4

Critiques of the CMI

Critics of the Chiang Mai Initiative and East Asian regional financial cooperation more broadly make several arguments. These fall under the headings of necessity, moral hazard, additionality of resources, political support, covariation of shocks, and worst-case scenario, each of which is evaluated below. They apply not simply to the CMI as it currently stands, which is generally regarded as benign, but also to these arrangements as they might evolve through enlargement of the swaps and the membership of the group.[1]

Necessity

Some critics argue that the CMI is unnecessary because the International Monetary Fund, the United States, European governments, and the non-Asian international community have already accommodated a large portion of the legitimate Asian objections to the multilateral response to the

1. Owing to the large differences between the two arrangements, the arguments against the Asian Monetary Fund proposal of mid-1997 are not necessarily valid against the Chiang Mai Initiative. As it was originally proposed, the AMF could have weakened the impetus for economic adjustment and compromised the centrality of the IMF in crisis management in the region. By contrast, as discussed here, the CMI maintains the IMF link, which protects the position of the IMF. Whether and under what circumstances East Asia should develop its own conditionality in the future will be addressed in chapter 7.

1997-98 crisis. The new paradigm, which began to emerge as early as the autumn of 1997, stresses or accepts standards, codes, and transparency; ex ante conditionality (as opposed to negotiating conditionality in the heat of the crisis); quick disbursement during crises; and complementary bilateral financing (as in the second line of defense). The IMF has rethought the conditionality that it applies and has developed a more nuanced posture toward capital controls. Private-sector involvement in crisis resolution is also on the agenda, although the outcome is so far inconclusive.

There have also been a number of reforms to IMF facilities. In December 1997, the Supplemental Reserve Facility (SRF) was introduced, allowing countries to draw more funds more quickly than had been possible and at higher interest rates. In November 1998, the New Arrangements to Borrow (NAB) came into effect and were activated in December. In January 1999, the hard-fought quota increase came into effect.[2] Thus the IMF's liquidity position has been enhanced considerably. It lists "usable resources" of SDR98.9 billion and "net uncommitted usable resources" of SDR66.5 billion (SDRs are Special Drawing Rights; these amounts are equivalent to $131.3 billion and $87.9 billion, respectively) as of July 2002.[3]

At the same time, there has been a sea change in exchange rate regimes, with only a handful of medium-sized emerging markets maintaining pegged rates. In East Asia, only China, Hong Kong, and Malaysia maintain fixed exchange rates; the other economies maintain exchange rate regimes with a certain degree of flexibility and have allowed rates to move substantially during the course of 2001 and early 2002 (see figure 4.1).

With the advent of the new crisis-prevention paradigm, reforms of IMF financial facilities, and the IMF's stronger liquidity position, critics argue that creating a large network of swap agreements would be tantamount to preparing to fight the last financial war rather than confronting more likely contingencies. If IMF resources must be supplemented, doing so on an ad hoc basis, as for Brazil in 1998-99, would be preferable.

Proponents of East Asian financial cooperation would argue, however, that although the IMF might have a generous liquidity cushion at the moment, those resources could be quickly exhausted in a crisis that matched the severity and contagion of 1997-98. Standing arrangements provide assurance that needed funds can be provided quickly. Even when the IMF remains liquid, access to its resources could be denied to some Asian countries for ideological or political reasons.

Even when access to IMF resources is secure, a second line of defense might be desirable or indeed necessary. The multilateral system departed

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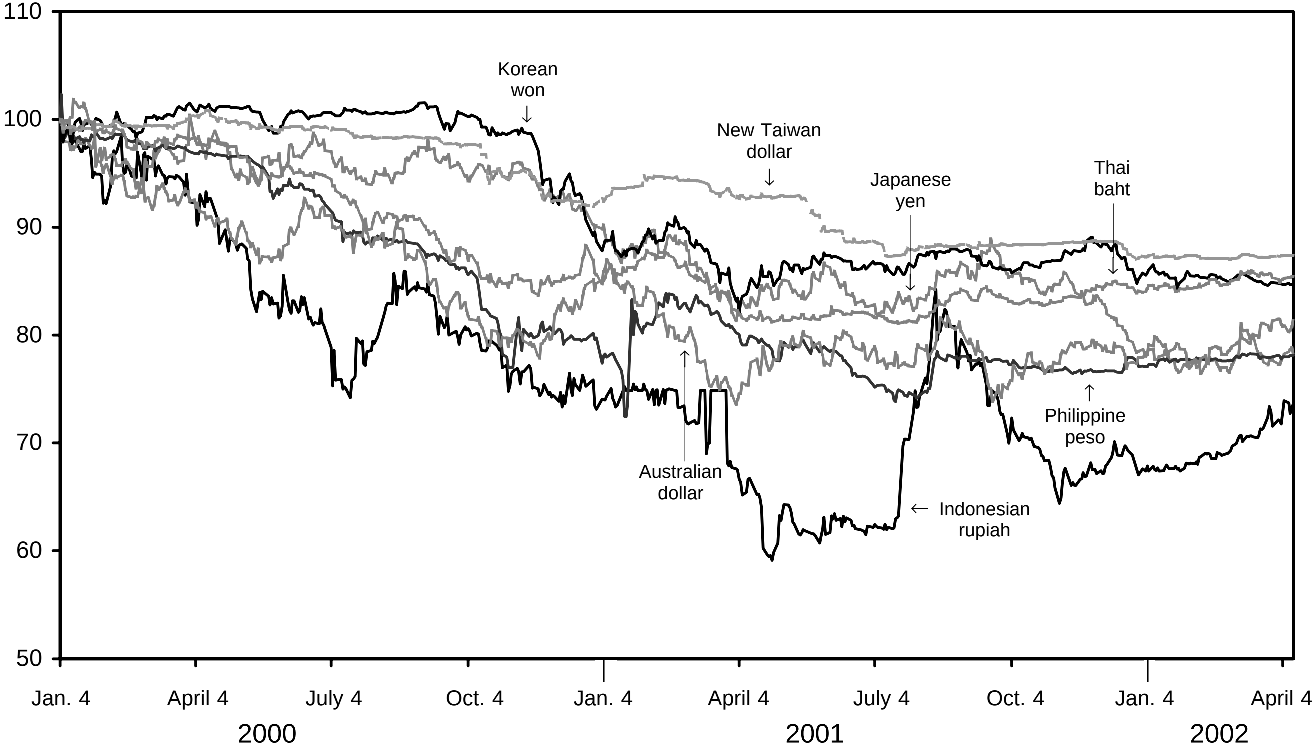
2. See the "IMF Chronology" at http://www.imf.org/external/np/exr/chron/chron.asp.

3. "IMF Financial Activities—Update, July 26-29, 2002," http://www.imf.org/external/np/tre/activity/2002/072602.htm.

Figure 4.1 Exchange rates of East Asian currencies (against US dollar; daily index value; Jan. 4, 2000 = 100)



Source: Pacific Exchange Rate Service.

from exclusive reliance on the IMF a long time ago, as we will see in the discussion of other regional arrangements. It did so most recently in 1995, when US money was provided in parallel to IMF funds for Mexico and then, at least in principle, with the second line of defense for Asian countries in 1997. Proponents note that during the 1997-98 crisis the amount of funds pledged under the second line of defense exceeded those pledged by the IMF by a large margin.[4] They decry the failure to mobilize most of those funds and note the complete absence of second-line-of-defense lending from outside the region.[5] Regional arrangements such as these could be regarded as simply another, more deliberate and reliable way to organize second lines of defense.[6]

Would regional financial arrangements such as the CMI become outmoded with the introduction of stronger regimes for involving the private sector in crisis management and resolution, such as Krueger's (2001) proposed Sovereign Debt Restructuring Mechanism? Critics might argue that regional arrangements work potentially at cross-purposes with private-sector involvement; by providing liquidity, they could reduce the incentive for private creditors to write down their claims in the face of debtors' inability to repay fully.

On this criticism, however, two observations are in order. First, a comprehensive regime with private-sector involvement is, at best, far from being adopted—with the US Department of the Treasury opting in favor of a less ambitious approach (Taylor 2002; Miller 2002), at least for the moment—and it is unclear whether such a regime could ever muster the requisite political support.

Second, any comprehensive regime involving the private sector, were it to be adopted, would not by any means obviate the need for balance of payments financing. Such a regime would require that the IMF and international community decide whether a crisis-stricken country faces default on its obligations and, if so, the appropriate mix of finance and concessions from the private sector. For those countries that do not face default, and countries that do and also require official finance as part of their stabilization packages, regional financial arrangements can play a role in the overall solution. With liberalization and increasingly

4. Rose (1998).

5. Bilateral funds that were actually disbursed exceeded IMF funds in the case of Thailand but were exceeded by IMF funds in the cases of Indonesia and South Korea.

6. On second lines of defense, see Parkinson, Garton, and Dickson (2002); Bird and Rajan (2002a); and Rajan (2001b). Proponents must acknowledge, however, that the IMF link slows disbursement to the pace of IMF decision making. The regional objective of more expeditious action is met under the CMI only to the extent that funds can be disbursed in anticipation of agreement on an IMF program, faster than IMF funds once a program has been put in place, and within the 10 percent limit below which an IMF program is not necessary.

sophisticated financial markets, progressively larger proportions of total domestic financial assets will be able to flee crisis-stricken countries, moreover, and larger financial packages may be required even when the private sector is involved.

Moral Hazard

Opponents suggest that the creation of a large standing pool of funds for crisis management would contribute to *moral hazard* on the part of both potential borrowers (governments and central banks) and international banks and investors. Originating as a response to the 1997 Asian Monetary Fund scheme, this argument is also applied to nonpooled reserves held by national central banks but earmarked for bilateral swap arrangements. The moral hazard critique represents a specific (regional) case of the general argument against international financial rescues.

Some critics worry that East Asian political authorities will mistakenly conclude that the present CMI is a bulwark against financial crises, when in fact the swap arrangements are insufficient in size to be effective. By overestimating their protection against financial crises, governments of the region could well delay adjustment, thus aggravating the severity of crises when they strike. Under this particular moral hazard scenario, the creditors refuse to activate, or activate and then fail to avert the crisis.

Governments in the region appear to be coldly realistic about the level of protection afforded by present (and even future) financial arrangements, however. The ability of regional creditors to refuse to activate the bilateral swap arrangements is one basis for their caution. The continued sense of financial vulnerability, as reflected in the extraordinary pace of reserve accumulation in the region since 1998, is another (see figure 2.1). Circumspection is also reflected in the fact that most governments insist current regional arrangements must be closely linked to the IMF and its facilities, surveillance, and conditionality.

More fundamentally, the moral hazard critique applies to the multilateral institutions as well as to regional arrangements. Analysts who believe that the moral hazard problem is intractable advocate abolishing the IMF. Opposition to regional financial arrangements is the logical extension of their arguments. Others believe that the moral hazard problem can be managed, as it is in a wide variety of other contexts, and should not bar financial multilateralism. The logic of these defenders of the IMF leaves their posture toward regional cooperation undetermined.

The dispute over moral hazard is a larger debate than we can or need to resolve in this book. Suffice it to say, to the abolitionists, that moral hazard can and should be controlled in international finance, just as it is in, for example, insurance and consumer and fire protection—through codes, regulation, and "deductibles," among other devices. Just as we would not advocate eliminating these other services, this author would not accept the abolition of financial multilateralism or deny a role for financial regionalism on the grounds of moral hazard.

To analysts in the broad (though perhaps shrinking) ideological center who defend the IMF and are skeptical of the CMI, suffice it to say that they confront a consistency problem with respect to regionalism. Specifically, they shoulder the burden of demonstrating that moral hazard is somehow more intractable in East Asian regional arrangements than at the IMF.

Additionality

Opponents question whether the financial resources supplied through a regional arrangement will be truly "additional," suggesting that other lenders, such as the IMF and the United States acting bilaterally, will reduce their contributions to crisis packages by the amount available from within East Asia. A natural division of labor applied in the cases of other regional arrangements, whereby the Group of Ten swaps, for example, provided short-term bridge-financing to longer-term IMF financing. Critics argue that, owing to the adoption of the faster-disbursing SRF at the IMF, regional short-term swaps such as those in the CMI now overlap in function with the IMF and can be expected to reduce SRF financing in particular.[7]

The validity of the additionality critique is difficult to assess ex ante. The problem arises in principle whenever there are multiple sources of finance, yet it appears to have been managed successfully in numerous historical cases. Despite the cooperative division of labor between the IMF and other regional arrangements, there were potential conflicts as well, the most prominent case being the European medium-term financial facilities. Potential conflicts were nonetheless generally avoided though coordination, which was provided in part by the United States and European governments. Rescue packages marshaled during the crises of the late 1990s suggest a "piling on" rather than "crowding out" of alternative facilities. Pledges of funds under the second lines of defense in particular do not appear to have crowded out IMF funds.[8]

Owing to the size and sophistication of financial markets, large quantities of funds are needed to confront crises. Yet, whereas the central purpose of any package must be to restore confidence on the part of private actors, the precise quantity of funds needed to achieve this

7. The CMI might do so, it is argued, in part because it offers lower interest rates than the SRF.

8. Thailand in 1997 may be an ambiguous case.

objective is nearly impossible to determine, and the "financing gap" is correspondingly difficult to estimate. The international community thus does not have the luxury of simply subtracting an Asian contribution from a confidently estimated financing gap to determine the amount of the IMF contribution. It must instead present a financing package that is likely to exceed the IMF's capacity and draw on contributions from a number of institutions; in practice, every source is welcomed.

Moreover, given that the market learned to discount the second lines of defense substantially, if not completely, during the Asian crisis, supplementary financing will have to be more credible in the future than during the 1997-98 period to be effective. The CMI is a mechanism to organize regional assistance more credibly.

The availability of multiple of sources of funds has imparted flexibility to the system of official international finance. Having to distribute the financial burden among alternative facilities is a cost of maintaining useful redundancy in the system. Whether CMI funds are additional, moreover, is at the discretion of the IMF rather than a mechanical consequence of the formation of the BSAs. The IMF can choose to maintain its commitment, if that is desirable. If it chooses to reduce its commitment by a portion of the amounts contributed under the CMI, it husbands its resources for other crises. Therefore, even if East Asian funds were not additional for a particular country, they would be additional for the system as a whole. In either case, the IMF benefits from having the option of treating Asian financing as additional or as a substitute.

Political Support

A variant of the additionality critique suggests that the international community could become less engaged and supportive of the global institutions as regional financial arrangements become stronger. In particular, some critics fear, the existence of regional financial arrangements could undercut *political support* for the multilateral institutions. This critique applies particularly to support for the IMF and multilateral development banks in the US Congress, which has been least forthcoming among national legislatures and the most insistent on setting terms and conditions on its government's participation in these organizations.

Proponents would argue that the critique mistakenly reverses the actual historical sequence of events. Congressional support for IMF quota increases has become increasingly dubious over the decades. Even in the teeth of the Asian crisis, Congress delayed granting the quota increase and approving the creation of the NAB. Only when the Russian default produced a global "flight to liquidity" in the autumn of 1998—which carried the prospect of a global recession—did Congress approve these measures. During 1999, certain members of Congress rejected the IMF's plan for selling gold to finance debt relief for highly indebted poor countries and threatened extraneous amendments, as also happened with the quota increase. A decline in US political support for the IMF preceded, rather than followed, Asian financial cooperation.

Two further considerations suggest that the creation of a regional financial mechanism in East Asia could raise, rather than reduce, political support in the United States for multilateral financial institutions. The first derives from a desire to control the terms on which financial stabilization programs are conducted and, more generally, to lead international financial institutions. As a senior US Treasury official put the case for participating in rescue packages to a prominent senator in October 1997, "You have to pay to play."[9] The prospect of the loss of US influence in East Asia and at the IMF is an incentive for Congress to support the IMF more steadily.[10]

Second, the willingness of East Asia to carry a larger share of the financial burden of crisis stabilization could well be regarded favorably in the United States. After all, "burden sharing" was a rallying cry for many members of Congress when insisting that the IMF participate along with the United States in the rescue package for Mexico in early 1995. Thus, the impact of the formation of East Asian arrangements on American political support for the IMF is, at a minimum, ambiguous.

Covariation

Another critique of the CMI springs from the observation that contagion plunged many of the members of ASEAN+3 into financial crises in rapid succession during 1997. The weakness and opaqueness of several national banking systems in the region render the group particularly prone to simultaneous crises. Members would be well advised to conclude financial stabilization agreements with countries with which the *covariation* of financial shocks is negative rather than positive. The membership of the IMF is a better group across which to spread the risk of crises.

A universal group would indeed be better inoculated against contagion than any regional group. Universality ensures that the country to which capital flees from any given crisis will be among the support group. However, the threat of contagion also creates an immediate, compelling interest among neighbors to nip a regional crisis in the bud—particularly a liquidity problem that could become a balance sheet problem across the region. Moreover, financial cooperation at the two levels is complementary: Financial risk can be spread across the multilateral system,

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9. The source for this quotation is a not-for-attribution conversation with the author.

10. Also see Bergsten (2000).

reaping the benefit of negative covariation, while regional cooperation provides several benefits (described in chapter 2). While it is insightful, then, the critique is not decisive.

Moreover, considerations of risk spreading are diametrically opposed to considerations posed by the theory of optimum currency areas (OCAs). This theory judges countries that are subject to negative covariance of shocks ("asymmetric shocks") to be unsuitable for a monetary union, unless they meet a demanding set of criteria that provide alternatives to the exchange rate as an instrument of balance of payments adjustment. Were we to accept this critique, we would reject any regional financial support for exchange rate stabilization leading to a monetary union that would be desirable on OCA grounds.

Although the monetary questions are not the primary focus of this study and will not be assessed here, some East Asian governments have ambitions for regional exchange-rate cooperation and currency stabilization.[11] Multilateral institutions and governments outside the region are averse to accepting risks associated with regional currency stabilization. Any regional currency arrangement must therefore be backed by a regional financial facility.

Finally, this and many of the other arguments made by opponents of East Asian regional financial cooperation could be used equally against plurilateral, regional, and multilateral facilities. The necessity, additionality, moral hazard, and covariance critiques, specifically, could be raised against the European medium-term arrangements, the North American Framework Agreement, and even the Exchange Stabilization Fund. The IMF itself is also a target of some of these critiques. Yet many opponents of Asian regionalism have vigorously supported and defended these other regional and multilateral facilities.

The Worst-Case Scenario

Some opponents, while unconcerned about the CMI in its present form, worry about the direction in which it might evolve in the future. (The possibilities for the development of the CMI were discussed in chapter 3.) They are particularly concerned that ASEAN+3 might not only develop more robust financial arrangements but also abandon the IMF link without first developing its own high-quality, regional conditionality. When faced with crises, governments in the region could then borrow from the regional creditor on conditions that are more permissive than those of

11. These are analyzed, among other places, in Bayoumi and Eichengreen (1994); B. J. Cohen (1998); Bayoumi and Mauro (1999); Eichengreen, Bayoumi, and Mauro (1999); Kwan (2001); Ngiam and Yuen (2001); and Adams and Semblat (2002).

the IMF.[12] Critics would point to the original AMF proposal as evidence for such a tendency on the part of the region.[13] The rest of this chapter examines the basis for this concern and the risk associated with this scenario.

Fears that regional conditionality would be "soft" or permissive rest in large measure on concerns about distortions and inefficiencies in Asian countries' banking and financial systems. Since the 1997-98 crisis, the stock of nonperforming loans in Japan and China has grown, rather than decreased, and credit has expanded quickly in some other Asian countries, where financial reform is often quite gradual. Because Asian governments take a different view than do the IMF and Anglo-Saxon governments of the evolution and regulation of these markets, the argument goes, these governments are less likely to introduce transparency, strict accounting, balance sheet restructuring, the consolidation of fragile financial institutions, and the recapitalization of banks. Consequently, they are less likely to insist that neighboring countries undergoing crises undertake such reforms. Asian officials might be prone to misdiagnosing a crisis that is actually driven by financial-sector fundamentals as one driven by fickle foreign banks and investors—a "liquidity crisis."

Some Asian institutions have sponsored research programs generating findings that emphasize imperfections in international financial markets (imperfect information, herd behavior, and contagion), as opposed to economic and financial fundamentals, as the cause of the 1997-98 crises.[14] These studies generally acknowledge the role that national policies played in generating excessive capital inflows before the crisis. Critics nonetheless fear that these lessons will be dismissed in the operation of regional financial arrangements.

Creating a regional capacity to provide financial assistance in emergencies, critics fear, could thus have two undesirable consequences. First,

12. Concerns about competing conditionality assume that regional and multilateral creditors compete to lend and thus cannot be warranted when creditors instead attempt to slough the financing burden onto one another. The conditionality and additionality critiques thus cannot be simultaneously valid.

13. In responding to the original AMF proposal, IMF managing director Michel Camdessus said, "You need a single institution in the world with a lot of credibility to negotiate with countries in crisis. If you have soft conditionality, the credibility would not be bought or found in the market. . . . It is better to have one source of conditionality. And so far only the IMF has that." (*Business Times,* Singapore, September 26, 1997.)

14. See, e.g., Yoshitomi and Shirai (2000); Asia Policy Forum (2000); and Ministry of Finance, Japan (1998a). During the 1997-98 crisis, Malaysia's prime minister criticized currency speculators, imposed capital controls, and refused to negotiate a program with the IMF (see Mahatir bin Mohamad 1999, 2000). (At the same time, however, he instituted some of the adjustment measures that the IMF probably would have required.) For an analysis of the Malaysian program by the IMF, see Meesook et al. (2001). Note that the alternative diagnosis also draws inspiration substantially from Western analysts. See, e.g., Radelet and Sachs (1998); Stiglitz (1998a, 1998b, 2002); and Krugman (1999).

the capacity could be used to bail out governments that in the past had unwisely provided guarantees to their domestic financial and corporate sectors.[15] The mere prospect of such bailouts could undercut the vigor with which governments and central banks could pursue financial-sector reform.

Second, creditor governments, such as Japan, might employ these financial facilities to bail out, effectively, their own banks with exposures to borrowing countries.[16] By lending under such arrangements, Asian creditors might socialize at the regional level the costs of guarantees made at the national level and delay needed adjustments.

Worse yet, having exhausted the BSAs without achieving adjustment, countries in the region could *then* go to the IMF. In the meantime, economic conditions in the crisis-stricken country and the region more broadly could well have worsened. Moreover, creditors within the region that had extended financing (unsuccessfully) would now have a strong interest in being "bought out," so to speak, by IMF funds and might thus advocate a softening of conditions to facilitate an agreement. This combination of economic and political pressure could well limit the IMF's choices, placing it in an untenable position.

For several reasons, however, these fears should not be exaggerated and should not lead the international community to reject East Asian financial cooperation. First, despite suspicions among some analysts that the Japanese government funneled large amounts of money into the 1997-98 crisis to the benefit of Japanese banks and corporations, statistical evidence that this occurred on a large scale is difficult to identify.

Second, though financial fragility in the region is still worrisome, supervision and regulation have improved, albeit gradually, and are likely to continue to do so. Third, and more important, the evolution and structure of the CMI to date is reassuring. In particular, the activation rules of the BSAs provide a safeguard against bailouts of international and local banks. Finally, the interests of creditor countries provide a natural check on the abuse of CMI swaps. Let us consider each of these counterarguments in turn.

Some analysts assert that Japanese financial support of regional partners during the 1997-98 crisis served to bail out Tokyo-based banks.[17] It would be correct to say that some of the money that flowed from the international community—through the IMF and, less significantly, second lines of defense—to Southeast Asia and South Korea during the crisis

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15. A number of governments in the region have clearly socialized the costs of bad lending and business decisions. For a discussion, see Haggard (2000) and IMF (1999), among other works. This temptation is not by any means unique to Asian governments.

16. Japan's original AMF proposal was viewed, both within and outside the region, as at least partly an effort to bail out Tokyo-based banks with exposure in ASEAN countries.

17. See, e.g., Green (2001, 239-57).

benefited banks and companies based in the creditor countries generally. A classic example was the drain of foreign exchange reserves from the Bank of Korea after the IMF made disbursements under the program of early December 1997. Although Japanese banks might have benefited because they had been highly exposed, European and US banks also reduced their exposures during the month.[18] This major hole in the rescue was plugged in the subsequent Christmas package with the effective standstill and renegotiation of bank debt in January 1998.[19] Though some funds "round-tripped" to Japanese banks, this problem was systemwide and not unique to Japan.[20] Involving the private sector in crisis stabilization remains a central challenge in the construction of a new international financial architecture.

Some also argue that, later in the crisis, Japan employed the New Miyazawa Initiative for the benefit of Japanese banks.[21] The NMI brought together several different support mechanisms under this roof, including traditional overseas development assistance (ODA) and more innovative short-term financing facilities. Because they have never been activated, however, the short-term swap facilities were never used to bail out Japanese banks that might have been exposed in South Korea and Malaysia, the two countries to which these facilities were nominally available. Private Japanese firms might have benefited from medium- and long-term loans under the ODA portion of the NMI. After all, pork-barreling is a long-standing criticism of Japanese ODA.[22] With pressure on the government budget and greater scrutiny of public infrastructure projects in general, among other reasons, Japanese ODA was reduced by 2.7 percent in fiscal 2001 and more than 10 percent in fiscal 2002.[23] More to the point, the

18. Whether the Ministry of Finance accepted or encouraged Japanese banks' reduction in their exposure to South Korea is an important, related issue. After the standstill began, Japanese banks were cooperative. In the Thai crisis, the ministry apparently secured a commitment from banks not to withdraw their funds, but enforcement was at best partly effective. Clearly, directives and guidance to the private sector must be consistent with stabilization.

19. See, e.g., Blustein (2001), Kenen (2001), and Hufbauer and Dobson (2001).

20. Further discussion of the behavior of Japanese banks during the 1997-98 crisis is provided in Kawai and Liu (2001), Peek and Rosengren (2001), and Callen and McKibbin (2001), among other places.

21. Green (2001). Note, however, that Kiichi Miyazawa, then Japanese finance minister, announced the initiative in early October 1998 (Altbach 1998a, 1998b; Miyazawa 1998), more than 14 months after the onset of the Thai crisis and nearly 1 year after the Indonesian and Korean crises, and thus it was not part of a Japanese contribution to those particular crisis packages.

22. For a discussion, see Islam (1993) and M. Cohen et al. (2001).

23. *Financial Times*, June 20, 2001, 12; Ministry of Finance, *Highlights of the Budget for FY 2002*, Tokyo, February 2002.

debate over ODA is largely removed from short-term financing in crises; and Japan's record on the short-term facilities is far more relevant.

Regarding domestic financial reform, many countries of the region have some distance to travel before reducing financial fragility to desirable levels and introducing robust regulatory regimes. Across the region, however, financial-sector reform is generally moving in the right direction, with the support of IMF standards, codes, and programs. Both South Korea and Japan have agreed to conduct Financial Sector Assessment Programs with the IMF. Any inclination to use regional facilities to bail out one's own banks is more likely to decline than to rise over time. Although progress is admittedly uncertain, this consideration should provide mild consolation to those fearing the worst case.

More compelling, the evolution of the CMI to date is reassuring, and the structure of the BSAs provides safeguards against abusive activation. The facilities are moderate in size, their activation is linked to the IMF in almost all cases, the term is short, review is frequent, and interest rates are significantly above normal IMF standby loans. These features reflect the natural preferences of the prospective creditors in the region and retain a central role for policy conditionality. In their discussions with ASEAN governments, Japan, South Korea, and China have insisted on tough terms. These features suggest that, contrary to a good deal of academic discussion in East Asia, these arrangements do *not* reflect the alternative diagnosis that crises are exclusively or primarily capital-account-driven liquidity problems.

The activation the BSAs would be joint and equiproportionate. If Thailand, for example, were to request activation, it would draw on its lines with the Northeast Asian three simultaneously rather than sequentially (i.e., rather than exhausting the swap with China, and then that with Korea, before drawing on the arrangement with Japan).[24] It is highly unlikely that China, for example, would be willing to provide money that was used to bail out Japanese banks. Any refusal by China to activate would cast the spotlight on Japanese motives, undermine the credibility of the package, and put the Japanese government in a tenuous domestic political position. Thus, the CMI activation rules provide an additional safeguard against abuse.

Critics might then ask whether the current arrangements are any guide to how regional finance might be developed in the future. Clearly, there are different views in the region on the future evolution of the CMI. Some countries might wish for quick-disbursing, low-conditionality regional facilities to combat creditor panic, and might underestimate the potential for a fundamentals-driven crisis. Others vigorously oppose the suggestion and continue to insist on the IMF link. Moreover, the

24. Korea would have the right to opt out if it were concerned it could fall victim to contagion.

interests of creditors continue to militate against indulging such financial regimes among regional partners. Willingness to bankroll the mistakes of other governments would require regional solidarity that is simultaneously (1) very high and (2) economically misguided. Such solidarity is simply nowhere in sight in East Asia.[25] Nor is any consensus that policy fundamentals are irrelevant to crises likely to emerge.

Moreover, whereas critics fear that financial system fragility could hijack regional financial cooperation, there is a distinct possibility that the latter could reinforce the determination of governments to address the former. Squarely confronting banking fragility creates pain in the short term but benefits over the long term. Because realistic acknowledgement of nonperforming loans will expose weaknesses in banking systems that might not have been fully discounted in international markets, there may be considerable "first-mover" *dis*advantages, which would be especially compelling for myopic governments.[26] Regional facilities, though not decisive, could encourage East Asian governments to take more ambitious steps toward financial-sector restructuring by providing greater reassurance that external financial stability can be maintained.

Those who fear the worst-case scenario raise concerns that have some merit. The countries of the region should pursue financial restructuring and be guided in that effort by multilateral codes and standards. Any regional arrangement, whether or not it develops its own conditionality, should coordinate its policies and operations with the IMF. This coordination must take place at the outset, rather than only after a regional effort might have failed to stabilize a country in crisis.

To protect itself from misguided regionalism, the IMF can protect itself by drawing on a little-utilized provision of its Articles of Agreement. Recall the possibility highlighted above that the IMF could be placed in a disadvantageous position by a regional arrangement that provided financing too easily—forestalling adjustment and aggravating the ultimate crisis. When the desperate borrower belatedly approaches the IMF, under this scenario, the IMF might not wish to have the proceeds of its loans redeem the outstanding swaps. Article VI (Section 1) states: "A member shall not use the Fund's general resources to meet a large or sustained outflow of capital. . . ." Because any payment by the borrower to the swap creditor would be a capital outflow, the IMF can threaten to invoke this clause in cases where it is concerned that swap funds might flow too freely.[27]

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25. The views that (1) the members of the region are insufficiently committed to cooperation and (2) the worst-case scenario is likely cannot logically be simultaneously held, because the premises of the two are in conflict.

26. I thank Edward M. Graham for this insight. See also Graham (2001) and Dobson (2002).

27. I thank Michael Mussa for this suggestion.

The concerns of critics are best addressed by instituting such safeguards against abuses rather than by opposing East Asian financial cooperation entirely. Long before East Asia could possibly develop its own conditionality, it would need to enhance the regional dialogue on policy, reinforce surveillance, and introduce serious discussion of exchange rates and external monetary policy. All of these steps are desirable in and of themselves. Any uncertainty about the future of the IMF link and the character of prospective regional conditionality should not discourage the international community from supporting Asia in taking such steps. The international community should instead support regional cooperation and work to ensure that it remains on a constructive path. For its part, ASEAN+3 can continue to provide assurances to the international community—both verbal and concrete—that it will not throw money at crises irrespective of underlying policies or the behavior of the private sector.