A Realistic Vision of Asian Economic Integration

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Asian Economic Integration

In thinking about how far Asian economic integration would go, it is noteworthy that the European Union is the outlier in the global experience. 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. 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). 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.

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 with 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."[1]

There has 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+China, ASEAN+Korea, ASEAN+Japan. The flurry of FTA formation activities has spilled into FTA agreements between East Asian countries and Oceania, and between East Asian

[1] Haruhiko Kuroda, "Towards a Borderless Asia: A Perspective on Asian Economic Integration," 10 December 2005; and Haruhiko Kuroda, "The Challenges of Economic Integration," 12 September 2008.

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 the integration on the trade and investment side, 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."[2]

The proposal for an Asian Currency Unit (ACU) is now on the table; and Masahiro Kawai 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."[3]

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 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.

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 have made East Asians understand 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 appeared in the Gulf of Siam on July 2, 1997 as to the causes of the typhoon and to the responses of the international financial institutions and the United States and Western Europe.

The financial typhoon first toppled the Baht and the Thai economy and then swept 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

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[2] Reported in "The Case for Asian Monetary Union," Wall Street Journal, June 1, 2004.
[3] Masahiro Kawai, Creating an Asian Currency Unit," The Japan Journal, September 2006.

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, pre-emptive interventions, emergency-room macroeconomics, and post-crisis recovery.[4] 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 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 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 veracity of this first lesson is vividly shown in the intellectual odyssey of Paul Krugman on his understanding the Asian financial crisis (i.e. in the education of a Nobel Prize economist as gathered from his website). In March 1998, Paul Krugman opined that:

> Broadly speaking, I would say that there are two approaches to the Asian crisis.One approach which I would identify mainly with Harvard's Jeffrey Sachs regards what happened to Asia as basically a modern, high-tech, multicultural version of a good old-fashioned financial panic The important point to make here is that a panic need not be a punishment for your sins. In principle, at least, an economy can be fundamentally sound and yet be subjected to a devastating run started by nothing more than a self-fulfilling rumor.
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> OK, as you may have guessed, I don't buy that story.. The story I believe argues that the preconditions for that panic were created by bad policies in the years running up to the crisis. The crisis, in short, **was** a punishment for Asian crisis, even if the punishment was disproportionate to the crime.
>
> What were these Asian crises? We hear now about crony capitalism. Its a good phrase, and it certainly captures the spirit of what went on in much of Asia.. The **specific** spirit

[4] See, for example, Wing Thye Woo, Klaus Schwab and Jeffrey Sachs (edited), The Asian Financial Crisis: Lessons for a Resilient Asia, MIT Press, 2000.

that pushed Asia to the brink was the problem of moral hazard in lending mainly domestic lending.

Following his crony capitalism analysis of the crisis, Paul Krugman went on to deliver a defense of the IMF policies, which had been criticized (by Jeffrey Sachs, for example) as overly deflationary. He felt that the policies were justified because the IMF was not a true lender-of-last-resort due to its limited financial capital, and because the IMF had little choice (the Fund must either confront crony capitalism or stay out of the picture altogether).

However, seven months later, in October 1998, Paul Krugman completely reversed his assessment of the crisis in an article entitled "The Confidence Game: How Washington Worsened Asia's Crash." In Krugman's new awareness:

> "When the Asian crisis struck, .. countries were told to raise interest rates, not cut them, in order to persuade some foreign investors to keep their money in place and thereby limit the exchange-rate plunge... In effect, countries were told to forget about macroeconomic policy; instead of trying to prevent or even alleviate the looming slumps in their economies, they were told to follow policies that would actually deepen those slumps.
>
> .. [To understand the perverse macroeconomic policy stance] consider the situation from the point of view of those smart economists who are making policy in Washington. They find themselves dealing with economies whose hold on investor confidence is fragile. The overriding objective of policy must therefore be to mollify market sentiment. But, because crises can be self-fulfilling, sound economic policy is not sufficient to gain market confidence; one must cater to the perceptions, the prejudices, and the whims of the market. Or, rather, one must cater to what one hopes will be the perceptions of the market.
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> In short, international economic policy ends up having very little to do with economics. It becomes an exercise in amateur psychology, which the IMF whose top economist Stanley Fischer, boasts credentials just as impressive as those of Summers and his crew and the Treasury Department try to convince countries to do things they hope will be perceived by the market as favorable. No wonder the economics textbooks went right out to the window as soon as the crisis hit.
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> Unfortunately, the textbook issues do not go away. The perceived need to play the confidence game supercedes the normal concerns of economic policy. It sounds pretty crazy, and it is.

What led to Paul Krugman's startling apostasy? In a retrospective piece in a September 1999 issue of *Slate*, Krugman asked:

> Where do I fit in? In the summer of 1998, I began to reconsider my own views about the crisis. The scope of global contagion, the rapid spread of the crisis to countries with no real economic links to the original victim convinced me that IMF critics such as Jeffrey Sachs were right in insisting that this was less a matter of economic fundamentals than it

> was a case of self-fulfilling prophecy, of market panic that, by causing a collapse of the real economy, ends up validating itself.[5]

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; that a newly-impoverished Indonesia, not being an immediate geographical neighbor to the US, could not send a tsunami of unemployed workers into the US as a newly-impoverished 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.

[5] It is indeed laudable that Paul Krugman does not allow pride on his previously expressed opinions to stand in the way of his constant search for self-improvement. May we all have Paul Krugman's humility to admit our mistakes in order to advance knowledge.

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 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 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."[6]

[6] This is the common paraphrase of the opening sentences in Karl Marx's The Eighteenth Brumaire of Louis Bonaparte (1852).

The Economic Basis for Exchange Rate Coordination and a Common Currency

The fundamental 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. There has also not been a prominent AEU proponent who has advocated EU-style labor mobility within East Asia in the medium term. This absence of significant support for free labor mobility and for political union certainly makes it appear that most AEU supporters prefer a NAFTA-style AEU over an EU-style AEU. Of course, it is possible that the absence of support in these areas were really caused by unjustified fears about loss of national identity, then an EU-type AEU would actually result in higher economic welfare for its members than a NAFTA-type AEU.

If this is the explanation for the lack of support, one should note that if there could be unjustified fears against EU-style AEU at one time, there would also be unjustified euphoria for an EU-style at another time period. Political objectives like avoidance of armed conflict among traditional competitors might drive the economic integration agenda. 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 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 a Goldman-Sachs study.[7] 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 normalisation 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.

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

[7] 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.

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

However, because 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 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 2008 Global Financial Crisis as an Opportunity for Asian Financial Integration

In response to the present deep global financial crisis, President George Bush has convened a G20 summit meeting in Washington DC on November 15, 2008. President Nicolas Sarkozy of France and Prime Minister Gordon Brown of Great Britain have called for a New Bretton Woods. Asia should definitely support the establishment of a working group on the reform of the IMF: 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 prostate 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 Monetary Fund (AMF), 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 AMF is to combat financial contagion and not to finance balance of payments adjustment caused by economic mismanagement.

An AMF 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 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 incredulous 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 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 is 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. 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 AMF 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.[8] 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.

Why should the US and Western Europe reverse its 1997 position and now support setting up an AMF? There are five reasons for their change of mind. First, 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.

Second, the US and Western Europe cannot really stop such a move anyway because 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.

Third, 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 AMF is the much-needed change toward an inclusive US approach that is diversified in modality to handle each specific multilateral issue.

Fourth, US and the rest of the interested world would be members of the AMF just as they are now influential members of the Asian Development Bank. The creation of the AMF 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 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.

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[8] 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.

Fifth, the AMF 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.

The Feasible Architecture for an Asian Economic Union

In our formulation, an Asian Monetary Fund (AMF) is operationally a large Asian swap facility that has its own surveillance mechanism to pre-qualify members for loans. The primary mission of AMF is to calm panic in the foreign exchange markets and not to defend overvalued currencies. The goal is to attenuate the cost of bad luck and not the cost of bad policies.

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 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 summarise, 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 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.

Table 1

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, China in future

	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.