29 October 2008. Washington, DC. Available at <http://www.federalreserve.gov/newsevents/press/monetary/20081029b.htm>.

<sup>38</sup> ASEAN+3 finance ministers' statement, para 5. 4 May 2005. Istanbul.

<sup>39</sup> While announcing some progress at their meeting in Kyoto in 2007, the finance ministers launched studies on the key elements of a "self-managed reserve pooling arrangement" with an eye toward developing a consensus. ASEAN+3 finance ministers statement, para 6. 5 May 2007. Kyoto.

Meeting in Bali, Indonesia, on the margin of the ADB meetings in May 2009, the finance ministers announced agreement on the main features of the CMI multilateralization (CMIM).<sup>40</sup>

- (i) Members would earmark at total of \$120 billion in their reserves and place them at the disposal of the fund.<sup>41</sup>
- (ii) They agreed on the specific contributions of each member. Specifically, the PRC and Japan would each contribute 32% of the total, with Hong Kong, China contributing a 3.5% share as part of the PRC's share. Hong Kong, China's inclusion was significant.<sup>42</sup>
- (iii) Borrowing limits were defined as multiples of a member's quota.<sup>43</sup>
- (iv) Fundamental issues such as membership and lending terms would be decided by consensus, while lending would be decided by majority.

The CMIM would retain the link to the IMF, but the linked proportion was subject to review. Reducing it would continue to hinge on development of a robust regional surveillance mechanism for which the finance ministers committed to establishing an "independent surveillance unit." Finally, the deputy finance ministers were tasked with concluding a detailed agreement by the end of 2009 that could provide for implementing the CMIM.

The progression from the CMI, a network of bilateral swap arrangements, to the CMIM, a common institution, is a potentially profound movement. As a common regional facility, the ASEAN+3 partners in the CMIM commit themselves to a joint decision making process. Moreover, the majority rule for lending decisions provides in theory for individual members, even Japan or the PRC, to be overruled. This shift, in principle, is akin to the transition from a free trade area to a customs union, which requires a common decision on external tariffs and a governing body or process for making the(se) decision(s). If ASEAN+3 were to implement common decision-making fully, this would represent a profound change in regional politics.

East Asian governments are hedging in their move to the common fund, however, by expanding many of their bilateral swap facilities. While planning to retire many of their bilateral dollar swaps in favor of the CMIM, Japan and the PRC have dramatically expanded their bilateral local currency swaps. After the Federal Reserve extended swap arrangements in October 2008, the People's Bank of China signed bilateral swap agreements with five countries (the Republic of Korea, Malaysia, Indonesia, Belarus, and Argentina) in the amount of CNY650 billion (about \$95 billion). The Bank of Japan also offered a large yen-won swap to the Republic of Korea in December 2008. When the CMIM agreement was announced in Bali, the Japanese Ministry of Finance announced that up to \$60 billion equivalent of yen swaps would also be made available to Asian partners on a bilateral basis and subsequently announced an agreement with

<sup>40</sup> ASEAN+3 finance ministers' statement, paras 7–9. 3 May 2009. Comments by Giovanni Capannelli at the Honolulu workshop.

<sup>41</sup> This number had been decided at meetings during the previous February.

<sup>42</sup> The following shares apply to the other countries: the Republic of Korea (16%); Thailand, Singapore, Indonesia, and Malaysia (4%) each; those of the remaining six Southeast Asian members sum to 4%. Overall, the three Northeast Asian countries contribute 80% and the ASEAN 10 contribute 20%.

<sup>43</sup> Ratios of 0.5, 1.0, 2.5, or 5.0, inversely related to the size of the contribution.

Indonesia. Although the stated purpose of several of these new swaps is liquidity provision, as distinct from balance-of-payments support, the line between the two is often blurred in practice.

Taken together, the 1997/98 and 2007–09 episodes highlight the importance of crises as generators of regional institutions. Skeptics might argue about the significance of the CMI, given that it has not been used. But few would argue that the crisis was not a direct motivation for the creation of the CMI. The evolution of the CMI reinforces this interpretation: the impetus toward regional surveillance and a common fund flagged during the liquidity boom years when the threat of crises was small and then accelerated when crisis loomed again in 2008. Agreement on the divisive issues surrounding the CMIM would have been considerably less likely in the absence of the 2007–2009 crisis. These episodes also suggest that crisis was more than a mere accelerator of some hypothetical underlying trend toward regionalism; it is hard to imagine a counterfactual scenario without financial crises that could have brought East Asia to the threshold of CMIM implementation in late 2009.

#### 4.7. Further Observations on the European Case

Before concluding this section, two sets of observations are germane regarding the role of political leaders and international secretariats in the genesis of the EMS and the role of aspirations for political union in the genesis of the monetary union.

**EMS.** Comparing present-day European to Asian and Latin American institutions is not as productive as focusing on earlier decades of European integration, decades that correspond to present-day arrangements in the other regions. The European experience of the late 1960s and 1970s holds particular lessons for East Asia. During this period, intra-regional exports as a percentage of total exports were about 45% in the EU6 compared to about one-third for the present-day ASEAN+3.<sup>44</sup> During this period, the international monetary regime underwent the transition from fixed to flexible exchange rates, confronting Europe with the question of whether and how to stabilize cross-rates. East Asia faces a similar transition from the Bretton Woods II regime.<sup>45</sup> Advocates of Asian institutionalization would do well to consider the European institution building and delegation during this period especially closely.

First, the accord between West German Chancellor Schmidt and French President Giscard d'Estaing placed regional exchange rate stabilization on a firm path. Their plan for the EMS was discussed and agreed upon by the two of them, and essentially imposed on their finance ministries and central banks. Their personal representatives met and consulted with the representatives of their fellow heads of government, and the negotiations were later broadened to the ministries. But the bureaucrats were skeptical and would not have launched a restructured version of the snake if left to their own devices (Ludlow 1982).

<sup>44</sup> This figure rises to over 50% for the seventeen countries in East Asia—ASEAN+3 plus Australia; New Zealand; Hong Kong, China; and Taipei, China—but should be adjusted downward significantly for entrepôt trade through Hong Kong, China and Singapore.

<sup>45</sup> A comparison made by Sapir (2006).

Second, for all the attention given to the role of the Commission in supranationalist interpretations of European integration, that bureaucracy was often not at the center of action in the evolution of the EMS. True, the Commission had been a consistent advocate of monetary cooperation and developed the early plans. The President of the Commission, the Commissioner for Economic and Financial Affairs, and the Directorate General under him helped to shape the overall strategy for monetary integration and conducted surveillance of economic and fiscal policy, which became especially important during the transition to EMU. But, in the late 1970s, EU leaders effectively delegated the management and operation of the EMS to the central banks and finance ministries, working through the Committee of Central Bank Governors,<sup>46</sup> Ecofin, and the Monetary Committee. This machinery stood largely apart from the standard institutional apparatus of the European Community, in which the Commission's role is usually central, and served as the foundation for the European Monetary Institute, the body that bridged to the creation of the European Central Bank (ECB).

Third, although the original EMS agreement was superficially symmetrical in the obligations imposed on surplus and deficit countries, the system in fact operated quite asymmetrically. The divergence indicator was designed to instill symmetry of adjustment obligations. But in practice the divergence indicator was marginalized in favor of the parity grid and Germany's partners undertook foreign exchange intervention to defend the margins. In practice, Germany and the Bundesbank dominated the operation and management of the EMS.

Fourth, the German position on the terms of monetary cooperation was firm but very consistent over the decades: others would have to converge toward West Germany's low rate of inflation; West Germany would not converge toward the European average. France, Italy, and the other partners often did not like these terms, but they knew that if they met them West Germany was likely to respond positively to integration proposals. On the table for a long period, this offer eventually attracted the adherence of the partners. The stability of the offer facilitated agreement; the Maastricht treaty would have been much less likely if the West German position had shifted from one government to the next or with each business cycle.<sup>47</sup>

Political Integration. The argument that aspirations for political union underpin the evolution of the EU is widely asserted in public commentary and some parts of the literature on the European economic integration. EMU, in particular, is frequently cited as the product of widely shared political ambition for something akin to a United States of Europe (Eichengreen 1992). This notion is widely cited in Asian discourse about regionalism and carries a negative implication: if aspirations for political union were central in Europe but are absent in Asia, Asian regionalism is not likely to be feasible. While commitment to political integration plays a role, however, it has been substantially over-rated by some analysts.<sup>48</sup>

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<sup>46</sup> On the Committee of Central Bank Governors, see Andrews (2003); on the operation of these institutions after the inception of the monetary union, see Henning (2007a and 2007b).

<sup>47</sup> Andrews (2003).

<sup>48</sup> This and the next three paragraphs are borrowed from Henning (2005).

Over the course of postwar history, first of all, economic projects for European integration have consistently received greater support than projects for political and security cooperation. Proposals for the European Defense Community and the European Political Community failed in the 1950s, for example, while the European Economic Community succeeded (Dinan 2004). To choose a contemporary example, the constitutional treaty would have gone some distance toward political integration, but it failed to secure support in critical referenda in France and the Netherlands. The Lisbon treaty preserves many of its institutional provisions but falls decidedly short of constituting a political union (Reh 2009).

Second, while it is true that war in Western Europe has become unthinkable, it has been unthinkable for quite some time, at least since the 1960s and 1970s if not before. European integration has continued far beyond the point where interstate violence was a conceivable threat. Finally, ambitions for political union do not easily explain the successive enlargements of the membership. The United Kingdom, Ireland, and Denmark did not join the European Community because they wanted to participate in an ever closer political union. Many in successive enlargements are reticent, including the 10 new members from Central and Eastern Europe. Indeed, the greater number and diversity of member states spawned by enlargements have created substantial barriers to political deepening. For these reasons among others, many political scientists conclude that the political unity motive is a contributing, but distinctly secondary, motivation for European integration.<sup>49</sup>

Analysis of political motivation should carefully distinguish among (i) ambitions for political union, (ii) desire to avoid security conflict and war, and (iii) political agreement on economic measures and the institutions necessary to implement them. Regional integration obviously cannot take place in the face of sharp security conflicts, threats, or interstate violence. Ambitions for political integration and a peace community can certainly reinforce regional integration, on the other hand, but they are not necessary. Political agreements on the economic measures, common policies, and regulations are indeed necessary, as is agreement on the institutions that would implement and monitor them. But the latter is a substantially lesser hurdle than the former. While the former is out of reach in East Asia, and probably in North America as well, the latter is achievable in both.

#### **4.8. Results of Comparison**

The review of these cases generates several observations and insights about the effect of crises on institution building within regions. We would not logically expect all crises to generate a regional response. When a crisis originates within the region and when the extra-regional response is supportive, then regional institution building is not likely. But, when a crisis originates outside the region and the extra-regional response is inadequate or adversarial, regional institution building is a logical response and we can sensibly ask analytical questions about the sources of variation in the regional reaction. In these

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<sup>49</sup> See, for example, Moravcsik (1998). O'Rourke's (2009) paper for this project gives similarly little credence to this motive.

instances, several background conditions emerge from this comparison as favorable for institution building in the wake of a crisis.

First, the presence of a secretariat with a mandate to defend and advance regional integration appears to be important, as it characterizes the most successful case, that of Europe. Intergovernmental cooperation through the Committee of Central Bank Governors (CCBG) and Ecofin was sometimes more important than the activism of the Commission in that case, of course, and the FSF experience suggests that a standing secretariat is not sufficient, while the CMI case suggests that substantial institution building can take place without a secretariat. We can conclude that, while neither strictly necessary nor sufficient, a secretariat facilitates further institution building. Notably, ASEAN+3 has effectively conceded that an independent secretariat is essential for an effective surveillance mechanism.

Second, a significant degree of market integration appears to be necessary but not sufficient for post-crisis institution building. The two cases of substantial institution building, Europe and East Asia, exhibit moderate to high levels of intra-regional trade; but so does North America, which produced little or no institutionalization beyond NAFTA after the 1994/95 crisis.

Third, functional spillovers among regional arrangements that are related to trade, money, and finance appear to be necessary conditions for an institution-building response. Crises must threaten the interests vested in political agreements on related economic matters in order to provoke institution building. But the Mexican peso crisis case suggests that such linkages alone are not sufficient.

Fourth, the presence of a dominant state appears to have ambivalent effects on regional institution building. Germany had greater influence than France over the construction of the monetary union in Europe, but that influence fell well short of regional hegemony. US dominance of North America contributed to the creation of NAFTA, but probably prevented the development of supranational bodies within it. A regional rivalry, as seen in East Asia, on the other hand, appears to constrain the depth and form of institutions.

Fifth, the multilateral context matters a great deal: when the international monetary system or international financial institutions clash with the preferences of member states, these states will seek to build regional institutions that better serve their aspirations. Present in both the European and East Asian cases, this condition appears to be necessary; present in the debt crisis of the 1980s and the Mexican crisis of 1994–95, this condition is clearly not sufficient to produce institution building. Conversely, if the multilateral system is benign or supportive, the construction of regional institutions is not a high priority and possibly redundant.<sup>50</sup>

Sixth, the position of the US on institution building within a region appears to be a powerful determinant. No regional institution was constructed over the opposition of the

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<sup>50</sup> Henning (1998 and 2008).



US. European monetary integration benefited from a benign stance in Washington<sup>51</sup> and East Asian financial cooperation progressed only after establishing the IMF link and thereby shifting the US stance toward neutral. However, US support for regional institutions is certainly not sufficient in itself.

One might question the importance of this last finding for the future of regionalism in Asia in light of long-term projections of the relative decline of the economic size of the US. It is indeed possible that the posture of the US will be less influential in the future than it was during the second half of the twentieth century. However, US influence is not likely to vanish altogether and the structural shift toward Asian influence over the world economy is uncertain. Given the robustness of this historical finding for the most important cases of the last 5 decades, it would be unwise to dismiss its potential relevance for institution building over even a long planning horizon.

Finally, I have argued that aspirations for political integration or political union are neither necessary nor sufficient for substantial progress on regional institution building in economic areas.

## 5. Regional Institutions as a Defense against Crises

While the previous section addressed the galvanizing effect of crises on regional institution building, the present section reverses the focus to examine the effect of institutions on the vulnerability of regions to financial and economic crises. To analyze the effectiveness of regional institutions, we would in principle want to compare the experience of two groups—regions with robust institutions and those without—for their ability to avoid crises. In constructing such a test, however, we immediately encounter the two issues of (i) what type of regional institution we would expect to provide such insulation and (ii) whether there are enough cases on which to build reliable results.

First, we would obviously not expect regions with just any institution to be effective in deflecting crises. Only those institutions that could plausibly play a role in reducing financial and economic vulnerabilities or combat crises once they strike could provide such defenses. Such arrangements would include surveillance mechanisms; peer pressure; financial facilities; formal and informal exchange rate arrangements; a monetary union, and the secretariats, intergovernmental boards, and bureaucratic organizations responsible for operating them. These are a subset of the broader concept of institution established at the outset of the paper, which we must now unpack. The remaining elements of the broader concept—general institutions of regional governance, intergovernmental networks, and agreements outside the monetary and financial field—are not designed to ward off crises and would have at best an indirect effect on a region's susceptibility to them.

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<sup>51</sup> O'Rourke's (2009) paper for this project stresses the importance of the US support for European supranationalism in the 1950s, to the benefit of continental visions for the European Economic Community and at the expense of the British preferences.

Another way to select regions with potentially crisis-deflecting institutional arrangements is to compare them to the IMF. Almost all of the countries in the regions considered here are also members of the IMF, participate in its surveillance mechanism, and have access to its financial facilities. Identifying regions that we would expect to provide insulation from crisis thus involves identifying the benefits that regional institutional arrangements provide beyond those already provided by membership in the IMF. Given the developed, formalized nature of the IMF, its experience in dealing with crises, and the resources at its disposal, this is a fairly substantial requirement.

Second, given this expectation of the types of regional arrangements that could deflect crises, the number of regional candidates for this class of cases is very limited. Certainly, no such effect could be expected of institutions in Latin America or North America. Some analysts might be tempted to examine East Asia's CMI as an example of a crisis-deflecting institution in light of a relatively quick recovery from the 2007–2009 crisis. But, as argued below, the CMI was too small and too linked to the IMF for such a test to be fair. Until the CMIM is implemented and proves its ability to operate in a crisis, we are limited to Europe as the one case where we might reasonably expect regional institutions to provide shelter against crises.

Although limited to one region, we can nonetheless get some analytical leverage by examining the evolution of European institutions and changes in vulnerability to crises over time. The 1992/93 Exchange Rate Mechanism (ERM) episode is a case of a crisis that was not prevented by regional institutions. The transition to EMU during 1997–99 is a crisis that did not happen when we might otherwise have expected one to occur. The 2007–2009 episode is the first case of a severe global crisis after the advent of the monetary union and thus the first test of the euro area's effectiveness in crisis deflection.

This section considers, first, the mechanisms through which regional institutions might be expected to provide insulation from crises. It then compares these expectations against experience during the 1992/93 ERM crisis, the transition to EMU, and the 2007–2009 crisis. It concludes with a discussion of the limits of the recent crisis as a test for the shielding power of the CMI and a summing up of the lessons of these experiences.

## **5.1. Causal Links**

When considering how institutional arrangements might shield regions from crisis, we must again keep in mind that secretariats, ministerial working groups and councils, and monetary and financial agreements are intermediate variables. Regional bureaucracies and intergovernmental bodies do not constitute a capacity to deflect crises. Only when they work effectively to reduce vulnerabilities by fostering policy adjustment—and thereby alignment between regional monetary arrangements, for example, and market expectations—can decision-making bodies deter crises. We should acknowledge that, if poorly designed, such arrangements could conceivably open regions to financial crises rather than shield them. With that important caveat, we would expect well-designed regional institutional arrangements to help deflect crises through the following mechanisms.

- (i) **Information.** Surveillance mechanisms can provide additional information about economic conditions and analysis of vulnerabilities—the first ingredient for addressing threats.
- (ii) **Corrective action.** Peer pressure can help to induce policy adjustments that limit vulnerability. Owing to the regional pattern of contagion, neighbors have a strong interest in such corrective action that is balanced by reluctance to interfere in the policymaking of neighbors out of fear that neighbors will reciprocate in kind.
- (iii) **Mutual financial support.** When regions create common financial facilities, the resources at their disposal can stabilize regional financial and foreign exchange markets though direct intervention in the markets.
- (iv) **Market confidence and expectations.** Political commitment to policy adjustment and mutual support, and the demonstrated willingness to apply these, can help regions guide market expectations to one equilibrium and away from others.

With these in mind, consider the role of institutional arrangements in the three European episodes below.

## 5.2. European Episodes

**ERM Crises of 1992/93.** The breakup of the ERM of the European Monetary System (EMS) during the years immediately following the signing of the Maastricht treaty was by far the most spectacular currency crisis up to that time. The causes of the 1992/93 crises are examined in a substantial literature published shortly thereafter.<sup>52</sup> We need not recount the episode in detail or review the full debate over the causes here. Suffice it to say that the (i) hardening of the EMS, (ii) divergence of competitive positions, (iii) increase in the volume of capital movements, (iv) divergence of macroeconomic policy in the wake of German unification, and (v) political surprises related to ratification of the Maastricht treaty all played important roles. Diametrically opposing movements of German and British monetary policies were key triggers for the dramatic ejection of the British pound and Italian lira from the ERM in mid-September 1992.

The EU, of course, had an elaborate set of regional institutions at the time of this crisis. These EU-wide institutions and treaties, as well as broad political support for implementing the monetary union, provided the context. The Committee of Central Bank Governors, Ecofin, and the Monetary Committee managed the EMS through surveillance of the economic policies of the member states, demarches against outliers, and a robust set of financial facilities. The latter included the Very-Short-Term Finance facility, the Short-Term Monetary Support facility, and the Medium-Term Financial Assistance facility. This regional architecture was nonetheless manifestly unable to prevent the buildup of misalignments within the system, finance the resulting imbalances, or coordinate macroeconomic policy until domestic cost disparities and political

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<sup>52</sup> Kenen (1995) provides an analysis and useful overview of this work, which includes Eichengreen (1993), Eichengreen and Wyplosz (1993), Goldstein et al. (1993), Group of Ten (1993), IMF (1993), and Cameron (1994).

uncertainties over the treaty could be resolved. The scale of the problem simply overwhelmed these bodies.

European institutions nonetheless provided the basis for a resilient response once the crisis subsided. Within a couple of years, European governments had realigned exchange rates, brought the lira back into the ERM, initiated convergence, established the European Monetary Institute, and coordinated monetary policy closely. Disruptions of the Single Market and other common policies of the EU helped to focus government leaders on the benefits of moving to the creation of the euro. The crisis had the further consequence of shaking loose the member state that was finding convergence to be the most politically challenging, the United Kingdom. The stance of outside actors, international financial institutions, and the US was benign. The performance of the region during the next crisis thus proved to be a stark contrast to that of 1992/93.

**Transition to EMU (1997–99).** As Asia was suffering a roiling financial crisis, Europe executed a remarkably smooth transition to the euro. In retrospect, the transition might seem preordained; but it was far from inevitable. Several political disputes and unresolved questions could well have undercut the credibility of the transition during the run up to the euro's creation. These included debates over the location of the European Monetary Institute and the ECB, the choice of the president of the ECB, the nature of economic governance of the monetary union, the terms of the Stability and Growth Pact, which countries would qualify for adopting the euro, the external policy of the new union, and the subsequent introduction of euro cash.<sup>53</sup> Changes in government in key states could have added uncertainty. Given the serial speculative attacks against currency pegs elsewhere in the world, it is remarkable that Europe avoided the crisis originating in Asia.

What exactly was it about the EMU project that inured Europe to the crisis in this critical, formative stage? What inoculated the region from a repetition of the disastrous experience of only a few years before? One obvious answer is that exchange rates were better aligned and member states' macroeconomic performances were more convergent. But convergence was substantially endogenous to the political economy of monetary integration. Government deficits in Italy, to choose a salient example, had been reduced by the fall in interest rates that accompanied the expected introduction of the euro. Moreover, convergence was not a guarantee that political discord could not feed speculation, driving market rates away from their conversion rates even when they might be close to long-term equilibrium levels (Eichengreen, Rose, and Wyplosz 1996). What, beyond convergence, explains the smooth transition?

Because this is a case of a dog that didn't bark—that is, a crisis that did not happen—there is little written on this question. Several factors, of which some relate to regional institutions, are consistent with this outcome. First, the countries that were undergoing the most onerous convergence requirements (such as Italy) also derived clear economic gains from the monetary union. This made their commitment to the convergence process and the monetary union credible. Second, the monetary union was embedded in a larger

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<sup>53</sup> Marsh (2009) is the most recently published history of European monetary integration; see pp. 176–205 for treatment of the transition.

web of economic integration, including the Single Market, the Common Agricultural Policy, and the Community budget. Reneging on the Maastricht commitments could threaten these other regional projects as well, imposing costs well beyond any foregone benefits of the euro area. Third, as a partial consequence, domestic politics within member states were aligned on adoption of the euro and the policy commitments necessary to qualify for inclusion. Fourth, and critically, the Maastricht treaty had delegated extensive powers to the European Commission (surveillance of fiscal policy) and ECB (monetary policy). The ECB had been established and its president had been installed 7 months before the transition to the monetary union, while the monetary policies of the national central banks were also closely coordinated. Finally, for its part, the US took a benign, mildly supportive stance with respect to the creation of the euro (Summers 1997, Geithner 1998, and Truman 1999).

**2007–2009 Crisis.** The recent crisis clearly demonstrates that the monetary union has not expunged crises from Europe but has altered the forms in which they manifest. The crisis damaged Europe’s banking system and the region suffered a deep recession. During the tranquil mid-2000s, moreover, the euro area accentuated another set of problems for some of its member countries—divergence, asset bubbles, and default risk. Spain and Ireland experienced real estate bubbles that could have arguably been preempted had their central banks operated a monetary policy geared to national requirements rather than having to accept the one-size-fits-all monetary policy of the euro area. With the onset of the crisis, government intervention to address bank failure contributed to serious sovereign debt problems in several euro area countries. Thus, the existence of euro area has to a substantial extent simply shifted the particular type of crisis to which its members were vulnerable, but has not shielded the members of the monetary union from all types.

With that important caveat, it is quite clear that the monetary union prevented the 2007–2009 crisis from disrupting international payments and currency relationships among its members. This is not primarily because of a robust regional response to the imminent bankruptcy of the private European financial institutions; that response was mixed at best (Posen and Véron 2009). Nor was it primarily a consequence of the Stability and Growth Pact governing fiscal policy; several high-debt countries within the euro area saw the spreads on government bonds widen to unsustainable levels. Rather, the insulation arose from the simple fact that sharing the same currency altered and deferred the effects of payments balances and made currency crises impossible.

Central and Eastern Europe was hit earlier and harder than any other region by the 2007–2009 financial crisis. GDP declined by 14.1% in Estonia, 15.0% in Lithuania and 18.4% in Latvia during 2009. Other EU countries outside the euro area suffered more modest recessions.<sup>54</sup> Countries on the periphery of the EU also suffered, most notably Iceland, where GDP declined by more than 6.50% in 2009.

Enlargement of the EU and preparation for eventual entry into the euro area have had ambivalent effects on the vulnerability of these countries to crises. On the one hand, by harmonizing their policies with those of the EU, adopting the *acquis communautaire*, and

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<sup>54</sup> Poland, on the other hand, has not had a single quarter of negative growth during the recent crisis.

entering the single market, the new member states have attracted foreign direct investment and other capital inflows. Combined with weak domestic financial regulation, however, these inflows enabled the build-up of large external debts and currency mismatches that later threatened collapse.<sup>55</sup> On the other hand, several of the affected countries in the region could access Medium-Term Financial Assistance, the balance-of-payments facility operated by the EU for its members. The EU lent to crisis-stricken countries in concert with the IMF. While not shielding new member states from such crises, therefore, EU institutions helped to manage the crisis and smooth adjustment in this way.

The transition from a nonmarket economy to a member of the EU and euro area is clearly fraught with peril. Countries are most vulnerable when they seek to stabilize their exchange rates in the presence of high capital mobility, incomplete convergence, and weak financial regulation. Once in the euro area, while still vulnerable to other types of problems, members are insulated from payments and currency crises. Seeking this protection, the initial response of several stricken Central and Eastern European countries was to accelerate their timetables for requesting admission to the euro area. While the European Commission and ECB responded very cautiously, the European Department of the IMF advocated accelerated euro adoption for several of these countries. In July 2009, Iceland applied for membership in the EU with an eye toward eventually joining the euro area; in January 2011, Estonia became a member of the euro area. But the Greek and Irish sovereign debt crises of 2010, which forced a review of the key features of the monetary union, raised serious questions about the timetable for future enlargements.

The monetary union has had another important consequence, one that resonates with the explanation for European monetary integration presented at the beginning of Section 4. West German Chancellor Schmidt developed the EMS in large measure to spread the pressure for currency appreciation across a larger monetary area and deflect pressure for fiscal stimulus from the US. During 2007 and 2008, for example, Germany ran current account surpluses amounting to 7.5% and 6.4% of GDP, respectively, which were very large even by German standards. Had it not been embedded in the euro area, Germany would have probably become the target of pressure on the part of the US and others for fiscal stimulus. The deutschemark would have appreciated substantially, causing an even greater drop in exports, growth, and employment than in fact occurred. But because Germany's surplus was offset by others' deficits, the overall current account position of the euro area was in rough balance and the upward pressure on the euro far more moderate. Outside actors were discouraged from attempting moral suasion and diplomatic pressure for stronger fiscal stimulus, constrained as Germany was at least in principle by the Stability and Growth Pact—notwithstanding a need for greater fiscal stimulus in Germany in 2009 to combat a deep recession. Judged on the basis of autonomy,<sup>56</sup> Schmidt's strategy has been spectacularly successful and has rendered the dollar weapon, at least so far during this episode, ineffective in the hands of the US.

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<sup>55</sup> This pattern echoes the effect of the transition to NAFTA on Mexico's international financial vulnerability.

<sup>56</sup> A criterion which is different from the economic merits of the policy settings.

### 5.3. East Asia (2007–2009)

East Asia as a region experienced growth declines during the 2007–2009 crisis that were roughly comparable to emerging and developing countries as a whole, but less severe than those in Central and Eastern Europe, and the Commonwealth of Independent States. The five Southeast Asian countries that suffered most during the 1997/98 crisis experienced only half the growth decline during 2007–2009 as during the earlier crisis (Goldstein and Xie 2009, Table 2). One might reasonably ask whether this relative insulation from the recent crisis owed to the regional arrangements that ASEAN+3 had constructed since 1998, the CMI in particular. The CMI, after all, was created specifically as a regional self-help mechanism for similar contingencies. On greater reflection, however, neither the CMI nor the broader set of regional cooperation initiatives sponsored by ASEAN+3 could have been expected to protect Asia from the latest crisis. The reasons for this are several.

First, none of the bilateral swap arrangements under the CMI had been activated either prior to or during the 2007–09 crisis. At the outset of this episode, therefore, the CMI was untested and there is no evidence that financial markets expected activation. The CMI cannot plausibly be credited with whatever stability might have been maintained.

Second, were the CMI to have been activated, most of the disbursements would have been linked to IMF programs: borrowers would have been able to access no more than 20% of their swap amounts without submitting to IMF conditionality. This provision made CMI activation unattractive in countries where the IMF carried domestic political stigma. The Republic of Korea drew instead on the new swap facility opened with the US Federal Reserve during its banks' liquidity crisis in late 2008. Indonesia organized support for its government budget through a consortium of funders including the World Bank and Japan Bank for International Cooperation (JBIC).

Third, the CMI was only one element of a multi-pronged crisis-defense strategy of states within the region. The unilateral leg of this strategy was the most important and consisted of currency undervaluation, current account surpluses, and reserve accumulation as forms of self insurance. It also consisted of reforms of domestic financial institutions and careful management of external debt. More than other factors, these unilateral measures account for the better performance of East Asia during the 2007–2009 crisis compared with the 1997/98 crisis, and compared with some other regions.<sup>57</sup> The multilateral leg, centering on the IMF, also remained important, notwithstanding the stigma attached to the organization. Japan, the PRC, and the Republic of Korea continued to support the IMF throughout crisis by agreeing to important reforms—including expansion of the New Arrangements to Borrow (NAB), issuance of Special Drawing Rights (SDRs), and an increase in quotas—as well as by extending special loans to the institution on a bilateral basis.

Finally, the accumulation of foreign exchange reserves was the flip side of a development strategy that left East Asia overly dependent on exports to the US and other advanced industrial countries. That export dependence, not exposure to US

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<sup>57</sup> See also Grimes (2009).

financial assets, proved to be the greater vulnerability of East Asia during 2007–09 (Goldstein and Xie 2009, ADB 2009, and Lee 2009). Regional institutions did little or nothing to mitigate East Asian countries' vulnerabilities in these respects. CMI and regional surveillance did not fail the region during this period; they simply had not been developed to the point where we would expect them to provide substantial protection against crises.

Having said that, the institutional arrangements that ASEAN+3 is now committed to implementing could indeed be expected to reduce the vulnerability of Asian states in the future. The CMIM would not be expected to prevent all crises—just as IMF membership or EU membership cannot—and would have to demonstrate its capacity to act in order to establish credibility in financial markets. Completing the CMIM and advancing surveillance, nonetheless, could establish the basis on which an Asian Monetary Fund could eventually be built.<sup>58</sup>

#### **5.4. Summing Up**

Regional institutions can provide collective defense against economic and financial crises, but are not in themselves a guarantee of a successful defense; their utility naturally depends upon their scope and design. Europe experienced multiple currency crises within the EMS during 1992/93 despite the presence of institutions that were robust compared to other regions. Those institutions nonetheless proved resilient and played a central role in fending off crisis during the transition to EMU in 1998/99. The delegation of (i) monetary coordination to independent central banks working collectively and (ii) the surveillance of fiscal policy and enforcement of fiscal rules to the European Commission and Ecofin were critical features of institutional design that distinguished the successful transition to EMU from the disastrous 1992/93 crisis. Having learned from the 1992/93 episode, these officials worked with a clear eye toward keeping policies and exchange rates more consistent with underlying fundamentals and maintaining the confidence of foreign exchange and financial markets. An overall political commitment to convergence and an ability to threaten miscreants with exclusion bolstered the standing of these officials. The 2007–2009 episode demonstrated the value of membership in the monetary union in inoculating countries against balance-of-payments and currency crises, but the continued vulnerability of euro area countries to banking and sovereign debt crises. Clearly, regional institutions must be designed carefully—with operational autonomy for experts responsible for managing common projects within a political mandate specifying the objectives—and operated cautiously by avoiding misalignments, large imbalances, and excessive debt.

## **6. Policy and Institutional Recommendations**

Our examination of the effect of crises on regional institution building and the effects of institutions on the ability of regions to prevent, deflect, or manage crises yields several suggestions for the design and construction of institutions in Asia. These fall under the headings below of (i) overall institutional strategy, (ii) substantive focus of cooperation,

<sup>58</sup> See, for example, Henning (2009).



(iii) balance between secretariats and intergovernmentalism, and (iv) membership and variable geometry.

## **6.1. Overall Institutional Strategy**

Our review of crises over the last 4 decades shows that they can provide a strong boost for regional institution building. But the magnitude of this boosting effect depends on prior circumstances, which are more favorable in some regions than others. One such circumstance is the existence of a regional secretariat and other institutions that provide a foundation on which to build. A fruitful strategy for advocates of Asian regionalism, therefore, would be to lay the institutional groundwork for integrative responses and then exploit it when crises open new possibilities for cooperation. By designing such institutions well, Asia could ratchet regional cooperation upward over successive iterations of crises, following the European pattern even while declining to adopt the European institutional form.

## **6.2. Substantive Agenda**

Regional cooperation should address the three related areas of surveillance, financial support, and balance of payments adjustment and exchange rate coordination. As this paper is being written, ASEAN+3 finance ministries are negotiating over implementation of the CMIM and creation of an independent secretariat to strengthen regional surveillance.<sup>59</sup> ASEAN+3 should follow through on this commitment, establish such a secretariat, delegate it clear responsibilities, and give it operational autonomy within a broad mandate to support regional integration. The objective should be to establish a robust surveillance mechanism that can identify vulnerabilities and needed policy adjustments, thereby supporting regional economic stability in general and providing a regional capacity to fashion policy conditionality when and if there are drawings on the CMIM.

East Asia faces a well-known problem of collective action in balance of payments adjustment and currency appreciation. Although the recent crisis had placed this problem on the back burner, it is re-emerging as payments imbalances widen with recovery in the global economy. Rebalancing international payments requires expansion of domestic demand in Asian countries with current account surpluses. Several governments have tried to accomplish this with expansionary monetary policy—the domestic counterpart of foreign exchange intervention to depress the external value of the currency. The collective action problem arises from the fear that appreciation will place countries at a commercial disadvantage relative to their neighbors, with whom trade is largely competitive rather than complementary. The solution is to negotiate joint appreciation against the dollar, tighten domestic monetary policy, and continue to provide fiscal stimulus to domestic demand. Thus, in addition to strengthening surveillance and implementing the CMIM, Asian governments should engage in an intensive dialogue over macroeconomic and exchange rate policies, coordinate them accordingly, and thereby raise the standard of living of their citizens and contribute to global payments rebalancing.

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<sup>59</sup> ASEAN (2009).

### 6.3. Delegation, Secretariats, and Intergovernmentalism

Asia today faces the question of how to delegate important functions to common regional institutions. When implemented, the CMIM and strengthened surveillance could represent a fundamental shift toward common institutions which would be analogous to a shift from a free trade area to a customs union. ASEAN+3 members have had difficulty crossing this threshold together, however. Three impediments seemed to be operating against the creation of a secretariat: (i) strong national ministerial bureaucracies; (ii) intra-regional rivalry, especially between Japan and the PRC; and (iii) the presence of multilateral arrangements which, despite the region's treatment during the 1997/98 crisis, have recently been adapted to serve Asia better. Consider the ministerial bureaucracies, then several other implications for regional institutions below.

The tradition of strong and autonomous ministerial bureaucracies in East Asia appears to have inhibited delegation to independent secretariats within the region—on trade, money and finance. Strong bureaucracies have arguably been one of the ingredients in the successful development model in East Asia. But, while some Asian government ministries have been internally cohesive and autonomous from the private sector, especially those in the three Northeast Asian countries, they have also tended to be autonomous from one another and the rest of the state apparatus. Bureaucratic autonomy has thus carried costs—in addition to the benefits—in the form of reduced communication and coordination among ministries and inter-ministerial competition.

Given the competition among ministries that occurs within countries, we can expect them to resist establishing international bureaucracies (secretariats) and delegating real authority to them. Bureaucratic competition is especially problematic for delegation for regional cooperation, which is new and unexploited territory, where bureaucratic leadership and prerogatives have yet to be defined. Here the shadow of the future works against cooperation: ministries know that the institutional arrangements to which they agree could cement bureaucratic prerogatives in regional cooperation for decades into the future, with consequences for competition among ministries at the domestic and multilateral levels, and are therefore very cautious when entering into them.

National ministries are therefore not likely sources of initiatives for delegation to independent secretariats. The intergovernmentalist model of European integration relied on periodic European Council meetings for such delegation. The Schmidt–Giscard episode suggests that the heads of government can serve this catalytic role, asserting the broader national interest in regional cooperation over the narrower concerns of ministerial bureaucracies. Summit decision-making in Europe also facilitated side payments. Heads of government in Asia, meeting in regional summit meetings, should instead set the regional agenda, create new institutions, and delegate specific tasks to them and their secretariats.

Summit-led regionalism does not exclude strong roles for national agencies and bureaucracies. Monetary integration in Europe developed through a strong network of relations among finance ministries and central banks meeting as Ecofin, the CCBG, and the Monetary Committee. Although the European Commission played an entrepreneurial role and participated in meetings, the relations among central banks and between them

and the finance ministers were more important in charting the path to the introduction of the euro. Asian heads of government could sponsor the deepening of similar intergovernmental and central bank networks to support, for example, financial and monetary integration.

Although key political decisions were taken at the most senior levels in Europe, the heads of government left the operation of the EMS and the technical preparations for the monetary union mostly to the central banks and finance ministries. Central banks had a considerable degree of autonomy—though not by any means complete autonomy—and that fact was essential to the maturation and acceptance of the EMS. Delegation to expert officials—whether to a joint secretariat or an intergovernmental group of central bank or finance ministry deputies—facilitates regionalism because they are more likely to configure regional arrangements on the basis of economic realities, whereas the senior political figures are more likely to risk conflict with the financial markets. Officials within the financial agencies can also sometimes agree with one another even when their leaders cannot. Foreign ministries and other agencies have little to contribute to the effective functioning of the CMIM, bilateral swap arrangements, and other monetary and financial initiatives in East Asia. Such matters should be left to the experts in these ministries and central banks to manage.

The example of the EU also shows that national governments need not fear renegade, power-grabbing secretariats. The authority of the European Commission expanded only as conceded by the heads of state and government meeting in the European Council. Within its grants of authority, the Commission was entrepreneurial and could often exercise considerable discretion. But conflicts with member states, such as the celebrated standoffs with French President Charles de Gaulle in the mid-1960s and British Prime Minister Margaret Thatcher in the early 1980s, occurred only in areas where member states had already created Community competence. The devolution of authority to Community institutions was not inexorable. Member states retained the authority to decide which matters would be transferred and refused to authorize such transfers in many important issue areas.<sup>60</sup> Asian governments can rest confident in their ability to hold regional secretariats to the remit that they collectively delegate to them.

Within the institutional structure that managed monetary integration in Europe, the German Bundesbank and Finance Ministry were first among equals. They circumscribed the range of policy choices and simplified decisions within these bodies. In contrast to the influence and leadership of Germany in partnership with France that has been seen in Europe, we have tension between Japan and the PRC in Asia. This tension might not be an insurmountable barrier to the establishment of regional institutions, but it is a substantial barrier indeed. Were East Asian governments to delegate substantial authority to intergovernmental or representative bodies, and independent secretariats, the region would have to set aside or transcend Sino–Japanese rivalry.

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<sup>60</sup> See, among others, Moravcsik (1998) and Simon Hix's (2010) paper for this project.

#### 6.4. Membership and Variable Geometry

Asian regionalism is characterized by a complicated patchwork of overlapping and cross-cutting groupings of subregional, pan-regional, and cross-regional arrangements. Membership of new arrangements is debated at length, as are the relations between these arrangements and outside states. The European example demonstrates that variable geometry can succeed in fostering regional integration, but variable geometry in the form of concentric circles rather than haphazardly overlapping groups. Fortunately, a regional surveillance mechanism is well suited to a concentric circles approach. Once ASEAN+3 strengthens its surveillance mechanism, the group can construct a layered system upon it. ASEAN+3 would comprise the core, the next larger circle would incorporate the other members of the East Asia Summit meetings—Australia, New Zealand, and India—and the broadest grouping would include the remaining states. Information and analysis that is added with the expansion of the exercise to successively broader circles benefits the analysis of the economic situations of core countries. The group can also receive input, as it does now, from the IMF without surrendering control of the peer review process.<sup>61</sup> Consultations regarding exchange rates, macroeconomic policy, and balance of payments adjustment would also benefit from a wider scope and more openness. Regionalism in concentric circles can lay the basis for deepening and broadening institutions in the future as negotiated between the core and prospective members.

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<sup>61</sup> Surveillance discussions can also benefit from the participation of private sector groups, such as banks and financial institutions, and experts from academe and independent research institutes. Stephan Haggard's (2010) paper for this project stresses the inclusion of outside stakeholders in regional integration.

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## **Economic Crises and Institutions for Regional Economic Cooperation**

This paper examines the extent to which economic crises facilitate the development of more effective regional institutions and whether such institutions can shield regions from crises. It compares six regional economic crises over the last four decades and the institution building—or decay—that followed. Regional market interdependence, secretariats, cross-issue bargains and the multilateral environment have strong bearing on the regional response. Once created, regional institutions can alter the forms in which crises manifest, but are not likely to eliminate all types of crises. Proponents of Asian regionalism can use crises as opportunities to ratchet delegation to institutions upward.

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