

What Motivates Regional Financial Cooperation in East Asia Today?

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S U M M A R Y Regional financial cooperation in East Asia is proceeding with unprecedented intensity. Latest developments include two Asian Bond Funds, created by the regional central bankers group, and an Asian Bond Markets Initiative launched by the finance ministers of the Association of South East Asian Nations member states plus China, Japan, and South Korea (or ASEAN+3). Some observers continue to attribute such cooperation to sharpened antagonism between East Asia and the West since the Asian financial crisis of 1997–98. But this view overlooks a key internal driver: China's shift to a more proactive stance toward regional cooperation. Far from demonstrating an antagonism toward market-based financial systems, ASEAN+3 members are embracing more liberal rules for economic interaction in their creation of regional bond funds and markets. Financial cooperation in East Asia is today motivated by factors that differ considerably from those observed in the immediate aftermath of the Asian financial crisis—and the implications extend beyond East Asia.

*In late 1997
the U.S. and
IMF opposed the
creation of an
Asian Monetary
Fund*

Introductionⁱ

In recent years, East Asian states have engaged in regional financial cooperation with unprecedented intensity. Meetings between finance ministers and central bankers are more frequent and formalized than ever before and have produced concrete commitments to a number of substantive projects and programs. These have included the establishment of a network of bilateral currency swaps to defend against speculative currency attacks; an institutionalized program of policy dialogue and information exchange that surpasses in frequency and depth that found in any other forum; and the creation of regional bond funds as initial steps in the long-term process of fostering a regional bond market.

Many observers see such regional cooperation efforts as driven by a sharpened “East Asia versus the West” sentiment that arose out of the 1997–98 Asian financial crisis.ⁱⁱ Proponents of this view focus on the tensions that emerged between regional actors and the U.S.-dominated International Monetary Fund (IMF) as IMF rescue programs were implemented in crisis-stricken countries. Strict policy conditions attached to IMF funds reflected conventional wisdom in Washington at the time about what constituted “good governance” but seemed to exacerbate—rather than mitigate—crises in a number of instances.

The Asian crisis was clearly a catalyst for Asian regionalism, but other forces serve as the primary drivers behind regional financial initiatives today and account for the acceleration of such initiatives since 2000. One of the most notable changes accompanying the increasing momentum within the region is China’s adoption of a more proactive stance toward regional cooperation. China felt little negative impact from the regional crisis and opposed Japan’s proposal to create a regional monetary fund in 1997. Today, however, the Chinese government is an enthusiastic participant in regional financial cooperation efforts—particularly those aimed at fostering the development of regional debt and capital markets.ⁱⁱⁱ

**The Asian Financial Crisis and
Regional Cooperation**

The Asian financial crisis began in July 1997 with the collapse of the Thai baht. Aid alone proved insufficient to stem Thailand’s crisis, and Japanese officials hosted a meeting in Tokyo to organize bilateral packages of aid to fill the gap. Japan, China, Australia, Hong Kong, Malaysia, Singapore, Korea, Indonesia, and Brunei committed funds, while the United States attended but pledged nothing. Although Japan and Australia had extensive experience as bilateral aid donors, others in the region were more accustomed to playing the role of aid recipient. Their rally in support of Thailand suggested new possibilities for regional cooperation and served as encouragement to Japanese officials to raise the idea—long latent but not yet seriously discussed—for a more permanent mechanism of regional support. However, when Japan’s Vice Minister of Finance for International Affairs Eisuke Sakakibara proposed the creation of an Asian Monetary Fund (AMF) in late 1997, the idea elicited opposition from the United States and IMF. Support from some countries within the region was also lacking—notably from China.

Japanese officials initially worked through the Hong Kong Monetary Authority to try to persuade China of the merits of a regional monetary fund. In doing so, they committed a grave diplomatic error that undoubtedly ruffled feathers in Beijing (Hong Kong had reverted to Chinese territory earlier in the same year). While Japanese finance ministry officials later consulted directly with the Peoples’ Bank of China, the Bank’s president was unable to lend formal support until the proposal had been vetted with the finance minister and other government officials. The AMF proposal occurred against the backdrop of intensifying negotiations over China’s ascension to the World Trade Organization (WTO), and therefore officials had to consider how support for an AMF might affect relations with the United States and other WTO member nations. The proposal also came at a time when the Chinese were isolated politically and diplomatically—a situation that would change

dramatically in the years thereafter. Chinese officials requested that Japan hold off on pursuing the AMF idea until China's bureaucracy could reach a decision, but Sakakibara ignored the request, feeling that time was of the essence. Japanese officials also failed to specify how such an institution would work and, because the contagion aspect of the crisis had not yet become evident, the need for a permanent regional mechanism of support to supplement the IMF was not yet clear to many observers. For Chinese officials, whose financial markets remained closed and largely insulated from wider regional developments, the sense of crisis was particularly weak.

Crisis management in 1997–98 was thus carried out in the context of IMF negotiations with individual crisis-hit countries, through bilateral aid packages provided by Japan to regional neighbors under financial duress, and through policy dialogue forums that included the United States and other extra-regional actors. While ASEAN member states met together with Japan, China, and South Korea for the first time in December 1997, this meeting included only officials from within the geographical confines of East Asia (minus Taiwan representatives) and was planned prior to the onset of the Asian financial crisis. It moreover failed to produce noteworthy results or a sense of regional solidarity.^{iv}

Sentiment Grows for Regional Mechanisms for Financial Cooperation

By 1999, tensions surrounding policy conditions attached to IMF rescue packages and the launch of monetary integration in Europe led many East Asian countries to think again more seriously about the prospects for regional financial cooperation. At the same time, a change in the attitude of Chinese officials toward regional cooperation was evident by the end of this year. The rapid growth of the Chinese economy (10 percent annually) and investment into China was increasingly viewed as a threat by ASEAN members, spurring Chinese officials to seek ways to tame such worries. A first step in doing so was a proposal for a free trade agreement (FTA) with ASEAN; greater support for regional financial cooperation initiatives followed thereafter.

At its third meeting in November 1999, the ASEAN+3 heads of state acted on this growing sentiment in favor of strengthened regional financial cooperation, integration, and policy dialogue by deciding to hold an annual meeting of finance ministers. Two aspects of this development were particularly notable. First, this decision followed a proposal by *Chinese* officials, whose motivations were clearly not antipathy toward the IMF (although an IMF member, China has never been a recipient of an IMF bailout). Second, despite the AMF rebuff, the successful provision of aid from within the region for Thailand in 1997 remained an important source of encouragement for regional actors as they looked to the future. In this way, the move toward more formalized mechanisms for regional cooperation was driven by more than simple antipathy toward the United States or the IMF.

In May 2000, at a meeting in Chiang Mai, Thailand, the finance ministers agreed to exchange data on capital flows. Following a proposal from Japan, the finance ministers also put forth what came to be known as the Chiang Mai Initiative (CMI). This was a plan to construct a network of bilateral currency swaps. These swaps would permit a country beset by a speculative attack to draw on reserves of other nations. In May 2001, the ASEAN+3 finance ministers announced the general guidelines for the currency swaps, and bilateral negotiations of the swap contracts commenced thereafter. Most were in place by the end of 2003.

China lent its support to the CMI, although it was not a major proponent of the initiative. Japan played the role of arbitrator as countries in the region negotiated the general terms for the swap arrangements. Leadership capacity in these negotiations clearly rested on the size of a nation's foreign exchange reserves. While both Japan and China held reserves in excess of their potential needs, Japan's reserve amounts far surpassed those of China at the time. More importantly, when the basic framework of swaps was under negotiation, Japan and China were the only two countries whose roles would clearly be limited to that of lender, should the network be activated. The successful implementation of the CMI therefore had diplomatic merits for both Japan and China but

By 1999, the rapid growth of China's economy and of foreign investment there were increasingly viewed as a threat by ASEAN members

failed to provide either with tangible economic benefits; rather, it required both countries to bear a degree of risk with regard to possible default by borrowers in the swap network. Material incentives for China on the region's next financial cooperation initiative would differ markedly.

Fostering Regional Bond Markets in East Asia^v

Regional cooperation via the CMI was akin to a team of doctors treating the symptoms of illness. By 2002, however, many officials in the region felt it was time for the doctors to work with their patients to eliminate the source of the illness—structural weaknesses in their financial systems. One key weakness identified is the heavy reliance by firms in the region on *short-term* bank loans for financing. Many countries in East Asia maintain high savings rates but, because of the absence of stable long-term debt markets, the savings deposited into local banks tended to be funneled out to international financial centers and then back into the region as short-term foreign currency loans. This situation creates a problem referred to as a “double mismatch”—that is, a mismatch between debt maturities (short-term borrowing for long-term investments) and the denomination of this debt (in foreign rather than local currencies). In the presence of “double mismatch” a major change in market sentiment has the potential to bring about a currency crisis.

When bonds are denominated in local currencies, bond markets provide a method for raising long-term funding while avoiding maturity and currency risks. Most investors also desire the stability of long-term bond issues, but such investment opportunities are sparse in Asia. By introducing the option of longer term capital procurement and investment to the region, bond markets should in theory serve as engines to greater productivity in national markets across the region.

Yet many individual governments face enormous hurdles to the successful development of national bond markets. Long-term issues require stable institutions, credible regulatory oversight and ratings agencies, and governments or quasi-government entities with the capacity and the will to guarantee bond solvency. Infrastructure related to fund settlements,

tax codes, and foreign exchange transactions are also important for drawing investors into local-currency-denominated bonds. Investors may be wary of the limited number of buyers and sellers in small, emerging markets, since this might lead to low levels of liquidity or sudden shifts in prices. The creation of a regional bond market could help this situation by consolidating risks inherent in local bond markets, introducing economies of scale to improve liquidity, and providing incentives for individual governments to pursue investor-friendly reforms. Such reforms would allow these governments to participate in the market and benefit from income and capital they might not otherwise enjoy.

In 2003–04 the region's central bankers forum sought to take an initial step toward promoting the supply side of bond market development by launching regional bond funds. The first, launched in 2003, involved the investment of \$1 billion in dollar-denominated high-grade securities issued by eight ASEAN+3 nations. In 2004 the group announced the launch of a second set of regional bond funds created for investment in local currency bonds. While the region's central bankers worked to promote the supply of investment funds into regional bonds, the ASEAN+3 finance ministers sought from 2003 to improve the demand side via the Asian Bond Markets Initiative. This initiative aims to promote greater issuance of bonds in the region by facilitating access to the market through creating a wider variety of issuers and enhancing the infrastructure for a bond market. Notable progress has been made to date (see Table 1 on p. 5).

Enthusiastic Support from China

Individual economies in the region have much to gain economically from the development of both their own bond markets and a unified regional bond market. Countries across the region have therefore strongly supported the bond market initiatives. China's enthusiastic support has been particularly notable, given the country's more passive stance toward earlier regional financial cooperation initiatives.

By 2002, when bond market ideas began to be considered seriously in regional forums, China was

A regional bond market would allow many governments to benefit from additional sources of income and capital

Table 1. EMEAP* and ASEAN+3 Initiatives and Outcomes Since the Asian Crisis

Date	Initiative	Progress to Date
2000	Chiang Mai Initiative (CMI): network of bilateral currency swaps among ASEAN+3	16 agreements amounting to US\$36.5 billion
2001	Voluntary monthly exchange among ASEAN+3 of data on short-term capital flows to facilitate effective policy dialogue (IMF compiles only annual data on short-term capital flows)	Regular exchange of data among the following: Korea–Japan, Korea–Thailand, Korea–Philippines, Japan–Indonesia, Japan–Thailand, Japan–Vietnam, Japan–Philippines, and Japan–Brunei
2002	Policy “dialogue” within the ASEAN+3	Annual ministerial level meeting and twice yearly deputies level meeting
2003	First stage of Asian Bond Fund initiative launched by EMEAP	Currently investing \$1 billion in US dollar-denominated bonds issued by sovereign and quasi-sovereign borrowers in eight EMEAP economies
2003	Asian Bond Markets Initiative (ABMI)	Establishment of six working groups and a focal group to coordinate among them; changes in tax treatment for bonds in some member economies; issuance of local currency–denominated bonds in China and Thailand by ADB, IFC, and JBIC; issuance of JBIC–guaranteed won-denominated collateral-backed obligations (CBO) in Korea; cooperation with Association of Credit Rating Agencies in Asia to strengthen local credit rating agencies; launch of Asian Bond Website via the ADB to disseminate information on bond markets in the region; technical assistance on bond market development via the Japan–ASEAN Technical Assistance Fund as well as bilaterally in region
2003	Establishment of ASEAN+3 Research Group that commissions research institutes in the region to produce reports for discussion	Issuance and discussion of two reports: “Towards a Regional Financial Architecture in East Asia” and “An Exchange Rate Arrangement for East Asia”
2004	EMEAP announces launching of second stage of Asian Bond Fund initiative (ABF2)	Concrete details announced of framework for investing approximately US\$2 billion in domestic currency bonds issued by sovereign and quasi-sovereign actors in eight EMEAP economies in early 2005

* The Executives' Meeting of the East Asia and Pacific (EMEAP) Central Banks was established in 1991 following an initiative by Japan. EMEAP member institutions are the Reserve Bank of Australia, People's Bank of China, Hong Kong Monetary Authority, Bank Indonesia, Bank of Japan, Bank of Korea, Bank Negara Malaysia, Reserve Bank of New Zealand, Bangko Sentral ng Pilipinas, Monetary Authority of Singapore, and Bank of Thailand.

The worst case scenario is not Chinese domination but a Chinese meltdown

a member of the WTO and had a timetable in place for financial deregulation and liberalization, in accordance with its WTO obligations. While the country was sheltered from the 1997–98 crisis due to its closed capital account and protected financial sector, it will become more vulnerable to exogenous shocks as it opens up its financial sector in line with WTO commitments. The potential for a crisis is high, given the massive amounts of nonperforming loans held by the nation's banks (estimated by some to be more than 40 percent of total lending) and the surge in additional bank lending in 2004 (a 20 percent increase from 2003). Last year, China's central bank governor publicly stated that he felt that the financing of China's economic development relied too much on the banking system and that the concentration of risk was unacceptably high.^{vi} Measures to help develop China's bond markets serve to reduce these vulnerabilities in the financial system.

Securing new sources of stable long-term financing for the Chinese government and the country's firms also takes on increased importance as many previous sources can no longer be taken for granted. China's rapid economic development will soon prevent it from enjoying the same degree of access to World Bank and Asian Development Bank funds as in the past; meanwhile, Japan has cut severely its level of bilateral development assistance to China. For all of these reasons, the government is eager to see the emergence of longer term and more stable sources of funding. The development of the nation's domestic bond market, and the creation of a regional guarantee institution that would back up bonds issued locally, would be of tremendous help to the Chinese in this endeavor.

At the same time, China's neighbors are eager to see the country actively involved in the bond market. Interdependence between the Chinese economy and other economies in the region has deepened significantly in recent years. Today, trade by ASEAN member nations with China far exceeds trade conducted within the ASEAN grouping, while China is predicted to soon overtake the United States as Japan's top trading partner. Levels of investment in China by countries in the region are also extremely high. Against this backdrop, regional monetary authorities

are quick to note that the worst case scenario is not Chinese domination but a Chinese meltdown. China's participation in regional bond market initiatives is perceived as encouraging a smoother financial liberalization process and thereby bolstering regional stability. In this way, China's economic "rise" provides incentives both for China and its neighbors in the region to cooperate on the bond market initiatives.

Embracing Regionalism Does Not Mean Rejecting Global Institutions

The increasingly important role played by regional forums that exclude the United States from membership leads some observers to suspect that the work in these forums is inimical to U.S. interests.^{vii} Those articulating such concerns equate U.S. exclusion with the rejection of liberal rules for economic interaction championed by the United States.^{viii} Such fears are unwarranted. At least four developments or trends in the region provide strong evidence that the exclusion of the United States does not reflect East Asia's rejection of market principles or of broader regional and global institutions.

First, the ASEAN+3 decided the basic conditions for the swap agreements under the CMI through direct reference to the system of short-term supplemental lending established by the IMF in the wake of the Asian financial crisis.^{ix} Moreover, the release of 90 percent of the funds in the swap network remains linked to the recipient having an IMF program in place—and the remaining 10 percent may only be renewed once for a period of 90 days. While the arrangements are presently under review for possible revision, there is little indication that officials in the region will choose to delink these arrangements from the IMF, given the continued absence of an independent surveillance mechanism within the region. China, in particular, stands opposed to expansion of the current arrangements.

Second, a number of countries in the region have participated in or expressed their desire to participate in a *voluntary* IMF-World Bank–sponsored Financial Sector Assessment Program (FSAP). Launched in 1999, the program is intended to strengthen the

surveillance of the financial sectors of IMF member countries. Korea, the Philippines, Japan, Hong Kong, and Singapore have all undergone assessments to date. Moreover, Indonesia—perhaps the nation in the region seen as most antipathetic toward the IMF as a result of policy conditions attached to its bailout packages during the 1997–98 crisis—recently announced its intention to also join the program, citing its desire to raise the international credibility of its banking sector.

Third, monetary authorities in the region continue to work closely with the Switzerland-based Bank for International Settlements (BIS), which facilitates cooperation among central banks across the globe. The Bank opened a regional center in Hong Kong in 1998 that serves as the secretariat for the Asian Consultative Council, a vehicle for communication between the Asian and Pacific members of the BIS and the Bank's board and management. The region's central bankers forum also entrusts the BIS with management of the Asian Bond Funds noted earlier, while many regional governments continue to entrust the management of their national foreign exchange reserves to the Bank.

Fourth, the clear trend within the region is toward the deregulation of financial systems and the opening up of financial sectors to foreign participation. There is little evidence that East Asian nations are advocating a distinctive financial system model as they move forward with regional cooperation initiatives. In fact, the evidence is to the contrary. Japan is a prominent example, with its so-called Big Bang financial reforms and its recent shift away from relational regulation toward arms-length rules-based financial supervision. Announced in 1996 and gradually (despite the name) implemented since 1998, the financial Big Bang—in conjunction with the nation's 1997–98 domestic financial crisis and reorganization of regulatory authorities—has led to a breakdown of longstanding bank cartels and monopolies in the financial sector. While some remnants of Japan's former main bank system admittedly linger, these can hardly be called the cornerstones of a new system being propagated in the region. The situation is similar to varying degrees in most other economies in the region. The trend is clearly toward more open financial systems.

Regional discussions enable domestic leaders to bring a new angle to domestic debates over regulatory reforms

Conclusion

The Asian financial crisis served to jump-start regional financial cooperation in East Asia, but the negative crisis experience is not what sustains this cooperation today. Intra-regional developments and dynamics since 1999—including China's adoption of a more proactive stance toward cooperation—are critical internal drivers for cooperation more important than any "us" versus "them" sentiment pitting the East against the West. Whereas China opposed the informal 1997 proposal to create a regional monetary fund, China supported the creation of a regional currency swap network and enthusiastically embraces the operational task topping the ASEAN+3 agenda today: the Asian Bond Markets Initiative. This initiative is one that strikes deeply at the heart of financial reforms and liberalization in all ASEAN+3 members countries.

It is important to clarify here that China's capacity to lead or make substantive contributions on this initiative is weak; China will be the *beneficiary* of capacity-building rather than a deliverer of know-how on effective financial arrangements. Nevertheless, the country stands to gain the most from the creation of a regional guarantee institution and other measures intended to strengthen the bond market infrastructure. The tangible benefits expected to accrue to China are higher on this initiative than on any previous one.

Many are justifiably skeptical of the region's ability to achieve the creation of a Pan-Asian bond market. Yet, the potential elusiveness of the end goal should not distract us from recognizing the small advances being made in the name of that goal—advances that serve to strengthen individual financial systems in important ways. Various working groups in regional forums are helping to bolster transparency, improve information dissemination, and strengthen settlement systems. Perhaps more importantly, region-level discussions of various issues and regulations enable domestic leaders to bring a new angle to domestic debates over regulatory reforms. This, in turn, may enable—and, according to some officials, has already enabled—the overriding of entrenched interests.

It is important to recognize that regional financial cooperation in East Asia today is driven by more

Cooperation to strengthen regional bond markets will create healthier financial systems—good news for the U.S. and IMF

complex motives than the negative 1997–98 regional crisis experience and tensions with the IMF. At a time when the United States is being called on to undertake increased burdens on many different fronts, U.S. leaders need to know that leaving regional financial arrangements to regional actors will ultimately coincide with U.S. interests in regional and global financial stability. Regional financial cooperation efforts in East Asia today will create healthier financial systems

that are likely to lighten the potential financial burdens and coordination costs associated with cleaning up after or quelling financial crises in the region. This should be good news for both the IMF and the United States. The fostering of national bond markets in the region and the establishment of a regional bond market will moreover create new investment and underwriting opportunities for actors—both within and outside the region.

Notes

ⁱ This paper draws on material gathered in interviews carried out in 2003–04 with current and former finance ministry and central bank officials in East Asia.

ⁱⁱ See, for example, Lincoln, Edward. 2004. *East Asian Economic Regionalism*. Washington, D.C.: Brookings Institution Press; and Terada, Takeshi. 2003. “Constructing an ‘East Asian’ Concept and Growing Regional Identity: From EAEC to ASEAN+3.” *The Pacific Review* 16(2): 264–266.

ⁱⁱⁱ This shift to a more proactive Chinese stance on regional financial cooperation is consistent with a more proactive stance adopted in general by China across a number of other foreign policy areas. See, for example, Ba, Alice D. 2003. “China and ASEAN: Re-navigating Relations for a 21st-Century Asia.” *Asian Survey* 43 (July–August): 622–647.

^{iv} Tanaka, Akihiko. 2004. “The Development of ASEAN+3.” *Social Science Japan Newsletter* (March): 7–9.

^v The literature on the rationale for and perceived benefits of an Asian bond market is now voluminous. See, for example, Lejot, Paul and Douglas Arner, Liu Qiao, Mylene Chan, Marshall Mays. 2003. “Asia’s Debt Capital Markets: Appraisal and Agenda for Policy Reform.” Hong Kong Institute for Monetary Research Working Paper (October).

^{vi} People’s Bank of China Governor Zhou Xiaochuan, quoted in Bradsher, Keith. 2004. “In China, Troubling Signs of an Overheating Economy.” *The New York Times* (April 14): (C)1.

^{vii} This is a theme that emerges repeatedly in Lincoln, op. cit.

^{viii} See, in particular, Lincoln, op. cit.

^{ix} Kuroda, Haruhiko. 2004. *Gen Hikiage [Revaluating the Yuan]*. Tokyo: Nikkei-BP-sha, p. 165.

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