

JAPAN CHAIR PLATFORM

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Asian Regional Cooperation and Global Reform after the Financial Crisis

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The world economy is entering a period of instability unseen since the 1930s, with important consequences for international peace and security. Banking crises increase in frequency with global capital flows, and such flows have recently exceeded the previous peak attained in the early twentieth century.¹ Furthermore, the international financial system faces new, destabilizing challenges. The Japanese-style economic crisis has called into doubt the efficacy of conventional economic policy tools. In addition, the economic balance of power is shifting decisively away from the United States and toward broader East Asia. In the past, such power transitions have proved destabilizing to the world economy and international peace.² Existing international institutions and arrangements are ill-equipped to handle these monumental shifts, and international cooperation within the G-20 has thus far failed to produce effective solutions. It is time to consider innovative reforms.

Challenges to Existing International Financial Architecture

From the end of World War II through the 1990s, international financial crises generally affected developing countries facing balance of payments crises. The International Monetary Fund (IMF), with the support of major creditor states and other international financial institutions, acted as an effective if controversial lender of last resort.

Recent crises have tested the effectiveness of the international financial architecture. Japan's so-called lost decade of the 1990s and similar experiences by Nordic states foreshadowed the current crisis afflicting major Western countries including the United States. The Japanese-style crisis is characterized by a vicious cycle of deflating asset prices, souring loans, weakened financial institutions, and reduced economic activity. It affects developed countries with no obvious balance of payments difficulties. Existing international arrangements cannot effectively address this type of crisis. The IMF has minimal leverage over countries that do not require short-term liquidity. Informal pressure and coordination, such as that recently pursued within the G-20, proves ineffectual as countries closely guard their autonomy over macroeconomic policymaking.

The policies required to manage these crises—massive fiscal stimulus packages, innovative monetary policy, private-sector bailouts—are politically controversial and difficult to sustain over long periods. This is well-illustrated by the policy reversals in the United States in 1937–1938 and Japan in 1997, which both served to prolong economic malaise. Paradoxically, autocratic regimes may be more effective in responding quickly and sustainably to Japanese-style crises. Among the great powers, Germany, Italy, and Japan performed far better during the Great Depression than democracies such as France and the United States. In the current crisis, the Chinese response stands out for its rapidity and scale. There is therefore room for further cooperation, particularly among democratic states, to provide mutual support and assistance for crisis response. A critical task is to provide political insulation for policymakers adopting crisis measures. One of the most unpopular steps policymakers must take during crises is bailout of private-sector actors, particularly financial institutions. Although bailout funds are often recouped as the crisis eases, large headline figures and moral outrage provide tempting fodder for political attacks. One way to address this problem is by pooling international capital in a co-investment fund. On request of the relevant country, and contingent on approval by member states, such a fund would provide capital to invest alongside national governments engaging in private-sector bailouts. This mechanism would provide a

¹ Carmen M. Reinhart and Kenneth S. Rogoff, "Banking Crises: An Equal Opportunity Menace" (Working Paper no. 14587, National Bureau of Economic Research [NBER], Cambridge, Mass., December 2008), 24.

² Charles Kindleberger, *The World in Depression, 1929–1939* (Berkeley: University of California Press, 1973).

measure of political insulation by reducing national-level headline figures and adding international legitimacy to the bailout decision. In terms of fiscal and monetary policy, formal mechanisms should be established to provide international certification and approval for national-level crisis response measures. Such certification can provide political ammunition and legitimacy for leaders and central bankers facing domestic political criticism.

A Greater Voice for Asia

A systemic shift toward East Asia also poses a challenge for the world economy. Including India, broader East Asia encompasses more than half of the world's population. The region already accounts for more than a third of global economic output, and this is only likely to grow in the future. Over the course of the twenty-first century, Asia's economic and geopolitical weight in the world will, in all likelihood, come to rival that of Europe in the nineteenth century. With Asia's dramatic rise, Asian problems will increasingly become indistinguishable from global problems.

Despite this dramatic shift, global institutions remain incongruently dominated by the West. My analysis of voting shares in the IMF indicates that Allied Powers have been consistently overrepresented compared to Axis Powers despite the passing of over 60 years since the end of World War II.³ Studies by economists and political scientists including myself show that IMF lending is biased in favor of recipients with strong economic and diplomatic ties to the United States and key European states at the expense of other members.⁴

This unbalanced representation had real consequences during the Asian financial crisis of 1997–1998, when the IMF implemented policies widely viewed as contrary to Asian interests and policy prescriptions. During the crisis, Japanese financial authorities proposed an Asian Monetary Fund as a potential alternative source of liquidity.⁵ This proposal was rejected by U.S. officials who feared dilution of IMF conditionality. However, over the past decade, East Asian states have stockpiled foreign currency reserves and gradually developed financial cooperation. The recent multilateralization of the Chiang Mai Initiative, a network of currency swap arrangements, has the potential to develop into a credible alternative to the IMF.

Unfortunately, the Chiang Mai Initiative Multilateralization (CMIM) is unlikely to be effective as a functional institution. As with the preceding Chiang Mai Initiative, the new framework will link a large percentage of lending to IMF conditionality. This stems from a fundamental trilemma for East Asian monetary cooperation. Such a fund involves three unattractive choices. First, the fund could lend unconditionally and without IMF involvement. This is problematic for major creditor states in the arrangement, such as China and Japan, which are hesitant to lend large sums with no strings attached. Second, the fund could make loans completely linked to IMF conditionality. This solution calls into question the *raison d'être* of a regional fund—simply supplementing IMF resources would do. Third, the fund could lend based on autonomous conditions independent of the IMF. Political realities make this option unpalatable. China and Japan would contribute the lion's share of funds and most likely dominate the voting power of the CMIM. Given historical tensions and transparent Sino-Japanese dominance over the proposed institution, it is difficult to see how effective conditionality could be imposed on borrowing states without igniting volatile political sensitivities.

The arrangement under development deals with this trilemma with half-measures: a small percentage of lending is available unconditionally, and the remainder is contingent on IMF conditionality. Unfortunately, this means the fund will be largely dysfunctional without IMF involvement—the sums available without conditions are insufficient to deal with a major regional crisis. However, regional mistrust of the IMF remains deep. This leaves East Asia perilously dependent on ad hoc reactions in the event of a major financial crisis.

³ Phillip Y. Lipsky, "Japan's Shifting Role in International Organizations," in *Japan and the World: Japan's Contemporary Geopolitical Challenges*, ed. Masaru Kohno and Frances Rosenbluth (New Haven, Conn.: Council on East Asian Studies at Yale University, 2008).

⁴ Among others, see Phillip Y. Lipsky, "Distributive Conflict in the IMF: Motivations and Consequences for Japan" (working paper, Department of Political Science, Stanford University, 2009); Lawrence Broz and Michael Hawes, "Congressional Politics of Financing the International Monetary Fund," *International Organization* 60, no. 2 (Spring 2006): 367–399; Robert J. Barro and Jong-Wha Lee, "IMF Programs: Who Is Chosen and What Are the Effects?" (Working Paper no. 8951, NBER, Cambridge, Mass., May 2002).

⁵ For a detailed exposition, see Phillip Y. Lipsky, "Japan's Asian Monetary Fund Proposal," *Stanford Journal of East Asian Affairs* 3, no. 1 (Spring 2003): 93–104.

Steps toward Institutional Reform

Ultimately, decisionmaking and representation in the IMF must be reformed to better reflect contemporary geopolitical realities. However, institutional reform is an excruciatingly slow process, particularly for institutions like the IMF where member states have limited leverage due to unattractive outside options.⁶

While larger questions about representation and equity are worked out, temporary measures must be instituted to ensure effective management of future financial crises. Asian mistrust of the IMF stems from insufficient influence over decisions concerning the region. There are several mechanisms to boost Asia's role in the IMF without altering institution-level voting shares. For example, members of the CMIM could be given committee status to set the agenda or preapprove IMF packages related to member states. Alternatively, selective voting share increases may be granted in proportion to CMIM contributions for decisions concerning CMIM members. To redress underrepresentation of Asian nationals among IMF staff, the capacity of the IMF Regional Office for Asia and the Pacific should be boosted to handle a broader range of issues. Intractable, zero-sum conflict over representation cannot be allowed to destabilize the international financial system. These are not long-term solutions, but they will help restore the IMF's credibility in East Asia while more general reform is pursued.

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⁶ Phillip Y. Lipsy, "Outside Options and the Renegotiation of International Organizations" (working paper, Department of Political Science, Stanford University, 2009).