Korea's Regional Financial Cooperation: Implications of Bilateral Swap Agreements and the Emergency Liquidity Fund in Northeast Asia*

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Abstract

This paper seeks to examine the prospects for regional financial cooperation in Northeast Asia in the midst of the worldwide financial crisis. Asian economies have been staggering as a result of the global crisis: China's rapid economic growth has been slowing down, Japan's exports dropped precipitously, and South Korea's economic growth dropped to its lowest level in a decade. In an effort to combat financial adversity and to secure liquidity, the finance ministers of China, Japan, South Korea and the 10 member nations of the Association of Southeast Asian Nations (ASEAN) agreed to launch an emergency liquidity fund of $80 billion in February 2009, which was expanded to $120 billion the following May at the Asian Development Bank's annual meeting. The 13 countries will also set up a $500 million guarantee for bonds issued in the region. Although the swap agreements themselves have had little effect on markets since they were widely anticipated, reviewing the background of the agreement will allow assessment on whether the current global economic crisis will serve as a critical juncture that can push the three main economies of Northeast Asia toward a new level of regional financial cooperation. While such efforts may be emergency responses to boost immediate liquidity, the creation of a common currency still remains a question in Northeast Asia, even after the countries of the region have faced two decade-long economic crises in a row. This paper examines the limitations of bilateral swap agreements, what these limitations imply for prospects for regional financial integration in Northeast Asia, and the interests of South Korea as a middle power.

I. Introduction: Northeast Asia's New Critical Juncture

Asian Financial Crisis compels interaction among NEA countries

Since the 1997-1998 Asian Financial Crisis, vulnerability to external financial shocks had been perceived as a potential threat to Asian economies. In Northeast Asia, South Korea was the hardest hit among neighboring nations after the economies of Thailand and Indonesia collapsed in turn. During the Asian Financial Crisis, South Korea went from the most successful story of economic development to an economy dependent on IMF rescue packages. The damage was not limited to South Korea alone. Although foreign direct investment in the form of factories prevented a rapid capital flight in China, its GDP growth slowed in 1998 and 1999 due to the crisis, causing the Chinese government to take measures to fix its weak financial structure and wean its heavy reliance on trade with the U.S. and Japan.

Before the Asian Financial Crisis, an *organizational gap* prevailed in Northeast Asia due to the absence of a power balance and different state structures.[1] While it was widely understood that Northeast Asia featured the paradox of growing economic integration and stagnant political cooperation, the Asian Financial Crisis was a turning point for regional institution building in the region.[2] The Asian Financial Crisis inevitably made East Asian countries aware of the need to promote regional financial cooperation to prevent further crises and retain stable economic growth. Northeast Asia remains a region of high potential growth for interdependence and cooperation but nevertheless a region that still demonstrates a relatively slow integration.

Korea's Economic Setbacks and its Struggle to Secure Financial Liquidity

The exchange rate for the Korean Won against the U.S. dollar has depreciated considerably since late 2007. Since the second quarter of 2008, the local currency showed abrupt rises and falls. With the current global crisis unfolding, the fluctuation of the Korean Won has worsened owing to current account deficits and double mismatch (currency mismatch and duration mismatch). Stabilizing the currency is a burdensome task for the Bank of Korea despite its efforts to manage the Won with its foreign exchange reserves of over $200 billion.[3]

In an effort to secure liquidity, the Korean government signed a temporary bilateral swap agreement with the United States in October 2008 for the total amount of $30 billion. However, the swap, understandably, did not solve the core problem. Having experienced a tumultuous breakdown of the economy during the Asian Financial Crisis, South Korea cannot be too careful in constructing a preventive method. In this respect, South Korea may have far more interests in building a mechanism that prevents a regional crisis than the neighboring major economies of China and Japan. Other than securing future assistance for liquidity from the United States, it may well seek regional alternatives and secure all the help it can from nations overseas should a severe currency crisis occur. For South Korea, the policy significance of ensuring its people that the country will not go through the same routine under harsh IMF conditions for rescue packages also appears to be a motivating factor in actively participating in the renewal of the Chiang Mai Initiative (CMI).

Combined Efforts for Crisis Prevention since the Asian Financial Crisis

Since the Asian Financial Crisis, East Asian countries inevitably became interested in building a regional crisis prevention mechanism amidst the evolving financial architecture. Financial liberalization and globalization may have allowed for easier paths for investment at home and abroad for many of these countries, enabling further economic growth. However, the interdependent characteristics of the global financial structure have also increased the financial vulnerability of East Asian countries and the danger of contagion of financial crises within the region and worldwide.

With economic interdependency on the rise, Japan, as the financial hub of the region, has been taking the lead in promoting financial cooperation together with the rest of the ASEAN+3 member states. Japan's initiatives had been fairly clear and straightforward, despite U.S. opposition to its proposal of establishing the Asia Monetary Fund in the aftermath of the Asia Financial Crisis, and its failure to internationalize the Yen. However, as much as the regional scheme is in hand, Japan cannot go it alone without the motivated participation of China and South Korea. For many of the countries in the region, negative experiences with IMF rescue packages that caused domestic turmoil and economic strain remain another reason for seeking alternative solutions such as cooperation within the region.

Setting up a network of currency swap agreements was the core of the CMI, established in 2000 as a framework for bilateral swap agreements between the main economies of the ASEAN+3 – the five original members of the Association of Southeast

Asian Nations, plus China, Japan and South Korea. Under these agreements, countries are obligated to exchange currencies for a limited period of time and then return the original amount. What has caught the attention of some in the course of ASEAN ministerial meetings is the legalization and multi-lateralization of the CMI. Over the past two years, the CMI had transformed from a bilateral mechanism for supplying liquidity to a state that signed currency swap agreements to a multilateral mechanism in the form of a legally binding agreement to affect reserve pooling for all member states in the event of a financial crisis.

While the functions of the CMI have yet to take effect and assessing the efficiency of the CMI pooling remains a task for the future, it is important to address the details of country-specific interests that escalated to the agreements. Bearing in mind that these developments are a relatively big leap in the process of institutionalization and a step forward towards financial regionalism, the main question for this paper is three-fold. First, what are the regional political dynamics behind the regional currency swap arrangements? Second, will the current economic crisis suffice as another critical juncture for solidifying different forms of institutionalization in Northeast Asia? And last, what do the recent changes in the CMI imply for South Korea?

The paper first provides the theoretical framework and levels of analysis for emerging financial regionalism in Northeast Asia, and proceeds to the domestic and regional interests of respective countries for regional financial cooperation. For a global perspective, the paper also notes the recent decisions in the G-20 Summit that are relevant to the regional interests of Northeast Asia and explains how Northeast Asia's regional integration is balanced from outside the region. The renewed CMI mechanism is reviewed in detail, accompanied by evaluations on prospects and possible shortcomings. The paper concludes with policy implications for South Korea when it comes to regional financial cooperation in Northeast Asia.

II. Northeast Asia's Emerging Financial Regionalism: Theoretical Framework and Levels of Analysis

1. Theoretical Framework of Cooperation and Institutionalization

Realist and Neo-Liberalist Approaches

a. Economic Statecraft: The Important Role of States

Before discussing regional financial cooperation, the role of states in the region must be examined in order to understand the interaction of states in Northeast Asia. Prior to the Cold War, the overwhelming military threat created regional power instability that enforced competition and intense rivalry among the countries. Considering that the foreign policy decision-making process ends at the state level (i.e. states are sovereign), the economic statecraft of a sovereign state is essential because it is a useful option by which governments can pursue their foreign policy objectives. In explaining economic statecraft in the realm of real politics, it is assumed that nation states will take advantage of the international trading system.[4] This was especially the case for countries in Northeast Asia in the decades prior to the Asia Financial Crisis.

States in the global financial system also follow the same logic. As claimed by proponents of the hegemonic stability theory, the hegemonic power reigns and controls the international economy, and despite the fact that the EU and China are chasing at its tail, the United States is still the biggest economic power in the world.[5] It is true that states are leveraged by internationalization and economic interdependence; however, governments are still in control. States are still the main decision makers of monetary and fiscal policies. Because of the fundamental *raison d'être* of states (i.e. exerting national interests), economic interdependence *formulates* and even *manipulates* state behavior but does not take full control over their sovereignty or autonomy. Additionally, it is inevitable that the financial capability of a state is manifested with a degree of clarity through the exertion of its foreign economic policy.

b. Power and Interdependence in Regional Financial Politics

While acknowledging the prominent role of states in the international system, the increasing roles of non-state actors, transnational corporations, and international institutions have gradually gained importance in explaining the international political economy. It is almost impossible to explain power politics among states without emphasizing the growing interdependence of today.

Keohane and Nye's attempt to integrate dominant realist traditions and liberalist ideas emphasize the expansion of economic interdependence and globalization. It is apparent that states are forced to adapt themselves to a growing economic interdependence. In a vast and complex network of trade, states recognize that the existence of other states provide them with markets and sustain the world economy, and that cooperation is a must for survival.[6] Whether they like it or not, there is no choice for states but to deeply consider the trade-offs of participating in a multilateral scheme. This can also be applied to the cases of crisis management which requires the concerted efforts of all countries involved.

2. Levels of Analysis: Domestic Politics and Regional Power Issues

International Level: Seeking for Market Stability and Regional Cooperation

The Asian Financial Crisis exposed the dangers of a fixed exchange rate and capital account opening in economies where banking and financial institutions were ill prepared to cope with a flood of short-term capital.[7] During the Asian Financial Crisis, the countries that received the most damage followed IMF guidelines and received rescue packages without making alternative decisions. In criticism of IMF's structural adjustment policies, countries in the region that went through difficult times because of IMF naturally became reluctant to accept the core policies of the so-called 'Washington Consensus.'

In the past decade, scholars have pointed out that all the IMF did was make East Asia's recessions deeper, longer, and harder. To restore foreign confidence in Asian investments, the IMF first provided rescue packages in the form of bailouts to sustain the exchange rate, and then encouraged East Asian countries to raise interests (up to 25 percentage points) to attract foreign capital. Stiglitz argues that rather than attracting foreign capital, the sustained rate allowed the rich to convert their money to dollars and move it abroad, resulting in capital flight. He also criticizes the IMF for forcing many indebted domestic firms into bankruptcy which further weakened the economy.[8]

At the core of the crisis was the flow of speculative money. Some of the countries wanted to impose capital controls, but many, like South Korea, were afraid to go against the IMF and so did not. But other countries like Malaysia and China, rejected IMF policies, implemented capital controls, and gradually opened up their markets as domestic industries strengthened. These countries suffered less than Thailand and South Korea. Northeast Asia's prior experience with the IMF has created a sentiment in which sole reliance on the international institution can no longer be taken as a remedy in the event of a financial crisis.

In addition, the Asian Financial crisis compelled the countries in the region to shift away from de facto U.S. dollar-pegged regimes to flexible exchange rates.[9] Given the negative national sentiments caused during the IMF assistance period and the relatively smaller scale of the crisis compared to a decade ago, South Korea has decided not to apply for IMF assistance to respond to immediate domestic financial needs.[10] However, it is difficult to imagine how the CMI as a regional framework will function independent of the IMF. As it will be elaborated in the following section, 80 percent of the total amount of currency swaps is bound by IMF's measures. The CMI is not designed to replace the IMF, and the IMF will continue to have a role in providing surveillance and assistance to the ASEAN+3 countries should the financial necessity arise.

The financial interests of ASEAN+3 gradually fall into piece when the countries face liquidity shortage. The global economic crisis has evidently provided a new critical juncture in which Northeast Asian countries reassess and find both the necessity and the opportunity of regional financial cooperation rather than solely depend on international institutions for assistance. The past decade of interactions among neighboring states in the region is evidence of a leap forward towards regional integration.

Regional and Domestic Level: Financial Politics and Rivalry in the Making

Prior to the Asian Financial Crisis, Asian countries were not keen on regional integration or cooperation, owing not only to the dominant role of the financial market to some extent, but also to the role that states played in fostering inter-regional trade and capital flows.

Contest and rivalry are constant themes in Northeast Asia's monetary and regional order. China and Japan, the two biggest economies in the region are vying to be the one that makes the rules. China has shown contrasting monetary policies. It first opposed the proposal for an Asia Monetary Fund in the immediate post-crisis period but supported the currency swap arrangement some three years later. It started making contributions to the IMF, and gained accession to the WTO, while keeping its currency devalued. China's past behavior tells us that it was balancing against Japan's leading role in Northeast Asia in monetary issues.[11] However, China is now confident enough to balance Japan based primarily on its rapid economic growth. Japan, on the other hand, was the source of emerging trade initiatives derived from the benefits of regional economic arrangements within the context of its long support for a developmental structuring of the regional economy (i.e. the Flying Geese Model) and the increasing political bargaining power at the international and regional level.[12]

As a middle power in the region, South Korea had to define its pathways to protect its economic stance and national interests. While trade relations with China has become all the more important since China became Korea's number one trading partner and the largest destination of outward FDI, South Korea's relations with the U.S. and Japan matter a great deal when it comes to security issues such as a regional balance of power. At the moment, while efforts for a U.S.-Korea Free Trade Agreement have gone into a temporary stalemate due to difficulties in ratification within the U.S. Congress, South Korea is seeking various routes to keep its financial status under control and move forward. Its active participation in the G-20 Summit and its goals for free trade agreements with ASEAN countries are a few examples of its self-help behavior.

a. China

The priority of the Chinese government at this point in the crisis is to support economic growth and address concerns of its trade dependent economy. As shown in **Figure 1**, China's foreign reserves began to increase dramatically after 1990, when imports fell and exports continued to rise, producing a merchandise trade surplus. By 1993, China's trade and current accounts were in deficit, but the acceleration in inward FDI flows kept foreign exchange reserves rising for most of the remaining decade. China's joining the WTO in 2001 contributed to rapid growth in imports, but exports also expanded at a fast pace. In October 2006, China's foreign exchange reserves exceeded $1 trillion for the first time. By the end of September 2008, the reserves topped $1.9 trillion, equal to nearly $1,500 per person for the entire population of China. It remained around this level until the end of 2008 when the crisis hit as trade growth slowed and foreign investment inflows declined.

China may be well equipped with abundant foreign reserves to deal with the global economic downturn, but the government is becoming increasingly worried about the implications of rising unemployment. So far, the Chinese government's main responses have been the announcement of a $586 billion fiscal stimulus package (although the details of the package appear vague) and an aggressive loosening of monetary policy.[13] Despite these measures, there have been reports of growing unrest in several provinces in China. Workers have held protests against unpaid wages in the rural areas in which factories have closed down due to the global economic crisis.[14]

The domestic turmoil within China is assumed to be the extension of the changes in China's party state system since the liberalization in 1978. There are divided opinions on China's capitalism without democracy or a competent civil society. While some scholars believe that the Communist Party's maintenance of power owes to the *authoritarian resilience* and its successful economic development, others stress the *volcanic stability* of China in which social inequality and corruption may culminate in a nervous breakdown of society.[15] Despite the high central authority of the Chinese government, their ability to respond to issues is seriously called into question.

Scholars argue that since the Asian Financial Crisis, China has promulgated a number of significant economic and political reforms (including reforms in the private sector) due to both exogenous and endogenous shocks.[16] Though today's China may not guarantee an economic development accompanied by democratization, it has chosen the integration of wealth and power under a socialist democracy as its survival strategy.[17] By keeping its renminbi devalued against the dollar and storing up its foreign currency reserves, China is exhibiting concerns over its financial status. With its economy so intricately linked with that of the U.S., it is hard for China not to be influenced by economic crisis stemming from the U.S.

Under these circumstances, China's continued regional financial cooperation can be understood as a means of its will to maintain regional influence and a tool to ensure its domestic financial capability. While it is hard to tell whether China retains a positive view of the current regional financial cooperation, its vigorous attitude regardless of its position is a big leap forward compared to its behavior just after the Asian Financial Crisis. Not only is China balancing against Japan, but it's also implying that the last thing it wants to see is an incontrollable stage of domestic disorder coupled with the current financial crisis.

b. Japan

Japan has had a leading role in the regional economy, but has faced dilemmas in the so-called 'Lost Decade' of the 1990s due to economic stagnation. Having experienced the liquidity trap following the Big Bang policies of the Hashimoto administration in 1996, Japan was forced to rethink the liberalization of finance that occurred in the 1980s.[18] Since the decade-long recession, domestic politics were pushed to the edge in order to find ways to secure a stable international environment for its economy.

Compared to South Korea and China, Japan took more time for institutional change and political economic transitions, ironically disadvantaged by its status as a creditor nation and its domestic politics in which democracy functions without a vibrant party system (i.e. LDP has held power, with few exceptions, since 1955). Japan did not have external pressure to change in the form of IMF guidelines that South Korea had, nor the central power or the momentum to put aside a nonfunctioning communist system like China.[19]

In the past, Japan had pursued the internationalization of the yen. However, Japan simply cannot afford to be a key currency country; the amount of yen in circulation in the international economy is far less than that of the dollar, and it cannot burden itself with significant damage to its economy nor bear responsibility for other Asian countries in the event of another Asian Financial Crisis. As internationalizing the yen is not feasible, taking the lead and moving towards establishing a regional currency seems to be Japan's rational choice.

Japan has been participating within the CMI framework, but it has not yet expressed interest in another common Asia Monetary Fund since the current financial crisis. The ambiguity of Japan's position may be because its Asia Monetary Fund proposal was turned down by the U.S. a decade ago. Instead, during the G-20 Summit held in November 2008, it has suggested an increase of IMF funds for developing nations and bigger roles for China and other Asian countries.

For Japan, it is only rational that it strategically adheres to the U.S.-centered international financial order involving the IMF, based on its long historical alliance with the U.S. However, utilizing the IMF system to support developing nations would lessen the risk of moral hazard in a possible regional financial cooperation framework outside the IMF umbrella. In the long run, building a stronger foundation from the beginning stage is definitely another option for Japan.

c. South Korea

During the period of economic revitalization under the Kim Dae-jung administration just after the Asian Financial Crisis, South Korea enforced domestic corporate restructuring. Externally, it saw how closely the financial crisis was connected to the regional economy and sought for regional initiatives to prevent potential financial crises.[20] However, the economy slowed down considerably during the Roh Moo-hyun administration, and domestic and foreign policy issues were mixed and did not gain full public support.

A decade after the Asian Financial Crisis, President Lee Myung-bak seemed to suffer considerably from the same public discontent during his first few months in office. Specific agendas during the presidential campaign were not implemented, and domestic policy directions were swayed greatly by public opinions, culminating in the exchange of leadership in the Ministry of Strategy and Finance (formerly Ministry of Economy and Finance).[21]

To make matters worse, in the aftermath of the late President Roh Moo-hyun's suicide in May 2009 which may have stemmed from investigation on corruption led by the incumbent administration, the support rate for the Lee administration dropped to a dismally low level. Unfortunately, these events coupled with North Korea's missile tests have caused great public disarray and domestic protests, leaving out the opportunity for the administration to pay close attention to regional policy initiatives.

In dealing with the global economic crisis, the Lee administration along with the Financial Services Commission and the Korea Fair Trade laid out ten action plans aimed at creating jobs, boosting corporate investment, and supporting the low-income class.[22] The fourth plan addresses the government's willingness to increase efficient foreign exchange liquidity. The Korea-U.S. currency swap line will be used prior to other liquidity supplies for funding domestic banks. With $55 billion worth of foreign currency liquidity provided by the government and the Bank of Korea, domestic banks are expected to repay their external debts in the first half of 2009.

As a middle power among great powers in the region, Korea's rational choice would be to continue to be on good terms with China for economic gains, while seeking for improved relations with Japan as a long-term strategy.[23]

III. The Politics of Providing Liquidity: The Multi-lateralization of CMI

1. Structure and Current Status of the Chiang Mai Initiative (CMI)

The Chiang Mai Initiative (CMI) was intended to establish a network of bilateral swaps, aimed at greater monetary cooperation and reserve pooling among Asian countries. Initially, the CMI consisted of two regional financial arrangements: the expanded ASEAN swap system, and the network of bilateral swaps and repurchase agreements among eight members of ASEAN+3.[24] The relative augmentation of official reserves of respective IMF member countries shown in **Figure 2** reveals the self-interests for securing liquidity as well as the innate capability for reserve pooling among neighboring countries.

Based on basic principles and operational procedures for bilateral swap transactions, a crisis country borrows from other CMI member countries the amount of money it would transfer in its local currency for the temporary period of the swap. After the swap period, the crisis country would pay back the lender countries in U.S. dollars with interest set by IMF drawing rates.[25] Such a framework is essential because a stable financial environment is needed to enable dynamic trade and transactions and to attract inflows of foreign direct investment in the region. **Figure 3** is a matrix of multiple countries under the CMI framework that explains the safety nets created through bilateral swap agreements.

Current events are advancing the level of cooperation at a fast pace. Finance ministers from 13 countries in East Asia announced after a special meeting in Thailand in February 2009 their agreement to launch an emergency fund. In early May 2009, the total amount of the February agreement for an emergency liquidity fund was $120 billion.

With China (including Hong Kong) and Japan providing $38.4 billion each, and South Korea offering $19.2 billion, the three economies in the region will contribute 80 percent of the fund. ASEAN members will be responsible for the remaining 20 percent. Many East Asian countries already sealed bilateral currency swap agreements under the CMI and recently agreed to transform the individual agreements into a single fund.[26] This movement is meaningful in that it is a step forward towards a multilateral regional financial cooperation in Northeast Asia.

2. Country Specific Currency Swaps

In response to the current economic crisis, currency swap lines have been linking the Asia-Pacific region to assure liquidity flows. A number of bilateral currency swap agreements were made, renewed, and extended around the globe in the aftermath of the crash of the U.S. economy. Bilateral currency swap agreements are prevalent in Northeast Asia, where the three major Asian economies are building economic ties within themselves as well as with neighboring Southeast Asian countries.

The United States has swap lines with 14 countries. Due to its prolonged economic crisis, the United States has offered extended currency swap programs to the central banks of Australia, Brazil, Canada, Denmark, UK, the European Union, South Korea, Mexico, New Zealand, Norway, Singapore, Sweden and Switzerland. Japan will also consider an extension when its policy makers convene.

The U.S. Federal Reserve has extended currency swap lines due to substantial strains in many financial markets. The extension applies to five emergency-lending programs that provide funds or treasury securities to security brokers and money-market funds and companies that issue commercial paper and swap lines to 13 other central banks around the world. Authorized under a provision that allows loans to non-banks under unusual and exigent circumstances, outstanding loans and swaps under the programs totaled $884 billion as of January 28, 2009.[27]

Table 1. Core Bilateral Currency Swaps

Country	Country of Swap Line Establishment	Amount and Details of the Agreement
China	Japan (Signed March 2002, renewed September 2007)	$6 billion (expanded from $3 billion)
	Korea (December 2008 – Effective for 3 years)	180 billion yuan / 38 trillion KRW ($26.3 billion)
	Hong Kong (January 2009 – Effective for 3 years)	200 billion yuan ($29 billion)
	Malaysia (February 2009 – Effective for 3 years)	80 billion yuan / 40 billion MYR ($17.5 billion)
Japan	United States (considering)	
	China (Signed March 2002, renewed September 2007)	$6 billion (expanded from $3 billion)
	Indonesia (to be renewed)	$6 billion
	India (Signed June 2008, renewed January 2009)	$3 billion
Korea	United States (until October 30, 2009 – Extended)	$30 billion
	China (December 2008– Effective for 3 years)	180 billion yuan / 38 trillion KRW ($26.3 billion)
	Japan (December 2008 – until April 2009)	$20 billion (seeks to extend)

Source: Ministry of Finance, Japan; Ministry of Strategy and Finance, Republic of Korea;

The People's Bank of China; Monetary Authority of Hong Kong, United States Federal Reserve

China: Safety-Nets for Shortage in Liquidity and Further Economic Growth

With regards to reforming the global financial system, China has expressed its willingness to consider the establishment of an East Asia Monetary Fund for regional financial cooperation as a *helpful complement* to the existing financial system. For currency swap arrangements, China's central bank governor Dai Xialong announced China's active participation to achieve a win-win globalization.[28] However, the Chinese intent to take the CMI to a higher level of institutionalization is not clear at this point. Nonetheless, securing a stable ground for export within ASEAN countries is all the more important for China. Also, as exhibited through the struggles and processes of negotiation with Japan for the maximum proportion of funds it will contribute to the CMI, standing in the front line of regional movement without getting behind is a visible goal of China.

Japan: Overcoming Dilemmas and Leading in Financial Regionalism

Japan's role in implementing the CMI is being emphasized at home and abroad. The Bank of Japan has bilateral swap agreements with China, Thailand, South Korea, Indonesia, Singapore, the Philippines, and India. Scholars are expecting that Japan will take the lead in monitoring banking and capital market conditions in Asia. The Japanese government is well aware of the regional interdependence and economic ties between Asian countries, and there are speculations on the declining dollar. In the case that the Euro does not take over the dollar, a stable currency block may be a desirable option in the region.[29]

Korea: Political Changes and Diplomatic Efforts for Survival

While a bill for a U.S.-Korea FTA will likely not pass in the U.S. Congress in the immediate future, striking a deal with currency swap lines is highly desirable for the Korean side. Considering the fact that the U.S. responded reluctantly due to their different credit ratings (the U.S. credit rating is AAA, while Korea's is A), this bilateral currency swap agreement is said to be the outcome of diplomatic efforts and negotiations based on the interest of the two countries. The U.S. signed the agreement for safety reasons, fearing a *reverse spill-over* in which the financial instability of a newly emerging economy spills over to an advanced economy.[30] The Bank of Korea is reported to have approached the U.S. after the extension of the agreement for a further increase in the amount of the swap, but was refused due to the impartiality of the U.S. towards other countries with swap lines.

3. The Impact of Currency Swaps on Trade Relations in the Region

Efficiency of BSAs Being Tested in Northeast Asia

Bilateral currency swap agreements since the Global Financial Crisis in 2008 may appear solely to be the escalation to regional financial cooperation from the outside, but in actuality, the efficiency of the Chiang Mai Initiative for deepening regional financial integration is currently being tested. On the bilateral currency swap agreements derived from the Chiang Mai Initiative in the aftermath of the Asian Financial Crisis from 2000 to 2006, economists have stated that the swap arrangements might have been self-defeating because to the extent that financial integration increases the correlation of shocks hitting the region, it also undermines the credibility of bilateral swap arrangements. It is also widely understood that bilateral swap agreements may affect reserve accumulation of the countries involved due to moral hazard.[31] This necessitates the monitoring and surveillance functions among member countries of the CMI.

Limitations of BSAs under the CMI

While the efficiency of bilateral currency swap will require some observations in the long run, the multi-lateralization of the CMI retains several limitations.

First, considering the external mobile capital of members of the CMI, $120 billion is not sufficient for a rescue package during a financial crisis. One may take into account that the scale of the emergency liquidity fund sprung from the CMI does not correspond much to the massive amount of accumulated foreign reserves in China, Japan, and South Korea. Countries are garnering sources for self-help rather than seeking for multilateral cooperation.

Second, CMI is not a completely systemized mechanism regardless of the fluctuating dollar. The currencies of the ASEAN+3 countries are swayed by the exchange rates of the dollar and local currencies. In this respect, the multi-lateralization of the CMI may be meaningful only in that it can be used to partially coordinate exchange rates.

Third, the CMI has not yet been functional. In the end of 2008, towards the escalation of the crisis, there were periods during which the currencies of South Korea, Indonesia, and the Philippines were depreciated against the dollar. 20 percent of the emergency liquidity fund under the CMI that could have been used to test the actual functioning of the CMI did not come into play. Instead, South Korea and the U.S. signed bilateral swap agreements, revealing the necessity of liquidity security, but lessening the credibility of the CMI to a greater extent. In turn, other CMI member countries may manifest their intent for self-help through bilateral swaps rather than seek for help in the multilateral framework. The CMI will not prove useful until it has actually been used.

Northeast Asia Balanced from the Outside: Recent Developments of the G-20 Summit

Despite the gradual transformation towards financial cooperation, there are obstacles and limitations to legalization and institutionalization in Northeast Asia. So far, the Asia-Pacific region has demonstrated a relatively low level of legalization. This being the case, the role of states in the process of institutionalization is critical. Institutional choices are a fundamental means to accomplish other strategic national goals, and the choice of legalization is highly dependent on other actors.[32]

Seen from a global perspective, East Asia's financial regionalism and its institutionalization are balanced from the outside. The impact of the U.S.-led global economy is still prevalent in all East Asian countries; the launch of a common currency in the region or the creation of an Asia Monetary Fund could be seen as a rash agenda of the U.S and other European economies.

The Group of Twenty (G-20) Finance Ministers and Central Bank Governors was established in 1999 to bring together systemically important developed and developing economies to discuss key issues in the global economy. The G-20 is an informal forum that promotes open and constructive discussion between industrial- and emerging-market countries on key issues related to global economic stability.

Not surprisingly, issues concerning alternative key currencies other than the dollar were not fully addressed during the G-20 Summit held in London in April 2009. Instead, the G-20 economies decided to enforce the functions of existing international financial institutions while working towards the recovery of the global economy. Agendas against protectionism to encourage international trade and investment were emphasized. The G-

20 Summit depicted the need for an effective response to global financial and environmental issues. The growing institutionalization of the G-20 Summit hints that it may replace the G-8 Summit meetings someday.

IV. Conclusion: Implications of Developing Financial Regionalism in Northeast Asia

Policy Implications for South Korea

Following the Asian Financial Crisis, South Korea has witnessed and self-assessed the weak points of its financial and economic structures. Due to the inherent security issues in the Korean Peninsula, dovetailing North Korean nuclear and military issues with economic agendas is crucial for South Korea.[33] In this respect, strengthening the U.S.-South Korea alliance while strategically examining its stance and capabilities within the current international financial system and regional initiatives will foster South Korea's role-play in the global arena in the long run.

In the short run, South Korea can seek for opportunities in the regional and global arena to increase its say in global-decision making processes. Korea's proactive participation as chair of the G-20 Summit in 2010 would provide opportunities to propel its regional financial and economic agendas. The chair is part of a revolving three-member management Troika of past, present and future chairs, ensuring continuity in the G-20's work and management. As the incumbent chair, South Korea will establish a temporary secretariat for the duration of its term, coordinating the group's work and organizing its meetings.

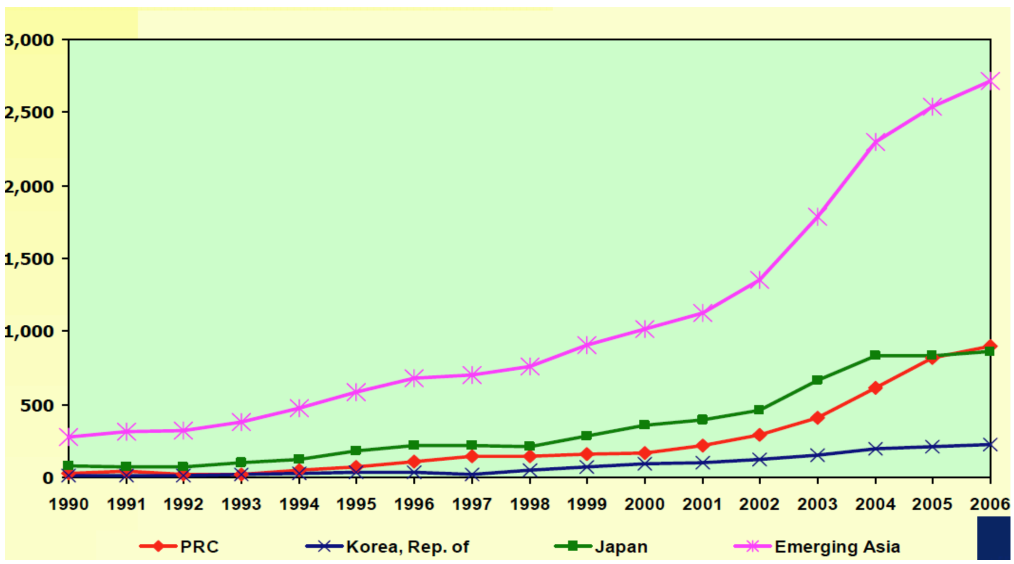
Prospects for Financial Cooperation and a Monetary Union in Northeast Asia

According to economist, Barry Eighengreen, the international monetary system has only two options: flexible rates and the creation of a single currency such as the Euro. In the case of EU, creating a monetary union would require reciprocal financial cooperation and political will amidst economic transitions. So are there lessons to be learned from Europe?

Within East Asia as a whole, if CMI members were to agree on multi-lateralization and the creation of a regional surveillance unit, their agreement would be equivalent to establishing an institution similar to a regional monetary fund.[34] However, considering the political sphere of contest and rivalry in the region, political scientists have remained skeptical of monetary cooperation or the idea of a common currency in East Asia, noting the differences in economic structures, political systems, and a turbulent history. The prospects for the immediate establishment of a monetary union in East Asia are very dim, but the recent currency swaps have raised alternative views and opinions on the issue. Economists from a theoretical standpoint have stressed the need for a common currency and financial cooperation amongst China, Japan, and South Korea. The three countries hold more than 40 percent of the world's international reserves, and trade surplus and investment opportunities overflow in Northeast Asia.[35]

Proponents of a common currency in Northeast Asia believe that although the Northeast Asian economies are not ready for a common currency yet, China, Japan, Taiwan, and South Korea should be able to form an exchange rate union where each country still has its own currency, but all of their currencies are pegged to the same anchor.[36] If not a single currency, a common currency may be the ideal option for survival in Northeast Asia.

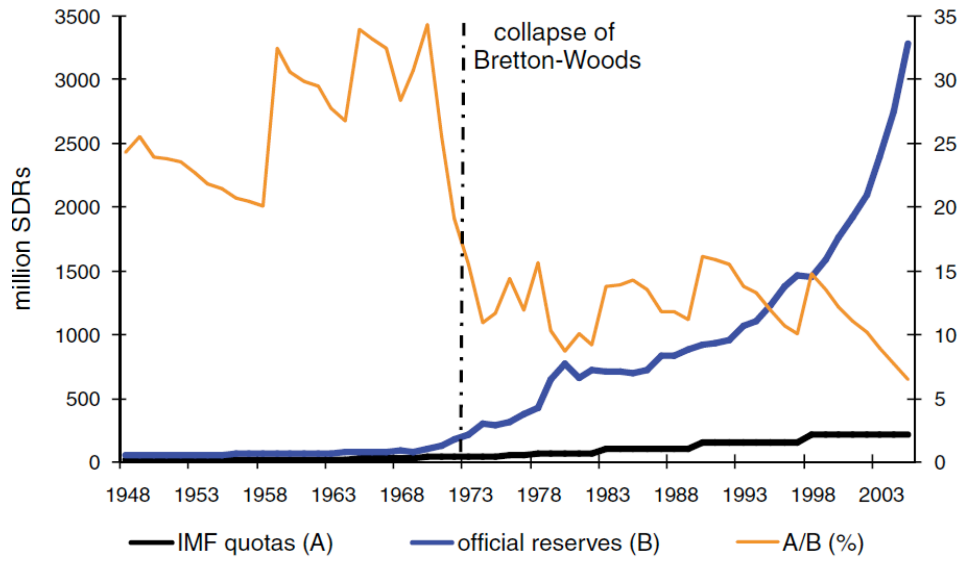
Figure 1. Foreign Reserves — Selected Northeast Asian Economies[37]



Unit: USD $ Billion

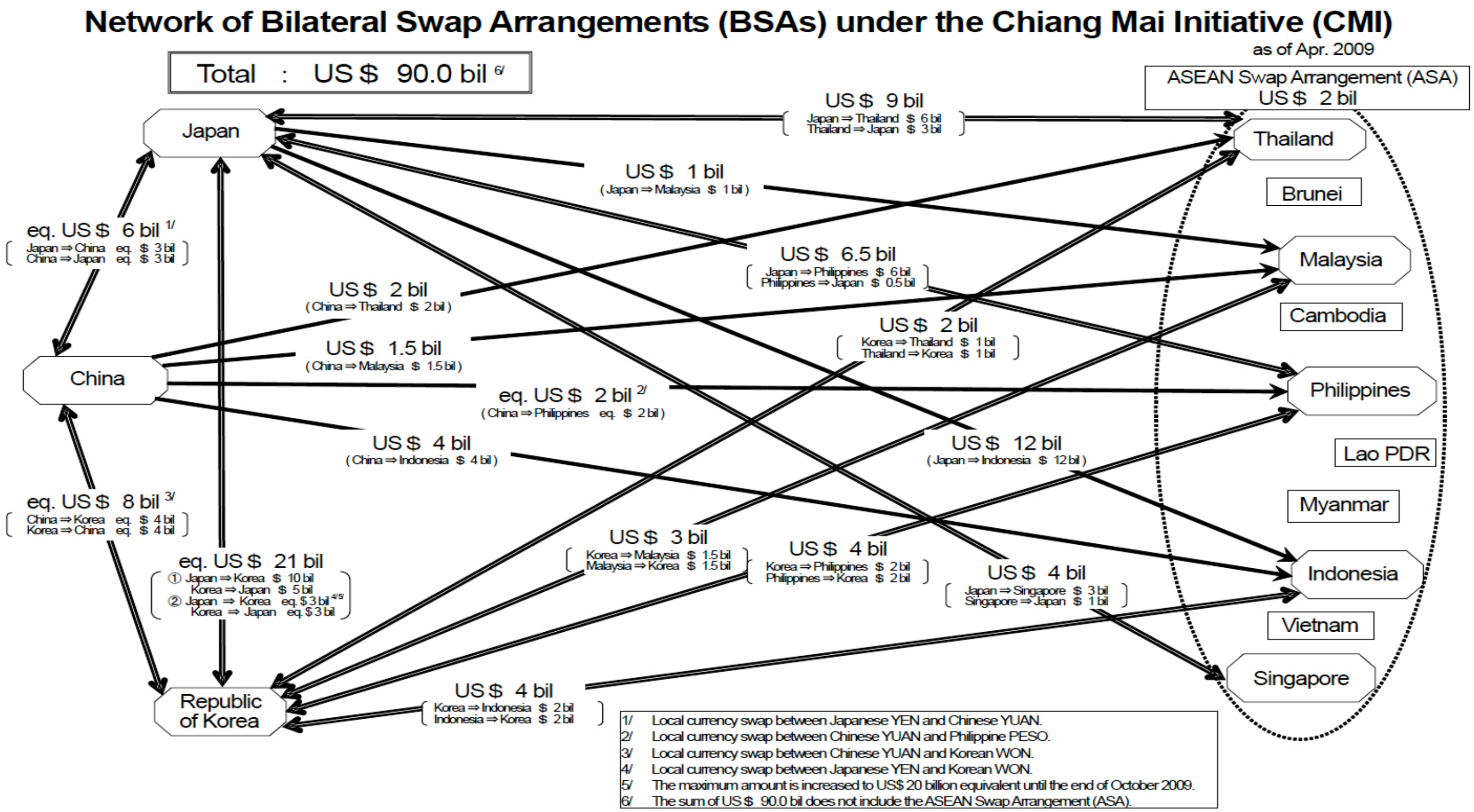
Source: Asian Development Bank Institute

Figure 2. Self-Insurance vs. Reserve Pooling via IMF



Source: IMF, World Economic Outlook Database

Figure 3. Bilateral Swap Agreements (BSAs) under the Chiang Mai Initiative



Source: Ministry of Finance, Japan, April 2009

Note: the updated version of this figure after the ASEAN Financial Ministerial Meetings in May 2009 is not available yet. As of now; the total figure is $120 billion. The updated document will soon be uploaded on the Japanese Ministry of Finance website at the following URL: http://www.mof.go.jp/english/if/regional_financial_cooperation.htm

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