

Monetary Regionalism: Regional Integration without Financial Crises

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May 2000

Abstract:

The financial crises of the late 1990s have marked a watershed for the global economy and for regionalism. Prior to these crises, deregulation and liberalisation, in particular of financial markets, enjoyed widespread support. On the other hand, regional integration was aimed at improving conditions for regional trade and was based on Bela Balassa's forty year old theory of regional integration. At the beginning of the 21st century, the theoretical approach to regional integration will have to be a different one. Regionalism will have to offer enhanced protection against financial crises, whereas trade liberalisation in an era of rapid trade liberalisation both offers fewer benefits and may be too complicated to implement due to high administrative costs associated in particular with free trade areas. The aim of this paper is to provide a theoretical framework for the emerging new monetary regionalism. Regions that wish to strengthen their co-operation in monetary and financial affairs today have the option of regionalism without trade agreements. East Asia is the most likely candidate for the implementation of monetary regionalism, also because East Asian policy makers continue to be frustrated with the lack of progress in the IMF's reform process.

Keywords: Monetary regionalism, financial crises, East Asia, IMF, international financial architecture

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1. Introduction

The financial crises of the late 1990s may have marked a watershed for the global economy. Although neither the United States nor the European Union or Japan were severely affected by the crises in Asia, Latin America and Russia, they have changed our understanding of the most appropriate economic policies in particular for developing countries. After the crises, the emphasis is different: Before 1997, the concepts of deregulation and reduced influence of governments seemed to enjoy majority support not only in the G 7-countries, but also in the developing world. Achieving high growth rates was the single most important aim of economic policy. Today, policy makers have to meet other goals of equal importance: In particular in the developing world, economic policy has to provide mechanisms against severe financial crises.

In this paper, I will argue that at the beginning of the 21st century monetary regionalism provides a plausible and potentially beneficial option for economic policy in some regions of the world, particularly for East Asia and Latin America.² Monetary regionalism offers solutions that conventional regionalism has not been able to provide: Conventional regionalism is based on trade integration and does not increase the monetary and financial linkages between participating economies until they reach quite a high level of integration. It has taken the European Union more than 40 years until such a level was reached and a common currency could have been created.³ In the meantime, the countries participating in a conventional integration project do not enjoy additional protection against financial crises: Neither with regard to the stabilisation of the exchange rate of their currencies nor with regard to the stabilisation of capital flows do conventional integration schemes strengthen the economies of their member states. Furthermore, the creation of a traditional integration scheme can make countries politically more vulnerable. This is particularly so in East Asia: The creation of a free trade area, customs union or common market would provide ammunition for American Senators in the event of a recession in the US. Asian countries could be accused of closing their own markets, but simultaneously benefiting from the open American market. Needless to say that this cannot be a tempting prospect for policy makers in East Asia or Latin America.

The improvement of the existing multilateral institutions, in particular of the International Monetary Fund, would certainly be a better choice. But today this is not a plausible option: The IMF continues to be an institution whose policies have frequently resulted in disaster, in particular

2) Throughout this paper, the term region is used for supranational regions.

in East Asia and Russia, and which suffers from too much influence of the American Treasury and Wall Street. It is a creditor cartel, not an institution primarily concerned with the needs of its clients, i.e. the member states. After the IMF was heavily criticised by observers from East Asia, now the IMF's performance is questioned by insiders: The former Chief Economist of the World Bank, Joseph Stiglitz, has in April 2000 provided a fierce critique of the IMF's policies during the crisis in Asia as well as in the process of Russia's transformation, accusing the Fund of implementing the wrong policies and being an institution that lacks both democratic structures and able economists (cf. Stiglitz 2000).⁴

The developments in early 2000 have underlined that the US administration is not willing to give up any influence on the IMF. The rejection of the first European candidate, Caio Koch-Weser, was not based on a lack of qualification of the candidate, but rather on the assumption that Koch-Weser would have represented a political position that the American government, in particular Finance Minister Larry Summers, could not share. Summers has provided us with his own vision for reform: The IMF shall, according to a proposal he made in late 1999, no longer be concerned with the financing of economic development. Rather, the IMF shall concentrate on the prevention of financial crises and on the provision of liquidity in the event of a crisis.

Although this does not seem to be a radical proposal, in fact it is. The main point is that emergency funds shall no longer be available to **all** members of the Fund. Instead, only those countries which have observed the IMF-blueprint for financial liberalisation will be given access to credits of the Fund. The centrepiece of this proposition is the by and large complete liberalisation of national financial markets. If the Summers' proposal would be implemented, American and other banks would have many new opportunities, but the developing world would suffer, for at least two reasons. Firstly, the complete opening of financial markets prior to the development of an own competitive financial system would deprive the affected countries of the opportunity to develop. The dominance of banks and institutional investors from G 7-countries would continue. Secondly, the policies suggested by Larry Summers are risky because the complete liberalisation of financial markets, as we have seen in particular in the Asian crisis, frequently results in the inflow of "hot

3) However, the creation of the European Monetary System in 1979 already provided some level of monetary co-operation in Europe.

4) Stiglitz has asked: "Most importantly, did America – and the IMF – push policies because we, or they, believed the policies would help East Asia or because we believed they would benefit financial interests in the United States and the advanced industrial world" (Stiglitz 2000, p. 10).

money”.⁵ In the absence of measures to regulate financial inflows and outflows, monetary policy becomes very difficult.⁶

In this paper, I will first look at the weak performance of existing regional integration projects in East Asia and Latin America during the recent financial crises. Surprisingly, neither APEC nor ASEAN provided any help. The trade regime in the Mercosur even caused a further spread of the crisis from Brazil into neighbouring Argentina. After a brief discussion of the deficiencies of traditional, trade-based regional integration I will introduce some elements that constitute monetary regionalism. Although the practicality of this concept will yet have to be proven, we can already witness today the introduction of some measures that may eventually result in regional integration without formal trade agreements. In East Asia and Latin America, small steps have already been taken. Finally, I will try to assess the prospects for monetary regionalism in East Asia as well as the consequences for existing multilateral institutions, namely the IMF.

2. The Asian Crisis and the failure of existing regional integration projects

The events in 1997 and 1998 have both contributed to the evolution of an Asian integration project and to the development of a new type of regionalism. The existing regional integration projects, in particular the Association of South-East Asian Nations (ASEAN) and the Asia-Pacific Economic Cooperation (APEC) have not played any significant role during the crisis.

The failure of ASEAN underlines the inability of conventional, trade-based integration to avoid the emergence of financial crises and to successfully limit their intensity. Although ASEAN is one of the oldest regional integration projects and has been in operation for more than 3 decades, it had nothing to offer in 1997. Neither liquidity nor at least good advice were provided. Instead, two ASEAN countries, Thailand and Indonesia, had to call the IMF to the rescue. ASEAN has emerged from the crisis in a damaged constitution. It has become clear that ASEAN’s current vision, the establishment of a free trade area and the continuation of its low key approach to regional integration have little future: The benefits from this type of supranational regionalism are

5) Theoretically, foreign banks could be permitted without simultaneously abolishing capital controls. However, foreign banks without access to international financial markets would probably have difficulties establishing their business quickly.

6) In the case of an economy tending to simultaneously overheat and being subject to massive capital inflows, a central bank cannot do much. Raising interest rates would increase the flow of capital into the country, an unwanted effect. Lowering interest rates would contribute to the further overheating of the economy, also not a promising prospect. The Bank of England may currently be in precisely that position in the first months of the year 2000.

too limited to warrant the effort. Successful exporters to world markets can expect very limited advantages from the creation of a free trade area in their region.⁷

For APEC, the Asian crisis that started in July 1997 has contributed to its further decline. The failure of APEC to provide any meaningful response to the biggest economic crisis in the Asia-Pacific region since 1945 has made the project less important, if not irrelevant, primarily for Asian countries. As in the case of ASEAN, not even good advice was provided. The two APEC Summits that could have proposed solutions to the crisis, the 1997 meeting in Vancouver and the 1998 meeting in Kuala Lumpur, were not able to provide the slightest hint on an alternative rescue package for the countries affected by the crisis. In particular the Vancouver meeting could have been important, but the leaders only endorsed the IMF's policies.⁸ These, however, have driven the region much deeper than necessary into crisis and did not contribute to its solution (cf. for example Dieter 1998; Stiglitz 2000).

However, some observers have claimed that APEC has been blamed unfairly. Harris argues that the Asian crisis has not resulted in a protectionist surge in the region:

„Given the limited role APEC could be expected to play directly, the hope was initially that APEC could hold the line in the trade field in the face of the downturn; to resist the pressure on countries to turn inward and protect individual domestic markets and producers. Contrary to a wide expectation at the time, the line was held – and indeed in a number of countries, further liberalisation has taken place” (Harris 1999, p. 13).

Harris' argument raises two issues in particular. Firstly, it has to be asked why APEC is not able to provide a response to an economic crisis. Instead not only the IMF, but also the World Bank and the Asian Development Bank were called to the rescue. Even though APEC does not have financial resources for a bail-out, a meaningful project of regional co-operation and integration should be able to at least provide some expertise in a crisis. The inability to provide an answer to the problems of the countries affected by the crisis has downgraded the standing of the project in the region. It could also be argued that the Asian crisis has underlined APEC's status as a mere dialogue scheme: APEC serves the purpose of creating a forum to talk to each other in a very

7) Two reservations have to be made: Firstly, the creation of a free trade area of sufficient size may encourage direct foreign investment. Secondly, the establishment of a free trade area with one of the poles of the global economy, e.g. between South Africa and the European Union, can bring substantial benefit to the participating developing economy.

8) The Leaders' Declaration did mention the discussion of the financial crisis, but the suggested responses on the regional level were limited to regional surveillance and improved regulatory capacities. With regard to crisis prevention on the global level, the IMF's importance was underlined: "We believe it is critically important that we move quickly to enhance the capacity of the international system to prevent or, if necessary, to respond to financial crises of this kind. On a global level, the role of the IMF remains central" (APEC Leaders' Declaration, 25 November 1997, Vancouver).

heterogeneous region, but it does not represent a case of genuine regional integration.⁹ Secondly, it is not clear why a protectionist backlash should have been expected in the first place. The countries in crisis were confronted with a sudden shortage of capital, not with an inflow of goods from other countries. The only APEC countries that can claim to have eased the crisis by not raising the barriers to imports are the USA and to a lesser degree Australia. It is hard to see a positive influence of the APEC process on policy makers in Washington. The policy choice to keep American markets open was made, but not because Congress or the Clinton administration wanted to strengthen APEC.

Although the rivalry between an Asian integration project and APEC is not new, elites in Asia seem to reconsider the benefits of regionalism without America, probably without Anglo-Saxons. In particular the American opposition to an “Asian Monetary Fund” may have sown the seeds for a further polarisation of the relationship between the Anglo-Saxon and the Asian APEC countries (cf. Dieter/Higgott 1998, p. 51).¹⁰

While East Asia provides the strongest arguments in favor of monetary regionalism, the Brazilian crisis underlines further the assessment that conventional regionalism has failed in the event of a financial crisis. The existing trade regime, i.e. the Mercosur, did not reduce the consequences of the crisis. Although the Mercosur is not even a complete customs union yet, it even contributed to the spreading of the crisis. Brazilian companies were benefiting from the devaluation of the Real and could increase their exports to neighboring Argentina, in particular in the automotive sector. Argentina in turn could not do anything, for its currency has been tied to the US dollar at an exchange rate of one to one since 1991.¹¹

The existing regional integration projects in East Asia, but also in the Southern Cone, have not fared well during the recent crises. They have neither contributed to the prevention of the crises nor have they made the resolution any easier. The challenge is to develop new forms of regionalism that address these deficiencies of conventional regionalism.

9) For a discussion of the various types of regionalism that emerged during the 1990s see Dieter 2000.

10) With hindsight, the Japanese proposal of an Asian Monetary Fund would perhaps not have avoided the Asian crisis entirely, but it would have made a very valuable contribution to limiting the downturn. In fact, the crisis in Korea, which started after the AMF proposal was rejected by the Americans and which primarily has been a liquidity crisis, not a solvency crisis, could probably have been avoided all together.

11) Argentina has a so-called currency board with the US-Dollar. Moreover, the fixed exchange rate vis-à-vis the US-dollar has been written into Argentina's constitution, which will therefore have to be altered in the event of a new currency regime. Although the currency board may have been necessary after the almost traumatic experiences of the country with hyperinflation in the 1980s, today this inflexible regime represents a burden for the Argentinean economy.

3. The theory of conventional, trade-based regionalism: Balassa in the 1960s and in the 21st century?

Since the early 1960s, our thinking about regionalism has been influenced by Bela Balassa's approach to regional integration. Balassa has suggested that regional integration shall take place in five distinct steps: Free trade area, customs union, common market, economic and monetary union and finally political union (cf. Balassa 1961, 1987).

Balassa's theory has been developed 40 years ago. The historical context was a different one: In the 1960s, trade barriers, namely tariffs, were much more important than they are today. Financial flows across the boundaries of national economies were not important. Most countries, including the United States, were using capital controls to ensure that the fixed exchange rates of the Bretton Woods system were not undermined by high inflows or outflows of capital.¹² Trade integration offered an answer to the economic goals of many countries: They could prepare for the world market or, in a more radical but popular version, could dissociate their economies from the global economy, which was obviously easier for a group than for individual countries.

In principle, Balassa's theory reflected the regulations of the General Agreement on Tariffs and Trade (GATT). Article 24, permitting the creation of free trade areas and customs unions, was the only major exception from the famous article 1, the most favoured nation clause. Balassa's theory reflected those given conditions, but the theoretical underpinnings remained somewhat vague.

Why a scheme that requires a lot of bureaucratic effort, the free trade area, is included in Balassa's theory is not clear. The administrative work to set rules of origin and use certificates of origin can be an obstacle to trade rather than facilitate it. The lower the average tariff, the higher the relative burden of certificates of origin.

12) The USA had reintroduced capital controls in the early 1960s, when rising imports, the costs of the Vietnam War and high capital inflows were threatening the regime of fixed exchange rates (cf. Scherrer 2000, p. 21).

Table 1: Main components of regionalism based on trade integration

| Level | Main Component | Main Disadvantage |
|-----------------------------|---|---|
| Free Trade Area | Free trade within, but different external tariffs | Need for certificates of origin |
| Customs Union | Common external tariff | Need for the establishment of a common external tariff, which can be difficult between heterogeneous economies |
| Common Market | Free movement of capital, goods and labour | Freedom of labour can cause problems between heterogeneous economies |
| Economic and Monetary Union | Common currency | Fixing of exchange rates limits ability to react to changing economic conditions in the different parts of the monetary union |
| Political Union | Creation of common political institutions | Loss of sovereignty to supranational body may prove difficult |

Table 1 provides an overview of the main components of conventional regionalism. Today, the most problematic aspect of Balassa's theory is that it does not provide any link of the monetary policies and the financial sectors of the participating economies on the first three levels of integration. In an era of growing capital flows, this constitutes a major deficiency. Furthermore, the introduction of an economic and monetary union is a complete change of tune from the previous three steps, where the emphasis lay on trade.

One may argue that this theory was modified when implemented in Europe. The creation of the European Monetary System in 1979 added a strong element of monetary co-operation. Although Europe added this element to its own integration process, the need for intensive co-operation with regard to monetary and financial stability in an integration project is not yet reflected neither in the theory of regionalism nor in the projects currently implemented outside of Europe.

4. Theoretical aspects of monetary regionalism

In contrast to conventional regionalism, monetary regionalism aims directly at levels four and five of Balassa's integration concept. Monetary regionalism wants to contribute to the stability of currencies and financial markets in a region without having to formalise trade links. Like conventional regionalism, it requires the willingness of participating states to enter a process which will, if successfully implemented, lead at least to the creation of a common currency, but eventually to a political union. Therefore, the willingness to give up a part of what has been understood as a central element of a nation's sovereignty and independence, in particular the ability to issue an own currency, is central to monetary regionalism.

To prepare a group of economies for a monetary union, several steps need to be taken. These measures fall in two broad categories: Measures that stabilise financial markets and measures that contribute to the stabilisation of exchange rates. These steps could be taken either by policy field or in steps. It is imaginable to try and stabilise financial markets first and attempt to reduce exchange rate volatility later. However, it is more plausible to structure the process in steps. Implemented in steps, there is a chance for immediate gains in all policy fields relevant to monetary regionalism.

I am suggesting an Integration process organised in four steps. The first two levels could be termed 'Regional Liquidity Fund' and 'Regional Monetary System'. Level 3 and 4 are similar to Balassa's scheme. However, it is only in those steps that I suggest the implementation of agreements on trade integration.

Table 2: Key components of monetary regionalism

| | Level 1: Regional Liquidity Fund | Level 2: Regional Monetary System | Level 3: Economic and Monetary Union | Level 4: Political Union |
|--|--|---|---|---|
| Main Component | Creation of a public regional liquidity fund | Introduction of a regional monetary system with exchange rate bands | Permanent fixing of exchange rates and creation of a single currency | Creation of a political union, national political systems continue to exist and cover most issues |
| Political Measures | Creation of a forum for the central banks of the region, i.e. a regional monetary committee | Regular meetings of the regional monetary committee | Creation of common political institutions, establishment of a Regional Central Bank | Creation of supranational institutions in some, defined areas |
| Additional Components (crisis management) | Creation of a private liquidity fund | Expansion of coverage of existing regional liquidity funds | | |
| Additional Components (crisis prevention) | Creation of a regional banking supervision system based on the BIS' 25 core principles of effective banking supervision, parallel national systems continue to exist | | Phasing out of national banking supervision | |
| | Implementation of Universal Debt-Rollover Options with a Penalty (Udrop) | | | |
| | Compulsory hedging of credit denominated in foreign currency | Reduction of the coverage of compulsory hedging | | |
| | Capital controls of the individual countries, in particular on inflows, may continue to exist | | Phasing out of capital controls | |
| Trade Components | | Facilitation of regional trade by harmonising norms and standards | Customs Union | Free movement of labour |
| Macroeconomic Policy | Joint monitoring of monetary and fiscal policy | Co-ordination and harmonisation of monetary policy, in particular interest rate policy as well as fiscal policy, in particular on debt levels | | |

These proposals are not a complete list of measures that could be taken within a regional integration project that intends to improve its immunity against financial crisis. However, they represent a set of policies that both aim at profound regional integration and provide instant benefits for the participating economies. The concept of monetary regionalism as well as the advantages and disadvantages of the individual measures will be considered in the following section.

4. 1. Level 1: Regional Liquidity Fund

The central measure to be taken on level 1 is the creation of a public regional liquidity fund. This is an attempt to provide a regional safety net if a crisis hits. The countries participating will have to earmark a part or all of their foreign reserves for a liquidity pool. A participating central bank will in such a system not only be able to use their own reserves, but also those of the other central banks.

Evidently, this is a measure that requires substantial political will of the participating countries. A factor limiting the required confidence is a ceiling on the percentage of foreign reserves that participating central banks are willing to earmark for regional use. For the first level of monetary regionalism, it seems adequate to limit the funds to ten per cent of foreign reserves. Conditions for the use of other countries' reserves would have to be strict: To avoid the abuse of the regional liquidity fund, interest would have to be paid and the interest rate would have to be set at a relatively high level. Also, the regional credit line should only be available for a short period, e.g. three months up to six months.

The advantages of a public regional liquidity fund are substantial:

- A central bank using the other central banks' reserves has a much higher chance to act as a lender of last resort for the domestic financial sector, thus developing the ability to limit the consequences of a credit crisis. Using the regional reserves, a central bank gains leverage. This aspect is particularly relevant for economies that have partly or completely abandoned capital controls, because the use of international financial markets and of loans denominated in foreign currency limit the ability of central banks to act as lender of last resort.
- A regional liquidity fund could be used to defend fixed exchange rates. This potential function, however, is probably not required on the first level of monetary regionalism.

- Being able to use the entire region's foreign reserves reduces the need for the individual central bank to maintain costly foreign reserves. However, the whole group will have to maintain substantial reserves.
- The provision of liquidity in a region would allow to avoid having to go to the IMF. This might be the single biggest advantage of a regional fund.
- Although a regional liquidity fund would only be activated in the event of a crisis, it would encourage participating central banks to engage in permanent monitoring of economic developments in the region.

In order to be able to establish a purposeful regional liquidity fund the participating central banks will have to possess significant foreign reserves. Taking into consideration that initially probably not more than 10 or 20 per cent of the reserves will be available for the regional liquidity fund, this constitutes a major obstacle for monetary regionalism in some parts of the world. In other parts, namely in East Asia, this does not represent a problem.

Whereas the measures to prevent a crisis from developing, which I will discuss below, are no radical departure from the current system, a public regional liquidity fund is. It is directly aimed at challenging the IMF's current monopoly on crisis management. In the event of a crisis, there would not be a need to negotiate with Washington. Consequently, the IMF would suffer a substantial reduction of its relevance for the world economy.

A public regional liquidity fund could be accompanied by private regional liquidity funds. The idea is that private banks and other financial intermediaries create a system which provides liquidity in the event of a banking crisis. In Germany, such a system has been in place since 1974. The "Liquiditäts-Konsortialbank", Liko-Bank in short, is currently available to 136 participating banks. When a bank gets into trouble, the other banks have to supply fresh money up to the initially agreed limit. In the case of the Liko-Bank, private funds are augmented by funds from the Bundesbank.¹³ As a principle, the private regional liquidity fund should operate as a first line of defence for banks.

The creation of this system of private and public liquidity funds would be a significant step forward for a regional integration project. It would both provide powerful instruments to limit

13) At the beginning of the year 2000, an expansion of the Liko-Bank to cover the Eurozone is discussed. The Bundesbank has suggested an expansion of the maximum amount provided by the private banks of up to Euro 10 billion and an extended credit line of the Bundesbank, which would be raised to Euro 5 billion (Frankfurter Allgemeine Zeitung, 11 January 2000).

financial crisis and generate the functional basis for further integration.¹⁴ This becomes particularly evident when monitoring of financial markets and banking supervision are included in the integration process.

The provision of a public regional liquidity fund ought to be accompanied by two monitoring bodies, a regional monetary committee and a regional banking supervision system. Committing foreign reserves of a country's central bank, even if it is limited to a certain percentage, is not a simple bookkeeper's exercise, but a genuine expression of confidence. In order to further build this mutual trust, the regional monetary committee is of vital importance. Central bankers could meet frequently, e.g. monthly, to discuss developments in the financial sector and in foreign exchange markets. Although in the proposed structure of level 1 the fixing of exchange rates is not envisaged, the regional monetary committee could prepare this step.

The establishment of a regional monetary committee would also contribute to the creation of "intra-regional policy networks", which enable policy makers to deepen their knowledge of their partners in the region (cf. Higgott 1997).

Similarly, banking supervision could be advanced to the regional level. Apart from the beneficial effect this could have for the integration process, national banking supervision seems to have become more obsolete in the age of banks operating in global, rather than national, financial markets. The installation of a regional body for banking supervision may not end the need for national banking supervision immediately. However, in both systems the Bank for International Settlements (BIS) 25 core principles for effective banking supervision should be adhered to.

In addition to the creation of a Regional Liquidity Fund, measures to reduce the likelihood of financial crises are a vital element of monetary regionalism. The aim is to force the private sector to consider the risks associated with lending and borrowing.

Universal Debt-Rollover Options with a Penalty (Udrop) are a concept that Anne Siebert and William Buiters suggested in 1999. Udrop are an option which can be exercised upon maturity of a loan. The use of the option results in an extension of the credit, e.g. an additional 3 or 6 months. The option has a price, which will have to be set before the deal is done. The cost of the option in effect works like a tax on borrowing abroad. Consequently, borrowing domestically becomes cheaper compared to foreign loans. Both parties would have to agree on the price, consequently they would have to consider the risk associated with the loan.

14) See also the functional integration theories of Mitrany (1975) and Keck (1991).

The implementation of Udrop would provide a number of advantages:

- Financial crises tend to be characterised by panic and by a lack of sober evaluation. In this situation debtors gain valuable time. Liquidity problems caused by panic will be less likely.
- The necessity to find a price for the option will increase the readiness to thoroughly evaluate the credit risk.
- The pressure on the exchange rate of a country affected by a credit crisis can be reduced.
- The implementation of a regional liquidity fund may raise the risk of moral hazard. Although Udrop cannot completely exclude moral hazard, creditors would not walk away from a financial crisis totally unaffected either. Losing the ability to get their capital back immediately should dampen the risk of moral hazard. A public regional liquidity fund and Udrop represent the most important elements of the first level of monetary regionalism.
- Udrop may enhance the macroeconomic stability of an economy, which in turn improves the prospects for investment and growth.
- The implementation of Udrop requires neither a global consensus nor the approval from the IMF.
- Although Udrop can also be implemented by individual countries, they are particularly suitable for monetary regionalism: The collective introduction of Udrop will strengthen the bargaining position of the participating countries and will reduce the risk of being cut off from international financial markets.
- Implementing Udrop as an element of monetary regionalism will increase the strength and efficacy of the financial systems.

By contrast, the disadvantages of Udrop, in particular when implemented by a group of economies, are quite limited:

- Udrop can only provide help in the event of a liquidity crisis, not in a solvency crisis. In other words: A bank or company facing bankruptcy will not be saved.
- Udrop increase the cost of borrowing and consequently deteriorate the competitive position of the debtor relative to companies borrowing without Udrop.

- The ability of individual countries to introduce Udrop may be limited because lenders may collectively refuse to accept these rollover-options.
- The support by the IMF for the introduction of Udrop is unclear and depends on the outcome of the current reform discussion.

Another element of level 1, the compulsory hedging of credit denominated in foreign currency, serves a similar purpose. Banks and companies that have to hedge their borrowings cannot be affected by a deterioration of the exchange rate. Also, the compulsory hedging would also contribute to exchange rate stability, because a shortage of foreign exchange, caused by debtors trying to meet their payment deadlines, is less likely. Similar to Udrop, hedging increases the cost of borrowing abroad. This may be a welcome prospect, since it raises the attractiveness of borrowing domestically. But for the companies that prefer foreign loans compulsory hedging, just as Udrop, represents additional cost. However, the stabilising effects seem to be more important: If hedging of loans in foreign currency would have been the norm in East Asia, the Asian crisis would have been much less severe, if it would have taken place at all.

On the first level of monetary regionalism, just like in conventional forms of regionalism, the economies of the participating countries are quite likely to be heterogeneous. Taking the experiences of the first wave of regional integration in the 1960s into consideration, it seems necessary to provide measures for the weaker countries for self-protection. A main element would be the permission to continue the use of capital controls. In particular, countries should be allowed to limit the inflow of capital and to tie the inflow to certain conditions, e.g. favouring long-term loans over short-term loans. Also, taxes on short-term inflows, a policy successfully implemented by Chile in the 1990s, ought to be possible on the first level.

The establishment of formal schemes to facilitate trade is not necessarily part of the level 1. The reason for excluding trade is mainly political: The creation of a free trade area or customs union can be misinterpreted as the formation of a trade bloc and consequently can be used by policy makers in other countries to justify import restrictions. These notions are particularly relevant for economies producing high surpluses in their trade accounts over longer periods of time, i.e. East Asian countries. Consequently, in other parts of the world, in particular in the Mercosur, the exclusion of a formal regional trade regime is not important.

Macroeconomic policy does not have to be co-ordinated and harmonised on level 1, but institutions should be created that permit the joint monitoring of macroeconomic developments.

Such a step not only is an important precondition for the introduction of a monetary union, but also contributes to the creation of intraregional policy networks.

4.2. Level 2: Regional Monetary System

The second step should be characterised by further preparation for monetary union. The introduction of a regional monetary system with exchange rate bands between the participating economies enables the participating economies to gain macroeconomic stability. The advantage of this system over a system with permanently fixed rates is obvious: It permits adjustments of exchange rates.

Finding the appropriate exchange rates and useful exchange rate bands obviously is not an easy task. If the bands are too broad, the benefits from such a scheme are limited. Exporters and importers in such an arrangement with wide bands would still have to hedge their receipts from transactions in foreign currency. Therefore, exchange rate bands which are wider than, say, 10 per cent might be more symbolic than functional. On the other hand, if a very narrow exchange rate band is chosen, i.e. \pm two per cent, the risk of markets testing those bands quickly and successfully seems to be quite high.

After the experience with the European Monetary System, which operated successfully for more than a decade but partly collapsed in 1992, a regional monetary system may have lost some of its appeal. However, this system has to be evaluated in comparison with the other plausible alternatives: Countries may either opt for completely flexible exchange rates or currency boards. Neither of these two alternatives is without substantial disadvantages either.

Flexible rates seem to be the easiest system: Central banks just watch the fluctuations of exchange rates and do not try to stabilise them. But flexible rates are a major obstacle for an expansion of international or regional trade. Importers and exporters do not have a solid basis to calculate future receipts. This can partly be overcome by hedging, but hedging is a costly insurance. Needless to say that the providers of this type of insurance, i.e. big banks, regard flexible rates as the best exchange rate system.

A currency board on the other hand leaves the central bank with very little room for manoeuvre. The exchange rate is fixed vis-à-vis an anchor currency, and domestic money supply is determined by the amount of foreign reserves a central bank holds. Although this system offers an alternative for economies previously plagued by very high inflation and very volatile exchange rates, it is no cure for the majority of developing countries and emerging economies. The reason for this is that

finding a suitable anchor currency is much more difficult than it appears at first. Due to the volatility of exchange rates between Dollar, Euro and Yen a currency board only transmits those fluctuations. A currency tied to the US-Dollar, for instance, would currently be a problem for an economy which exports substantially to the Eurozone.

Therefore, rather than trying to stabilise exchange rates at the periphery, more stable exchange rates in the core of the world economy would be helpful. The desirability of a system of exchange rate bands between the poles of the world economy was underlined in a report of the Council on Foreign Relations published in 1999. In a minority vote US economist Fred Bergsten, hedge fund celebrity George Soros and Paul Volcker, from 1979 to 1987 head of the US Federal Reserve Bank, have called for the implementation of flexible bands between the main currencies. They vividly pledged for a new currency regime, without which they cannot envisage a successful reform of the international financial system:

“Our point is that ‘reforming the international financial architecture’ without reforming the currency regime is like watching Hamlet without the Prince. The international monetary system will continue to be ineffective and crisis prone until that crucial centrepiece of its operation is thoroughly revamped. We urge the G-3 countries to adopt some variant of target zones in the near future” (Council on Foreign Relations 1999, p. 129).

The problem is that such a regime seems increasingly less likely. Although from a pure technical point it is feasible, the political will for such a project is hard to spot, in particular in the USA. Policy makers in the US currently seem to suffer from “hegemonic illusion”: Their willingness to encourage in co-operative multilateral regimes appears to be very limited. Although this unipolar moment will not last, for the time being other countries and regions cannot expect the US to play a constructive role in the shaping of a more stable global financial system.¹⁵ Consequently, a regional system of exchange rate bands appears to be a plausible alternative.

The establishment of a regional monetary system will have to be accompanied by an intensification of the co-operation by monetary authorities. Although separate currencies continue to exist, the intensity of communication between central bankers would have to be improved and regular meetings of the regional monetary committee appear to be useful. The press coverage of these meetings could be used to raise the awareness of citizens in the region with regard to the implementation of the integration process.

15) For a discussion of the current American unilateralism and its consequences for world politics and the world economy see, for example, Bergsten 1999, Huntington 1999, Pfaff 1998.

When monetary co-operation is intensified and the coverage of the existing regional liquidity fund has been expanded, the additional measures taken for crisis prevention can gradually be phased out. If the regional monetary system operates sufficiently well, in particular the compulsory hedging of credit denominated in foreign currency may be phased out.

Trade facilitation could start to play a greater role on level 2. However, the establishment of a free trade area is not suggested: Firstly, because of the undesired administrative costs, secondly, because of the potential political vulnerability caused by formal trade regimes. Nevertheless, trade facilitation may be implemented. Especially the harmonisation of norms and standards could make a valuable contribution to the integration process.

In preparation for level 3, the economic and monetary union, monetary and fiscal policy will have to be harmonised. Although the experience of the Eurozone offers no blueprint that can directly be applied elsewhere, the five criteria used in the process leading to the creation of the Eurozone have a certain plausibility. These have been:

- the level of existing public debt shall not exceed 60 per cent of GDP,
- new public debt has to be less than 3 per cent of GDP,
- the inflation rate should not be more than 1.5 per cent above the inflation rate in the three countries with the lowest inflation,
- the economies must have participated successfully, i.e. without adjustments, in the European Monetary System for at least two years,
- long-term interest rates should not be more than 2.0 per cent above the respective rates for the three best economies.¹⁶

The plausibility of those criteria is sufficient. The combination of measures to evaluate public debt and inflation is simple enough to be workable. It includes two criteria which are primarily determined by markets (exchange rate, long-term interest rate), not by official declaration. At the same time, the treaty provides some flexibility regarding these five criteria, in particular concerning the level of public debt, which may be above 60 per cent provided it is sufficiently fast approaching the 60 per cent criterion. On the other hand, the levels set have no specific explanation. For instance, why a level of 60 per cent was chosen is unclear. Nevertheless, the combination of factors considered assures a certain level of macroeconomic stability.

4.3. Level 3: Economic and Monetary Union

The creation of an economic and monetary union is more than a simple step for an integration project. Clearly, quite a few conditions have to be met before such a far-reaching measure can be implemented. At the same time, an economic and monetary union has disadvantages that participating countries may not want. In particular the inability to react to differing economic developments within the union with exchange rate adjustments can be seen as a major disadvantage of this level of regional integration.

However, an economic and monetary union clearly has major advantages over a regional monetary system. Transaction costs are permanently reduced and competition within the union is strengthened. Above all, exchange rate adjustments within the union are no longer a threat. Companies do no longer have to pay for hedging against exchange rate volatility.

It seems hard to envisage the establishment of an economic and monetary union as the final stage of regional integration. Once a common currency has been created, an integration project that would limit itself to economic policy would quickly face, rightly so, criticism regarding the lack of democratic control over economic policy. Therefore, beyond the creation of a regional central bank other common political institutions will have to be created, at least in an integration project of democratic societies.

As integration proceeds, it is plausible to see the phasing out of national banking supervision. The regional banking supervision should in the process have been strengthened sufficiently to warrant the abolishment of national banking supervision. Also, the creation of a single currency could be accompanied by the phasing out of capital controls: The risk of a speculative attack on the currency of an economy is done away with. The entire integration project may decide to maintain or even introduce capital controls vis-à-vis the rest of the world, but internal flows should no longer be restricted.

With regard to trade, once the third level of integration is reached at least a customs union is required. Although theoretically trade within a project of monetary regionalism could still be subject to tariffs and other forms of trade restrictions, one of the aims of a common currency, i.e. the strengthening of competition, could not be achieved. A free trade area, however, should not be implemented, because of the need to administer certificates of origin: Trade would not be facilitated. At the same time, restrictions on migration could remain in place. In particular in areas

with greatly differing levels of development, the introduction of the freedom of employees to move within the union might be limited to the last and final level of integration.

4.4. Level 4: Political Union

The completion of the integration process, the creation of a political union, will not require many additional measures with regard to economic policy, but rather demand political integration. In particular, supranational political decision making bodies have to be founded.

In most areas, economic policy integration will have been implemented on lower levels of integration. A deepening of the integration process could be the reduction of national tax systems in favour of a uniform union-wide tax system. But measures of that nature do not seem to be vital for the success of the political. A certain variation of tax rates would not undermine the integration project.

The main benefit of the integration project continues to exist during the entire implementation phase: The region would gain independence and would be quite immune against financial crises. The preconditions for such a scheme are high, and probably only in East Asia monetary regionalism could be implemented.

5. Prospects for Monetary Regionalism in East Asia and Consequences for the IMF

The first evidence of an emergence of monetary regionalism and a turning away from the IMF is to be found in East Asia. Rightly so, the region perceives the IMF's policy as humiliating and wrong. In addition, in the summer of 1997 the IMF together with the US government impeded the Japanese initiative to create an Asian liquidity fund. The Asian Monetary Fund was explicitly to apply softer conditions than those of the IMF. The AMF's concept corresponded to being more of a 'lender of last resort' than the IMF. Essentially, the AMF idea was about providing unconditional loans to overcome liquidity crises (cf. Dieter/Higgott 1998).

At the end of 1999, after the worst impacts of the Asian crisis had been overcome, East Asian circles once again addressed the topic of more intensive regional cooperation. The regular ASEAN summits were expanded by the participation of Japan, China and South Korea, and the meeting held in Manila at the end of November last year adopted an ambitious plan. The summit chair, Philippines President Joseph Estrada, told the news media the goals were a common market, monetary union and an East Asian Community (Financial Times, 29 November 1999, p. 4).

The significance of the fact that Japanese observers also now advocate monetary cooperation in East Asia should not be underestimated. In an interview with the *New Straits Times* in mid-January this year, Eisuke Sakakibara, former state secretary of the Japanese finance ministry, spoke out for a cooperative monetary regime in East Asia (*World Bank, Development News*, 12 January 2000).

To be sure, the outlines of this East Asian integration project are still very unclear. But it appears that cooperation in the sectors of monetary policy and finance markets will have more importance than trade policy agreements. At present, it does not appear to be unrealistic to expect the development of an 'East Asian Financial Caucus' in the medium term. The project will focus less on trade issues than on cooperation in the monetary and finance policy sector.

The first details of the new project were given during the fourth ASEAN finance ministers' conference at the end of March this year. True, there is no longer talk of an East Asian monetary fund, but there are plans for setting up a regional liquidity aid system. In a crisis, the central banks of the participating countries are to have speedy access to the currency reserves of the other states (*Frankfurter Allgemeine Zeitung*, 29 March 2000; cf. the declaration of the ASEAN Finance Ministers www.asean.or.id). In other words: The region has started to create a regional liquidity fund. Implemented successfully, it would give the region greater autonomy: in a crisis the neighbours help out, not the IMF.

At the beginning of May 2000, Japan has suggested a plan of a network of currency swaps, in effect a regional liquidity fund, to Asian finance ministers attending the annual meeting of the Asian Development Bank in Thailand. The idea is that Asian countries should be able to borrow from each other through short-term swaps of currency reserves (cf. *Financial Times*, 6/7 May 2000, p. 9). The fact that Japan is trying to take the lead in this initiative invites two conclusions. Firstly, Japanese policy makers have learnt from the missed 'golden opportunity' (Walden Bello) to create an Asian Monetary Fund in 1997 and do not want to be passive bystanders this time. Secondly, the matter seems to be taken care of with urgency, considering the short time span between the first suggestion for such arrangements were made: Barely six weeks passed between the Manila meeting of ASEAN finance ministers and the tabling of the Japanese proposal.¹⁷

17) However, the Japanese government is still unwilling to confront the US and the IMF with such a proposal. Rather than calling it what it is, i.e. an alternative to the IMF, Japanese delegates stressed that bypassing the IMF was not an aim of their proposal (cf. *Financial Times*, 6/7 May 2000, p. 9). But why suggest that plan if there is no need to bypass the IMF?

Il Sakong, chairman of the Korean Institute for Global Economics, during the meeting in Chiang Mai underlined the need for a regional response:

“We need to have some kind of defense mechanism. Since not much is expected to be done at the global level, something should be done at the regional level” (Financial Times, 6/7 May 2000, p. 9)

The finance ministers of the ten ASEAN countries, China, Japan and South Korea reached an agreement in Chiang Mai, although major elements of the proposal still have to be finalised. However, the very fact that these countries are focussing on the generation of greater financial stability marks a new era of regionalism in East Asia.

The forward looking and inclusive character of the project is underlined by China’s participation. Today, China has no need for additional liquidity from the region. Together with Hong Kong’s monetary authority, China’s central bank has reserves of US-Dollar 250 billion, much than enough for an economy that enjoys the additional safety net of comprehensive capital controls. Xiang Huajcheng, China’s finance minister, therefore emphasised in his statement not the relevance of the project for China, but rather for the region.¹⁸

The currently existing level of reserves in East Asia makes the creation of a regional liquidity fund a plausible exercise. The region has more foreign reserves than any other. Even without Taiwan, which alone enjoys reserves of more than US-Dollar 100 billion, the central banks of East Asia together have more than US-Dollar 800 billion at their disposal. The European Central Bank, by comparison, even after the recent doubling of reserves only has foreign reserves of about \$ 90 billion.¹⁹ Even if only 20 per cent of this amount would be used in a financial crisis, the amount of money available would appear to be sufficient to act as lender of last resort. If, say, Thailand would be faced with a new financial crisis, it could draw upon almost US-Dollar 190 billion: its own reserves of US-Dollar 34.1 billion plus additional US-Dollar 155.4 billion from the regional liquidity fund. The amount of money available to the Thai central bank would exceed the IMF-led lending to Thailand, Korea and Indonesia by about US-Dollar 50 billion.²⁰

18) Xiang said that China supported the project because it would contribute to the economic and financial stability of the region (cf. Financial Times, 8 May 2000, p. 10).

19) The entire reserves of the Eurozone, including the reserves of the national central banks, stood at about \$ 345 billion in February 2000 (cf. Der Tagesspiegel, 9 May 2000).

20) In the Chiang Mai meeting, the envisaged volume of the swap agreements was very limited. Thailand, Malaysia, Singapore, Indonesia and the Philippines discussed an expansion of their existing swap arrangements from \$ 200 million to \$ 2 billion (cf. Financial Times, 8 May 2000, p. 10). Although such a step would not do harm, it clearly is too limited for an effective regional liquidity fund, which needs both Japan and China as contributing partners.

The Financial Times has immediately criticised the agreement of Chiang Mai. Asian policy makers would be tempted to delay reform, thereby missing the opportunity to provide real safety against speculative attacks on their currencies:

“Asian governments must not forget that sound policies, strong banks and well-run corporations are better than any currency arrangements for warding off speculative attacks” (Financial Times, 10 May 2000, p. 22).

Although the Financial Times acknowledges that the creation of a regional network system is a major step forward for East Asia, in its critique, essential points are missed. The creation of the regional liquidity fund does not necessarily imply that Asian governments must use the additional financial means to return to fixed exchange rates; at least not immediately. The initial purpose of the regional liquidity fund may well be limited to providing sufficient liquidity for banks and corporation that, due to a sudden swing in market sentiment, may be confronted with an inability to rollover existing debt denominated in foreign currency. The absence of comprehensive capital controls in most economies of East Asia has made the task of central banks much more complicated. Due to the fact that banks and corporations are able to borrow abroad in foreign currency a central bank with limited reserves has limited power to provide liquidity in the event of a crisis. For this reason without strong central banks it is difficult to build a solid, strong financial sector. It might be helpful to remember the influential roles that central banks had in western economies when financial crises hit. Just consider the role of the Bundesbank played in solving the bankruptcy of the Herstatt Bank in 1974 or the Federal Reserve’s role in solving the Savings & Loans debacle of the 1980s. Therefore, the creation of a network of strong central banks is a precondition for stability in the financial sectors of East Asia. Thus, the FT’s comment underestimates how much markets can overshoot. A primary concern of Asian finance ministers is therefore to avoid the negative consequences of this dark side of market processes, as the Bank for International Settlement has called it. This is a legitimate and significant function of governments.

The high level of foreign reserves is making East Asia not only the most likely region for monetary regionalism, but it might be the only region where such a concept can be implemented. Reserves are not only high, they are also quite well distributed in the region. The two largest economies, Japan and China, also have the largest reserves. In the event of a crisis, those two economies would make the highest contribution. Also, considering the high level of reserves, a regional liquidity fund is plausible even without using too high a percentage of the reserves of the participating central banks.

In other parts of the world the picture might be a different one. The Mercosur, for instance, would have too limited foreign reserves to start a project of monetary regionalism based on the creation of a regional liquidity pool. Even if Chile would participate, the foreign reserves of Argentina, Brazil and Chile currently only total US-Dollar 74.9 billion, an amount insufficient for the creation of a regional liquidity fund that only uses ten or twenty per cent of all reserves.²¹ However, those economies with more limited reserves could still implement other elements of monetary regionalism, e.g. Udrop, regional banking supervision or the creation of a private regional liquidity fund. Also, macroeconomic co-ordination and joint monitoring would be possible.²²

21) In March 2000, Argentina had reserves of \$ 24,7 billion, Brazil \$ 36.2 billion and Chile \$ 14.0 billion (cf. the Economist, 22 April 2000, p. 122).

22) Brazil's president Fernando Enrique Cardoso has called for an augmented Mercosur. He suggested the inclusion of macroeconomic issues and suggested a stability pact à la Maastricht for the Southern Cone (Financial Times, 10 November 1999, p. 5).

Table 3: Foreign reserves of East Asian economies

| Country | Reserves in March 2000 in billions of US-Dollar | 20 % available for a regional liquidity fund |
|-------------------|---|--|
| Brunei (1999) | 0.5 | 0.1 |
| China | 156.8 | 31.36 |
| Hong Kong | 96.3 | 19.26 |
| Indonesia | 26.3 | 5.26 |
| Malaysia | 30.6 | 6.12 |
| Philippines | 12.9 | 2.58 |
| Singapore | 74.3 | 14.86 |
| South Korea | 74.0 | 14.8 |
| Thailand | 34.1 | 6.82 |
| Japan | 305,5 | 61.1 |
| Total | <u>811.3</u> | <u>162.26</u> |
| Taiwan | 103.5 | 20.7 |
| Total inc. Taiwan | <u>914.8</u> | <u>182.96</u> |

Source: The Economist, March 4th 2000, p. 122; Brunei Currency Board, Japanese Ministry of Finance.

6. Conclusions

The concept of monetary regionalism potentially offers a new avenue of regional integration in particular to the economies of East Asia. Elsewhere, the level of foreign reserves that is necessary to implement the first level of integration seems to be too limited. In East Asia, the conditions for monetary regionalism are good. Economically, the level of reserves is high enough to provide sufficient liquidity. Politically, the Asian crisis has substantially increased the willingness of policy makers to try a new international regime that promises to avoid a repetition of the traumatic events of 1997 and 1998. Although the Asian crisis did not result in war or civil war, the hardship suffered by millions of people in Thailand, Indonesia and South Korea, but also the Philippines and Malaysia has raised policy makers' willingness to explore new avenues of regional co-operation.

Although a successful implementation of monetary regionalism in East Asia would be good news for the region, it might be bad news for the IMF. If East Asia opts for an alternative safety system, the Fund will lose importance and consequently will be less able to shape the global economy. In contrast to the situation at the beginning of the 21st century, the IMF would be unable to provide a blueprint for the road of development developing countries in East Asia ought to be taking. At the same time, one of the few important institutions of multilateral institutions would be driven out of business. That might not be a bad thing, but on the other hand the prospect of a world that is once again characterised by bloc confrontation is not very promising.

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