

# What Form Should An Asian Economic Union Take?

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## The Impetus to Recent Initiatives for Asian Economic Integration: The Asian Financial Crisis

A financial typhoon appeared in the Gulf of Siam on July 2, 1997, first toppling the Baht and the Thai economy and then sweeping to-and-fro across East Asia for the next eight months, doing severe economic and political damage to South Korea, Indonesia, and Malaysia. The ripples of the typhoon were felt as far as Brazil and Russia, with an equally disastrous outcome in the latter. Post-mortems have abounded since; initially in the form of media and official assertions; next in dissertations from academic dissections; and finally in Paul Blustein's excellent book, *The Chastening* (Public Affairs, 2001). Each autopsy report typically contained the following three findings, with each work differing in emphasis on the importance of individual findings in each country.

**Finding 1:** The victim died because she was already so wasted internally by self-inflicted wounds that she keeled over when the wind started blowing. The role of the storm was happenstance because a sneeze later on would also have caused her to crumble when her constitution had been rendered more fragile by the soft rot.

*Translation: Prior to July 2 1997, crony capitalism and economic mismanagement in these 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.*

**Finding 2:** The victim died because she was crushed in her sleep by the coconut tree brought down by the gale.

*Translation: 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."*

**Finding 3:** The victim died not from the bad cold she caught with the change in weather but by the mistaken administration of nitrogen instead of oxygen while in the ambulance on the way to the hospital.

*Translation: The incompetence of the IMF turned a downturn into a depression with contractionary "rescue" packages, and helped to exacerbate (if not initiate) the regional panic with dire diagnoses of the patient. The Koreans were correct to dub the perfect storm they found themselves in "The IMF Crisis."*

While the Asian financial crisis was most probably the product of all these three factors, it would be irresponsible to completely avoid apportioning blame because this would deny the importance of accountability. It is convenient to embrace Finding 1 readily because no economy is without

flaws. However, the fact that output in Malaysia, South 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.

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, preemptive interventions, emergency-room macroeconomics, and post-crisis recovery.<sup>1</sup> 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.

<sup>1</sup> See, for example, Wing Thye Woo, Klaus Schwab and Jeffrey Sachs (edited), *The Asian Financial Crisis: Lessons for a Resilient Asia*, MIT Press, 2000.

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There has long been a tradition of resistance within the economics profession to acknowledge the phenomenon of disorderly market behavior. The most commonly used defense against claims of speculative bubbles is the alternative hypothesis that unstable asset prices reflect unstable government policies. The claim (labeled the "peso problem") is that observed flip-flop movements in asset prices reflected rational anticipations of changes in government policies that turned out not to occur. The truth is that the peso problem hypothesis cannot really be disproved—there is just no way of getting around the sophistry of a determined peso problem believer.

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 ruble 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

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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 realize 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 Mobutu of Congo-Leopoville, was; that a newly-impooverished Indonesia, not being an immediate geographical neighbor to the US, could not send a tsunami of unemployed workers into the US as a newly-impooverished Mexico could; and that 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 China 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, China, Japan and South 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:

1. The 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.
2. An Asian Bond Market (ABM) would be established 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.

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 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?

The Chiangmai Initiative turned out to be only the first part of a more comprehensive program of regional economic integration. In November 2001, China and ASEAN agreed to start negotiations for an ASEAN+1 free trade area (FTA) that would be achieved in 2010. By November 2002, China and

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ASEAN had made enough progress to sign the framework agreement for the ASEAN+1 FTA. This fast pace of economic embrace between ASEAN and China 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.

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 formalized 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 industrialist normally taking off at an explosive speed compared to the first industrialist?

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."<sup>2</sup>

<sup>2</sup> This is the common paraphrase of the opening sentences in Karl Marx's *The Eighteenth Brumaire of Louis Bonaparte* (1852).

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### The Economic Basis for Exchange Rate Coordination and a Common Currency

It is important to note that 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. The two possibly most successful free trade areas in existent are the European Union (EU) and the North American Free Trade Area (NAFTA). 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.

The most commonly proposed forms of the Asian Economic Union (AEU) are closer to NAFTA rather than to EU. The proposals, especially those not associated with ADB sponsorship, generally anticipate exchange rate coordination to be possible only in the far future; foresee no future political union; and have tighter restrictions on labor mobility than NAFTA. What is the basis of these proposals for a NAFTA-type AEU? Are they based on unjustified fears about loss of national identity? If these NAFTA-type AEU proposals were not the results of economic calculation, then would an EU-type AEU result in higher economic welfare for its members? It is of course rational to make recommendations about what form

an AEU should take based on political considerations alone, but it would be even more rational if we 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 a 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 a Goldman-Sachs study<sup>3</sup> Table 1 reports the projections 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 normalization of GDP the country that had the smallest GDP in 2005, then the GDP ratio of USA-Canada-Mexico would be:

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

<sup>3</sup> O'Neill, Jim, Dominic Wilson, Roopa, Purushothaman and Anna Stupnytska, "How Solid are the BRICs?" Global Economics Paper No: 134, Goldman Sachs, December 15, 2005.

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 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 normalize 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; and
- 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.

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

- 6.6 : 2.4 : 1.0 in 2005;
- 2.6 : 4.5 : 1.0 in 2025; and
- 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 China 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

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reasoning would dictate that this Yen-bloc transform itself into a Yuan-bloc by about 2035.

However, because Chinese policy makers 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 China today would want to support the establishment of a regional economic architecture that would establish a Yen-bloc. Similarly, even if China 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.

Our opinion is that the NAFTA-like disparity in economic power in AEU at the present and in the future means 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. The proposed closer exchange rate cooperation might be justified for the 2015-2025 period when the GDP of Japan and China are of the same magnitude.

### **The Feasible Financial Architecture for an Asian Economic Union**

It must be recognized that the present system of (bilateral and multilateral) swap arrangements is not sustainable and would not increase to meaningful sums unless members believe that the borrowed funds would be used only to defend an exchange rate against speculative attacks not justified by fundamentals (i.e. the borrowed funds would not be used to defend an exchange rate that has been rendered overvalued by inflationary domestic policies). In addition, members would not have such faith unless each country has been pre-qualified by an objective party that is

competent to recognise good behavior. This means that a regional surveillance mechanism is required if regional swap arrangements (the pooled reserves) are to reach meaningful sums.

In our opinion, an Asian Monetary Fund (AMF) would be such a surveillance mechanism.<sup>4</sup> Just as we have the system of the World Bank and several regional development banks (like the Asian Development Bank, and the African Development Bank), it is also natural and desirable to have regional monetary funds (RMFs) in addition to the IMF. The IMF is by no means obsolete with the establishment of RMFs. The IMF can play a very helpful role in speeding up the institutional maturity of the RMF, and in keeping up the competition of ideas.

Given the large size of East Asian foreign reserves, the AMF 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

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<sup>4</sup> Yunjong Wang and Wing Thye Woo, "A timely information exchange mechanism, an effective surveillance system, and an improved financial architecture for East Asia," in Asian Development Bank, *Monetary and Financial Integration in East Asia: The Way Forward, Volume 2*, Palgrave Macmillan, 2004, pp. 425-458.

of the East Asian foreign reserves into the assets of G7 economies.

It is important that the AMF 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 AMF 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 AMF 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 summarize, an Asian Economic Union should take the form of a free trade and open investment area that has a regional monetary fund. And it cannot be over-emphasized that there is no economic logic for a regional monetary fund to naturally morph into the regional central bank. Given the great disparity in the present and future distribution of economic

Table 1

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

<b>Case 1. NAFTA GDP: US dominates now and in future</b>	USA	Canada	Mexico
2005	12.5	1.2	0.7
2025	19.6	1.8	2.4
2050	37.7	3.0	7.8
<b>Case 2. EU GDP: Fairly equal size</b>	France	Germany	UK
2005	2.3	3.1	2.3
2025	3.2	3.9	3.3
2050	4.9	5.4	5.1
<b>Case 3. Asia GDP: Japan now, China in future</b>	China	South 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.*

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.

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