

Much Ado about Nothing? Chiang Mai Initiative Multilateralisation and East Asian Exchange Rate Cooperation

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Abstract

This article asks why the creation by the ASEAN+3 countries of a common reserve pool, the Chiang Mai Initiative Multilateralisation (CMIM) of 2010, has not brought about a decisive breakthrough towards regional exchange-rate cooperation of Japan and China. With the global financial crisis acting as catalyst, optimists expected CMIM to facilitate agreement of the two East Asian powers on an Asian Currency Unit and Asian Monetary Fund-style institution, but nothing of relevance materialised. The article analyses this disappointing outcome by criticising the neo-functionalist optimistic view from both a realist and liberal intergovernmentalist perspective. It concludes that the lack of progress in Sino-Japanese regional currency cooperation can be explained by combining realist and intergovernmentalist analysis: regional rivalry of China and Japan, driven by 'high politics' national security concerns and diverging 'low politics' policy preferences rooted in incompatible domestic economic policy-making regimes, is the key reason for lack of progress.

Key words: East Asian Regionalism, Chiang Mai Initiative Multilateralization, Sino-Japanese cooperation, neo-functionalism, liberal institutionalism

1. Introduction

This paper asks why the creation by the ASEAN+3 (APT)¹ countries of a common reserve pool to provide financial assistance to East Asian nations in case

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1. For the purpose of this paper I define East Asia as the ASEAN+3 grouping (APT), that is the 10 ASEAN countries plus China, Japan and South Korea.

of financial crisis, the Chiang Mai Initiative Multilateralisation (CMIM) of 2010, has not brought about a decisive breakthrough towards regional exchange-rate cooperation. With international currency instability resulting from the global financial crisis (GFC) that began in 2008 acting as catalyst, it was hoped that the new institutional structure of CMIM would serve as a starting point for building a regional exchange rate regime.² Optimists envisaged the rapid creation of an Asian Currency Unit (ACU), a common currency basket including yen and RMB at the centre of regional exchange rate stabilisation, managed by an Asian Monetary Fund-style institution. However, since the CMIM was launched it has disappointed both as an institutional stepping stone to decouple East Asia from US monetary and financial hegemony and as a vehicle for further deeper regional financial and monetary cooperation, especially between China and Japan. Was the excitement about the potential of CMIM for a paradigm shift towards deeper regional monetary integration just a lot of fuss about nothing of importance?

This paper analysis the causes for the disappointing outcome of CMIM for exchange rate cooperation between Japan and China by criticising the neo-functionalistic optimistic view, which supports hopes for currency cooperation, from a realist and liberal intergovernmentalist perspective. It concludes that the limited institutional outcomes of CMIM are primarily explained by the power rivalry for regional leadership between China and Japan, driven by national security concerns and mutual suspicions rooted in history. However, these high politics explanations have to be complemented by pointing out the complex low politics differences bedeviling Sino-Japanese intergovernmental attempts to pool aspects of their monetary sovereignty. These problems stem from the two countries' diverging regional economic policy preferences, rooted in different domestic political-economic structures and interests.

This paper is organised as follows: Next it will give an overview of the state of APT monetary and financial cooperation before the GFC. Section three will expand on the case for post-GFC Sino-Japanese exchange rate cooperation with the GFC acting as catalyst. Section four will review the neo-functionalistic expectations for a spill-over from CMIM to institutionalised APT exchange-rate cooperation. Section five will then explain the actual deadlock of Sino-Japanese regional currency cooperation from a realist point-of-view. Section six will bring in

2. The 'crisis as catalyst' hypothesis has been applied to East Asia, with reference to the Asian Financial Crisis, by MacIntyre et. al (2008).

liberal intergovernmentalism as a necessary and complementary qualification of the realist explanations for the Sino-Japanese gridlock. Section seven concludes by pointing out that without substantive convergence of the Chinese and Japanese domestic political economies towards greater compatibility, regional institutions will remain largely ineffective in promoting deeper Sino-Japanese currency cooperation.

2. Financial and monetary cooperation in East Asia before the global financial crisis

Over the last decades East Asian economies have become increasingly integrated through trade, financial flows and direct investment. Contemporary intra-regional trade shares are similar to those of the EU or North America (ADB 2008, 40). At the core of East Asia's high trade and investment interconnectivity are regional production networks linking the region in with the global supply chains of manufacturing MNCs. Although intraregional trade now represents more than half of East Asian trade, East Asia's export-oriented economies are critically dependent on final demand from outside the region, mainly the US and the EU. Economic integration in East Asia has so far been market driven, with government cooperation in trade and finance gradually following behind. Free trade agreements are still mainly bilateral or multilateral, with the exception of the ASEAN Free Trade Area (AFTA) and the associated AFTA+1 agreements.³ A comprehensive APT free-trade framework, bringing together China and Japan, is still missing, although there have been deliberations of a trilateral China-South Korea-Japan FTA.

The turning point towards regional financial cooperation was the Asian Financial Crisis of 1997/8 (AFC). Japan and China are at the centre of this post-AFC financial cooperation. In response to the inadequate multilateral response to the crisis, Japan suggested the creation of an Asian Monetary Fund (AMF), but the proposal foundered on US and European objections and a lack of Chinese support (Henning 2005, 13). However, China, after stabilising the region by refusing to devalue the RMB, warmed to the original Japanese idea of a regional liquidity mechanism to provide balance of payment support for crisis-hit East Asian countries. The outcome of these developments was the Chiang Mai

3. For a good overview of the 'noodle bowl' of East Asian regional trade agreements, see Searight (2009).

Initiative (CMI), agreed upon by APT finance ministers in May 2000. The CMI consists of two elements: first a network of bilateral swap agreements (BSAs) among ASEAN countries of a size of US \$2bn. Secondly, and more importantly, a network of BSAs between individual ASEAN countries and China, Japan and South Korea (+3 countries), and BSAs between the +3 countries themselves, with a combined size of US \$90bn.⁴ Finally, in 2003, two institutions for the development of a regional bond market were initiated, the Asian Bond Fund (ABF) and the Asian Bond Market Initiative (ABMI).⁵ Together these initiatives brought a new quality of institutionalisation into the process of East Asian regional economic integration.

However, as Amyx points out, despite this considerable achievement, the CMI network of bilateral swap agreements has always been incomplete (2008, 122). The most glaring weakness was the lack of a robust and independent surveillance and monitoring mechanism. Although the APT ministers established an Economic Review and Policy Dialogue Mechanism (ERPD) to exchange information, gradually to be extended towards policy monitoring, peer review and due diligence, the CMI's BSAs ultimately relied on the IMF as an enforcer, with release of 80 percent of the funds conditional on the negotiation of an IMF programme.⁶ This institutional weakness points at the unwillingness and/or inability of China and Japan, the two key financing countries of the CMI, to agree on a robust institutional mechanism to address the problem of credible governance of the system. Instead they delegated this critical aspect to the US dominated IMF. Therefore, CMI was neither a decisive step towards an independent AMF-style mechanism, nor a break with US hegemony in the financial and monetary relations of East Asia.

The original CMI had little effect on monetary and exchange rate coordination. This can be explained by the fact that the AFC, triggering the initiative in the first place, was a capital account crisis, a *financial* emergency asking for balance of payments assistance. Secondly, monetary cooperation is more demanding in terms of constraining national economic policymaking autonomy than financial cooperation. Given the unwillingness of APT countries in

4. For details on the CMI and its evolution, see Henning (2005), Kenen and Meade (2008) and Searight (2009).

5. For details, see Rajan (2008b)

6. see Searight (2009, 230-233), and Amyx (2008, 124)

general and of China and Japan in particular to compromise on their monetary sovereignty, regional monetary cooperation had to wait.⁷ However, CMI multilateralisation (CMIM), the creation of a common reserve pool, decided by APT finance ministers in May 2007 and enacted on March 24, 2010, did come with great expectations for a paradigm shift towards institutionalised regional exchange rate cooperation.

3. Crisis as catalyst: the case for Sino-Japanese monetary cooperation after the GFC

Before I come to an assessment of CMIM as a potential nucleus for Sino-Japanese monetary cooperation, a brief review of the economic and political argument for APT monetary cooperation is in order. From an abstract economic viewpoint a lot speaks for coordination, with China and Japan as the logical centre. East Asian exchange rate cooperation would support trade, investment and financial integration in a region where many political conflicts, especially between Japan and China, remain unresolved. Finally it would enhance the influence of East Asia in multilateral organisations including the G-20, an aspect particularly attractive in the on-going GFC and the related redesigning of the global financial architecture.

Critical for *why* CMIM, more than the original CMI, was expected to lead into a qualitative leap towards regional currency cooperation is 'systemic context', or, in simple terms, the GFC as catalyst. As Henning explains, periods of systemic disturbances, (such as the GFC) provide a strong incentive for governments of a region to coordinate exchange rates to create a zone of regional monetary stability.⁸ Applied to East Asia, systemic context should give APT countries, and especially China and Japan, a strong incentive for regional currency management to cope with the crisis of the global dollar standard. Historically most East Asian countries have relied for a degree of exchange rate stability on the US dollar. As Eichengreen (2001) explains, US dollar-centred exchange rate stability was integral to the success of the East Asian miracle. Consequently, after the exchange rate turbulences of the AFC, Asian countries returned to what McKinnon (2005) calls 'soft dollar pegs'. This soft East Asian dollar standard constitutes a system of managed floats aimed at maintaining a degree of stability

7. This aspect will be discussed further in section six.

8. For the systemic context approach, see Henning (1998 and 2005).

vis-à-vis the US dollar (McKinnon and Schnabl 2004).⁹ At the heart of this regional dollar standard is the so-called 'Bretton Woods II' system of relative exchange rate stability between East Asian currencies and the US dollar.¹⁰ It revolves around sustaining growing real imbalances between East Asia and the US by recycling Asian current account surpluses back to the US through the accumulation of massive US dollar denominated reserve assets.

However, the soft dollar pegs did not solve the volatility problem. Especially the volatile yen-US dollar rate remained to be the 'loose cannon' of East Asian monetary relations (McKinnon and Schnabl 2003: 8). Furthermore, the soft dollar pegs of East Asian economies have increased their external vulnerability: they find themselves trapped in what McKinnon (2005) described as the 'conflicted virtue' of accumulating ever increasing amounts of dollar reserves. The longer this currency strategy continues, the more difficult it becomes to allow appreciation, because East Asian countries risk massive reserves losses in case of US dollar depreciation.

With the GFC these underlying tensions of the Bretton Woods II system have reached a critical juncture. Firstly, with the US internal and external deficits approaching unsustainable levels, further dollar weakness and even a dollar crisis are likely, diminishing the mercantilist benefits of the recycling mechanism. The attractiveness of the dollar for foreign investors seems to be crumbling in a situation of escalating US financing needs.¹¹ Secondly, the crisis has revealed that the policy of 'conflicted virtue' is not only economically risky but also politically unsustainable. As the case of China demonstrates, if East Asian nations continue with stabilising their currencies vis-à-vis the dollar, they risk a currency war with

9. Kawai (2008c: 93) describes McKinnon's thesis of a post-AFC revived dollar standard as too strong, identifying a clear trend of East Asian nations moving away from dollar-based regimes towards currency basket pegs including regional currencies, the yen and the euro. However, he acknowledges that stability vis-à-vis the dollar is still the preferred option of most East Asian countries.

10. The BWS II thesis has originally been put forward by Dooley et al. (2003). On the systemic instability of the BWS II, see Roubini (2008).

11. Masahiro Kawai of the Asian Development Bank Institute predicts that, 'after the dust of the current financial crisis has settled' the dollar will possibly face a crash. This prospect has led to 'growing nervousness of East Asian policymakers' (Author's interview, 26/09/2008). Those worries are confirmed by the recent downgrading of the US credit rating by Standard & Poor's (see *Financial Times*, 'S&P cuts US debt rating to double A plus', August 6, 2011).

the US, being accused of 'exchange rate manipulation'.¹² The US-Japanese monetary relationship too has become more complex. Japan's external competitiveness is affected by the escalating weakness of the dollar against the yen, forcing its administration to undertake ad-hoc interventions in an attempt to stabilise the yen-dollar cross.¹³ Finally, the crisis raised the spectre of undermining intraregional exchange rate stability. This is particularly relevant for the critical yen-RMB cross. Whereas Japan has so far abstained from systematic exchange rate management to mitigate the effect of systemic dollar instability on its currency and accepted appreciation of the yen against the US currency, China has defended its soft peg to the dollar. By doing so, China has shifted adjustment costs onto Japan, with the yen appreciating both against the RMB and the dollar since 2008. Without closer regional monetary cooperation the risks are growing that East Asian regional monetary stability will be destroyed by a race of competitive devaluations (Chhibber 2008, 45-6).

In view of these problems there has been no lack of proposals for regional exchange rate cooperation.¹⁴ Ideas range from coordinated pegging to the US dollar to single-country or multi-country basket-pegs.¹⁵ The most detailed proposals, related to the APT country grouping, have been put forward by the Asian Development Bank Institute (ADBI) in Tokyo. The case for regional moves to deal with dollar instability is best put by the ADBI's Dean Masahiro Kawai:

When a sustained, sharp downward pressure on the US dollar emerges (...) resisting currency appreciation (...) can result in a continuous build-up of foreign exchange reserves, (...) the risk of price inflation, asset price bubbles and banking sector vulnerabilities. Faster currency appreciation (...) can contain these risks. (...) Collective appreciation would spread the adjustment costs across countries in the

12. The escalating currency tensions between the US and China are demonstrated by the recent passing of a bill in the US Senate aiming to punish China for sustained currency manipulation, threatening so-called "countervailing duty" tariffs. (*Financial Times*, 'US currency bill passes Senate vote', October 11, 2011).

13. On the effectiveness and complex links between ad-hoc exchange rate intervention and domestic monetary and fiscal policy in Japan, see *Financial Times*, 'Hot yen leaves Tokyo with cold, hard choices', October 27, 2011.

14. For example Chhibber (2008), Rajan (2008a), Kawai (2008c), Wong (2008).

15. For a good overview and critical discussion of these options, see Williamson (2005) and Kenen and Meade (2008, 160-171). A flexible peg to a basket comprising the US dollar, euro and yen has been proposed by for example Ogawa and Doo Yong Yang (2008), internal basket proposals are discussed by Kim et al. (2005).

region. (Kawai 2008b, 5)

The ADBI suggests a gradual path of decoupling from the US dollar, starting with a currency basket system as benchmark for cooperative regional exchange rate stabilisation (Kawai 2008c, 96-98). Although such a basket is, in the beginning, supposed to be dominated by the G-3 currencies (US dollar, euro, yen), the proposal envisages a gradual move towards coordinated stabilisation against an ACU, a weighted internal basket of APT currencies. Monetary cooperation between China and Japan is seen as essential, given the weight of their economies in East Asia and their massive FX holdings.

This leaves the question of *how* such currency cooperation between APT governments, especially China and Japan, can be facilitated. As Kenen and Meade (2008, 156, fn.27) emphasise, the task of constructing such an ACU is fraught with political difficulties because of inevitable disagreements about the weights of individual currencies in the basket and about who should adjust in case of divergence of national currencies from the basket.¹⁶

4. Great expectations: CMIM as a ‘neo-functional’ gateway to APT exchange rate coordination?

Proponents of East Asian regional exchange-rate policy coordination, especially in the Asian Development Bank (ADB), thought to have found in CMIM a technocratic way to overcome the political-economic obstacles to cooperation, hoping for a neo-functional spill-over dynamics from CMIM to an ACU basket, governed by an AMF-style institution.¹⁷ To understand the neo-functional case for a spill-over from CMIM to a regional currency regime we have to review the qualitative changes CMIM has brought about in view of its potential for facilitating regional exchange rate coordination.

Multilateralisation of the CMI, agreed by APT finance ministers in May 2007 and implemented in March 2010, indeed represents development from the BSAs

16. See Kim et al. (2005) on the issue of asymmetry and monetary autonomy in currency basket-pegs.

17. Neo-functionalism developed as a theory explaining European integration. Key representatives are Haas (1958), Sandholz (for example, 1993) and Schmitter (for example, 1969). A good overview is given by Niemann (2009).

of the old CMI towards a self-managed reserve pooling arrangement governed by a single contractual agreement. The key elements of the CMIM can be summarized as follows:¹⁸

- An overall reserve pool of \$120bn is created, replacing the old BSAs of the CMI. The reserve pool operates under the principle of 'self-management'. That means that states will maintain their reserves but pledge to make their share available in situations of crisis.
- The purpose is balance of payments financing in crisis situations and supplementing existing international financial arrangements.
- The ASEAN economies collectively contribute 20% of the total funds, while the remaining 80% are contributed by the +3 countries (Japan 32%, China 32%, South Korea 16%). The contribution shares determine voting weights, with fundamental issues decided by consensus and lending issues by majority.
- The CMIM creates a new APT Macroeconomic Research Office (AMRO) to monitor economic performance of economies in the region. On top of this surveillance mechanism the Economic Review and Policy Dialogue (ERPD) will remain the key locus of state-to-state coordination and review.
- The IMF-link of the old CMI is maintained: withdrawal from the reserve pool is conditional on an IMF programme for 80% of the total funds available.

From a neo-functionalist point of view the implications of CMIM are as follows: CMIM multilateralisation, concerned about providing balance of payments financing to crisis-hit countries, is about exchange rate stabilisation and thus financial *and* monetary cooperation. More significant are the indirect consequences of CMIM. Firstly, creating a self-governed reserve pooling mechanism seems to lay the institutional stepping stone towards an AMF, backed mainly by Sino-Japanese funding. The financial institutionalisation of CMIM, which had been missing so far, opens an avenue towards the institutionalisation of monetary regionalism on similar lines: once the IMF link for lending decisions is removed the newly created AMRO and the strengthened ERPD mechanism will

18. I am drawing on Grimes (2011, 94-5) and Kawai (2010, 6). The features of CMIM were outlined in an official joint press statement by the Monetary Authority of Singapore of 24 March 2010.

be transformed to a strong AMF-style executive secretariat (Kawai 2010). This heralds a major institutionalisation of deepening Sino-Japanese cooperation, since an executive secretariat providing for rigorous economic surveillance and policy conditionality would need the joint backing of the two major financing powers.¹⁹ Secondly, a similar functional dynamics is assumed to be set in motion by CMIM towards the creation of an ACU as benchmark for future East Asian exchange rate stabilisation. As Kawai explains, the share of APT countries' contributions to the reserve pool can be envisaged as a 'technocratic' way to determine the respective weight of APT currencies in a future currency basket constituting the ACU. 'If shares are decided, ACU weights will be decided'.²⁰ Following this suggestion, the Japanese and Chinese contribution share of 32 percent would decide the share of the yen and RMB in the ACU basket and the voting weight of the two countries in an AMF.

5. The 'realist' reality check of Sino-Japanese currency cooperation: strategic deadlock

Triggered by the global financial crisis, CMIM was implemented in 2010 against the expectations of observing political economist.²¹ However, the expectations for a neo-functionalist spill-over towards currency regionalism have so far failed to materialise. Neither has the paradigm shift towards a regional exchange rate regime occurred, nor have there been significant developments towards exchange rate coordination between China and Japan. Looking at the outcome of CMIM it appears that its new institutional arrangements do not represent a breakthrough which could serve as basis for exchange rate cooperation. Most importantly, the much heralded self-governing surveillance and monitoring regime of the CMIM is much weaker than expected.²² It provides only for a layered and vague surveillance system, with AMRO in charge of monitoring and surveillance and the ERPD of APT ministers being the location for state-to-state policy communication. Critically, lending decisions will require a two-third majority of voting shares, making it unlikely that conditionality can be agreed upon if opposed by either Japan or China. Holding each 32 percent of the votes, each of them will have little problems to muster sufficient votes from other

19. Author's interview with Masahiro Kawai, 26/09/2008.

20. Author's interview with Masahiro Kawai, 26/09/2008. See also Kawai (2010, 13-14).

21. Sceptics included Henning (2009) and Amyx (2008).

22. The following analysis of the CMIM regime draws on Searight (2009) and Grimes (2011).

APT member states to veto undesired policies. Given this rather toothless self-governing arrangement, APT countries preserved the central IMF link of the old CMI, maintaining the rule that 80 percent of funds can only be disbursed with IMF approval. This makes the IMF the real power when it comes to surveillance, conditionality and disbursement decisions. The de facto dominance of the IMF standard in CMIM is confirmed by a senior Japanese financial official, justifying the IMF role by remarking: 'there cannot be two different standards'.²³ In short, rather than constituting the nucleus for an AMF to break free from the US-dominated IMF, CMIM bases its governing regime on exactly the IMF link it was supposed to overcome. Neither Japan nor China, the main funding countries of CMIM, seem to be willing to give up substantial financial sovereignty to regional technocratic governance institutions whose decisions can easily be contested, preferring instead to delegate responsibility for the disbursement of their reserve shares to an outsider, the IMF.

One of the strongest explanations put forward for the disappointing outcomes of CMIM comes from the realist perspective.²⁴ Evelyn Goh, in a recent article, succinctly highlights that proliferating functionalist cooperation is not effective in itself in a region where the great powers are fundamentally suspicious of each other (Goh 2011, 396). Power rivalry between China and Japan as the key problem of East Asian regionalism has been analysed extensively.²⁵ As realists assert, at the heart of the rivalry of the two regional powers are mutual distrust grounded in historical experience and the balance of power in East Asia: Japan's regional policy, ultimately relying on the US-Japanese security alliance, aims to balance an increasingly powerful China in the region, whereas China's goal is to establish regional hegemony. In this analysis Japan has to enter regional cooperation from a position of strength, to counter Chinese hegemonic ambitions.²⁶ Consequently Sino-Japanese power rivalry has resulted in a struggle

23. Quoted in Grimes (2011, 98).

24. A range of complementary, but less central explanations for this outcome have put forward. Analysts point at the entrenched dominance of the US dollar in East Asian trade and finance and US opposition to an effective East Asian regional exchange rate regime (Katada 2008). Others emphasise the original institutional deficit of the 'ASEAN way' of regional integration, often described as a talking shop (Yahuda 2005).

25. For recent examples, see Hernandez (2008), Takahara (2008), Mochizuki (2005). An excellent survey of the different aspects of the debate is provided by Calder and Fukuyama (2008).

26. Togo (2008, 188). For the broader realist argument on Sino-Japanese balance of power, see Ikenberry (2008) and Friedberg (2011).

for positioning in East Asian regional politics, with cooperation and peaceful coexistence interwoven with competition and friction (Mochizuki 2005, 140). In this view Sino-Japanese regional financial cooperation, a low politics issue, is in reality about high politics. Because both countries are jostling for regional influence and leadership for strategic reasons, their engagement in CMIM lacks substance and has been mainly symbolic. It aims primarily to signal regional engagement towards ASEAN countries and South Korea (Amyx 2008, 137). The realist view on prospects for deeper Sino-Japanese regional currency cooperation is put bluntly by Cohen: 'Security still trumps finance in East Asia', with the likelihood of radical reforms towards exchange rate coordination 'close to nil'.²⁷

Grimes (2011) has provided a detailed realist analysis of the weaknesses of CMIM as a result of Sino-Japanese competition for regional leadership. He interprets the compromise on equal contributions and voting shares, granting both China and Japan near veto power, as a strategy by the two governments to hedge their bets when committing to the CMIM. Plagued by mutual suspicions and distrust, Japan and China opted for 'nesting' multilateralisation within the IMF regime, thereby making CMIM intentionally irrelevant as a stepping stone towards a powerful AMF. Agreeing on delegating surveillance, conditionality and disbursement authority to a jointly-managed self-governing executive secretariat would have meant to rely in a crisis situation on each other for a joint understanding on what represents a solvency crisis, how much funds should be made available and what structural adjustment measures would be required. It would have required for China and Japan to agree upon what constitutes sound policies and to trust each other that those policies would be enforced, to reduce the moral hazard inherent in any international-lender-of-last-resort mechanism. Given the fundamental power conflict between the two nations, they agreed not to agree and delegated the governance of CMIM to the IMF.²⁸

This realist assessment of the potential for Sino-Japanese currency cooperation constitutes an explicit criticism of the neo-functionalist excitement about CMIM. As Grimes put it, 'challenges arising from competition and mistrust cannot be resolved through institutional means, despite the best efforts of the AMF advocates' (2011, 84). Whereas the neo-functional logic suggests great

27. Cohen (2011, 30; 2008, 44).

28. See Grimes (2011, 85-86).

potential for CMIM to facilitate functional spill-overs towards deeper Sino-Japanese regional cooperation, the realist analysis puts it that China and Japan approached CMIM essentially as a zero-sum game for regional power and leadership. The strength of this view lies in its focus on the reality of international politics, with Japan's and China's national interests and relative power ultimate determining whether regional cooperation can succeed or not. Empirical evidence, such as the weakness of the CMIM agreement and the standstill in Sino-Japanese monetary cooperation, lends substantial support to the realist critique of the neo-functional vision. However, the realist analysis of CMIM has to be complemented and qualified by bringing in the liberal intergovernmentalist dimension of currency rivalry between China and Japan. This dimension has so far been given scant systematic attention in the literature on CMIM.

6. Sino-Japanese intergovernmental bargaining: 'rescuing' national autonomy in regional interdependence²⁹

Similar to realism, liberal intergovernmentalism puts national interest and state actors at the heart of the analysis of regional cooperation.³⁰ However, in contrast to neo-realism, which prioritises 'systemic' security and balance-of-power factors to explain national interests, intergovernmentalism starts from liberal institutionalism. In this prism the foreign policy goals of governments in international economic cooperation conflict because they are shaped by divergent domestic institutional and interest constellations (Moravcsik 1993, 481). National preferences in regional intergovernmental bargaining are not reflecting a monolithic and immutable concern with national security, but vary according to issue-specific domestic interests and structural factors. In this view national governments share an interest in achieving mutual gains through regional economic cooperation. However, since their preferences for the shape, scope and institutional design of regional cooperative arrangements differ, given different domestic interest and institutional constellations, the distribution of relative gains from cooperation matters. As a result, bargaining for regional economic

29. The idea that regional cooperation is about 'rescuing' state capacity in the age of globalisation is adopted from Milward (2000).

30. Like neo-functionalism, intergovernmentalism has been developed as an explanation of European integration. Its main representative is Andrew Moravcsik (see, for example, 1998). For a good overview of liberal intergovernmentalist theory, see Moravcsik and Schimmelfennig (2009).

cooperative arrangements is hard-nosed and does not always result in successful outcomes (Moravcsik and Schimmelfennig 2009). Regional agreements will be difficult to achieve if critical aspects of national economic policy autonomy are at stake. Relative power of governments in intergovernmental bargaining depends on 'asymmetric interdependence'. The more a state is dependent on achieving regional integration in an issue area, the more willing will its government be to compromise (Moravcsik 1998, 3). Finally, the institutional outcomes of intergovernmental bargaining will reflect the desire by governments to tie others into legal frameworks which can be reinforced to reduce uncertainty about whether agreement will be implemented and properly administered by the other side (Moravcsik and Schimmelfennig 2009, 73).

From the intergovernmental perspective the conflict of China and Japan in CMIM cooperation and their inability to arrive at substantive outcomes for currency cooperation appears more grounded in actual differences in domestic structures, rather than simply being the result of a regional security dilemma. Their rivalry is about reducing the constraints imposed by cooperation on their respective national economic policy autonomy. The *Financial Times*, commenting on CMIM, describes this problematic dimension of East Asian currency cooperation well:

In practice, the lesson of the past decade is probably that the complex dealmaking and concessions on sovereignty required by sophisticated multilateral currency arrangements are beyond Asia's capacity at this stage of its development.³¹

The structural differences of the two national economic systems, resulting in different foreign economic policy preferences, are substantial. Japanese and Chinese domestic monetary and financial policies are embedded in different interest and institutional settings. The governance of Chinese monetary and financial policies is unreliable. The economy is managed by an authoritarian regime, unaccountable to proper rule of law or democratic checks and balances. Within this state-capitalist system the party-state controls the central bank and maintains a system of domestic financial repression by relying on state-owned banks, capital controls and a managed exchange rate.³² Japan, in contrast,

31. *Financial Times*, 'Currency co-operation creeps on to Asian agenda', January 11, 2011. The FT remains carefully optimistic on the longer-term prospects for limited progress in currency cooperation.

32. See Shih (2008) and Huang (2008).

displays the sound institutional checks and balances of a mature market economy and parliamentary democracy. It features an independent judiciary, an independent central bank, and a private banking system which is integrated into the structure of global financial markets. Furthermore, it combines an open capital account with a fully convertible international key currency.³³

China and Japan are confronting domestic economic management challenges of a different kind, reflecting differences in the way their economies operate and interact with the open world economy. Japan's coordinated market economy is stuck in the long-run malaise of a liquidity trap, resulting in deflationary low growth, a condition which is putting huge demands on domestic monetary and fiscal management.³⁴ In addition, as Katada (2008) explains, Japan's current global integration into the dollar-centred international exchange rate regime is structurally embedded in its financial and business practices, with little domestic support of policy initiatives to break loose from the US dollar in favour of regionalisation. China, in contrast, is caught-up in an entrenched mercantilist developmental growth model, which is supported by, and at the same time supporting, the Chinese party-state. As a result its policy-makers struggle with a highly distorted dual economy with dynamically growing internal and external economic imbalances.³⁵ Given these different national economic and monetary policy challenges, Japan and China are both reluctant to constrain their domestic economic and monetary policy autonomy by cooperating. They are unwilling to enter into serious regional exchange rate commitments since this risks that the other big power might be able to impose its policy preferences, constraining the own monetary policymaking room-for-manoevre.³⁶ This means that Japanese or Chinese policymakers will only commit to a regional monetary cooperation regime if it is either institutionally weak and ineffective, or dominated by their own currency, so that they can enforce their preferences across the region and against the other power.

At the centre of Sino-Japanese currency competition is the problem of national autonomy, key currencies and asymmetry.³⁷ The problems of the

33. See Henning (1994).

34. See Ito et al. (2005). On the liquidity trap, see Krugman (1998).

35. See Pei (2006)

36. The trade-off between domestic autonomy and fixed exchange rates is formalised in the Mundell-Fleming Model. For an excellent discussion of the political economy of this trade-off and the domestic politics of exchange rate management, see Frieden (2010).

37. On 'oligopolistic currency competition', see Cohen (1998, 131-149).

asymmetrical nature of international monetary relations and the privileges the key currency country enjoys in a pegged exchange rate system have long been recognised by international monetary economists.³⁸ Building on the Mundell-Fleming Model, they show that regional exchange rate stabilisation, if it is asymmetrically dominated by a major currency such as the yen or the RMB, results in the key currency country being able to preserve a high degree of monetary policymaking autonomy.³⁹ Equal shares or symmetry of major countries who cannot agree on substance offers no way out of this problem, since it makes efficient and coherent management of the regional monetary regime unlikely, with the major players being able to block each other's policy initiatives.⁴⁰

Against this backdrop Sino-Japanese currency competition can be summed up as a struggle for securing the highest degree possible of domestic policy autonomy in any move towards a regional exchange rate arrangement. Regional currency rivalry between the two powers is then about promoting the own currency as anchor currency and preventing the rival currency from establishing a dominant role.⁴¹ Furthermore, neither China nor Japan can afford to agree to a powerful self-governing AMF which technically resolves the problem of currency rivalry by given them both equal say. Both for China and Japan the other's national currency regime is unacceptable as basis for managing an AMF/ACU regime. For Japan, the Chinese, caught in the dilemma of keeping an inconvertible RMB undervalued and rising domestic inflationary pressures, cannot currently offer a currency regime which could serve as anchor for regional cooperation.⁴² China, on the other side, is

38. For example, De Grauwe (1997).

39. For a good elaboration for East Asian monetary cooperation, see Kim et al. (2005).

40. Monetary political economists point out that currency hierarchy in regional monetary arrangements is a necessary structural condition for stable exchange rate arrangements to be credible in financial markets (Cohen 1998, Andrews 1994).

41. This is succinctly put, from a Chinese perspective, by two Chinese academics, who state: 'China should take effective actions to reinforce the cooperation with Japan in this field, and to ensure China the axis power and RMB the anchor currency in East Asian currencies cooperation.' Zhang, H., and Liu, L. (2009) 'Game Analysis of the Sino-Japanese Relationship in East Asian Currency Cooperation', *Contemporary Economy of Japan*, 2, abstract (grammatical mistakes in the original). http://en.cnki.com.cn/Article_en/CJFDTOTAL-XDRJ200902003.htm

42. Amyx (2008, 125) suggests that not only Japan, but policymakers across the East Asian region are concerned about the reliability of China's commitments within the CMI framework in light of the distorted political economy of Chinese currency management. On the political economy of the RMB, see Kroeber, A. 'The Renminbi: the Political Economy of a Currency', *Foreign Policy*, September 7, 2011. http://www.foreignpolicy.com/articles/2011/09/07/the_renminbi_the_political_economy_of_a_currency?page=0,0

unwilling to accept an asymmetrically strong position of Japan in an AMF and ACU-basket, concerned that this might be used by Japan to exert influence on China to liberalise its capital account, move towards full convertibility and reform its current exchange rate management arrangements (Amyx 2008, 137-8).

The different policy preferences naturally led to hard-nosed and long-dragged out intergovernmental bargaining about the shares of the yen and the RMB in the CMIM reserve pool and a possible future ACU basket.⁴³ Katada explains that Japan tried to consolidate the existing asymmetric advantage of the yen, attempting 'to lock in the existing disparity by formalizing arrangements such as the wider use of yen in the region.' China in contrast was unwilling to accept a subordinated position of the RMB.⁴⁴ Amyx confirms this assessment, explaining that Chinese suspicions about the ACU initiative by the ADB, dominated by former Japanese Ministry of Finance officials, delayed negotiations: China's concern was that the Japanese government might be using the composition and weighting of the basket to promote the yen (Amyx 2008, 134, esp. fn 18).

Finally, the institutional outcome of CMIM reflects the widely diverging national preferences of China and Japan as well as the respective strength of their bargaining positions. Firstly the two countries settled on equal shares in the reserve pool, although Japan had aimed at locking in disparity in favour of the yen. This indicates 'asymmetric interdependence' for Japan: facing a declining role of the yen in East Asian monetary relations, the Japanese administration was finally willing to compromise by accepting equal weights. China on the other side was in no hurry to enter into an early arrangement with Japan, given the ever-increasing importance of the RMB in East Asian economic transactions. Furthermore, by delegating governance to the IMF, Japan was reassured of sound management of the reserve pool despite its suspicions about the Chinese commitment to sound regional monetary policies. China, on the other hand, got with the weak CMIM governing structure and the IMF link a regime which is of little relevance as a blueprint for a self-governing AMF, allaying its concerns that it might get locked into a condominium with Japan in regional currency affairs which would preclude future Chinese currency hegemony in East Asia.

43. CMIM implementation, originally scheduled for May 2009, was delayed until March 2010 by difficulties to find a consensus on the relative shares of the +3 countries in the reserve pool.

44. (Katada 2008, 410).

7. Conclusion

Both the realist and the intergovernmentalist analysis of CMIM support the view that CMIM is 'Much Ado about Nothing' when it comes to Sino-Japanese regional currency cooperation in the foreseeable future. In the words of Kahler, the GFC 'has done little to jolt the [East Asian] region out of its institutional rut' (2011, 23). In the light of the outcomes of CMIM and the subsequent lack of substantive developments, the functionalist hopes for a spill-over from CMIM to an AMF and ACU-basket remain, for the time being, unfulfilled. Rather than leading into Sino-Japanese currency cooperation, CMIM was followed by steps of both Japan and China to reinforce and expand the regional position of their national currencies. Japan has substantially increased its bilateral swap agreements with South Korea, tying in the strategically important third player in regional currency cooperation.⁴⁵ China, for its part, is busily pushing for the gradual internationalisation of the RMB by focusing firstly on expanding its regional role.⁴⁶ In short, Sino-Japanese currency competition, post-CMIM, is alive and kicking, confirming realist and intergovernmentalist interpretations.

However, the intergovernmentalist analysis arrives at the same conclusions as realism from a rather different perspective, emphasising the domestically driven low politics of exchange rate cooperation. This does not mean that the realist and the intergovernmentalist explanations are mutually exclusive. On the contrary, they are complementary, each emphasising different aspects of the political-economic reality of Sino-Japanese rivalry. Like realism, the intergovernmentalist explanation of this rivalry poses a serious challenge to the technocratic logic of neo-functionalism. But the challenge comes from a different angle, approaching Sino-Japanese currency competition not as an exogenous security problem, but as endogenous to the political economy of currency regionalism, rooted in the conflict between regional cooperation and the desire to maintain domestic monetary policymaking autonomy. Given the fundamental differences in their national systems of capitalism, a meaningful trade-off between domestic autonomy and international cooperation, accommodating both Japan's and China's core national economic preferences, could not be accomplished.

45. See *Financial Times*, 'S Korea and Japan boost currency swap deal', October 19, 2011.

46. For a good review of the Chinese strategy to turn the RMB into a global currency, see the HSBC research report 'The Rise of the Redback' (Qu et al., 2010).

The differences between the realist and the intergovernmentalist perspective matter when it comes to the question of whether China and Japan will in future be able to cooperate. The realist viewpoint sees little objections to Sino-Japanese currency cooperation if their high politics security concerns were resolved. Since the Sino-Chinese security dilemma is essentially exogenous to exchange rate cooperation, it should become possible if China and Japan learn to trust each other. However, as sophisticated realists are aware, a mutually acceptable resolution of Sino-Japanese security tensions might require a decisive breakthrough in domestic political liberalisation in China.⁴⁷ The sophisticated realist argument is here converging towards the liberal intergovernmental position that domestic factors have to be taken into consideration to understand intergovernmental differences.

However, the liberal intergovernmentalist perspective does not see defusing regional security rivalry as the magic bullet to get serious Sino-Japanese exchange rate cooperation going. Only once domestic political-economic interests and institutions have sufficiently converged, resulting in converging national economic policy preferences, will meaningful political compromises for effective regional exchange rate cooperation become possible. In view of the vast cleavage between the Chinese and Japanese domestic political-economic structures the intergovernmentalist perspective does not give more cause for optimism than its realist counterpart. In the final analysis convergence in regional monetary policy preferences might require significant progress in China's economic and, arguably, political liberalisation for Chinese exchange rate policies and monetary governance to become more compatible with their Japanese counterpart.⁴⁸ It is unlikely that the Chinese government will undertake those changes to allow CMIM to spill over into regional monetary cooperation as hoped for by neo-functionalists, since these are domestic reforms that might go to the core of what the current Chinese regime considers their national interests.⁴⁹

47. See, for example, Friedberg (2011, 49-52)

48. In the realist logic another solution of the problem of Sino-Japanese cooperation would be for China to become economically and politically so powerful that it can enforce its hegemonic version of regional exchange rate cooperation against Japanese preferences. Grimes (2011, 104) hints at such a possibility.

49. Global Times, a Chinese government controlled newspaper, reports that in a recent White Paper by the Chinese government, released in September 2011, 'China's political system and ensuring sustainable economic and social development have been officially declared as being among China's core interests' (*Global Times*, quoted in *Financial Times*, 'China's spreading core interests', September 13, 2011).

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