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FINANCE AND SECURITY IN EAST ASIA

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ABSTRACT

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

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

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

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

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

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

stage for yet more financial initiatives down the road.

THE RECORD TO DATE

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

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

> The 1997-98 crisis highlighted the financial vulnerability of the open East Asian economies and left an indelible mark on regional financial policymakers. It also significantly eroded regional policymakers' confidence that the IMF and the United States had their best interests at heart... Regional solutions to global financial pressures, which were unthinkable (or at least unthought of) until the crisis hit, became a major focus of the East Asian states' efforts to reduce vulnerability (Grimes 2009: 67).

The result was a flurry of discussions aiming to promote closer financial relations, concentrating on three issues in particular: (1) currency management; (2) development of regional capital markets; and (3) emergency liquidity assistance. Hardly a month now goes by without some meeting somewhere in the region to address one or more of these policy challenges. In practice, however, accomplishments have been disappointing. As compared with the status quo ante, achievements have not been inconsiderable. But as compared with the region's own loftier ambitions, the record to date must be rated as modest at best.

Currency management

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

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

Capital markets

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

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

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

In parallel, the purpose of the ABF was to increase liquidity in Asian capital markets, mainly through purchases of local government bonds by regional central banks. The idea – a brainchild of Thaksin Shinawatra, then prime minister of Thailand – was to encourage greater private investments in Asian debt issues. The ABF was formally launched in 2003 by the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP), a grouping of eleven central banks and monetary authorities in the region first formed as long ago as 1991.[1] In a first iteration of the ABF, a total of some $1 billion worth of dollar-denominated sovereign debt was acquired.

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[1] Participants in EMEAP includes the five founding members of ASEAN – Indonesia, Malaysia, Philippines, Singapore, and Thailand – plus China, Hong Kong, Japan, Korea, Australia, and New Zealand.

Two years later, in a second version dubbed ABF2, the concept was extended to government bonds denominated in local currencies. Some nine new bond funds were created, including a diversified regional fund labeled the PAIF (Pan Asia Bond Index Fund) and eight single-country funds. The PAIF was funded with the EMEAP Group's initial investment of $1 billion. An additional $1 billion was allocated among the eight single-country funds.

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

Not surprisingly, therefore, results have been anything but impressive. Though the volume of new debt issues has grown, turnover rates and market liquidity are still low by international standards and markets remain overly dependent on government bonds of relatively short maturity. More than a decade after the fall of the baht, maturity and currency mismatches are still a serious problem in the region, and market integration remains a distant dream. Vulnerabilities are as great as ever.

Liquidity assistance

Most progress has been made in the provision of emergency liquidity assistance via the Chiang Mai Initiative, now soon to be expanded into a more comprehensive Asia Joint Fund. Launched in May 2000 at a meeting of ASEAN+3 finance ministers in the Thai resort town of Chiang Mai, the CMI established the basis for a network of bilateral swap arrangements (BSAs) between, on the one hand, the Three Plus countries and, on the other hand, members of ASEAN. As the BSAs were negotiated and concluded over subsequent years, their number grew to as many as nineteen. (The number in effect at any one time actually varies as arrangements lapse and are renegotiated and reinstated). Initially, the total amount of money that could be mobilized under the CMI came to some $33.5 billion. After the start of a "stage two" in 2005, the nominal size of the swaps was roughly doubled to a net total (after eliminating double counting) of about $60 billion (Henning 2009: 2).

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

Great hopes have been placed in the CMI as the foundation for increasingly close financial and monetary relations in the region. Functions of the scheme would include monitoring,

surveillance, and, if possible, coordination of exchange rates and other related policies. Here too, however, tangible achievements have so far been modest at best. Like the ABMI and ABF, the CMI is a worthy project that could, in time, prove significant – but not yet. Until now, the initiative has not made much of a difference.

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

Similar timidity has also plagued the BSA network itself, which has required laborious and time-consuming negotiation (and renegotiation). To placate the United States and IMF, member governments agreed that participants would be authorized to draw automatically only up to 10 percent of the contractual amount of a BSA (raised to 20 percent in 2005). Beyond that limit a country would have to agree to place itself under IMF tutelage, complete with a macroeconomic and structural adjustment program, thus effectively substituting Fund conditionality for a surveillance system of the region's own making. Though obviously necessary to protect the credibility of the CMI, the IMF link has had a significant chilling effect on actual behavior, owing to memories of the 1997-98 experience. To date, no participating country has yet to draw on a BSA.

In an attempt to overcome some of these limitations, governments agreed as early as 2005 to seek to "multilateralize" the CMI, so that funds committed to individual bilateral swaps could be pooled together to enhance the amounts that any single country might draw when in need. Four years later, in May 2009, agreement in principle was finally struck, aiming to transform the CMI into a new common facility to be known as the Asian Joint Fund. Resources are to be effectively doubled to $120 billion, with 80 percent coming from China, Japan, and Korea and 20 percent from the ten members of ASEAN. In addition, building on the ERPD, a new surveillance unit is supposed to be created with responsibility to identify risks to the region as well as to exercise oversight over the reserve pool.

However, it remains to be seen how much further "multilateralization" might actually take the nations of East Asia. Some observers see the AJF as a critical step toward realizing, at long last, Japan's original idea of an Asian Monetary Fund. But crucial details have yet to be negotiated, concerning especially issues of borrowing accessibility, surveillance, and governance of the system. To date, ministers have described their new initiative as a "self-managed reserve pooling arrangement" (SRPA), with each government doing no more than earmarking a portion of its own reserves for joint use. That is a far cry from a genuine common fund of the sort envisioned at the time of the Japanese proposal. An SRPA is no AMF. Moreover, the total amount of money involved, while representing a substantial increase from the existing BSA network, is still puny in

relation to potential need or the value of reserves currently hoarded away by the region's central banks (now totaling more than $3.5 trillion overall for the thirteen ASEAN+3 countries). And the 20-percent IMF link remains intact, still discouraging potential borrowers. One has the suspicion that the value of the AJF lies mainly in its symbolism. Its practical impact is not apt to be dramatic.

EXPLAINING THE RECORD

What explains the modesty of this record? Many factors are undoubtedly involved, both economic and political. Most discussions focus on the economic side, highlighting structural and institutional differences among the economies of the region. But even more decisive is the political side, where security tensions dominate. For all the talk of financial regionalism in East Asia, little real progress is possible without a significant moderation of underlying rivalries and animosities.

Economics

On the economic side, the impediments are obvious. Among economists, it is common to judge prospects for financial regionalism on the basis of the well-known optimum-currency area (OCA) theory, which highlights the salience to any integration project of such considerations as structural homogeneity and the degree of convergence among the countries involved. In most respects, East Asia scores poorly. Econometric studies confirm that the region as a whole is far from anything that might be described as an OCA, though various sub-groups might conceivably qualify by some of the usual criteria (Eichengreen and Bayoumi 1999; Zhang et al. 2001; Kawai and Motonishi 2004).

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

Moreover, ties among the economies of the region are generally weak, reinforcing centrifugal forces. The principal exception is in the area of trade, where the pace of activity within the region has grown exponentially over the last third of a century. Among the forces driving the expansion of intra-regional trade are the many "invisible linkages"created by extensive ethnic business networks, encompassing overseas Chinese communities or other groups such as Koreans or Vietnamese (Peng 2002). Equally important are the much more visible linkages created by the direct investments of multinational corporations (MNCs) – initially coming mainly from Japan, Europe, and the United States, but now followed increasingly from within the region itself. The

result has been a bourgeoning of closely organized production networks and supply chains across East Asia, promoting vertical intra-industry trade in capital equipment, parts and components, semi-finished goods, and final products. Among the ASEAN+3 countries, the share of intra-regional trade in total commerce has risen from some 30 percent in 1980 to close to 40 percent in 2007. If Hong Kong and Taiwan are added, the intra-regional share has risen from 37 percent to nearly 55 percent (Kawai 2008).

In most other respects, however, ties remain tenuous. In capital markets, little has changed despite efforts like the ABMI and ABF. Although a few governments have made progress in deregulating domestic monetary systems and opening up financial services to foreign competition, market integration overall, as noted, remains a distant dream. Apart from Japan, Hong Kong, and Singapore, most states still impose strict exchange controls and other barriers to limit the free flow of funds. Restrictions are particularly tight in China and the poorer members of ASEAN, where financial systems remain underdeveloped and shallow.

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

Overall, therefore, circumstances could hardly be described as favorable. The economic barriers to regionalism are substantial.

Politics

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

The reason is clear. International cooperation of any sort involves a degree of *commitment*, which is naturally antithetical to the preferences of formally sovereign states. Involved is what one source (Litfin 1997) calls a "sovereignty bargain" – a voluntary agreement to accept certain limitations on national authority in exchange for anticipated benefits. In effect, sovereignty is pooled. The conditions conducive to such a commitment are, to say the least, demanding.

What are those conditions? Previously (Cohen 2001), I have used comparative historical analysis to identify the key conditions that appear to determine the *sustainability* of close financial cooperation among states. The same factors can be assumed to be instrumental in gaining the necessary commitment to regionalism in the first place. Two requisites stand out. One, suggested

by traditional realist approaches to international relations theory, is the presence or absence of a powerful state or combination of powerful states committed to using their influence to keep the joint effort functioning effectively on terms agreeable to all. The other, suggested by more institutional approaches to world politics, is the presence or absence of a broad constellation of related ties and commitments sufficient to make the sacrifice of sovereignty, whatever the costs, basically acceptable to each partner. Judging from the historical record, I conclude that one or the other of these two types of linkage is necessary to sustain the necessary degree of commitment. Where both types have been present, they have been a sufficient condition for success. Where neither was present, cooperation has tended to erode or fail.

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

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

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

The problem for East Asia is that neither of these critical conditions is presently much in evidence. Political circumstances give regional governments little incentive to go beyond the most minimal sort of joint financial initiatives.

On the one hand is a dearth of coherent leadership. The region does not lack for plausible leaders. There are in fact two of them in East Asia, Japan and China, potentially not unlike the duopoly of France and Germany in post-World War II Europe that provided the decisive impetus for the early Common Market. But there is a distinct lack of comity between the Japanese and Chinese that makes it difficult for them to jointly lead the way. In retrospect it is clear that Europe's Common Market, now the 27-member European Union, could never have come about without the historic reconciliation of France and Germany after 1945 – two long-time adversaries who decided to join together to promote a common regional project. Nothing comparable has

emerged in relations between Japan and China, who still regard themselves more as rivals than partners. The lack of trust between East Asia's two giants is palpable, fraught with bitterness and mutual suspicion. Japan, once the dominant economic power of the region, fears falling under China's lengthening shadow, while the Chinese continue to harbor acute resentments toward the Japanese for their military and colonial activities from 1895 to 1945 – the so-called "history problem." Neither country is willing to commit to any collective initiative that might cede a measure of influence or prestige to the other. Moreover, in the background there is the United States, still a major presence in the region with lingering leadership aspirations of its own.

At the broadest geopolitical level East Asia is dominated by a "strategic triangle" involving Washington as well as Beijing and Tokyo, each with its own distinct interests and preferences that color every effort to promote financial cooperation in the region. For Japan, a declining power fearful of losing its traditional position of pre-eminence in regional finance, the key goal is to lock in as much influence as possible while not jeopardizing its close political and military ties with the United States. Conversely, for China, a rising power, the objective must be to support institutional initiatives that will allow it to continue to grow rapidly while avoiding commitments that could contain its future world role. All the while the United States can be expected to seek to do what it can to preserve the historical role of the dollar and U.S. financial enterprises in the region. All of this was evident back in 1997 when both China and the United States, each for its own reasons, resisted Tokyo's proposal for an Asian Monetary Fund that might have consolidated a dominant regional role for the yen. The contestation remains manifest down to the present day. In practical terms, regional leadership in financial matters is effectively divided three ways. Putative followers are naturally reluctant to do anything that might, in effect, compel them to "choose sides."

On the other hand is a dearth of genuine solidarity. Put simply, East Asia lacks any sense of common identity. As William Grimes (2009: 41) has noted, a "defining characteristic of East Asia has been regional fragmentation... a lack of centripetal forces." Other than geography, little binds the countries of the area together, while many factors work to keep them apart, including a legacy of European imperialism, the experiences of World War II and the Cold War, and deep differences of language, religion, ethnicity, and social organization. For all their protestations of amity, regional governments remain noticeably distrustful of one another and place a high premium on preservation of as much national sovereignty as possible. Unlike Europeans, East Asians are as yet unwilling to pay even lip service to the notion of "an ever closer union" among their peoples. Most, having only recently emerged from colonial status, are more intent on individual state-building than on promoting regional solidarity. Few demonstrate much inclination to define themselves in relation to one another rather than in their own terms.

Nor is there any sort of natural core of states on which to build a regional project. The requisite like-mindedness is just not there. More or less by default, ASEAN+3 has come to be the main forum for regional financial initiatives. But the group is a wholly artificial construct, in terms of both who is included (Myanmar?) and who is excluded (Taiwan?). The advantage of such a broad grouping is that it includes the two countries, China and Japan, who separately or together could play the role of supportive local hegemon. But even apart from the animosities that divide the two potential leaders, there is the problem that suspicions of both powers remain widespread throughout the region. Wariness about the Japanese goes back to Tokyo's attempts during the interwar period to create a Greater East Asia Co-Prosperity Sphere, which most Asians remember

as an exploitative and demeaning relationship. Fears of future domination by a huge, rapidly growing China are equally strong. Governments are not particularly eager to commit to the leadership of either of the two.

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

REVERSE CAUSATION

Political will, however, is not written in stone. While security tensions may cause governments to think twice about financial regionalism, the reverse, I would contend, is also possible. Tentative steps toward closer monetary and financial relations might also cause governments to reconsider their security concerns, paving the way for additional cooperation on initiatives like the ABMI, ABF, and CMI. In time, a kind of self-reinforcing virtuous circle could generate results rather less modest than we have seen until now.

The key lies in the process of socialization that occurs when cooperation becomes institutionalized. The more actors learn to work together, finding joint solutions to common problems, the less reason they will find to cling to ancient suspicions and animosities. Gradually, bitterness and fear can yield to an accumulation of the mutual trust needed for more far-reaching initiatives.

Critical to the process is the eruption of crisis, which may temporarily ease resistance to new forms of cooperation. As I have previously argued (Cohen 1993), major financial upheavals tend, at least for a time, to alter governments' calculations of the costs and benefits of cooperation. The perceived disadvantages of a commitment to common action are reduced when all parties seem threatened by a large systemic shock. As a result cooperation may be ratcheted up a notch or two beyond what previously might have seemed possible, in initiatives like the ABMI, ABF, and CMI. A higher level of institutionalization in turn creates more opportunities for socialization, thus providing new impetus for the development of mutual trust and setting the stage for yet more joint initiatives in the future. It is no accident that the first real moves toward financial regionalism in East Asia did not occur until after the great crisis of 1997-98. It is also no accident that the latest decision to "multilaterialize" the CMI came during yet another period of distress a decade later. Crises are the necessary catalyst to propel the virtuous circle forward.

There is nothing inevitable about the process, of course. For one thing, it relies on the recurrence of events – crises – whose frequency and timing is by definition unknowable. In practice, therefore, progress is apt to be episodic at best, proceeding in fits and starts in a manner not unlike the pattern of "punctuated equilibrium" described in the modern theory of evolution. Furthermore, even in the midst of a crisis, the reach of any new financial commitments will be strictly circumscribed by larger security concerns, which inevitably are accorded a higher priority by governments. I have already emphasized that the modesty of the CMI and East Asia's other recent initiatives is no accident, either.

Nor is there any reason to expect much speed in the process, which demands a substantial shift of inter-subjective understandings in the region. Peter Aykens (2005) distinguishes three stages in the process of trust development: (1) "momentary trust," based on calculations of risk

resting solely on immediately available information; (2) "reputational trust," derived from growing familiarity and experience; and finally (3) "affective trust," representing stable and unquestioned sets of expectations. Only when the final stage of affective trust is attained – the end-product of a long process of social interaction and learning -- can a really deep sovereignty bargain be struck. But getting to that stage, if feasible at all, will require a considerable amount of time.

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

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