

RIS DISCUSSION PAPERS

**Towards an Asian Economic Community:
Monetary and Financial Cooperation**

Ramgopal Agarwala

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**Research and Information System
for the Non-Aligned and
Other Developing Countries**

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**Towards an Asian Economic Community:
Monetary and Financial Cooperation**

by

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**RESEARCH AND INFORMATION SYSTEM FOR THE
NON-ALIGNED AND OTHER DEVELOPING COUNTRIES
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Enhancing Trade and Investment Cooperation in Asia: Issues, Policies and Institutional Reform

This paper forms a part of a larger research project launched at RIS in October 2001 on 'Enhancing Trade and Investment Cooperation in Asia: Issues, Policies and Institutional Reform' as a part of the Sasakawa Peace Foundation (SPF)'s Research Programme on Future of Asia: Institutional and Structural Changes.

The objective of the project is to present a case for an Asian Economic Community (AEC) that would be broader in coverage than the current programs for economic co-operation in different sub-regions such as East Asia, South Asia and Central Asia. Such a grouping would facilitate fuller exploitation of the region's considerable resources –material as well as human—for expediting the process of its development.

There is growing realization that stimulus for future growth in the region has to come from within given the trend of formation of regional trading blocs in rest of the world and slow down in growth expected in the US and EU over the medium term. The Asian region combines the fastest growing economies in the world. Together they form a huge market that is growing faster than any other region in the world.

The project reviews the rationale, significance and relevance of Asia-wide economic integration. It would cover closer economic cooperation in all areas of mutual interest where the complementarities exist. These areas broadly include monetary and financial cooperation, infrastructure development, trade and investment liberalization in the framework of an regional trading bloc, complementarities in industrial and technological capabilities and other resource endowments, among others.

It will also discuss the policy challenges for the regional economic integration in Asia to succeed. A roadmap for a phased implementation of economic integration in the region will be proposed.

The project is progressing as per schedule. After the Inception Meeting held in Manila in October 2001, the project team reviewed the progress of the work at the Coordinating Workshop held in Kuala Lumpur on 20-21 February 2002. Some interim reports will be discussed at a Workshop to be held in Bali on 30 September-1 October 2002. RIS proposes to organize an International Conference in New Delhi in early 2003 to discuss the outcome of the project along with the projects coordinated by the Malaysian Institute of Economic Research (MIER) and the Centre for Strategic and International Studies, Jakarta under the auspices of the SPF research programme.

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I. Introduction

1. International professional opinion on regionalism (which is dominated by the US academics) has gone through some strange twists and turns over the last few decades. Until mid-eighties, it was by and large solidly behind multilateralism. It was pointed out that the theory of international trade clearly suggests that the gains from trade liberalization would be maximized by making it non-discriminatory and world-wide. The case of European Common Market was treated as an exception justified because of the geopolitical aspects involved. However for most of the regional co-operation efforts in Latin America, Africa and Asia, there was no support among the top professionals or among the major financial institutions which exerted a dominant influence on aid flows. The lack of intellectual and financial support often meant half-hearted regional co-operations efforts and very limited success on the ground. These results were then used as support for the basic inadvisability of regionalism for development. However, since eighties, following the successful free-trade arrangements in automobile industry between the US and Canada, there was a gradual move toward free-trade arrangements between US and Canada. Based on success of these arrangements for the US, there was growing support for Free Trade Area in North America including Mexico. The advantages of free trade area in terms of access to Mexico's oil wealth and utilization by US companies of cheap Mexican labor on Mexican soil rather than through immigration to the U.S. proved important enough to build a political coalition in favor of NAFTA. The old arguments were about trade diversion through regionalism were set aside and regionalism in North America was presented as a stepping stone rather than a stumbling block to multilateralism. However so far as developing countries were concerned the negative attitude to regionalism continued. Without worrying about double standards, the top professionals in the US continued to argue against Asian regionalism, except when it was under leadership of the US as in Asia Pacific Economic Co-operation (APEC). This experience clearly shows that the so-called international professional opinion is not beyond political influence of the dominant partner which is naturally more interested in its own welfare than global welfare. For promoting Asia's interests, Asians must think for themselves and not rely unduly on US professional opinion on the assumption that it is objective and guided by concern for global welfare. Asia is now paying heavily for its intellectual dependence on outside opinion. Time has now come to think in terms of regional policies and programs that can help Asia to achieve rapid growth rather allowing the outsiders (including IMF) to have an effective veto power over Asian co-operation programs.

2. It is in this spirit of intellectual self-reliance that the present paper is written. It argues that Asia is now trapped in the greatest slump of the last fifty years and is becoming more dependent on non-regionals. Business as usual with fragmented efforts at regional co-operation, growing dependence on outside players in terms of trade, finance and investment as well development paradigm is likely to lead to a continuation of the present slump. What is needed is restoration of confidence in the Asian development paradigm (as pioneered by Japan and successfully followed by major East Asian countries) and establishment of Asian institutions to provide intellectual and financial support to such policies that can restore growth momentum in Asia.

II. Limitations of Fragmented Regionalism in Asia

3. During the pre-War period, there was a high degree of integration in Asian economies. As documented by Peter Petri (1994), east Asian trade as a share of total trade was high in 1938: 70% for China, 26% for Indonesia, 99% for Taiwan, 70% for Japan, 100% for Korea, 35% for Malaysia, 11% for the Philippines, and 65% for Thailand. Movement of labor was relatively free particularly amongst the countries under one colonial rule. The scale of movement of labor from India and China to other countries in Asia and abroad has not been equaled in the post-war period. Regional banking, finance and travel were also less restricted in that period than today.

4. In the postwar period Asian economies became more fragmented than ever before. Emergence of Communist regimes in China, Vietnam Cambodia and Laos drastically reduced trade and investment flows between these and other Asian countries. In most other Asian countries, the era of planning meant greater controls on trade, investment and labor flows and reduced integration of these economies with others in the region. The effort for regional integration that came forth ere fragmented and determined by as much by geo-political considerations as economic logic. For example, the drive for regional co-operation in South-East Asian countries under ASEAN came mainly from the desire to check expansion of communism in these parts. North Asian economies of Japan, South Korea, Taiwan (China) were, for geo-political reasons, bound closer to the US economy than to their neighbors. PRC, North Korea, Vietnam were similarly more integrated with their Soviet partners than with Asian neighbors. South Asia was following, by and large, an autarkic economic

approach and had a low degree of openness to the rest of the world, including its Asian neighbors. In this atmosphere, the efforts of regional co-operation that were initiated were fragmented. They did not utilize the great variety in stages of development that Asia had and the resultant complementarity. This fragmentation of regional co-operation efforts combined with the dominant intellectual opinion against regionalism led to the poor results and continued high dependence of the region on the non-regional players.

a. ASEAN and ASEAN plus

5. ASEAN economic integration efforts started in mid-1970s and was widely seen as a “cover” for political co-operation, in particular vis-à-vis instability in Indochina. Preferential Trading Arrangements were piecemeal and voluntary ; the product-by-product approach that was initiated allowed for exclusion of almost all items that would be important in stimulating trade within ASEAN. Several programs were initiated to promote industrial co-operation. Among them were: ASEAN Industrial Projects (AIPs), ASEAN Industrial Complementation (AIC) scheme, Brand-to-Brand Complementation (BBC) and ASEAN Industrial Joint Ventures (AIJVs). However, very few ASEAN projects came into being; some success was achieved in automobile sector but that was with Japanese joint ventures.

6. In 1992, the ASEAN Free Trade Area (AFTA) was formally to realize an FTA within the 15 years beginning in 1 January 1993. The Common Effective Preferential tariff (CEPT) scheme was designed to bring down tariffs on all manufactured and processed agricultural products to 0–5 percent within a 15 year time-frame. In September 1994, during the 26th ASEAN Economic Ministers (AEM) Meeting, the time –frame was shortened from the original 15 years to 10 years with the aim of achieving the AFTA goals by the year 2003. Another important accomplishment of that meeting was the inclusion of all unprocessed agricultural products in the CEPT scheme.

Under the CEPT scheme, four lists,-- the Inclusion List (IL), the Temporary Exclusion List (TEL), the Sensitive List (SL), and the General Exceptions List (GEL), are used as key instruments to determine the pace and scope of liberalization. The IL consists of the items subject to tariff reductions immediately to bring them down to the range of 0-5 percent by the year 2003. During the ASEAN Summit in December 1998, the six original ASEAN members agreed to accelerate the implementation of AFTA by one year from 2003 to 2002 for most of the items in the inclusion list. The items in the TEL were initially excluded from tariff

reductions, but these items were to be transferred to the IL by 2000 in 5 equal installments beginning from 1996 and then reduced to 0-5 percent by 2002. The SL is the list of unprocessed agricultural products to be phased into the IL between 2001 and 2003 and to be in the 0-5 percent range by 2010. In principle, GEL is intended to consist only of items that satisfy Article XX of the GATT. Such goods may be permanently excluded from tariff reductions for reasons such as national security, protection of public morals, protection of human, animal and plant life and health, or the protection of articles of artistic, historic or archaeological value.

7. A key feature of the CEPT is that the concessions are granted on a reciprocal, product-by-product basis. There are three conditions for a product to be eligible for concessions under the CEPT. a. the product has to be included in the IL of both the importing and exporting countries; b. To receive all concessions, a country must have a CEPT tariff of 20 percent or below on that product. If the tariff on a product that a country has included in the CEPT is above 20 percent, then it is eligible for concessions only in those member countries that also impose a CEPT rate that is higher than 20 percent; c. It has to satisfy the local content requirements of 40 percent. In the short-run the reciprocal nature of the CEPT scheme provides incentives for member countries to include commodities they wish to export in the IL and to reduce tariffs below 20 percent to receive concessions. Following inclusion, all tariffs must be phased down to the 0 to 5 percent range. Another important feature of the CEPT is that member countries are required to eliminate quantitative restrictions on products on which they receive CEPT concessions, and to eliminate other non-tariff barriers within five years after receiving concessions. Based on the UNCTAD classification of NTBs, a working definition of NTBs covers par-tariff measures, price control measures, finance measures, monopolistic measures, and technical measures.

8. In contrast with the former Preferential Trading Arrangement (PTA) scheme, the AFTA/CEPT scheme has achieved substantial liberalization between ASEAN members. 54,367 tariff lines out of 55,525 lines are either in IL or TEL. This means that 97.9 percent of tariff lines will be between 0-5 percent by 2002/2003 (by 2006 for Vietnam and 2008 for Lao PDR and Myanmar. The share of the SL and GEL appears to be small relative to the IL and TEL. The process of transferring tariff lines to the liberalization lists is ongoing, and significant progress has been made in a number of countries since 1998 in areas such as reducing the number of tariff lines in the GEL.

9. ASEAN countries have substantially lowered their MFN rates since the late 1980s. The reductions in applied rates have in most cases brought applied rates well below the levels that would have resulted only from the liberalizing effects of the Uruguay Round. As a consequence, there is a significant overhang, where the tariff bindings offered at WTO are frequently much above currently applied rates. The AFTA rules encourage, or at least do not discourage, liberalizing on an MFN basis. This is done through a provision in the CEPT Agreement which allows Member States that reduce their tariffs to 0-5 % even on an MFN basis, to enjoy the CEPT concessions from other Member States on those products. AFTA may be used as a useful stepping stone to further liberalization because it exposes domestic industries to greater competition and creates a situation where there are substantial benefits from reducing the trade diversion associated with discriminatory liberalization. Indonesia and the Philippines are prime examples of this, in having announced their intention to build on AFTA concessions to advance their unilateral MFN-based liberalization.

10. More recently there have been agreements to study free trade areas for broader groups such as ASEAN+3 (Japan, China and Korea and even for ASEAN+China. Another trend is the willingness to sign FTAs on the part of countries that had not formally joined FTAs in the past. For example, South Korea-, which like Japan has not signed any FTAs - has in recent years begun to make efforts toward this goal. In December 1999, South Korea began negotiations with Chile. Japan has also begun to study the potential of FTAs. In December 1999, it reached an agreement with Singapore to establish an industry/government/academic study group to investigate the potential for an FTA between the two countries. The group's report advocated more than just tariff elimination; it also says that Singapore and Japan should cooperate in new areas like investment, competition, trade facilitation, and information technology co-operation. Studies are also being conducted on the potential of FTA between Japan and South Korea and between Japan and Mexico.

11. While ASEAN is often mentioned as the most important trade co-operation agreement in the region, its bottom line impact on promoting intra-regional trade has been only modest. The initiation of FTA program was soon followed by the financial crisis in the region in 1997/98 and although faster trade liberalization in ASEAN is sometimes mentioned as an instrument for stimulating growth, growth has remained sluggish despite accelerated

liberalization in ASEAN.. The intra-regional export ratio has in fact registered a decline between 1996 and 2000, although the import ratio has increased. (see Table 1)

Table 1: Intra-ASEAN Trade as share (%) of total ASEAN Trade, 1980-2000

	1980	1985	1990	1996	1997	1998	1999	2000
Exports	17.7	18.5	18.92	24.6	24.0	21.0	21.4	22.7
Imports	14.3	17.1	15.1	18.2	18.9	20.8	21.7	24.4

Source: Direction of Trade Statistics, IMF

12. There are several reasons why the true regional interdependence may even be less than what is indicated by the above statistics. With Singapore an entrepot, trade between Singapore and other ASEAN countries is treated as intra-regional trade but much of it is meant for extra-regional trade partners. Another complication is that for the rapidly growing trade in IT sector, a large proportion of trade in the region is really part of the value-added chain within the region meant for the ultimate destination outside the region. Thus a high level of trade among these countries in IT sector shows not their interdependence but shared dependence on extra-regional demand. Detailed data are not available to separate the trade in IT sector in the region between the parts driven by domestic demand and by extra-regional demand. However, The high dependence of the region on the extra-regional markets was dramatically illustrated by the rise of exports in 2000 (pulled by US demand) and the drastic reduction of exports of the region in 2001, following the slow-down in demand for IT products in the US in 2001.

13. Nor has ASEAN co-operation proven effective in the area of financial security. Inter-ASEAN network of currency swaps and repurchase agreements set up in 1977 was to provide immediate short-term swap facilities to members with temporary international liquidity problems. Initially set at US\$ 100 million for 5 members with a maximum of \$40 million receivable per member, it was raised to \$200 million for \$80 million per member in 1978. EMEAP (Executives' Meeting of East Asia and Pacific Central Banks) was set up in 1991 with 11 members (South East Asian and Australasian members) and its objectives include enhanced regional surveillance, exchange of views and information, and financial market developments. In 1994 a group was set up for four major Asian financial centers (Australia, Hong Kong, Japan and Singapore) which was to review issues related to stability of the region's financial and foreign exchange markets. Also set up in 1994 was APEC Finance Ministers Group which provided a forum to exchange views and information among

members on regional financial developments and to pursue cooperative programs to promote financial sector development and liberalization. In addition there have been longstanding fora in the region for training in central banking and discussion of central banking issues.

14. These arrangements however proved totally inadequate to help the affected countries during the Asian crisis of 1997. The money available (\$200 million) was of course woefully inadequate and reportedly was never used. Immediately after the crisis, Japan came forward with a plan for an Asian Monetary Fund (AMF) so as to assist in bringing stability to Asian currencies and financial markets. It planned to raise \$ 50-60 billion in contributions from participating countries and another \$50 billion from the Japanese Government. It was to be independent of the IMF and function as a substitute for IMF activities such as regional surveillance. The original membership was to be Japan, Korea, PRC, Taipei, China and Hong Kong. With lukewarm support from PRC and vehement opposition from the US and IMF, the plan was scrapped a few months later. It was argued that AMF will enhance the moral hazard problem, create a double standard (IMF and AMF) and challenge the IMF leadership.

15. In place of AMF came Manila Framework Group (MFG). In November 1997, finance and central bank deputies from the Asia-pacific region and high-level representatives from the IMF, World Bank, and ADB met in Manila to create a new framework for regional cooperation to enhance the prospects for financial stability. This framework included the following initiatives: (1) a mechanism for regional surveillance to complement global surveillance by the IMF. (2) economic and technical cooperation to strengthen financial systems and regulatory capacities, (3) measures to strengthen the IMF's capacity to respond to financial crises, and (4) a cooperative financing arrangement that would supplement IMF resources. Noteworthy in this framework, as evidenced by these initiatives is the recognition that the IMF has the central role in the international monetary system. According to knowledgeable persons such as E. Sakakibara, although this group is still meeting today, it does not appear to be influential in the region.

16. At the ASEAN Finance Ministers' meeting (AFMM) in October 1998 in Washington DC, the ASEAN Surveillance process (ASP) was officially established based on the principles of peer review for all member states and complementarily with the global surveillance undertaken by the MF. The objective of the process was to strengthen cooperation through an exchange of information, a peer review process, and

recommendations for action at not only the regional, but also the national level. As part of the ASP function, all ASEAN member states are to provide the ASEAN Surveillance Coordinating Unit with baseline data like that provided to the IMF under its Article IV consultation mission. Technical assistance and capacity building for this process are to come primarily from the Asian Development bank. (ADB).

17. In October 1998, came the New Miyazawa Initiative (NMI). This arrangement was implemented by Japan as a bilateral support mechanism focussed on assisting Asian countries affected by the currency crisis in overcoming their economic difficulties and contributing to the stability of international financial markets. The support package consists of \$30 billion, of which \$15 billion is available for Asian countries' medium-to long-term financial needs for economic recovery provided either as Official development assistance (ODA) or untied loans. The other \$15 billion is for countries' short-term capital needs during the process of implementing economic reforms. Commitments under this initiative as of February 2000 totaled \$21 billion of which \$13.5 billion were for medium and long term support. These are not grants but loans, the objective of which is to support corporate debt restructuring, strengthen the social safety net, stimulate the economy and facilitate trade finance and assistance to small and medium size enterprises. There are two short-term swap arrangements (2.5 billion with Malaysia and \$5 billion with Korea). These are not tied to the IMF and are annually renewable.

18. In the "second Stage" of the NMI, Japan pledged its readiness to assist in mobilization of up to 2 trillion yen of domestic and foreign private-sector funds for Asia through assistance for fund-raising in international financial and capital markets (via JBIC and ADB credit guarantees and interest subsidies), and through assistance for investment in Asian private sector enterprises via equity-funds. Through this initiative Japan hopes to utilize its abundant savings and promote active use of the Tokyo market.

19. Probably the most concrete and currently active regional financial arrangements to come out of the Asian crisis was Chiang Mai Initiative (CMI). The CMI was established by the ASEAN plus 3 (China, Japan, and Korea) Finance Ministers at Chiang Mai in Thailand in May at the time of the Annual Meeting of the ADB. The CMI has two parts:

- i.) ASEAN Swap Arrangement (ASA). This is the swap arrangement originated by ASEAN in 1977 in an amount of \$200 millions. In November 2000 it was enlarged to \$1 billion and expanded to include all ASEAN members.
- ii.) Bilateral Swap arrangements (BSA) and Repurchase Agreement. The purpose of BSA is to provide short-term financial assistance in the form of swaps to a country in need of balance of payments support or short-term liquidity support. Up to 10 percent of the maximum amount of drawing can be provided for a short-term period without linkage to the IMF. The interest rate was not disclosed but a rate 1.5 percent points higher than LIBOR has been mentioned by some. The purpose of Repurchase Agreement is to provide temporary foreign exchange liquidity to a country, which is in need of foreign exchange liquidity support via the sale and buyback of appropriate securities. Bilateral swaps negotiated and signed as of May 2001 are as shown in Table 2.

Table 2: Chiang Mai Initiative: Swap arrangements as of May 2001

Countries	Currencies	amount (\$million)	IMF Conditionality
Japan/Korea	Dollar/Won	2000	Yes
Japan/Malaysia	Dollar/Ringgit	1,000	Yes
Japan/ Thailand	Dollar/Baht	3,000	Yes
Japan/Philippines*	Dollar/Peso		Yes
Japan/ China*	Yen/Renminbi		No
China/Thailand*		4,000	

*Currently under negotiation.

Source: Sakakibara (2001).

20. Some see CMI as a natural progression leading to the renewal of the old idea of AMF. However for this progression to take place some fundamental rethinking is necessary about the link of Asian program to IMF. Under present conditions with all the initiatives noted above, the support that can be provided to Asian countries that does not want to take IMF medicine is so small as to be inconsequential. On the basis of evidence of poor performance of countries with IMF conditionality², one can argue that so long as the regional co-operation is linked to IMF, it has, under current conditions, no chance of success.

² William Easterly, one of the most respected economists of the World Bank has recently pointed out (see Easterly (2002) that the IMF had during the last decade, given 36 poor countries 10 or more loans each, with conditions attached. "The growth rate of income person of the typical member of this group during the past two decades was zero".

b. SAARC³

21. The South Asian Association for Regional Co-operation (SAARC) comprising the seven South Asian countries of Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan, and Sri Lanka formally came into existence in 1985. However, within the SAARC region a fundamental asymmetry among the Member States, their varied levels of development, including administrative procedures and rules, suggested that economic co-operation, while important, was likely to be complex and gradual process. Accordingly, the first SAARC Summit in Dhaka(1985) primarily focussed on regional co-operation in areas such as health, population activities and child welfare; culture and sports. It was only in December 1995 a SAARC Preferential Trading Arrangement (SAPTA) came into being. Three rounds of Trade negotiations have so far been completed under SAPTA. In SAPTA-I, trade concessions were offered to 226 commodities by all countries. In SAPTA-II, trade concessions were offered to 1868 products reflecting an increase by almost ten fold over SAPTA-I. In SAPTA-III, trade concessions were increased to 3456 commodities, reflecting almost a doubling over SAPTA-II.

22. SPTA was envisaged primarily as the first step towards the transition to a South Asian Trade Area (SAFTA) leading subsequently to a Customs Union, Common Market and Economic Union. A Committee of Experts has been constituted to draft a comprehensive treaty which would incorporate, *inter alia*, binding time frames for freeing trade, measures to facilitate trade, protection of LDCs including mechanisms for compensation of revenue loss, etc. SAARC has also initiated action on a series of practical measures to facilitate the process of economic integration. These include: (a) A Group on Customs Cooperation with the objective of harmonizing HS lines and customs rules and regulations, simplifying procedures for intra-regional exports, upgrading infrastructural facilities, (b) drafting a Regional Investment Agreement to create conditions favorable for promoting and protecting investments in Member States by investors from other Member States of the region, and (c) discussions on harmonizing tax laws, standards, quality control and measurements within the region (d) setting up a SAARC Chamber of Commerce and Industry, (e) organizing SAARC Trade Fairs and (f) establishing a Net Work of Researchers to identify, analyze and help SAARC face upto current global financial and economic issues affecting the Region.

³Based on material provided by SAARC Secretariat at the web site: www.saarc-sec.org.

23. These efforts at promoting regional co-operation in South Asia are on the right lines. But the basic fact of asymmetry within the region with India as a dominant player and political tensions within the region have impeded the progress in promoting intra-regional trade. In any case most of the trade-promoting measures are still in the future. As noted in Table-3, the ratio of intra-regional exports is low and stagnant over the last twenty years. The ratio of intra-regional imports is also low at 4%, although it was even lower at 2% in 1980.

Table 3: Intra-regional Trade in South Asia as Share(%) of Total South Asian Trade

	1980	1985	1990	1995	1996	1997	1998	1999	2000
Exports	4.8	4.5	3.2	4.4	4.3	4.0	5.3	4.7	4.2
Imports	2.0	1.9	2.0	3.8	4.5	3.7	4.8	4.2	3.9

Source: Direction of Trade, IMF

c. Asian Clearing Union (ACU)

24. The Asian Clearing Union (ACU) has been one of the earliest attempts by developing countries in Asia toward monetary co-operation. As noted in B.K. Madan (1986) United Nations Economic Commission for Asia and Far East (ECAFE, subsequently ESCAP) arranged for a study group to consider the question of a suitable payments arrangements in Asia as early as 1948. On its recommendations, the IMF was inducted into investigation of the scope for a regional clearing arrangement and the IMF on review of the intra-regional trade reported against such a move. Another experts group was set up in 1953 and reported in December 1954. The group also reported against the idea because in its view the regional co-operation arrangements would be associated with emergence of persistent debtors and creditors and extension of credit to deficit countries was unlikely in the absence of financial support from outside the region, in particular from the United States which was unresponsive to development of such a regional payments facility. It is only when Ministerial Conference on Asia Economic Co-operation held in Manila in December 1963 took the political decision to proceed with trade liberalization and payments arrangements that things began to move in a positive direction, albeit still at a slow pace. Following the strong support of the Third Ministerial Conference on Asian Economic Co-operation in 1968 in ESCAP secretariat, with the assistance of IMF and UNCTAD, experts formulated programs, including draft guidelines, of trade liberalization and payments arrangements. A high level expert mission set up by ESCAP canvassed the draft proposals with concerned authorities of prospective member countries in 1970 and draft guidelines for establishment of the Asian Clearing Union (ACU) emerged. With the stamp of approval of the Kabul Declaration on monetary co-

operation the Preparatory Committee for ACU got into stride and a meeting of senior government and Central bank officials held in February 1973 adopted the Draft Agreement for establishment of the ACU.

25. The Agreement on the Asian Clearing Union (ACU) was signed by Central Banks of six countries, namely, Iran, Sri Lanka, India, Pakistan Nepal and Bangladesh was signed in December and ACU commenced its operations on November 1, 1975. Myanmar joined in 1977 and Bhutan in 1999. The membership of the Union is open to all Central Banks of members and associate members of Economic and Social Commission for Asia and Pacific (ESCAP).

26. The objectives of ACU were:

- a. to provide a facility to settle, on a multilateral basis, payments for current international transactions among the territories of participants;
- b. to promote the use of participants' currencies in current transactions between their respective territories and thereby effect economies in the use of the participants' exchange reserves; and
- c. to promote monetary co-operation among the participants and closer relations among the banking systems in their territories and thereby contribute to the expansion of trade and economic activity among the countries of the ECAFE region.

27. Under the Agreement, current international transactions between residents of participant countries are eligible for settlement through the Union. Multilateral clearing takes place at the end of the settlement period (initially one month and now two months) when the individual net position of each participant is determined as a result of the combined clearance of the various bilateral transactions. This net position is notified to members. The creditor members are also paid interest on the daily outstanding credit balances recorded between the two settlement periods. Each debtor participant is required to make payment of the amount due from it in US dollar or in any mutually acceptable currency within four working days of the receipt of notice from the ACU. The facility of settlement every two months economizes on a day-to-day basis the use of convertible currency, final payment has to be made in foreign exchange. Thus the role of the ACU has been practically limited to that of clearing cell and not as a medium of financial co-operation.

28. While the basic structure of ACU has remained unchanged since inception, several steps have been taken toward expansion of its role. Among these are:

- a. elimination of limits on net creditor and net debtor positions;
- b. extending the settlement period from one month to two months;
- c. inclusion of trade in petroleum and petroleum products in the clearing scheme since the end of 1985;
- d. making it mandatory that trade among the members go through the clearing system after 1983;
- e. inclusion of trade between Iran and Pakistan within the clearing mechanism since the end of 1990;
- f. change in the value of the unit of account from SDR to US dollar from January 1, 1996 and developing the method of funding the ACU dollar accounts;
- g. establishment of the ACU permanent technical Committee in January 2000.

29. Total transactions channeled through the ACU have increased US\$25.72 in 1976 to US\$1366 million in 1990 and \$3383.5 million in 2000. (see Asian Clearing Union (2001)). Over this period 55 percent of these transactions were cleared in the system and the rest settled in foreign exchange. During this period, ACU has not, unlike many other payment unions, experienced a single default.

30. One important new development was establishment of a swap facility. In accordance with the Agreement establishing the ACU, the currency swap Arrangement became available in September 1989 to all debtor participants during a settlement period to avail two-month facility for settling imbalances in clearing. Every eligible participant is entitled to the facility from every other participant up to 20 percent of the average gross payment made by it through the ACU mechanism to other participants during the three previous calendar years. In 2000 the total entitlement of all member countries to avail SWAP facility was 541.6 million US dollars. The total amount of SWAP facility which has been used by the member central banks since inception of this arrangement in ACU in September 1989 to end of December 2000 was US\$438.7 million.

31. One benefit of ACU derives from elimination of international banks' intervention. As noted by M.Y. Khan (1991) the major costs involved in settling international transactions are: (1) cost of conversion of currency due to difference between buying and selling rates of

banks; (2) cost of interest rate applicable to transaction time of a transaction;(3) commission for opening and confirming letters of credit and commission for collection of bills and other handling charges and (4) other charges such as cost of cables, postage and stamp duty. Under the ACU, there is no need for the conversion of currencies twice and so there has been a reduction in the cost of settlement. The cost of exchange spread works out lower when transactions are routed through ACU due to two factors: (i) the conversion of currency is at one stage instead of two and (ii) the exchange rates of the regional currencies for settlement through ACU accounts are based on the exchange rates between the AMU and the currency for participating countries. Khan reports an estimate of saving in the cost of transaction payments is 0.25 per cent of value of transactions. On that basis in 2000, the saving in transaction costs in ACU was about US\$8.5 million.

32. The other benefit derives from saving in foreign exchange reserves. If one assumes that desired foreign exchange reserves are equal to about 4 months' imports, ACU members saved in 2000 about \$544.8 million in foreign exchange reserves (i.e. one third of the amount \$1635 million cleared in the system). If the difference between cost of foreign borrowings and earning on foreign exchange reserves can be assumed to be about 3 percentage points, the cost savings due to economizing on foreign exchange reserves works out to be about \$16.6 million in 2000.

33. The third objective of ACU was promotion of intra-regional trade. It is difficult to decompose the contribution of ACU in this area from that of regional trade co-operation efforts through for example SAARC. But as noted above, the intra-regional trade ratio in South Asia (which accounts for most of the membership of ACU) has remained low and largely stagnant over the last twenty years.

34. The overall conclusion that one can derive from the above review of ACU is that there are some benefits from the Union but they are quantitatively small, primarily because of low ratio of intra-regional trade. Recognizing this fact there have been ongoing efforts to enlarge the membership of ACU. Maldives, China, Tajikistan, Turkmenistan, Uzbekistan and Malaysia have been identified by ACU Technical Committee as target countries for enlargement and several exploratory meetings have taken place notably with Chinese authorities. But there has been little progress towards enlargement of ACU. An alternative approach will be to link up these monetary co-operation efforts in South Asia with those

going on in East Asia under a new umbrella of Asia-wide monetary co-operation and that is the thrust of the present paper.

d. Labor movements

35. Labor migration was a crucial component of the economic rise of Europe. Over the last two centuries, millions of European population migrated to other continents, primarily to the Americas. It is noteworthy that at present the population of the major hosts of migration from Europe-Americas, Australia, and New Zealand is about equal to that of Europe, the main source of migration to these continents. In Asia too, outward migration was a prominent feature of the late nineteenth and half of the twentieth century. A large part of labor movement was from PRC and Japan to the US and other industrial countries and there were also large movements of labor particularly from PRC and India to other Asian countries. In the last two decades, with increasing income differences within Asian countries and changing demographic patterns, there has been something of a resurgence of the importance of labor migration in several economies of Asia.

36. The Philippines where per capita income has been largely stagnant over the last twenty years and where the level of unemployment and underemployment is high has been the second largest net exporter of labor in Asia in terms of the amount of remittances of its foreign workers. As shown in Table 3, these receipts rose from US\$0.6 billion in 1980 to over US\$6 billion in 2000. By 2000, the income from migrants was 8.3 percent of GDP and 16.2 percent of exports. In 1999, these inflows were more important for the country than all the official and private net resource inflows combined which was 10.6 percent of GDP. Over the years, North America and Middle East have been the favored destinations of Filipino workers, but in recent years an increasing number of workers have been going to other Asian countries, including Hong Kong, China; Malaysia; and Singapore.

37. South Asian countries with their low income and high unemployment have also been major suppliers of labor. For Bangladesh, India, Pakistan, and Sri Lanka, rising remittances from overseas workers were a major source of foreign exchange to cushion the shock of oil price rises in the 1970s and 1980s. In the 1990s, these inflows combined with decline in oil prices contributed to easing of foreign exchange constraints in the South Asian economies. By 2000, these inflows accounted for 13.6 percent of GDP for Bangladesh, 1.9 percent for India, 1.8 percent for Pakistan, and 7.1 percent for Sri Lanka. As a proportion of exports,

these inflows were between 12 and 35 percent for these countries. For all of them, these inflows became more important than all net resource flows combined (that is net official flows plus private capital flows); in 1999, the latter was 1.6 percent of GDP of Bangladesh, 1.1 percent for India, 3.6 percent for Pakistan, and 1.8 percent for Sri Lanka. A large proportion of these workers went to Middle East but more recently, there has been increasing migration to some Asian countries, in particular to Malaysia. Also in the wake of IT revolution, the export of skilled manpower to developed countries has become a significant source of foreign exchange for South Asia, in particular India.

Table 3. Labor Income Flows in Selected Asian Countries

Country	In Million US\$	As % of GDP	As % of merchandise exports	As ratio of net capital inflows
Philippines				
1980	626.00	1.93	10.82	0.34
2000	6175.00	8.26	16.16	1.96
Bangladesh				
1980	338.67	4.93	42.86	0.60
2000	1967.53	13.58	35.20	2.59
India				
1980	2756.97	1.59	32.66	1.66
2000	9160.27	1.89	20.68	1.00
Pakistan				
1980	2047.62	8.61	78.22	1.83
2000	1075.00	1.78	11.74	5.44
Sri Lanka				
1980	151.70	3.67	14.60	0.41
2000	1154.29	7.07	21.14	2.14

Sources: Balance of payments Statistics (IMF) and International Financial Statistics (IMF), various years.

Note: net Capital inflows include inward net foreign direct investment, net portfolio investments and net inflow on loans.

38. The major importers of labor in Asia are Japan and Malaysia, followed by Hong Kong, China; Korea; Singapore; Taipei, China; and Thailand. Despite severe restrictions on immigration, legal aliens in Japan are over 1.3 million in the mid-1990s. Malaysia hosts over 500,000 legal foreign workers and perhaps another 500,000 illegal workers mostly from the neighboring Asian countries, including Bangladesh, Indonesia, Myanmar, and Thailand. Thailand also hosts a large number of migrants, of these some perhaps clandestine, from the neighboring countries, primarily Myanmar. The other economies with net migration--Hong

Kong, China; Korea; Singapore; and Taipei,China--probably host nearly a million workers, a large part of which may perhaps be clandestine workers in one form or another.

III. A Case for Pan-Asian Regional Co-operation

39. To the extent intra-regional trade, investment and finance increased until recently it was largely between North Asia and the rest.

Table 4 : Intra-regional Trade of Developing Asia as Share(%) of its Total

	1980	1985	1990	1995	1996	1997	1998	1999	2000
Exports	22.5	26.8	32.7	40.8	41.5	42.0	38.2	38.7	36.0
Imports	16.8	22.3	30.0	34.2	34.8	36.1	39.2	39.9	38.6

It was stimulated not by regionalism in reducing tariff and non-tariff barriers but by rapid growth in the major countries of the region and by flows of investment, technology and finance from more advanced to less advanced countries in the region. "Flying geese" model rather than PTAs explain the phenomenon of regional integration in Asia.

40. With slow down in the lead goose since early 1990s and in others since mid-1990s, there has been a retrogression in intra-regional integration in trade, investment and finance, particularly since 1996. The region is now more dependent on the non-regional partners than it was in 1996. As noted in Table 4, the intra-Asian export ratio has been declining since 1996.

41. A similar picture of progress in regional co-operation until mid-1990s and retrogression since then obtains for investment and financial flows. In the wake of Plaza Accord and appreciation of yen in 1985, there was a surge of intra-regional investment and finance. Between 1985 and 1995, foreign direct investment in Malaysia, Thailand, Philippines and Indonesia, and China increased rapidly. The major share of these FDI flows was from within the region: this ratio in 1996 was 79 percent for China, 50 percent for Thailand, 73 percent for the Philippines, 65 percent for Malaysia, and 23 percent for Indonesia. However, since 1996, the share of regional investment has been declining and by 2000 it declined to 61 percent for China, 60 percent for the Philippines, 34 percent for Malaysia, but increased to 60 percent for Thailand, and 32 percent for Indonesia. During this period there have been

much increased activity from extra-regional partners for acquisition of domestic companies, both financial and non-financial, particularly in countries such as South Korea and Japan.⁴

42. Similarly, cumulated foreign bank loans to the region (PRC, Indonesia, South Korea, Malaysia, Philippines, Singapore (offshore-center), Taipei,China, and Thailand) increased from \$199 billion in 1985 to \$375 billion in 1990 to \$650 billion in 1995. Of these, in 1990, 59 percent came from within the region, mostly Japanese banks. However, since 1990 there has been massive withdrawals of Japanese bank loans from the region and by 1995, the share of regional banks declined to 69 percent and by 2000 to 26 percent. By contrast, the share of EU banks increased from 34 percent in 1990 to 44 percent in 1995 and to 62 percent in 2000.

IV. The Great Economic Slump in East Asia

43. At present much of Asia is going through an economic slowdown. However, the problem is particularly severe for East Asia, which has been badly hit by the financial crisis of 1997. In view of the economic importance of East Asia for the entire continent, this section concentrates on East Asian economic situation. East Asia region is in the grip of the greatest slump in its history since the Great Depression. According to the latest publication of the Asian Development Outlook by ADB (2002), GDP growth in the ASEAN for 2001 is 1.9 percent. The mighty economy of Japan registered a fall of 0.4 percent in its GDP in 2001 and is expected to register a fall of 0.4 percent in 2002. The Korean economy grew by 3 percent in 2001; Taipei,China declined by 1.9 percent in 2001. The Chinese economy is the only one that grew at the erstwhile typical East Asian rate of over 7 percent. (see Table 5 below).
Table 5.

Table 5
GDP Growth rates and Forecasts
Selected Asian
2001-2003

	2001	2002
ASEAN +		
China, People's Republic of	7.3	7.0
Hong Kong,	0.1	2.1
Indonesia	3.3	3.0
Japan*	-0.5	-1.1
Korea, Republic	3.0	4.8
Malaysia	0.4	4.2
Philippines	3.4	4.0
Singapore	-2.0	3.7
Taipei, China	-1.9	2.8
Thailand	1.8	2.5
Southeast Asia	1.9	3.4

Sources: ADO 2002 for all countries except Japan
World Economic Outlook (April 2002)

Note: Numbers for 2001 are actual growth rates
those for 2002 and 2003 are

44. The poor performance of 2001 comes on top of the mediocre performance ever since the outbreak of the financial crisis in the region in 1997. In Indonesia, per capita income in 2001 is 10 percent lower than in 1996, in Thailand 6 percent lower, and stagnant in Japan. For Malaysia and Philippines, annual growth rates in per capita income over the last five years has been less than 0.5 percent. Only PRC and Korea have been able to register significant growth rates in per capita income. For the Southeast Asia, annual average growth rate in per capita income over the last five years (1997-2001) has been -0.1 percent, the lowest recorded for the regions for any five year period over the last 50 years.

A Trillion Dollar of Lost Output Every Year

45. As reported in IMF (1999), the growth of potential output in Japan during the 1990s has been about 2.6 per cent per year (on a production function approach). The actual output growth has been only about 1.3 percent per year. This suggests that as of 2001, the economy is operating about 17 percent below capacity which means a loss of potential output of over \$700 billion (at 2000 prices) per year.

46. Similar estimates by IMF Staff of potential output for other countries in ASEAN+3 are not available. However Table 6 presents some rough estimates of potential output based on

the use of ICORs. This approach suggests an estimated loss of potential output of over \$ 300 billion (at 2000 prices) per year in developing Asia in 2001.

**Table 6: Potential Output Lost in East Asia in 2001
in billions of dollars at 2000 prices)**

Countries	Potential Output lost
Japan	722
PRC	119
Hong Kong	26
Indonesia	32
South Korea	55
Malaysia	18
Philippines	1
Singapore	17
Thailand	44
Total	1034

47. The loss of potential output has been associated with low capacity utilization in manufacturing and construction sectors. Capacity utilization in manufacturing sector in Thailand in 2001 was as low as 53%. In South Korea, Philippines, Taipei, these rates were around 75%. In Japan, operating rate indices for industries declined by about 20 percent between 1990 and 2001. This under-utilization of capacity is vividly illustrated by slowing production in construction industry in Japan and in IT industries in several East Asian countries .

V. The Way Forward

a. Continued trade liberalization

48. Accelerated trade liberalization, including PTAs remains a possible instrument for recovery in the region. Average tariff rates in most of the region have come down from 30-40 percent in mid-1980s to about 10% by 2000. However, within the framework for relatively low average tariffs, there is a general tendency for protection rates for agricultural commodities and labor-intensive manufacturing to be high in the ASEAN countries. For instance, the weighted average of tariffs for apparel are particularly high for low-middle income ASEAN countries, ranging from 20 to 50 percent. High protection of processed foods, drinks and tobacco is observed in the Philippines, Laos, Thailand and Vietnam. The protection of transport equipment remains high for all the ASEAN countries. Tariff rates have

been reduced in recent years in India and other South Asian countries. But they still remain relatively high in the range of 30-40 percent on many products. In addition to tariffs there are extensive non-tariff barriers in many Asian countries. Thus continued efforts for trade liberalization at global as well as regional level remains important.

49. However, in order to maximize the benefits from trade liberalization, it is important to supplement the efforts for trade liberalization with building up regional public goods to facilitate trade and investment. Such regional public goods would include infrastructure for transport, communication and finance. For reasons elaborated below, now is a particularly good time to make accelerated regional efforts for building up regional infrastructure.

b. Growing importance of liberalization in labor markets

50. As noted above, the resource inflows due to labor movements are far more important than those through capital movements for many Asian countries, and it is arguable that for the future, welfare gains from liberalization in labor movements are likely to be much greater than those from liberalization in merchandise trade. The simple point is that the increase in welfare from liberalization depends on the degree of distortion before liberalization. In the case of merchandise trade the degree of distortion has been severely reduced; as noted above for most of Asia, the average tariffs are now less than 10 percent. In the case of labor prices however, the degree of difference is often 10 to 1. Thus, gains from liberalization of labor movements are likely to be very large for Asia as well as for the world.

51. The potential for such welfare gains can perhaps be illustrated with reference to possible co-operation between Japan and the Philippines. The Japanese economy is becoming rapidly aged with the elderly population in dire need of labor services from the younger population for domestic chores as well as nursing needs which are in short supply and expensive in Japan. The Philippine population is on the other hand relatively young and has demonstrated expertise in services, both domestic and health-related. Over time, if an acceptable mechanism could be devised for work permits for Filipino workers for domestic and nursing services for the elderly in Japan, it would lead to very large increases in welfare for both sides. Similar potential opportunities for mutually beneficial exchanges in labor movements exist for many other Asian countries in both skilled and unskilled laborers.

52. The main problem in this area arises from social impact of foreign labor in importing countries. Over time, Asian countries have developed a framework for controlled migration for specific skills and specific periods. With a concerted program for liberalizing labor movements in a fully controlled manner, the risks of illegal immigration could be minimized. Just as in the case of trade reforms, the early fears of import liberalization proved unfounded, it is quite likely that the fears of liberalization in labor movements will prove unfounded. A time has perhaps come to try and articulate the possible fears about labor movements and discuss openly the control mechanisms that could be put in place to minimize these risks.

c. Gains from Financial co-operation.

53. Equally important are possible benefits of co-operation in financial matters including concerted exchange rate policies and establishment of regional balance of payments safety nets.

54. Despite its eminence in many other areas of economic policy, Asia has been far from following optimal exchange rate policies particularly during the last two decades. Exchange rates have gone through gyrations which clearly were not favorable to the development of the countries. During this period, the two key currencies for the region for its trade, investment and finance, US dollar and Yen have gone through great fluctuations. Adjusted for prices (consumer price index with 1995 as base) dollar was worth 161 yen in 1980. Through some ups and down, it depreciated sharply until it was only 94 yen in 1995; and since then it appreciated to 120 in year 2000. Over this period there were year-to-year variations of over 15 % and four year variation of over 40%. (The protection/subsidization that such changes in exchange rates can provide may be larger than liberalization of trade provided by reductions in average rates of tariffs.) The risks to trade and finance that such fluctuations introduce are clearly more than what most enterprises can handle comfortably and reflects clearly a failure in the task of achieving stability in exchange rates for which the IMF was set up. In principle, these fluctuations can be handled by forward contracts on currencies. But such options are not widely available to all enterprises and in any case the forward market must charge a high premium for assuming these risks inherent in sharp fluctuations.

55. For individual countries on the region, there were major ups and downs in their effective exchange rates. The fluctuations in individual currencies in the region with respect to the trading partners can perhaps be illustrated by referring to the experience of one country, say,

the Philippines. The Philippines exchange rates have maintained a relatively stable link with US dollar. In real terms (adjusted by consumer price indices), the Philippine Peso declined steadily from \$.045 in 1980 to 0.028 by 2000, with sharp depreciation of up to 20 per cent as in 1983 and in 1998. However fluctuations with yen were far greater with up to 45% depreciation in one year (1986) and up to 25% appreciation in another (1996). With respect to its regional trading partners too the Philippines has gone through some sharp fluctuations. Over the last twenty years, peso has undergone mild appreciation with respect to Malaysian Ringgit, and sharp appreciation (which hurts Philippines regional exports) with relation to Indonesia and China. With respect to Korean won, Singapore dollar and Thailand Baht, Peso has been relatively stable over the twenty year period though there were some year-to-year fluctuations. With regard to exchange rates of other countries the sharp deterioration in exchange rates in Indonesia in 1997-98 from 2909 on average for 1997 to 10014 for 1998 was a stark example of mismanagement of exchange rate in conditions of turbulence. It was a cruel blow to the economy, something that Malaysia was able to prevent, even though it would have suffered the same fate if its leaders did not have the courage to withstand the pressures from abroad. The social, political and economic difficulties in Indonesia that followed were not unconnected with the failure of the authorities to follow a more appropriate exchange rate policy.

56. In the post-crisis period, there has been a move toward more flexible exchange rates in the region. However as the empirical work done by Mashahiro Kwai (2001) shows the “observed” exchange rate arrangements in East Asia indicate that dollar’s role as the dominant anchor has become prominent once again since late 1998. He also notes that for emerging East Asia, the United States is no longer the most dominant economic partner and the relative importance of Japan is as large as and in some cases larger than that of the United states. Given the continued volatility of yen/dollar exchange rates, this results in excessive fluctuations in effective exchange rates of these countries. As Mr. Kwai mentions, “Free floating rates are inappropriate for developing countries, including those in East Asia, because rates tend to be very volatile and can easily move beyond what the economic fundamentals dictate, exerting harmful impact on trade, investment and growth.”

57. While it may be desirable for the region to move away from anchor to US dollar, it is not easy for any particular country to move unilaterally away from the current US-dollar based exchange rate arrangement to a new arrangement in which the weight of the dollar is smaller

and that of other currencies larger. This may result in misalignment of the country's exchange rate in relation to the other countries in the region which may be competing in the same external market. This demonstrates the potential importance of coordinated action on the part of the countries in the region.

58. In view of the regional consensus of improving the exchange rate regime for the region, serious discussions are on-going as to the appropriate regime for the region. At one extreme is the idea of a currency union within a common currency. As part of the initiatives under the Hanoi Plan of Action approved by the ASEAN leaders in December 1998, a Task Force was set up to assess the feasibility, preconditions, merits of coordinated action on exchange rates and the form an ASEAN currency and exchange rate mechanism. The Task Force, consisting of central bank officials from the ASEAN countries and chaired by Bank Negara Malaysia was established in August 2000, and the first meeting of the Task Force was held on August 8, 2001. However, the political preconditions for common currency which requires basically a sacrifice of independent monetary policy are just not there in Asia.

59. A second line is that suggested by Mundell (2001), namely creation of a parallel currency, which involves less of a political commitment. The idea of a parallel currency is that it could be used by all or most of the Asian countries. Countries could retain their own currency but link it to the parallel currency in some fashion, and the parallel currency could be the trading currency for the Asian countries. This could start by introducing an Asian Currency Unit (ACU) which is a basket of currencies, regional and non-regional and which can be used as a unit of account for current account and capital account transactions. Individual currencies can vary in relation to ACU within a broad band depending upon the circumstances of the country (similar to the European system of ECU (see Box 1). In principle it could be like SDR at Asian level. Over time, Asian countries may try to implement the idea of an Asian monetary system based on an Asian SDR. The technical ideas on creation and allocation of SDR for such a system have developed by a long line of eminent monetary experts beginning with Keynes (with his proposal for bancor at the Bretton Woods conference) and followed up by many in the IMF (see for example, paper by J.J. Polak (1979)). Such a system was frustrated because it conflicted with the interest of the dominate power in IMF (US) which

stands to lose its benefits of seigniorage from the present system.⁵ In Asia, there is no such seigniorage accruing to major powers, Japan or China and an Asian SDR-based system may well be feasible over the long run before it can at a global level.

60. While exploring the policy options for an Asian currency unit, it is advisable in the short-run to develop policy harmonization on exchange rate policies of the countries in the region, and create an institutional set-up for helping the countries to implement that common understanding. Individual country exchange rate management with a view to maintaining a relatively stable real effective exchange rate may be the most important step in the near-term.

61. In theoretical literature it is fashionable to refer to the so-called “impossibility theorem”: it is impossible to have simultaneously a fixed exchange rate, an open capital account and independent monetary policy. This is true in the rarified atmosphere of theory. But in real life, none of these variables stay in pure form. Exchange rate does not have to be either fixed or completely flexible there can be floats that are managed as is indeed the case in many countries. Capital account can also have varying degrees of openness with regard to direct investment inflows, long-term capital inflows and short term capital inflows. Regulations on activities of hedge funds and restrictions on pure speculations in currencies without any demonstrated needs for financing trade or capital inflows are possible and widely practiced in many countries. Nor should independence of monetary policy be framed in either or terms. Monetary policy may well take the external developments as one element in its decision making without being left to the forces of the market.

62. The financial crisis of 1997 in East Asia and the subsequent programs (led by IMF) for stabilization illustrate the cost of inadequate BOP safety nets in Asia. The cumulative loss of output in the last five years in Southeast Asian countries (in particular Thailand and Indonesia) in comparison with the long-term output trends is easily over 10% of GDP. A regionally designed BOP support program with less emphasis on contractionary policies

⁵. It is estimated that in 1999, about 70 percent of US dollars in circulation (\$568 billion) were held by foreigners. Even at a conservative interest rate of 5% on these long term “loans” to the US, the seigniorage benefit is \$ 28 billion per year. In addition, foreigners held \$ 1.6 trillion of securities issued by US government and monetary authorities. It is understandable that if an SDR based system is indeed introduced, the US will have to redeem these trillions of dollars of paper obligations and that would be a big burden, even for the mighty economy of the US. However as the experience with Sterling balances of the UK shows the day of reckoning cannot be postponed forever. **The s** Sooner the US starts to reduce its reliance on the” dollar balances” abroad, the better it is for the country in the long run. At present the country is living beyond its means (with about \$450 billion of current account deficit in 2000 alone) and transferring the burden of its profligacy to the future generations.

could have reduced this loss by several percentage points. Countries such as China and India, which escaped financial crisis in 1997, have been maintaining (apart from some controls on capital movements) excessively high foreign exchange reserves as an insurance against financial crisis. If a regional safety net for BOP problems were available it would enable these countries to economize on foreign exchange holdings.

d. Promoting Regional Public Investment Activity: Regional Keynesianism

63. Apart from stability in exchange rate mechanism and setting up of BOP safety nets, there is an urgent need to help the regional economies out of the current slump. Given the state of financial system in much of the region and low confidence of the private sector, a private sector led recovery is not on the cards. The region may well be in a Keynesian situation of underemployment equilibrium.

64. The most promising source of recovery in the region is promotion of public sector led investment. Domestic pump-priming will have to play the crucial role in revival of growth in the region. And pump-priming efforts are being undertaken in several countries, though reluctance to accept the Keynesian framework in the conditions of slump is a major hindrance. But in most of the major countries in the region, regional pump-priming can provide a useful supplement to the domestic efforts. For example, in Japan, domestic pump-priming efforts are running into difficulties partly because of the problem of finding worthwhile public works projects and partly because the public debt has already reached high levels and there is a political reluctance to allow public debt to increase much further. However at a regional level there are many viable infrastructure projects which can help to increase utilization rate in Japanese manufacturing and construction sectors. And if a regional institutional mechanism could be developed to channelise Japanese excess savings into loans for these infrastructure projects, regional pump-priming can proceed without increasing public debt in Japan. Even if some concessional financing becomes necessary to make Japanese bidders for these infrastructure projects to be internationally competitive, the public resources required will be a fraction of what is required in domestic public works projects. Similar logic would apply to pump-priming in economies such as Singapore, Hong Kong, Taipei (China) where there is large excess capacity in sectors such as IT industry for which there is not enough potential domestic demand but there is potential regional demand which can be transformed into effective demand through regional financing mechanisms.

65. In a report published by Economic and Social Commission for Asia and the Pacific in 1994 entitled Infrastructure Development as Key to Economic Growth and Regional Economic Co-operation, it was estimated that the estimated increment in physical infrastructure facilities required between base period of 1990-92 and the year 2000 for ESCAP member countries excluding Australia, Japan and New Zealand were approximately \$1400 billion, of which up to \$500 billion was identified as available. The financial resource gap was therefore estimated to be \$900 billion.

66. More recent comprehensive estimates are not available. But country studies in many Asian countries clearly show that there are public investments programs in several countries whose viability over the long term is not questionable but which cannot be implemented because of shortage of funds and lack of profitability in the short and medium term. Many of these investments have positive externalities in terms of environment and social stability and some public assistance for such investments would be eminently justified, particularly when the opportunity costs of supplying these investment goods from countries with excess capacity is low in the current situation. Individual country efforts are not enough, either in the resource surplus countries (such as Japan) or in resource deficit countries in developing Asia. There is a mutuality of interest in regional co-operation.

67. One group of such investment needs relate to infrastructure investments for tackling the growing environmental problems in Asia. For China alone additional (to the business as usual scenario) investment needs for environment friendly development with high pay-offs are estimated by World Bank (1997) to be of the order of about 1 percent of GDP (over \$10 billion per year) during the next 20 years. Over the long term China will have to implement the programs of water transfer from the water surplus south to the water deficit north. The programs for such transfers are at an advanced stage of preparation and need funds for implementation. There are large programs of watershed management and reforestation in China which require huge construction activities. The trend toward urbanization is strong in China and there are mega cities emerging in several parts of China. Over the long –term there is very little doubt that these mega cities will require subway systems for urban transportation. The subways require huge investments upfront for which funds are not currently available. The investments are construction intensive and can provide a fillip to the moribund construction sector in Japan. There are similar viable programs for environment

friendly investment in several other East Asian countries such as Thailand, Indonesia, Philippines, Vietnam, and Myanmar.

For India alone, the infrastructure investment needs over the next decade are estimated to run into nearly \$500 billion (Kumar (2002)). Some of the main components of these investment requirements are: power generation and transmission (\$143 billion), exploration and transportation of oil and gas (\$100-150 billion), coal mining (\$18 billion), telecommunications (\$53 billion), expansion and upgradation of roads and highways(\$34 billion), Ports(\$7 billion), mass rapid transit (MRTs) systems for metros (\$20 billion) and improvement in sanitation and water supply (\$6 billion).

68. Regional co-operation can play a major role in improving energy security of East and South Asia. Over the long-term countries in this region would need to develop alternative land routes for transportation of oil and gas from central and western Asia to the consumption centers in Japan, Korea, PRC and India. Central Asia has vast potential of oil and gas but at present lacks the means to transport them to Eastern consumption centers. Among the projects identified for facilitating such transportation are the following:

- Expanding rail transport of oil between Kazakhstan and Xinjiang, PRC as an interim solution to meeting the needs of both Kazakhstan and the PRC;
- Construction of oil pipeline between western Kazakhstan and Xinjiang, PRC;
- Building electric transmission infrastructure between the Kyrgyz republic and southern Xinjiang, PRC;
- Completing and renovating the gas pipeline from Turkmenistan and Uzbekistan through the Kyrgyz Republic to Almaty, and eventually extending this pipeline to Urumqi;

69. These and such other projects are essential for long term energy security of Asia. But their implementation is held up due to the huge amount of resources required upfront. They should be priority candidates for funding under a strategy of regional Keynesianism.

70. Another area of investment where the long-term viability is not questionable is IT investments in Asia. Despite some progress, the reach of IT facilities in many Asian countries is quite limited. A publicly supported investment program in IT facilities in these countries

could give a fillip to the IT industries in the region in particular in Taipei, China, Korea, Japan, Malaysia and the Philippines.

71. Yet another area relates to pan-Asian infrastructure projects. For many decades there have been intensive discussions in Asia on several major infrastructure projects which connect different Asian countries and Europe. Two among them are: Pan Asian Highway and Pan Asian Railway. Under the auspices of the UN system, detailed technical work has been done on various components of these projects. ADB has been active in developing infrastructure projects for Great Mekong Sub-region. Due to shortage of finance, the progress on these projects has been inadequate. Project for pan Asian information highway may also be given a boost at this time. The funding requirements for these projects run in tens of billions of dollars and their long-term viability is not questionable. In the context of excess capacity in construction industry in Japan, Korea and elsewhere, now may be the ideal opportunity to launch a major project for completion of these pan Asian projects.

VI. Institutional Reforms: Establishment of an Asian Monetary Fund (AMF) and Strengthening of ADB

a. Creating an Asian Monetary Fund

72. For making regional monetary co-operation effective, it seems appropriate to go back to the original concept of Asian Monetary Fund (AMF) which will have at least US\$100 billion of capital and will help the region to achieve stability of real effective rates and help the countries in need of short- and medium-term BOP assistance. It would develop its own form of policy dialogue and conditionality (preferably of ex post variety) based on the regional realities. Its operations will be delinked from IMF conditionality as has been the case with EU monetary institutions.

73. Some see Chiang Mai Initiative (CMI) as a natural progression leading to the renewal of the old idea of AMF. However for this progression to take place some fundamental rethinking is necessary about the link of Asian program to IMF. Under present conditions with all the initiatives noted above, the support that can be provided to Asian countries that does not want to take IMF medicine is so small as to be inconsequential. On the basis of poor performance of the countries under IMF programs (see Easterly (2002), we argue that so long as the regional co-operation is linked to IMF, it has, under current conditions, no chance of success.

74. If IMF or countries outside the region were contributing funds for balance of payments support to the Asian countries in need of BOP support, their involvement would be understandable on fiduciary grounds. But the proposed AMF does not require any such assistance. In this situation, the link with IMF can be justified only on grounds of developmental benefits that may accrue to the region through such linkage. But as noted above, the record of developing countries under IMF programs in terms of growth and stabilization is not particularly glorious. In fact it seems those countries that have been subjected to the IMF medicine have seldom recovered along the lines suggested under the programs.

75. AMF can become an instrument for BOP support in the case of external shocks as well as for funding regional investment projects. One possible avenue is creation of an Asian SDR (ASDR). The modalities for SDR creation and their possible role in providing finance has been developed by the staff in the IMF over many years. More recently Nobel Laureates Amartya Sen and Joseph Stiglitz have argued for creation of SDR to help finance development. In a conference on “Globalizing Freedom and Prosperity” organized at Olof Palme Center (December 11, 2001), Even within the present structure (of IMF and World Bank) there are possibilities on which particularly George Soros has written very eloquently and very convincingly that “*we can use the Special Drawing Rights to finance the national as well as global public goods in which private business investments may be very much lacking*”. In the same conference, Joseph Stiglitz argued:

“Now, what we have are two problems, the problem of financing global public goods and the problem of maintaining global economic prosperity. And what is great about the notion of SDRs is that they can marry these problems together and solve both of them, because by having SDR allocations you can use the SDR allocations to finance global public goods and take responsibility of the basis of financing the public goods out of the hands of national budgetary processes subjected to provincial, to the particular narrow-mindedness that occurs in some countries and put this on an international scale and have an allocative mechanism that will say that the money that is created through these SDRs will be allocated to the provision of international public goods.”

76. However, given the fact that creation of SDRs will mean a corresponding loss of seigniorage to the US under the current dollar system, these proposals have very little chance of success at the global level. However, Asian countries can in their interest create an Asian SDR without requiring any support from non-regional players. Assuming that the ASDR will be used by member countries to meet part of their foreign exchange reserve requirements, deposits of US\$100 billion (as proposed by Japan in 1997) can enable AMF to create a multiple of the base amount, which could provide adequate resources for BOP safety nets as well as for regional Keynesianism proposed above. The regional investment programs can be orchestrated through regional development agencies such as the Asian Development Bank. The borrowers could be not just governments but also regional companies (such as Channel Tunnel Company for the UK and France) jointly owned by governments and private sector in the region.

b. Strengthening ADB's role in regional co-operation

77. Establishment of ADB as of other regional development banks was inspired by a desire for collective self-help. As Meltzer Commission Report (2000) notes, “ *Beginning at the end of the 1950s, members from each of the world's key borrowing regions, desiring more control of lending policy, united in three regional banks. Linked by geography, sympathetic by custom and culture, and staffed predominantly by their own citizens, they sought to serve their constituencies better than could a distant institution dominated by industrial countries.*” However, in view of the need for more expanded funding than was available in the region, all regional banks acceded to the need for membership of developed countries, while retaining the majority vote in regional hands.

78. There are three complementary functions for the Bank in regional cooperation: first, as a provider of information to the DMCs; second, acting as an “honest broker” among the DMCs; and third, as a means of leveraging public and private sector resources towards regional investments. Taken together, these three mutually supportive functions enable the Bank to act as a catalyst: encouraging information sharing and dialogue; providing forums for that dialogue; and assisting, if requested, in a regional cooperation through project identification, development, and financing.

79. In practice however ADB, like other regional banks, became largely a duplicate of the Bretton Woods Institutions. It generally followed, though with a time lag, the lead given by

the Bretton Woods Institutions in its lending policies as well as policy dialogue. During the crises faced by the region (for example the oil crises of 1973 and 1979, exchange rate crisis of 1985 and above all, the financial crisis of 1997/98), it was unable to formulate its own strategy for assistance to the regional members. During the financial crisis of 1997-98, there were occasions when some ADB staff members and some member countries felt that the policy reform programs pushed by the extra-regional partners were not in the best interests of the member countries and in hindsight they seem to have proven right. But even in that situation, ADB was not able to utilize its special regional knowledge and regional sensitivities to help its member countries and instead largely followed the lead given by the Bretton Woods Institutions.

80. On the issue of fulfilling its mandate for regional co-operation too, the performance of ADB has been lack-lustre. The mainstream opinion in Bretton Woods Institutions has been all along in favor of multilateralism and against regionalism. In the 1990s the mainstream economists' view in Washington turned strongly in favor of regionalism for the Americas but it remained against regionalism for other regions, including Asia. In this overall environment of skepticism on regional co-operation, the support given by ADB for regional co-operation was sporadic at best.

81. During the last 35 years of its existence, less than 1 percent of the ADB loans were given for regional projects. In the area of technical assistance the performance was better: over 20 percent of the TAs were in the form of regional TAs. However, there was no vision of a regional development strategy or regional development assistance guiding these RETAs and the impact of these RETAs on regional policy dialogue was only marginal. ADB was not able to deepen the understanding of the distinctly Asian strategy of development suggested for example by the "flying geese model" or play a lead role in understanding the factors behind the so-called "Asian miracle" or behind the Asian financial crisis of 1997/98. The main merit point for ADB was in terms of its cost-effectiveness: among all the development banks, ADB had the lowest staff cost per unit of lending operations.

82. The modest role played by ADB in the past was understandable and perhaps affordable because the region was performing well on its own and the costs imposed by the Bretton Woods institutions were not high. But now the region is in a great slump and the medicines administered by Bretton Woods Institutions have not been working. Also the region is now

the main resource surplus region in the world; it is meeting the resource needs not only of developing countries but also the major developed countries such as the US. In this situation, the past rationale for dependence on resources from outside the region no longer applies. The lessons of spectacular development performance of the region are being articulated in practical manner by policy analysts in the region itself. Among the ideas to draw upon are: Hayami's writings on development (2001), Malaysia's management of foreign capital flows, China's strategy of gradualist and endogenous reforms, and ADB's perspectives on promoting "competitive pluralism", playing the role of "family doctor" in its dealings with its member countries. There is now a clear case for greater activism of ADB for Asian development. In fact, there are some influential voices such as those of Meltzer Commission which argue that all country and regional programs in Asia should be the primary responsibility of ADB and that such transfer should be accomplished within five years. To quote: "Costly duplication and confusion arise from the overlap of function and resource flows between the World Bank and its regional partners. The comparative advantage of the regional banks resides in strong relationships with borrowing members based upon a mutual understanding, common language, and common culture. Both the Asian Development Bank and the inter-American Development Bank have reached a level of maturity and professionalism which qualifies them to take responsibility for the tasks of poverty alleviation and structural reform in their respective regions." (Meltzer Commission, 2000).

83. Even if such drastic step is not taken, serious thought should certainly be given to see how ADB's role can be expanded to help in achieving recovery in the region. It is arguable that the region needs a regional stimulus package of at least US\$100 billion over the near term (a stimulus similar in magnitude to that being given in the US (whose GNP in purchasing power terms is similar to that of the region) and ADB should play a lead role in a mutually beneficial resource transfer from more developed economies such as Hong Kong, China; Japan; Korea; Singapore; and Taipei, China to the less developed ones for pan Asian infrastructure projects as well as other viable infrastructure and environment-related projects in the region. Apart from direct loans, ADB could support formation of regional investment company (drawing on for example, the experience of the corporation set up to manage the tunnel linking the UK and France) to mobilize construction funds from countries in the region with surplus funds. Among the new instruments could be assistance through guarantees for floating infrastructure bonds by member countries or by Pan-Asian institutions for say Pan-

Asian Railway or Pan-Asian Highway, securitization of infrastructure facilities of member countries, and assistance in promoting BOT, BOO etc. projects for infrastructure.

84. In terms of institutional mechanism for such enlarged role for ADB, there are several precedents in the history of the World Bank to draw upon. In the early 1960s when it became evident that South Asian and African countries in need of development assistance could not afford loans on standard IBRD terms, a new affiliate (IDA) was created with its own membership and voting structure different from that of IBRD. Similarly when in mid-1980s it became evident that sub-Saharan Africa needed special assistance, Trust Funds were created in the World Bank with contributions from member countries on a voluntary basis, not necessarily according to the contributions in either IDA or IBRD. A special Trust Fund for Asian Recovery could be created in ADB with contributions on a voluntary basis from the member countries.

VII. Impediments to regional co-operation

85. The vision of regional economic co-operation presented above is not much more than what was actually achieved by EU. Most countries in EU have a model of economic management that combines market with social responsibility through state intervention. None of the EU countries have accepted IMF conditionally or IMF programs of reform in the last twenty years. The exchange rate regimes have been gradually harmonized with the eventual switch to Euro. Adjustment mechanisms have been set up to help countries to reallocate labour and capital as integration proceeds. Over time national boundaries have been virtually eliminated in economic matters. And despite images of fortress Europe, the Union is well integrated with the rest of the world.

86. Despite this precedent, the road to enhanced regional co-operation in East Asia is not likely to be easy. The level of trust among the major players, Japan, China, India, Korea and ASEAN has not always been high. The fears of domination by one country or other are commonly expressed. In factual terms the tensions in Europe among the major players in the early 50s were perhaps no less than they are in Asia today and the gains from better utilization of resources in Asia for all Asian countries are no less than was the case in Europe. But it is an open question whether the political leadership in the region will be able to

overcome the emotional impediments to co-operation and forge a consensus in favor of accelerating the pace of co-operation in the region.⁶

87. The biggest problem in regional cooperation arises when the cooperation framework impinges on sovereignty of the nations. The proposals made in this report, though ambitious, are very light in terms of infringement of national sovereignty. The call for implementation of current trade agreements rather than initiating new PTAs should reduce the burden of administration of customs in all countries concerned. Liberalization of labor movements does not require any supranational authority. These programs are to be designed and implemented at national levels. Coordination on exchange rate becomes difficult when stability of nominal exchange rates requires harmonization of domestic monetary policies. However, if the aim is to manage stability in real effective exchange rate terms, it does not infringe on independence of monetary policies. Different countries can have independent monetary policies, so long as the resultant differentials in inflation rates are allowed for changes in nominal exchange rates. Similarly, development of regional bond markets or other financial infrastructure for better utilization of regional savings does not require any regional controls on national policies. Even establishment of an Asian Monetary Fund and creation of Asian SDRs will be just repeat of what has already been done at global level without any sacrifice of national sovereignty. Thus the extra regional efforts called for in this report are for concerted actions for regional self-help without sacrifice of national sovereignty and to that extent they should be easier to implement.

88. The gains to developing countries in Asia from regional co-operation along the lines mentioned above are easy to identify. If regional Keynesianism helps to finance national infrastructure and IT projects with long-term viability in developing countries, the gains would be obvious. And in order to ensure an equitable distribution of these benefits, an allocation mechanism can be devised similar to what is done for allocation of external assistance by IFIs now. To the extent regionalism Keynesianism finances pan-Asian projects, it should have positive effects on all Asian countries. Increased labor movements should benefit both the exporting countries (such as the Philippines, Indonesia, Myanmar, Thailand,

⁶ It is encouraging to hear from some prominent economists in the region that the prospects of such co-operation is increasing. For example, in his paper "Beyond the Chinag Mai Initiative: Rationale and Need for Regional Monetary Arrangement in East Asia" (draft dated June 2001) Yung Chul Park states: "Having suffered such a painful and costly financial crisis, the East Asian countries are prepared to set aside their differences and to work together to develop a region-wide defense mechanism to the extent that it could help protect themselves from future crises. After three years of crisis management, East

India, Bangladesh, Pakistan, Sri Lanka) as well as labor importing countries (such as Malaysia, Republic of Korea, Taiwan, China, Singapore, Hong Kong and Japan). The issues of potential social and political complications of immigrant workers are by no means trivial. But there are now several models of contracts with guest workers which can be utilized to minimize such adverse side effects. Better financial cooperation in the region should be beneficial for all countries in the region. In particular, it would offer a chance for the crisis-affected countries of Indonesia, Thailand, and the Philippines to emerge from their current slump, which they are unlikely to do under the current IMF-dominated policies.

89. If Asian economic co-operation is to be strengthened, Japan, the largest economy of the region, must play a lead role. In the past, serious effort for regional co-operation were not forthcoming from Japan because it was not clear what Japan was to gain from such efforts. Regional co-operation was largely part of Japan's efforts in promoting investment, trade and financial flows to the rest of Asia and these could be done in the framework of Japan's own aid and investment programs without any regional effort. If the analysis presented in this paper is valid, Japan may have a lot to gain from the regional co-operation proposed here. The instability in exchange rate of yen has been a major source of instability in the Japanese economy and the proposed AMF with its help in maintaining a stable real effective exchange rates for its members may be of enormous help to the Japanese economy. More important is the possibility of better utilization of Japan's productive capacity through regional Keynesianism: Japan can gain several percentage points of its GDP and help revival of its construction and machinery sectors which are of vital importance to the country, both politically and economically.

90. More difficult is the task of demonstrating how the proposed changes will benefit the rest of the world, particularly the single most important economic partner of Asia, the U.S.A. In substantive terms there is very little doubt that rise of Asia from its present slump will provide a helpful engine of growth to the world economy and contribute to peace and prosperity in the world. However the proposed vision involves a departure from the Establishment view on economic management and reduced power of Washington-based institutions. There are some powerful voices in international community (such as Meltzer commission) calling for such decentralization. But much work is needed to convince the international community that they should not undermine the Asian efforts for economic and financial cooperation as they have been doing recently but support them as they did for

European co-operation. The proposed AMF will lead to some loss of seigniorage accruing to the USA at present. However, that should be seen as a move toward more equitable distribution of seigniorage in the world economy. The proposed changes would also mean some constraints on the profligacy of the present generation in the US which is building up enormous external debts (over \$ 2.7 trillion already). Any checks to this profligacy should be seen as reducing the economic and financial vulnerability of the future generations in the country.

91. Will the arguments for a fairer globalization prevail over the power of vested interests? Only time will tell. In the meantime, we draw some comfort from the words of John Maynard Keynes, on whose ideas the present proposals are based:

“Is the fulfilment of these ideas a visionary hope? Have they insufficient roots in the motives which govern the evolution of political society? Are the interests which they will thwart stronger and more obvious than those which they will serve?”

I do not attempt an answer in this place. It would need a volume of a different character from this one to indicate even in outline the practical measures in which they might be gradually clothed. But if the ideas are correct—a hypothesis on which the author himself must necessarily base what he writes—it would be a mistake, I predict, to dispute their potency over a period of time. At the present moment people are unusually expectant of a more fundamental diagnosis; more particularly ready to receive it; eager to try it out, if it should be even plausible. But apart from this contemporary mood, the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back. I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas. Not, indeed, immediately, but after a certain interval; for in the field of economic and political philosophy there are not many who are influenced by new theories after they are twenty-five or thirty years of age, so that the ideas which civil servants and politicians and even agitators apply to current events are not likely to be the newest. But, soon or late, it is ideas, not vested interests, which are dangerous for good or evil.” John Maynard Keynes (1936)

Box 1:

East Asia has a lot from EU experience in fundamentals though not in details

For centuries, philosophers and visionaries in Europe had talked about European unity embodied in some sort of United States of Europe. However these dreams were shattered by the conflicts which brought so much destruction to the European continent in the first half of the last century. The vision of new Europe which would transcend antagonistic nationalism finally emerged from the resistance movements which had sprung up to resist totalitarianism during the Second World War. The desire for integration was strengthened by the fears of an expansionary Soviet Union and the support given by the United States interested in containment of Soviet Union. Through progress over a period of 50 years, Europe now stands at the threshold of a true union with free movement of goods, services, capital and labor and a single currency. European Union is an example to learn from for all those nations which are seeking greater economic co-operation and Asia is no exception in this respect. Each region has of course to define its path of cooperation and integration in the light of its own social, political and historical circumstances and it is not realistic to define the paths and sequences of integration for all groups of nations. Often particular historical episodes lead to enhancing the urge for co-operation and determine the modalities of such co-operation. In the case of East Asia the financial crisis of 1997 was such a cataclysmic event and created strong urge for enhanced co-operation in monetary sphere, even ahead of institutionalized co-operation in trade in goods and services. In this connection it is worthwhile to review what European Community did in terms of monetary co-operation in the early phase of its history.

A European exchange rate system, popularly known as the 'snake' was introduced in 1972. In 1974 European Council adopted a decision designed to bring about a high degree of convergence between national economies and a directive on stability, growth and full employment. However growing economic instability gradually eroded the foundations of the system and the French franc, sterling and the Italian lira left the snake.

On 6 and 7 July 1978, at the Bremen European Council, the Heads of State or Government decided to establish the European Monetary System (EMS), which came into force on 13 March 1979.

The EMS created a zone of monetary stability in Europe, encouraging growth and investment.

The EMS had three main components:

1. *The ECU*. This was the key element in the system. It was a basket of the currencies of the Member States.
2. *The exchange rate and intervention mechanisms*. Each currency had a central exchange rate linked to the ECU. This was used to determine central rates for each pair of currencies. Until August 1993 bilateral exchange rates were allowed to fluctuate within a band of 2.25% or up to 6% in exceptional cases, around the central rate. Subsequently the band was increased to 15% following serious upsets on currency markets.

3. *Credit mechanisms.* In the event of bilateral exchange rates approaching the 15% threshold, central banks had unlimited liability to intervene to ensure that the threshold is not crossed.

Over time, the system of EMS was supplanted by common currency, Euro which has replaced the national currencies from January 1, 2002.

The lesson to draw from the European experience is that a group of sovereign and powerful nations can determine their exchange rate mechanisms and progress toward closer co-operation in the light of their own circumstances without being dependent on the International Monetary Fund. ASEAN+3 countries can learn much from the spirit of independence and solidarity exhibited by the Europeans in the context of monetary cooperation. The European monetary co-operation was a good example of what Deng Xiao Ping has in a different context called “crossing the river by feeling the stones”. East Asians need to do the same in their long march toward formation of Asian Monetary Fund.

Source: The description of the European system is based on Europe in 10 Points by Pascal Fontaine, Office of Publications of the European Communities, 1998, Luxembourg.

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