A Realistic Vision of Asian Economic Integration

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Abstract

In thinking about Asian economic integration, it is noteworthy that most attempts at regional economic integration have been failures. Beside the European Union (EU), the only other case that has been meaningful enough and durable enough is the North American Free Trade Area (NAFTA). Unlike the EU, NAFTA allows only limited labor mobility across countries; has no plans to coordinate exchange rate policies; and does not envisage an eventual political union.

Our conclusion is that the feasible architecture for an Asian Economic Union would be a free trade and open investment area that has a regional financial facility. For the medium run, an Asian Financial Facility (AFF) would operationally be a large Asian swap facility that has its own surveillance mechanism to pre-qualify members for emergency loans. The primary mission of AFF is to reduce the cost of bad luck and not the cost of bad policies. AFF would evolve according to the progress of reforming the IMF, and to the needs created by an increasingly integrated Asia. Given the large size of East Asian foreign reserves, the AFF should take on the additional task of designing a pooling scheme where part of the East Asian reserves could be safely used to finance sound infrastructure projects in the poorest Asian countries. It is important that the AFF does not suffer from the institutional inertia that is characteristic of the present global organizations like the Security Council of the United Nations, the World Bank and the International Monetary Fund. The leadership structure of the AFF should be designed to avoid simply locking in the balance of economic power that existed at the time of its founding. Given the great disparity in the present and future distribution of economic power in East Asia, and the greater restrictions on labor mobility within the (commonly proposed) Asian Economic Union, a NAFTA-type of Asian Economic Union would be preferable to an EU-type of Asian Economic Union. Exchange rate coordination might occur sporadically but it is unlikely to be the norm in the medium term, and most possibly even in the long term. East Asia should therefore be focusing its energy on creating as wide a free trade area as possible (i.e. be geographically unrestricted), and forgo the unrealistic goal of a common Asian currency. However, if an Asian common currency is still adopted, then the lesson from the Greek crisis in early 2010 is that it is necessary for the Asian Financial Facility to become the Asian Monetary Fund.

Keywords: Asian Currency Unit, Asian Economic Union, Economic Integration, NAFTA, EU, ASEAN, Common Regional Currency, Optimum Currency Area, Free Trade Area

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The Push for Asian Economic Integration

Having a harmonious neighborhood is of course a prerequisite to building a harmonious world. Most of the countries in the two most prosperous regions in the world, Europe and North America, have entered into formal arrangements for regional economic cooperation by establishing, respectively, the European Union (EU) on November 1, 1993, and the North American Free Trade Agreement (NAFTA) on January 1, 1994. By 2009, the membership of EU has expanded from 12 to 27; with 16 members in the Eurozone, and with 9 non-EU members using the Euro as their national currencies. Three countries -- Croatia, Macedonia, and Turkey – have been recognized as official candidate countries.[2] For NAFTA, there have been several talks aimed at expanding the agreement to encompass all the countries in the Americas (excluding Cuba) to form the Free Trade Area of the Americas (FTAA).

It is worth emphasizing that the EU and NAFTA are outliers in the global experience in terms of the amount of economic integration already achieved, and in terms of the continued attempts to deepen integration and enlarge membership. Most attempts at regional economic integration have ended in barely-integrating customs unions, with their high points being the signing ceremonies that announced ambitious targets and forecasted enormous gains all round, e.g. Mercusor and ASEAN.[3] EU and NAFTA are similar in that they permit free movement of goods and capital within their respective groupings. However, they also differ in many significant aspects. Unlike the EU, NAFTA allows only limited labor mobility across countries (notably restrictions on labor movements from Mexico to the other two countries); has no plans to coordinate exchange rate policies; and does not envisage an eventual political union.

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[1] Paper for the project *The Future of the Global Reserve System* co-sponsored by The Earth Institute at Columbia University and the Asian Development Bank. I am deeply grateful for the many helpful comments and critical guidance from the participants at the two conferences held on September 16-17, 2009 at Columbia University in New York City, and on March 16-18, 2010 at the Asian Development Bank Institute in Tokyo.

[2] The EU started off as group of 6 countries forming the European Coal and Steel Community in 1951 under the Paris Treaty.

[3] Mercosur was founded in 1991 but its coverage has not expanded beyond the original members of Argentina, Brazil, Paraguay and Uruguay. ASEAN stands for the Association of Southeast Asian Nations, and it was established in 1967 by Indonesia, Malaysia, Singapore and Thailand. ASEAN now includes Brunei Darussalam, Myanmar, Cambodia, Lao People's Democractic Republic, Philippines and Viet Nam. ASEAN was generally an inactive economic organization until the mid-1990s.

Even then events in the recent period do not suggest that the EU and NAFTA might continue to evolve steadily toward their stated final forms. When the citizens of France and the Netherlands in 2005, and of Ireland in 2008, were allowed to express their choice at the voting booth about the desirability of moving on to the next stage of integration, they rejected the motion. It is commonly believed that if Great Britain and Italy had conducted referendums on the issue, their citizens would have also rejected continued European integration. During the US primary elections for nomination as the candidate of the Democratic Party, both Hillary Clinton and Barack Obama expressed the possibility of renegotiating the terms of NAFTA.

Yet in the midst of these contrary developments within EU and NAFTA in the last few years, more prominent Asian voices have emerged in support of building an Asian Economic Union (AEU). For example, in 2005, Haruhiko Kuroda, the President of the Asian Development Bank, called for Asia to move "towards a borderless Asia"; and in 2008, he reported that despite Asian economic integration being a challenging task, "Asia is poised to take these steps."[4]

There have indeed been a great number of successes in the promotion of free trade areas (FTAs) within East Asia, or at least substantial progress in the negotiations towards such agreements, e.g. ASEAN + People's Republic of China (PRC), ASEAN + Republic of Korea (Korea), ASEAN + Japan (three separate ASEAN+1 FTAs). The flurry of FTA formation activities has spilled into FTA agreements between East Asian countries and Oceania, and between East Asian countries and the United States. These FTA agreements are also in most cases also agreements on the removal of restrictions on investments by residents of one country in the other country.

Parallel to this escalation in trade and investment integration, there have also been a growing number of proposals for exchange rate coordination, and then eventual monetary integration. In 2004, Haruhiko Kuroda opined that:

> "The more we think about a single currency the greater the political factor seems to dominate. Especially in Asia, where political systems vary so much from country to country and political rivalries between countries are still so intense, we tend to be pessimistic about a single currency even in the long run. …[H]owever, if we look at the younger generations who are free from old nationalistic sentiment, we can be more optimistic."[5]

The proposal for an Asian Currency Unit (ACU) is now on the table; and Masahiro Kawai (2006) has argued for its usefulness "as a statistical indicator summarizing the collective movement of Asian currencies; as a currency basket used by the market; and as an official unit of account for exchange rate policy coordination."[6] Clearly, in the eyes of some advocates of Asian economic integration, ASEAN, the PRC, Japan, and Korea must now act forcefully to coordinate their exchange rates in order to create the degree of stability in intra-regional exchange rates required for regional monetary integration.[7]

The objective of this paper is to offer an opinion on the extent of Asian economic integration that could be realistically expected to be achieved. My conclusion is that trade and investment integration is likely to progress even further in the medium term, but monetary integration is

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[4] Kuroda (2005) and Kuroda (2008).
[5] Reported in "The Case for Asian Monetary Union," Wall Street Journal, June 1, 2004.
[6] Kawai (2006).
[7] Such a view was expressed in Kawai (2008); which was why the terms "exchange rate coordination", "exchange rate stability", and "currency unification" were used interchangeably in his paper.

unlikely to occur in the next fifty years, if ever. Exchange rate coordination might occur sporadically but it is unlikely to be the norm in the medium term, and most possibly even in the long term. East Asia should therefore be focusing its energy on creating as wide a regional free trade area (or even a customs union) as possible, and forgo the unrealistic goal of a common Asian currency.

The global financial crisis in 2008 could turn out to be an opportunity to boost financial integration within East Asia. This is because the now raging global financial crisis has now removed the main objections that were raised against the establishment of the Asian Monetary Fund in 1997, and has made East Asians understand more deeply the benefits of self-insurance.

The Asian Financial Crisis as Impetus for Asian Economic Integration

In retrospect, the Asian financial crisis of 1997-1998 gave a huge boost to the impetus toward Asian economic integration. The yearn for greater economic integration in post-crisis Asia was due as much as to the consequences of the financial typhoon which appeared in the Gulf of Siam on July 2, 1997 as it was due to the causes of the typhoon and to the responses of the international financial institutions and the United States and Western Europe.

Numerous post-mortems have been performed on the Asian financial crisis.[8] Each autopsy report typically contained the following three hypotheses, with each work differing in emphasis on the importance of individual hypothesis in each country:

- Hypothesis 1 – Prolonged Economic Mismanagement: Prior to July 2 1997, crony capitalism and economic mismanagement in the East Asian economies had loaded their national financial systems with weak loans, and hence rendered their continued high growth unsustainable. These Asian economies imploded for the same reasons the Soviet bloc economies had imploded in the early 1990s. Their industries were not viable without various forms of subsidies (e.g. directed credit, protection), and the aggregate subsidy had reached a level in 1997 that the state could no longer provide.

- Hypothesis 2 – Financial Market Panic: International financial markets, just like domestic financial markets, are susceptible to bouts of mania, panics and crashes, causing them to help stoke booms and busts in their clients' performance (which in the periods of irrational exuberance are often dignified with self-congratulatory honors like The Asian Miracle, and Japan as No. 1). Paul Volcker (1999) has put the matter well:

  > "International financial crises, I might even say domestic financial crises, are built into the human genome. When we map the whole thing, we will find something there called greed and something called fear and something called hubris. That is all you need to produce international financial crises in the future."

- Hypothesis 3 – The Wrong Medicine of the International Monetary Fund (IMF): By enforcing the abrupt shutdown of banks in difficulties, the tightening of central bank credit, and the reduction of budget deficits through cuts in government expenditure, the IMF's "rescue" packages converted a minor downturn into a deep recession, and helped to exacerbate (if not initiate) the regional panic by constantly issuing dire diagnoses of

[8] See, for example, Woo, Schwab and Sachs (2000), and Blustein (2001)

the patient. This is why many Koreans have dubbed the perfect storm they found themselves in "The IMF Crisis."

It is convenient to embrace Hypothesis 1 readily because no economy is without flaws. However, the fact that output in Malaysia, Korea and Thailand rebounded just as quickly as they had fallen falsifies the initial IMF belief that, beside monetary-fiscal tightening, drastic overhaul of the economic system and incentive structure similar to those undertaken earlier in the former Soviet bloc (e.g. immediate increase in the capital adequacy ratio and abrupt large-scale closure of financial institutions) were necessary to restart growth. This initial misjudgment explains why the IMF kept under-predicting until the end of 1998 the strength of the growth that occurred.

Now in light of the financial meltdown of the US financial markets in the last quarter of 2008 and the massive indiscriminate bailout of financial institutions now being conducted by the US Treasury and the US Federal Reserve, it is highly credible to believe that Hypothesis 2 (Financial Market Panic) was the root cause of the Asian financial crisis, and that Hypothesis 3 (IMF's incompetence) was an important contributor to the deepening of the crisis in Indonesia, Korea, and Thailand. The V-shape of East Asia's re-bounce (except for Indonesia where the financial crisis sparked off a meltdown of the political system) rejected the view of Hypothesis 1 that structural adjustment was the precondition for economic recovery

The many careful studies in the voluminous literature on the Asian financial crisis have produced many valuable insights on every dimension of the crisis: the origins, early detection, pre-emptive interventions, emergency-room macroeconomics, and post-crisis recovery. For the topic of the types of economic policy cooperation that are appropriate for Asia, there are two lessons that are particularly useful. The first lesson concerns the natural working of the market mechanism, and the second concerns the availability of help during a financial crisis.

There has long been a tradition of resistance within the economics profession to acknowledge the phenomenon of disorderly market behavior. The fact that financial contagion has been common in the 1990's cannot be in serious dispute: the European Exchange Rate Mechanism crisis in 1992-93, the Mexican and Latin American financial crisis in 1994-95, the Asian financial crisis in 1997-98, the conversion of the Russian ruble to a rubble in August 1998, and the collapse of the Brazilian real in January 1999. It stretches credibility and the imagination that all these governments coincidentally shifted to destabilizing policies in the same decade. Herein lies the first lesson insight from the Asian financial crisis: *occasional excessive price movements in financial markets are normal and should not be labeled 'peso problems' in a knee-jerk fashion.*

The second important relevant lesson from the Asian financial crisis is that *"the only form of reliable help during an economic emergency is self-help."* The IMF could not be counted upon to be always correct in its diagnosis upon its first reading of the situation. Moreover, the United States could not be expected to be always ready to help out countries in desperate straits. In the three-decade long rule of General Soeharto, he had been bailed out several times before by the US and its allies (notably Australia, Japan, Holland, and the international financial institutions), and it was thus quite natural for him to expect some external aid when things started going awry in the last quarter of 1997. Soeharto was mistaken. He did not realise that with the end of the Cold War in 1992, he was dispensable to US security and ideological interests just as his fellow general, Joseph Mobuto of Congo-Leopoville, was dispensable; a newly-impoverished Indonesia was not as important to US policymakers as a newly-impoverished Mexico would because Indonesia was not an immediate geographical neighbor to the US and thence could not send a tsunami of unemployed workers into the US; and as he neared the end of his natural life-span, the Americans (after their costly experience with hanging on to the Shah of Iran until the bitter end in 1979) had become more interested in who would be replacing him than in maintaining him in power.

The only country that was willing to commit immediate large-scale financial assistance to the crashing Asian economies was the neighboring country of Japan, which proposed the Asian Monetary Fund (AMF). Japan did not succeed in establishing the AMF, however. Three of the key reasons for the failure of the AMF initiative were that some important developed countries believed in the crony capitalism explanation of the crisis and concluded that an AMF would merely mean throwing more money to the undeserving, corrupt elite of these countries; some other developed countries wanted to protect the monopoly position of the IMF so that they could continue to command a disproportionate influence on world affairs; and the PRC was not prepared to be rushed by events into supporting a new regional institution without careful consideration of all the implications.

These two lessons propelled the East Asian countries after their recovery to go on a reserves accumulation spree to insulate themselves from future speculative attacks (i.e. be independent of the supervision of the IMF). These lessons also led the Asian countries -- the 10 ASEAN countries, the PRC, Japan and Korea, collectively called ASEAN+3 -- to start the process of currency and financial cooperation when they met in Chiangmai, Thailand, in 2000. The resulting Chiangmai Initiative had two major components.

The first component was that countries agreed to come to each other's aid if similar speculative attacks were to reoccur. This pooling of reserves to defend the existing values of their exchange rates was enabled by each country entering into a web of bilateral swap arrangements. The second component was the establishment of an Asian Bond Market (ABM) to keep funds within the region. The assumption is that if there were an unjustified (i.e. panic-stricken) capital flight from one Asian country, the existence of the ABM would channel these funds to the other Asian countries. ABM is a defensive mechanism (just like the anti-ballistic missile), and it worked by reducing the probability of a collective capital flight from out of Asia.

The Chiangmai Initiative turned out to be only the first part of a more comprehensive program of regional economic integration. In November 2001, the PRC and ASEAN agreed to start negotiations for an ASEAN+1 free trade area (FTA) that would be achieved in 2010. By November 2002, the PRC and ASEAN had made enough progress to sign the framework agreement for the ASEAN+1 FTA. This fast pace of economic embrace between ASEAN and the PRC had the synergistic effect of accelerating what has been a leisurely-paced process of incremental economic integration within ASEAN, and energizing Japan into active FTA negotiations with ASEAN.

The ambition of Asian economic integration, or at least its rhetoric, has continued to broaden. The annual ASEAN+3 conference in 2005 was supplemented by the East Asian Summit (effectively an ASEAN+6 conference) to include Australia, India and New Zealand; and the host of the 2005 conference, Prime Minister Abdullah Badawi of Malaysia, expounded on his vision of an Asian community.

At the May 2006 meeting of the Asian Development Bank (ADB) in Hyderabad, India, the ADB led the call for the introduction of an Asian Currency Unit (ACU) to coordinate exchange rate movements within the region. This ACU proposal was similar to the first major step toward currency unification in Europe when the European Currency Unit (ECU), more popularly known as the European Currency Snake, was introduced in 1976 to coordinate a joint float against the US dollar. Would Asia in three years after Hyderabad, as Europe did in 1979, form the Asian equivalent of the European Monetary System? And then grow into an Asian Monetary Union another twenty years later?

Given the many parallels between the fast Asian developments in the last decade with the movement in Europe from the Treaty of Rome in 1957 that established the European Economic Community to the Maastricht Treaty in 1993 that formalised the European Union (EU), the sense of history repeating itself is naturally a strong one. Is there an Asian Economic Union (AEU) in the offing? Would it come soon, just like a late industrializer normally taking off at an explosive speed compared to the first industrializer?

We know enough from painful experiences, however, to be wary of linear thinking, otherwise, there would never be any turning points in history. We do well to remember the famous words of "History repeats itself, first as tragedy, second as farce."[9]

The Economic Basis for Exchange Rate Coordination and a Common Currency

The basic question is whether the final realized form of the Asian Economic Union (AEU) would be closer to EU or to NAFTA. So far, no prominent proponent of AEU has advocated a future political union as the final objective. While political objectives like avoidance of armed conflict among traditional competitors might suffice to drive the economic integration agenda, it would be more rational to also explicitly acknowledge the economic costs of these political decisions. To put the issue more fundamentally, is there a case for exchange rate coordination (and, maybe, monetary integration) within AEU in the absence of political unification?

In our opinion, we cannot compare the relative merits of an EU-type AEU and an NAFTA-type AEU without stating what the world would look like in the future. Luckily for us, the conventional view of the state of the world in 2025 and 2050 are conveniently contained in two Goldman-Sachs studies done in December 2005 and March 2007.[10]

Table 1 reports the 2005 projections by Goldman-Sachs of the inflation-adjusted GDP in 2025 and 2050 in the major countries in EU, NAFTA and AEU. Part A of Table 1 focuses on the three NAFTA countries; USA, Canada and Mexico. If we select for the normalisation of GDP in each year the current GDP of the country that had the smallest GDP in 2005, then the GDP ratio of USA-Canada-Mexico in each year
would be

- 17.9 : 1.7 : 1.0 in 2005
- 8.2 : 0.8 : 1.0 in 2025
- 4.8 : 0.4 : 1.0 in 2050

While the United States would become increasingly large vis-a-vis Canada and decreasingly large vis-a-vis Mexico, the fact is that the US is the overwhelmingly dominant country in NAFTA at the present and will continue to be overwhelmingly dominant in the future. In 2050, the US would be twelve times larger than Canada and almost five times larger than Mexico. Given this

[9] This is the common paraphrase of the opening sentences in Karl Marx (1852).
[10] The 2005 Goldman-Sachs study is by O'Neill, Wilson, Purushothaman and Stupnytska (2005); and the 2007 Goldman-Sachs study is by Dominic Wilson and Anna Stupnytska (2007).

great disparity in economic size, it will always be true that independent economic shocks in Canada and Mexico would have very limited impact on the US economy, while a sneeze by the US could send powerful tremors to the other two NAFTA members. In such an unequal situation, the survival of individual currencies is natural because the giant US economy sees no advantage in allowing its monetary policy to be influenced by the concerns of the smaller economies, and Canada and Mexico could use the exchange rate as an additional instrument to help offset shocks (especially trade shocks) originating from the US economy.

Part B of Table 1 reports the GDP of the three largest economies in the EU; Germany, United Kingdom, and France. Again using the smallest country in 2005 (France in this case) to normalise GDP, we see that the GDP ratio of Germany-UK-France would be:

- 1.3 : 1.0 : 1.0 in 2005
- 1.2 : 1.0 : 1.0 in 2025
- 1.1 : 1.0 : 1.0 in 2050

The GDP ratios reveal clearly that the biggest EU economies are of the same magnitude now and will continue to be so in the future. This means that independent shocks in each country will have sizable spillover effects on the others. This high level of economic interdependence amongst EU members means that the welfare of each member would be increased if national economic policies were coordinated in a manner that reduces negative spillover effects. One instrument for achieving this welfare-enhancing cooperative solution is a common currency.
Furthermore, on the political dimension, the natural compromise solution for a group of equally powerful countries would be a common currency rather than the adoption of any particular national currency. The fact that Europe is anxious to undertake political union in order to minimise the possibility of another war among Germany, UK, and France means that a common currency is a necessary by-product. (In 1950, when the French foreign minister Robert Schuman pushed for the creation of the European Coal and Steel Community, the forefather of EU, he explicitly admitted that this was a way to prevent further war between France and Germany. With the steel and coal industries under the control of a supranational organization, he would have made "war not only unthinkable but materially impossible."[11])

Part C of Table 1 projects that the distribution GDP of the three major East Asian economies -- Japan, the PRC, and Korea -- display drastic changes over time. The GDP ratio of Japan-PRC-Korea will be:

- 6.6 : 2.4 : 1.0 in 2005
- 2.6 : 4.5 : 1.0 in 2025
- 2.2 : 13.1 : 1.0 in 2050

Unlike the EU, AEU will not be a club of equals at any point in time; and, unlike NAFTA, there is no stable dominant economic giant across time. Japan is the economic giant in 2005; but the PRC will be the economic giant in 2050. If there is a compelling economic argument to form a Yen-bloc today, then the same compelling economic reasoning would dictate that this Yen-bloc transform itself into a Yuan-bloc by about 2035.

Making projections about future GDP is of course an exercise that involves bold assumptions about many uncertainties. This is especially true for Asia where fast economic growth and large-scale structural transformation are occurring. This fact is well evidenced in the big changes that Goldman-Sachs made in its 2007 projections of GDP size. Table 2 shows that in

[11] Quote is from website: http://en.wikipedia.org/wiki/European_Coal_and_Steel_Community

less than two years' time, Goldman-Sachs revised its estimate of the PRC's GDP to be bigger in 2010 by 31%, in 2025 by 53%, and in 2050 by 41%. The 2007 estimates for Japan's GDP was 20% smaller than by the 2005 estimates throughout 2010-2050. There was no consistent pattern in the updating of the projections because the 2007 projections has Korea's GDP to be 21% smaller in 2010 than the 2005 projections, 31% smaller in 2025, and 7% bigger in 2050.

Table 3 reports the 2007 projections of GDP of the main economies in each geographical grouping for the 2010-2050 period. According to the 2007 projections in Part A of Table 3, the GDP ratio of USA, Canada and Mexico will be:

- 15.6 : 1.5 : 1.0 in 2006
- 8.7 : 0.8 : 1.0 in 2025
- 4.1 : 0.3 : 1.0 in 2050

The 2007 projections in Part B of Table 3 put the GDP ratio of Germany, UK and France as:

- 1.3 : 1.1 : 1.0 in 2006
- 1.2 : 1.1 : 1.0 in 2025
- 1.1 : 1.1 : 1.0 in 2050

The GDP ratio for East Asia (Japan, the PRC, and Korea), according to the 2007 estimates of Goldman-Sachs in Part C of Table 3, was:

- 4.9 : 3.0 : 1.0 in 2006
- 4.3 : 4.4 : 1.0 in 2010
- 3.0 : 9.9 : 1.0 in 2025
- 1.6 : 17.3 : 1.0 in 2050

It is reassuring that the 2005 projections and the 2007 projections show the same qualitative results. The US is the economic giant in NAFTA now and will be the economic giant in NAFTA in 2050. This fact will be true even if NAFTA were to be expanded to include Brazil (in 2050, GDP would be $37 trillion for USA and $11 trillion for Brazil). The three largest EU economies of Germany, UK and France would remain to be roughly comparable in size over time. In the EU neighbourhood, Turkey would grow to become like them, being only 10% smaller than France in 2050 and 34% larger than Italy.

For East Asia, Japan is the biggest economy now but the PRC will be the economic giant from 2025 onward. The faster growth projections for the PRC in the 2007 Goldman-Sachs report means that PRC's GDP would now match Japan's GDP in 2010 rather in 2016, and US GDP in 2030 rather than in 2040. Two new giants will be present in the East Asian region in 2050: India and Indonesia. India's GDP would catch up to Japan's GDP in 2027, and Indonesia's GDP would match Korea's GDP in 2046. The PRC would still be the economic giant in Asia in 2050, being 88% bigger than India

As Chinese policymakers must be well aware of the changing balance in economic power within East Asia over the next three decades, it is hard to see why the PRC today would want to support the establishment of a regional economic architecture that would establish a Yen-bloc. Similarly, even if the PRC were to agree to the formation of a Yen-bloc right now, it is hard to see why it would not seek to change the fundamental nature of the regional financial architecture after 2035. It is, in short, politically unrealistic to expect a common currency for East Asia in the foreseeable future.

Moreover, it is also economically undesirable for East Asia to adopt a common currency because there has not been serious consideration of complete integration of national labor markets in the official and academic discussions on an Asian Economic Union. If economy A is entering into inflation while economy B is entering into recession, A will want to raise the interest rate while B will want to lower the interest rate. The uncomfortable reality is that whatever the compromise interest rate policy might be, it would be optimum only if labor from B could move freely and costlessly into A.[12] Without unhindered labor mobility across A and B as the adjustment mechanism to a common monetary policy, the benefits of a common currency could be greatly reduced, if not, overwhelmed.

Our opinion is that, one, the NAFTA-like disparity in economic power in AEU at the present and in the future, and, two, the absence of policy-induced integration of national labor markets mean that the only stable configuration is the survival of individual East Asian currencies with limited coordination among them in normal times. It therefore appears to us that the many present efforts to promote closer exchange rate cooperation will not succeed in the long-run.

<u>The 2008 Global Financial Crisis as another Wake-Up Call for Asian Financial Integration</u>

In response to the present deep global financial crisis, President George Bush convened a G-20 summit meeting in Washington DC on November 15, 2008. A second G-20 summit will be held in London on April 2, 2009. President Nicolas Sarkozy of France and Prime Minister Gordon Brown of Great Britain have called on the G-20 to establish a New Bretton Woods. We do agree that the PRC should support the establishment of a working group on the reform of the IMF to discuss:

- how much to increase its resources to allow it to fight global financial fires,
- how wide to increase its jurisdiction to authorize it to improve regulation of financial markets, and
- how radically to restructure its ownership to give it the legitimacy to impose its will on prostrate economies.

However, while an improved IMF is highly desirable, the fact is that the better first line of Asian defense against financial contagion would be a greatly enhanced Asian swap facility, the Asian Financial Fund (AFF), because Asia collectively now has enough reserves to fend off unwarranted speculative attacks on a subset of its members. It must be emphasized that the core mission of the AFF is to combat financial contagion and not to finance balance of payments adjustment caused by economic mismanagement. This present emphasis by AFF on the former is what distinguishes it from the International Monetary Fund, which has both functions as its core mission.

An AFF is necessary because it is simply impossible (certainly, inefficient) to increase the size of the IMF enough to enable it to have in-depth expertise on most of the countries to be able to respond optimally in a timely manner to each national crisis. Furthermore, the IMF policies are decided by Executive Directors who usually take their orders from their national ministries of finance and central banks, and it would be credulous to think that a significant proportion of these national economic agencies would have up-to-date understanding of most of the emerging economies. Even if the improved technical competence of the IMF is not doomed to disappoint the emerging economies, the emerging economies would be disappointed by the

[12] This is the fundamental insight of Mundell (1961).

long time required for an improved IMF to appear. The negotiations on meaningful IMF reforms would inevitably be cantankerous and hence protracted.

The Sarkozy-Brown proposal for a New Bretton Woods should be recognized to be part of the continuing effort by Old Europe to maintain its disproportionate representation in global governance bodies like the UN Security Council, the IMF and the World Bank.[13] The proposal to make the unreformed IMF the super financial policeman of the world is foolishness because the concentration of so much power in its hands would magnify the impact of any wrong operational procedure and allow the mistake to be unchecked for a longer time. If need be, the assignment of global financial regulation to an expanded BIS would be a better alternative. The IMF should forgo its dream of jurisdiction-expansion and become instead a more specialized agency that undertakes macroeconomic surveillance for the world, and balance of payments assistance for the emerging economies.

Right now, East Asia has a thin network of swap lines to defend their currencies. It would be desirable to hasten the evolution of the existing swap facility into the AFF by two actions. First, the existing swap facility specifies that a cumulative drawing that exceeds 20 percent of a country's quota would require the country to accept IMF supervision. This "flight-to-IMF" clause should be removed because painful memories of 1997-98 make it politically suicidal for any East Asian leader to do so.

Second, the Asian swap facility must now establish a surveillance mechanism to pre-qualify its members for emergency loans.[14] Without a credible procedure to pre-qualify members, the removal of the "flight-to-IMF" clause would guarantee that the present system of (bilateral and multilateral) swap arrangements would not be sustainable and would not increase to meaningful sums. This is because the members want the pooled funds to be used only to defend an exchange rate against speculative attacks not justified by fundamentals. The members would not support using the pooled reserves to defend an exchange rate that has been rendered overvalued by inflationary domestic policies. Without pre-qualification of potential borrowers, no member would be willing to risk committing a large part of its reserves to the swap facility.

During the height of the Asian financial crisis, the US, Western Europe and the PRC opposed the establishment of an Asian Monetary Fund (AMF) to help handle the crisis. Why should they now support the setting up of the AFF that would have some of the same features as the rejected AMF? There are six reasons for their change of mind.

The first reason is that the 2008 global financial crisis has removed all doubt that financial panic and not crony capitalism was the cause of the Asian financial crisis, and that the IMF programs had made matters worse.

The second reason is that the US and Western Europe cannot really stop such a move anyway because, one, the East Asians now have the requisite amount of foreign exchange reserves to undertake self-insurance against speculative attacks on a subset of their members; and, two, the PRC has now changed its mind about the desirability of a regional financial institution.

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[13] The veracity of this statement is strikingly seen in that the G-20 summit in November 2008 turned out to be a G-22 summit because some of the European members pressed successfully for the inclusion of the Netherlands and Spain in the summit.
[14] Wang and Woo (2004).

The third reason is that there is now realization by the US that, when dealing with Asia, it should rely less on the hard power of a formal dominant role in global leadership, and more on the soft power of US example, like helping Asia do what's best for Asia (which is an excellent start to the US re-engagement with Asia). The US support for AFF is the much-needed change toward an inclusive US approach that is diversified in modality to handle each specific multilateral issue. Such a change in modality by the US would be a realistic response to the Asia-ward movement in the center of gravity of the world economy.

The fourth reason is that with the end of the Cold War, the international agenda of the US is no longer so similar to those of the Western European countries. This is why when Sarkozy pressed Bush in October 2008 to convene a G-7 summit to deal with the global financial crisis, Bush chose to convene a G-20 summit instead. The international economic agendas of the US and some the major developing countries now share many more common elements that are at odds with the position of the EU, e.g. agricultural subsidies.

The fifth reason is that the US and the rest of the interested world would be members of the AFF just as they are now influential members of the Asian Development Bank. The creation of the AFF would not mean the disappearance of their policy engagement with Asia. Furthermore, just as we have the system of the World Bank and several regional development banks (like the Inter-American Development Bank, and the African Development Bank), it is also natural and desirable to have regional financial institutions in addition to the IMF. The IMF is by no means obsolete with the establishment of the regional financial institutions. The IMF can play a very helpful role in speeding up the institutional maturity of these regional financial institutions, and in keeping up the competition of ideas.

The sixth reason is that the AFF could expand over time to be an APEC-level institution; and be a good partner to the IMF because "two heads are better than one" in analyzing unexpected quickly-evolving crises and in preventing their contagion. In short, the better way to improve the supply of global public goods is not to simply increase the size of the existing providers but to increase the number of providers while seeking to improve the performance of existing ones.

Of course, over time, depending on the progress in reforming the operations and the governance of the IMF, and the new needs created by greater Asian economic integration, the Asian community might empower the AFF to also extend adjustment loans with conditionality to countries that needed balance of payments assistance because of past economic mismanagement. It is important to note that pooling national foreign exchange reserve funds and using them to enhance regional welfare is independent of whether AFF would promote exchange rate coordination or not. One activity does not imply the other.

The Feasible Architecture for an Asian Economic Union

Earlier, we pointed out two features about East Asian economic integration. The first feature is that there are three separate ASEAN+1 FTA agreements but not an encompassing ASEAN+3 FTA agreement. The second feature is that the ASEAN+3 forum has effectively expanded to an ASEAN+6 forum since 2005.

It is important to grasp that these two features reveal a key condition for the durability and effectiveness of any formal Asian economic integration, which is that the ASEAN+3 grouping is not a stable grouping. This is because some ASEAN+3 members were understandably concerned that the PRC could quickly come to dominate the grouping through its sheer size.

These members have therefore supported the admission of Australia, India and New Zealand into the regional grouping in order to create the possibility of forming a coalition to counterbalance the PRC's weight in the economic union, if they feel the need to do so. In short, unlike ASEAN+3, ASEAN+6 is a politically stable grouping because it allows check and balance within the organization.

The expansion of ASEAN+3 to ASEAN+6 is actually desirable economically as well as politically. Adam Smith has famously argued that the division of labor creates wealth, and that the degree of the division of labor is determined by the size of the market. As the biggest market that is available is the world market, the optimum size of an FTA is therefore the whole world! It is most probable that the bigger an FTA is, the bigger would be the gains from trade – which means that an ASEAN+6 grouping is economically superior to an ASEAN+3 grouping. The practical recommendation on regional trade and investment integration that emerges from our discussion is that an Asian Economic Union should go beyond being contiguously as large as possible to being as inclusive as possible, where geographical location is a secondary consideration.

On the financial side of the Asian Economic Union, our formulation of an Asian Financial Fund (AFF) is operationally the establishment of a large Asian swap facility that has its own surveillance mechanism to pre-qualify members for emergency loans. The primary mission of AFF is to calm panic in the foreign exchange markets and not to defend currencies that have been rendered overvalued by domestic inflationary policies. AFF's goal is to attenuate the cost of bad luck and not the cost of bad policies.

However, the last statement in the preceding paragraph is tenable only as long as there is not a common Asian currency. The difficulties of the Greek government in early 2010 in rolling over its debt and in issuing new debt were due to the growing perception of the investors that the steady large growth in Greek's debt-GDP ratio was a Ponzi scheme. The traditional economic cure for this crisis in confidence has two components. The first component is to reduce state spending and raise taxes to assure that investors that insolvency of the state is not in the cards. As this first component of the policy adjustment package lowers aggregate demand, the second component seeks to boost aggregate demand by devaluing the currency and, also possibly, by expanding the money supply moderately. However, because Greece is a member of the Euro-Zone, neither currency depreciation nor credit expansion is in the national toolbox of policy measures. Without these two macro-stabilization instruments, Greece (understandably) delayed the correction of its budget deficit, and hence created this deep fiscal crisis of the state.

Clearly, in a region with a common currency, it is desirable to have an IMF-type of regional body to be an external source of funding for structural adjustment programs. The lesson from the Greek crisis in March 2010 is that the Euro-Zone requires a European Monetary Fund in addition to the European Central Bank in order to implement bailout-with-punishment of the countries that got into economic trouble from its irresponsible policies.

Given the large size of East Asian foreign reserves, the AFF should take on the additional task of designing a pooling scheme where part of the East Asian reserves could be safely used to finance sound infrastructure projects in the poorest Asian countries. This outcome would be superior to the present practice of putting almost all of the East Asian foreign reserves into the assets of G-7 economies.

It is important that the AFF does not suffer from the institutional inertia that is characteristic of the present global organizations like the United Nations, the World Bank and the International

Monetary Fund. The leadership structure of the AFF should be designed to avoid simply locking in the balance of economic power that existed at the time of its founding; much like the unchanging composition of the permanent members of the UN Security Council, the head of the World Bank always being a US appointee and the head of the IMF always being a European. If AFF can adopt a self-updating type of leadership structure, its first contribution to the world (as well as to the East Asian region) would be the provision of an example to inspire positive developments in the reform of the leadership structure in the global organizations.

To summarise, an Asian Economic Union (AEU) should take the form of a WTO-plus[15] free trade and open investment area that has regional pooling of foreign exchange reserves (via the Asian Financial Facility). And it cannot be over-emphasized that there is no economic logic for a regional financial facility to naturally morph into the regional central bank. Given the great disparity in the present and future distribution of economic power in East Asia, and the greater restrictions on labor mobility within the (commonly proposed) Asian Economic Union, a NAFTA-type of Asian Economic Union would be preferable to an EU-type of Asian Economic Union. Exchange rate coordination might occur sporadically but it is unlikely to be the norm in the medium term, and most possibly even in the long term. East Asia should therefore be focusing its energy on creating as wide a free trade area as possible (i.e. be geographically unrestricted), and forgo the unrealistic goal of a common Asian currency. However, if an Asian common currency is still adopted, then the lesson from the Greek crisis in early 2010 is that it is necessary for the Asian Financial Facility to become the Asian Monetary Fund.

[15] WTO+plus = the degree of openness exceeds existing WTO standards

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Table 1: Projections by Goldman Sachs in 2005

The World Economy in 2005, 2025 and 2050
(GDP is measured in trillions of US$ in 2005 prices)

Case 1. NAFTA GDP: US dominates now and in future

	USA	Canada	Mexico
2005	12.5	1.2	0.7
2025	19.6	1.8	2.4
2050	37.7	3.0	7.8

Case 2. EU GDP: Fairly equal size

	France	Germany	UK
2005	2.3	3.1	2.3
2025	3.2	3.9	3.3
2050	4.9	5.4	5.1

Case 3. Asia GDP: Japan now, PRC in future

	PRC	Korea	Japan
2005	1.9	0.8	5.3
2025	11.7	2.6	6.7
2050	48.6	3.7	8.0

Source: Jim O’Neill et al, op. cit.

Table 2

The Goldman Sachs Revisions in GDP Projections for Asia

Ratio of GDP Size Projected in March 2007 to
GDP Size Projected in December 2005 (in percent)

	PRC	Korea	Japan	India	Indonesia
2010	131.0	80.4	80.5	107.8	114.0
2015	142.2	68.5	80.5	109.6	108.2
2020	149.6	61.7	80.4	112.4	103.2
2025	153.0	68.7	80.4	115.6	102.4
2030	153.1	76.7	80.5	118.4	107.6
2035	151.3	85.4	80.5	120.8	119.2
2040	148.3	93.1	80.4	124.5	136.6
2045	144.8	101.1	80.4	128.9	154.9
2050	141.0	107.4	80.5	134.0	173.1

Table 3

Goldman Sachs Projections in March 2007 of GDP Size in 2006-2007 (in 2005 US$ bn)

(I have converted the original data in 2006 US$ to 2005 US$ using the CPI of USA)

A Comparison with the December 2005 projections

Part A: Balance of Economic Power in NAFTA unchanged in 2050, rising Brazil still small vis-a-vis USA

	US	Canada	Mexico	Brazil
2006	12,831	1,221	824	1,031
2010	14,081	1,346	977	1,304
2025	19,459	1,798	2,231	2,743
2030	22,104	1,997	2,972	3,604
2050	37,310	3,051	9,048	11,011

Part B: Continued rough parity amongst the 2005 giants in 2050, with emergence of Turkey as growing economic power

	France	Germany	UK	Italy	Turkey
2006	2,125	2,762	2,238	1,752	378
2010	2,292	2,987	2,466	1,854	426
2025	2,960	3,518	3,229	2,253	935
2030	3,203	3,643	3,483	2,316	1,239
2050	4,449	4,867	4,973	2,858	3,820

Part C: PRC becomes 40% bigger and Japan 20% smaller in 2050 than expected; and two new giants in the neighborhood

	PRC	Korea	Japan	India	Indonesia
2006	2,598	859	4,201	881	339
2010	4,521	1,038	4,460	1,217	406
2025	17,861	1,803	5,396	4,181	1,001
2030	24,810	2,171	5,632	6,474	1,433
2050	68,500	3,955	6,468	36,491	6,791