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Regional Cooperation in Asia: Long-term Progress, Recent Retrogression, and the Way Forward

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Regional Cooperation in Asia: Long-term Progress, Recent Retrogression, and the Way Forward

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Brahm Prakash

October 2002
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Foreword

The ERD Working Paper Series is a forum for ongoing and recently completed research and policy studies undertaken in the Asian Development Bank or on its behalf. The Series is a quick-disseminating, informal publication meant to stimulate discussion and elicit feedback. Papers published under this Series could subsequently be revised for publication as articles in professional journals or chapters in books.
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### Acronyms

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<td>ACU</td>
<td>Asian currency unit</td>
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<td>ADB</td>
<td>Asian Development Bank</td>
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<td>AFTA</td>
<td>ASEAN Free Trade Area</td>
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<td>AMF</td>
<td>Asian Monetary Fund</td>
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<tr>
<td>ARB</td>
<td>Asian Reserve Bank</td>
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<tr>
<td>ASA</td>
<td>ASEAN Swap Arrangement</td>
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<tr>
<td>ASEAN</td>
<td>Association of Southeast Asian Nations</td>
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<tr>
<td>ASEAN+3</td>
<td>People’s Republic of China, Japan, and Republic of Korea</td>
</tr>
<tr>
<td>BSA</td>
<td>Bilateral Swap Arrangement</td>
</tr>
<tr>
<td>CEPT</td>
<td>Coomon Effective Preferential Tariff</td>
</tr>
<tr>
<td>ECU</td>
<td>European currency unit</td>
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<tr>
<td>GATT</td>
<td>General Agreement on Tariffs and Trade</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
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<tr>
<td>IT</td>
<td>Information technology</td>
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<tr>
<td>MFN</td>
<td>Most Favored Nation</td>
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<td>NAFTA</td>
<td>North American Free Trade Agreement</td>
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<tr>
<td>PRC</td>
<td>People’s Republic of China</td>
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<tr>
<td>PTA</td>
<td>Preferential trading arrangement</td>
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<td>SAARC</td>
<td>South Asian Association for Regional Cooperation</td>
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<tr>
<td>SAPTA</td>
<td>South Asian Preferential Trade Area</td>
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<td>WTO</td>
<td>World Trade Organization</td>
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Abstract

Despite soft and fragmented regionalism, intraregional flows of trade, labor, and capital grew rapidly in Asia over the last few decades. However, in recent years, there has been retrogression in all the three areas basically associated with the slowdown in growth and departure from the East Asian model in these economies. Major Asian economies are now going through a prolonged slump and suffering from a massive misallocation of its resources, both labor and capital. There is now an urgent need for enhanced institutional efforts for regional cooperation in all the three dimensions mentioned above.

The process of liberalization in trade, investment, finance, and labor movements needs to continue at the national as well as international level. However, considerable progress has been made in the area of liberalization in merchandise trade in the region and easy gains have already been made. What is urgently needed now is a program for strengthening the regional financial infrastructure, which would involve a vastly increased role for the Asian Development Bank (ADB) in resource transfer within the region and establishment of an “Asian Reserve Bank” (ARB) for greater stability in exchange rates, greater financial security, and greater resource mobilization in the region.
I. INTRODUCTION AND OVERVIEW

In the wake of progress achieved in Europe and North America, regional cooperation has recently acquired intellectual and political respectability, which it did not have in the 1960s, 1970s, and 1980s. During the 1990s, a plethora of regional cooperation efforts were in fact initiated in the Asian and Pacific region, though the success achieved to date has been modest.

Regional cooperation is of course not an end in itself but has to be seen as a means of promoting the fundamental objective of fostering economic development. That objective can in turn be divided into three components:

(i) Improving long-term efficiency of resource allocation within the region. The resources here can refer to capital, technology, and labor; while the instruments can refer to removing obstacles to free flow of these resources within the region or to creating special incentives for such flows. Much of the usual discussion of regional integration initiatives (free trade areas etc.) revolves around these issues.

(ii) Reducing fluctuations in output around the long-term trend. Due to internal or external shocks, the economies of the region may suffer fluctuations in its long-term output potential as happened during the oil crises in the mid-1970s and early 1980s, and more recently in 1997-1998. Regional cooperation can help minimize the adverse impact of these shocks. This objective has gained particular salience in Asia in the wake of the 1997 financial crisis.

(iii) Helping the economies to get out of underemployment equilibrium if they happen to get trapped in one. This happened to the world economy in the 1930s and it may be happening to the region at present with a large amount of resources being underutilized over an extended period.

The paper argues that regionalism in Asia has been soft and fragmented over the last few decades. However, in the context of rapid growth achieved in much of the region through pursuit of what may be called the East Asian model, the lack of formal cooperation arrangements was not a major problem and intraregional flows of trade, labor, and capital did in fact grow rapidly.

The situation is different now. In all the three areas noted above, there has been retrogression in recent years and that is basically associated with the slowdown in growth and departure from the East Asian model in these economies. Major Asian economies are now going
through a prolonged slump and suffering from a massive misallocation of its resources, both labor and capital. There is now an urgent need for enhanced institutional efforts for regional cooperation in all the three dimensions mentioned above.

The process of liberalization in trade, investment, finance, and labor movements needs to continue at the national as well as international level. However, considerable progress has been made in the area of liberalization in merchandise trade in the region and easy gains have already been made. The marginal contribution from further trade liberalization alone is likely to be small and extended over a long period.

More immediate and larger gains are likely to be achieved by closer financial cooperation in the region to reduce the vulnerability of the region to internal and external shocks. To tackle these problems, neither individual country efforts nor the current global efforts are sufficient. Enhanced regional cooperation is needed for that purpose and the region has adequate financial, technical, and intellectual resources to achieve that without waiting for help or approval from outside the region.

What is urgently needed now is a program for strengthening the regional financial infrastructure, which would involve a vastly increased role for the Asian Development Bank (ADB) in resource transfer within the region and establishment of an “Asian Reserve Bank” (ARB) for greater stability in exchange rates, greater financial security, and greater resource mobilization in the region. In this connection, the experience of the European Union (EU) is a guide and inspiration to Asia, although the exact modalities and sequencing of such institutional development have to be geared to the specific circumstances of the region.

II. INSTITUTIONAL ARRANGEMENTS FOR REGIONAL COOPERATION

Institutional arrangements for regional cooperation can be divided into two groups. One is the formal cooperation agreements in the form of customs unions and free trade areas, which are notified to the General Agreement on Tariffs and Trade (GATT) and now World Trade Organization (WTO) in terms of Article XXIV of the GATT Agreement. Among the most prominent of such formal agreements are the EU and the North Atlantic Free Trade Agreement (NAFTA). The other form could be informal cooperation agreements where there is cooperation among a number of countries in various areas such as trade, investment, policy coordination, etc. without requiring notification of WTO under Article XXIV.

By international comparison Asia is the least regionalized in terms of formal trade agreements. All countries of North America and Latin America and most of the countries in Africa and Caribbean are members of at least one regional trading arrangement. In Asia, there have been two formal trade cooperation agreements: ASEAN Free Trade Area (AFTA) and South Asian Preferential Trade Area (SAPTA). The major economies of the region such as the People's Republic of China (PRC), Japan, and Republic of Korea (Korea) have not been part of any formal trading areas until recently. There are now some signs of forming free trade areas on bilateral and
subregional levels. But by and large, the distinctive characteristic of the region has been to emphasize nondiscriminatory trade liberalization on a unilateral or multilateral basis with regional cooperation confined largely to informal cooperation agreements.

A. Formal Cooperation Arrangements

1. Association of Southeast Asian Nations (ASEAN)

ASEAN economic integration efforts started in mid-1970s and were widely seen as a “cover” for political cooperation, in particular vis-à-vis instability in Indochina. Preferential trading arrangements (PTAs) 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 cooperation. 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 although some success was achieved in the automobile sector but that was with Japanese joint ventures.

In 1992, the AFTA was set up formally to realize a free trade area within 15 years beginning 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 Meeting, the time frame was shortened to 10 years with the aim of achieving the AFTA goals by the year 2003.

ASEAN countries have substantially lowered their Most Favored Nation (MFN) rates since the late 1980s. The reductions in applied rates have in most cases brought applied rates well below 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.

More recently there have been agreements to study free trade areas for broader groups such as ASEAN+3 (PRC, Japan, and Korea and even for ASEAN+PRC). Another trend is the willingness to sign FTAs on the part of countries that had not formally joined FTAs in the past. For example, Korea, which like Japan has not signed any FTAs, has in recent years begun to make efforts toward this goal. In December 1999, 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. Studies are also being conducted on the potential of FTAs between Japan and Korea and between Japan and Mexico.

While ASEAN is often mentioned as the most important trade cooperation agreement in the region, its bottom line impact on promoting intraregional trade has been only modest. The
initiation of FTAs was soon followed by the financial crisis in the region in 1997 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.

2. **South Asian Association for Regional Cooperation (SAARC)**

The South Asian Association for Regional Cooperation (SAARC) comprising the seven South Asian countries of Bangladesh, Bhutan, India, 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 cooperation, while important, was likely to be a complex and gradual process. Accordingly, the first SAARC Summit in Dhaka (1985) primarily focused on regional cooperation in areas such as health, population activities and child welfare, and culture and sports. It was only in December 1995 that a SAARC PTA 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 1,868 products reflecting an increase by almost ten fold over SAPTA-I. In SAPTA-III, trade concessions were increased to 3,456 commodities, reflecting almost a doubling over SAPTA-II.

These efforts at promoting regional cooperation 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 progress in intraregional trade. In any case most of the trade-promoting measures are still for implementation in the future.

B. **Informal Cooperation Arrangements**

The distinctive feature of economic cooperation in Asia has been informal cooperation agreements on a wide front including trade, investment, technology transfer, infrastructure development, policy harmonization, and exchange of information. By and large these cooperation agreements tried to facilitate flows of goods, services, and factors within a subregion without erecting any discriminatory barriers against flows from other parts of the world. In some ways these efforts aimed at providing “regional public goods” for regional development. It is this approach that has been often described as “open regionalism.”

Some of these regional and subregional cooperation efforts are often popularly referred to as “growth triangles”, “growth polygons”, or “growth areas.” The main focus of these subregional economic zones (SREZs) is on transnational movement of capital, labor, technology and information, and on intercountry provision of infrastructure rather than on trade in goods and services. These zones are oriented toward the expansion of resources in the area and the growth of future output rather than the realization of static efficiency gains using existing resources. Moreover, they are centered mainly on private sector initiatives, with government providing the basic infrastructure and conducive policy environment and thus facilitating the establishment and operation of
businesses in the zones. Important among these SREZs are: The Brunei Darussalam-Indonesia-
Malaysia-Philippines East ASEAN Growth Area (BIMP-EAGA), Indonesia-Malaysia-Thailand
Growth Triangle (IMT-GT), Greater Mekong Subregion (GMS), Central Asia Regional Economic
Cooperation (CAREC), Pacific Cooperation Forum, and South Asia Subregional Economic
Cooperation (SASEC).

Another major forum for informal cooperation is APEC (Asia Pacific Economic Cooperation).
Straddling across the Pacific and dominated by the United States, this organization was established
in 1989 and currently has 18 member countries in the Asian and Pacific region. At the Seattle
meeting in 1993, the leaders of the APEC countries put forward a vision of a “community of Asia-
Pacific economies.” At Bogor, Indonesia in November 1994, these leaders set a number of specific
goals and objectives under the general headings of free and open trade and investment in the
Asian and Pacific region, expansion and acceleration of trade and investment facilitation programs,
and intensified economic cooperation. The goal of free and open trade and investment is to be
achieved no later than 2010 in the case of industrial country members, and 2020 in the case of
developing country members. At Osaka in November 1995, agreement was reached on a set of
fundamental principles to guide the achievement of liberalization and facilitation of trade and
investment. The participants also agreed to take a set of individual actions in each economy to
liberalize and facilitate trade and investment. APEC discussions have gone well beyond traditional
border trade measures to the consideration of other measures of trade and investment facilitation
such as visa-free travel for business people, standards and harmonization, and the possibility of
implementing an open skies policy.

III. LONG-TERM PROGRESS AND RECENT RETROGRESSION ON REGIONAL INTEGRATION

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

In the postwar period, Asian economies became more fragmented than ever before. Emergence of Communist regimes in Cambodia, PRC, Laos, and Viet Nam 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 in regional integration that
came forth are fragmented and determined as much by geopolitical considerations as by economic
logic. For example, the drive for regional cooperation in Southeast Asian countries under ASEAN came mainly from the desire to check expansion of communism in these parts. North Asian economies of Japan; Korea; and Taipei, China were, for geopolitical reasons, bound closer to the US economy than to their neighbors. PRC, North Korea, and Viet Nam were similarly more integrated with their Soviet partners than with their 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 cooperation that were initiated were highly fragmented. They did not capitalize on the great variety in stages of development that Asia had and the resultant complementarity. Despite this fragmentation of regional cooperation efforts, intraregional trade in Asia increased significantly over the last two decades, though there were signs of retrogression in this area in the last five years.

A. Merchandise Trade

As indicators of progress in intraregional trade cooperation, two measures are usually considered:

(i) The relative measure that compares the region’s internal trade to its total trade.
(ii) The double relative measure (also called gravity or intensity coefficient) that compares the share of the region in its own trade to its share in worldwide trade.

From the viewpoint of trade policy, what matters most is the relative measure—the trade share of interdependence. As more of the region’s trade is destined for its own markets, the region’s companies and governments are more likely to invest in contacts, infrastructure, and policies that support intraregional trade. Moreover, the problems with simple relative measures arise more in the context of comparison between regions than for trends over time. Since our interest is mainly in trends over time, our focus is on the relative measure, though for the sake of completeness we also report the results on double relative measures for the major trade groups.

In the cases of formal PTAs such as ASEAN and SAARC, the progress in intraregional trade has been meager. As noted in Figure 1, the intraregional trade ratio for ASEAN increased from 16.0 percent in 1980 to 16.9 percent in 1990 and to 21.2 percent in 1995. During the second half of the 1990s the trade ratio was stagnant at around 21 percent despite the efforts for enhanced regional trade through the formation of the AFTA in 1992 and an agreement on a fast track program for trade liberalization following the financial crisis of 1997. There was an increase in this ratio in 2000 by about 1.5 percentage points probably largely due to the entrepot nature of increased trade in the IT sector. Slow growth in intraregional trade and recent retrogression was even more evident in the case of export ratio: the intraregional export ratio was stagnant at around 18-19 percent during the 1980s; after a rise to 25 percent in 1995, it declined to 23 percent by 2000. The double relative measure of trade indicated even poorer performance: for exports, double relative measure showed a decline from 5.0 in 1980 to 3.5 in 2000; for imports, the corresponding ratios were 4.4 in 1980 and 4.3 in 2000.
For South Asia too, intraregional trade ratio remains low. Intraregional trade ratio increased from 2.9 percent in 1980 to 4.1 percent in 1995 and after some minor ups and downs was 4.1 percent in 2000. The double relative measure of regional trade declined from about 7 in 1980 to about 4 in 2000 for exports, though it registered an increase for imports from 1.6 in 1980 to 3.4 in 2000.

For Pacific countries and for Central Asian Republics, intraregional trade remains small with no significant upward tendency. For the former, the intraregional trade ratio was 1.5 percent in 1980 and 2.3 percent in 2000; for the latter, the ratio increased from 9.1 percent in 1992 to 15.4 percent in 1994 but declined to 11.8 percent in 2000.

In contrast it is the North Asian economies, which were not part of any formal agreement for trade promotion, which have been the main source of increased trade within Asia.

Figure 1. Intraregional Trade Ratios of Various Subregions in Asia, 1980-2000

(i) Japan’s exports to the Asian DMCs, which was 24 percent of the total in 1980 increased to 44 percent by 1996, though it declined to 41 percent by 2000. Similarly, the share of Asia in Japan’s imports continuously rose from 22 percent in 1980 to 42 percent in 2000.
(ii) For Korea, the rise in trade with Asia was even more spectacular. The share of its exports going to DMCs rose from 14 percent in 1980 to 39 percent in 1997 with a decline to 35 percent by 2000; the ratio for imports rose from 8 percent in 1980 to 24 percent in 2000. The share of Japan in Korea’s trade declined over the period: that for exports declining from 17 percent in 1980 to 12 percent in 2000 and that for imports from 27 percent in 1980 to 20 percent in 2000. For Asia as a whole, Korea’s trade ratio increased sharply: with the ratio for exports rising from 31 percent in 1980 to 50 percent in 1996, declining to 47 percent in 2000; the corresponding figures for imports were: 34 percent in 1980 and 44 percent in 2000.

(iii) For “the PRC Group”\(^1\) trade, there was also a significant increase in trade with Asia. For exports, “the PRC Group’s” trade ratio with DMCs increased from 12 percent in 1980 to 18 percent in 1997, declining to 15 percent by 2000; and that with Japan from 14 percent in 1980 to 19 percent in 1996, declining to 15 percent by 2000. For Asia as whole, the export ratio rose from 26 percent in 1980 to 37 percent in 1996 with a decline to 30 percent by 2000. For imports, Asia figures even more prominently for “the PRC Group”: 38 percent of its imports came from Asia in 1980 and this ratio rose to 52 percent by 2000, with Japan being the major partner accounting for 28 percent of imports in 1980 and 25 percent in 2000.

For all DMCs (with the adjusted “PRC Group”), the general picture, dominated by North Asian trading partners, shows a significant rise in intraregional trade with some decline in recent years. The intraregional share of exports rose from 19 percent in 1980 to 31 percent in 1997 with a decline to 28 percent by 2000; that for imports rose from 14 percent in 1980 to 32 percent in 2000. Japan’s share showed a decline over the period: for exports, from 20 percent in 1980 to 13 percent in 2000; for imports, from 22 percent in 1980 to 21 percent in 2000.

For ASEAN+3, the picture is also one of significant rise intraregional trade over the period 1980 to 1995 with some decline since then. The share of intraregional exports for this group rose from 29 percent in 1980 to 41 percent in 1996 with a decline to 36 percent by 2000. The corresponding ratio for imports was 31 percent in 1980 and 50 percent in 2000.

Much of the literature regard trade with the US as the most important component of trade of Asia, with the Asian economies rising or falling with the US economy and its power to purchase Asian goods. The data on trade however present a more complicated picture. While the US is the single most important trading partner for most Asian countries, its share is quite small in relation to the combined power of Asian markets (see Figure 2).

\(^1\) Since a significant part of trade among PRC; Hong Kong, China; and Taipei, China is of entrepot nature it is appropriate to consolidate their trade into one group, excluding trade among these economies.
For all DMCs (with the adjusted “PRC Group”) 20 percent of exports went to the US as against 39 percent to DMCs plus Japan in 1980. By 1996, DMCs plus Japan accounted for 46 percent of this group’s exports, which was more than double the share of the US of 22 percent. By 2000, the US’ share had increased to 26 percent but still it was significantly lower than that of DMCs plus Japan, which was 41 percent. The importance of the US as a source of imports needed by DMCs was even less. In 1980, 17 percent of DMC imports came from the US while 37 percent came from DMCs plus Japan. By 2000, the share of imports from the US had declined.
to 14 percent and those from DMCs plus Japan rose to 53 percent, i.e., four times as much.

(ii) For Japan, the share of exports to the US rose from 24 percent in 1980 to 30 percent in 2000, those to DMCs rose from 24 percent in 1980 to 41 percent in 2000. Similarly for imports, while the US met 19 percent of Japan’s needs in 2000, DMCs met 42 percent in the same year.

(iii) For Korea, dependence on US markets is even less than that of Japan. In 1980, the US accounted for 27 percent of Korea’s exports while DMCs plus Japan, 29 percent. By 1997, DMCs plus Japan accounted for 50 percent of Korea’s exports while the US accounted for only 16 percent. Since then there has been an increase in dependence on the US market but even with this increase, the US market accounted for only 22 percent of Korea’s exports in 2000 while DMCs plus Japan accounted for 47 percent. Similarly, while US met 18 percent of Korea’s import needs in 2000, DMCs plus Japan met 44 percent of its needs.

(iv) For “the PRC Group”, the US market is somewhat more important than for Japan and Korea. The US share of this group’s exports rose from 26 percent in 1980 to 33 percent in 2000 while that of DMCs plus Japan rose from 26 percent in 1980 to 30 percent in 2000. However, for meeting its import needs, Asia is far more important for “the PRC Group” than the US. The share of imports from the US was only 14 percent in 2000 while the corresponding figure for DMCs plus Japan was 52 percent.

(v) For ASEAN, the share of the US in exports rose from 17 percent in 1980 to 20 percent in 2000, while that of DMCs plus Japan rose from 53 percent in 1980 to 57 percent in 1996, declining marginally to 56 percent in 2000. Similarly for imports, while the US meets only 14 percent of ASEAN’s needs, DMCs plus Japan met 61 percent in 2000.

(vi) For South Asia, the importance of the US market has increased steadily while that of DMCs plus Japan has remained stagnant: the share of exports to the US rose from 10 percent in 1980 to 25 percent in 2000, while that of DMCs plus Japan was stagnant at about 24 percent. For meeting its import needs, however, DMCs plus Japan are far more important than the US: in 2000, the US accounted for 7 percent of South Asia’s needs, while DMCs plus Japan accounted for 38 percent.

(vii) For the Pacific countries, the US accounts for only about 5 percent of exports and imports, while DMCs plus Japan, 30-35 percent. Similarly for the Central Asian Republics, the US accounts for 5 percent of trade, while DMCs plus Japan, about 26 percent.

The above figures on trade may underestimate the importance of the US market for Asia in so far as trade among Asian countries may be, in terms of processing goods at various stages of production with the ultimate destination being the US. To the extent that intraregional trade...
is in semiprocessed goods with nonregionals as the ultimate destination, the increased intraregional
trade is an indicator of shared dependence of the region rather than interdependence. This issue
may be particularly important for information technology (IT) trade, which now accounts for a
significant part of East Asian trade and where production sharing among various Asian countries
is quite common. In an effort to correct for this factor, trade shares were calculated for non-IT
trade. While these adjusted numbers show a somewhat greater dependence of Asia on the US
market, the broad picture of the importance of Asia for Asia’s trade remains valid.

In order to assess the linkage between US imports with Asian exports and the Asian
economy, there is clearly a need for more intensive research on the subject. IT trade is now a
growing proportion of Asian trade (in 1999, it accounted for 30.3 percent of total trade of ASEAN,
PRC, and Korea). Even in non-IT trade, the share of trade in semiprocessed goods meant for
nonregional destination could be significant. Thus the exports of regional economies may be more
dependent on import capacity of the US and other nonregional economies than suggested by the
above numbers. Yet the fact that the major part of Asian trade is with Asia and is several times
that with the US is important. For one thing, it suggests that much greater attention needs to
be given to improving trade facilitation measures, including payment systems and trade
infrastructure relating to intra-Asian trade than trade with the US. In order to reduce the
uncertainty of pricing in trade, it may be advisable to denominate pricing of goods traded in Asia
by some Asian numeraire than to the US dollar, which has shown a tendency for wide gyrations
with respect to most Asian currencies. This leads to the important issue of exchange rate policy
in Asia discussed below.

B. Labor Movements

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 19th and half of the 20th century. A large part of the labor movement was from the PRC and
Japan to the US and other industrial countries. There were also large movements of labor
particularly from the 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.

The Philippines, where per capita income has been largely stagnant over the last 20 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 Figure 3, these receipts rose from $0.6 billion in 1980 to over $6 billion in 2000. By 2000, the
income from migrants was 8.3 percent of gross domestic product (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 the 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.

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 the 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 the Middle East but more recently, there has been increasing migration to some Asian countries, particularly to Malaysia. Also in the wake of the IT revolution, the export of skilled manpower to developed countries has become a significant source of foreign exchange for South Asia, in particular India.

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 numbered 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 neighboring Asian countries.
countries, including Bangladesh, Indonesia, Myanmar, and Thailand. Thailand also hosts a large number of migrants, of these some perhaps clandestine from 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.

As in the case of merchandise trade, this trend toward increasing cooperation in Asia seems to have suffered a retrogression in recent years. In the wake of the financial crisis in East Asia, there has been increasing unemployment in several countries in the region and there have been growing pressures for repatriating the immigrant workers and reducing the inflows of such workers. While figures are not available on the reduced flow of labor within the region, anecdotal evidence clearly suggests that there is a decline in the degree of integration of labor markets in the region.

C. Investment and Finance

A similar picture of progress in regional cooperation until the mid-1990s and retrogression since then obtains for investment and financial flows. In the wake of the Plaza Accord and appreciation of the yen in 1985, there was a surge of intraregional investment and finance. Between 1985 and 1995, foreign direct investment (FDI) in Indonesia, Malaysia, Philippines, and Thailand increased by 26.2 percent per year. The cumulative total by 1996 was $82.2 billion. For the PRC, the boom in FDI started in 1992 and by 1996 the cumulative investment was $168.8 billion. As shown in Figure 4, the major share of these FDI flows in 1995 (51.4 percent) was from within the region. However, since 1996, the share of regional investment has been declining and by 1999, it had fallen to 36.5 percent. The ratio of FDI from within ASEAN+3 countries declined from 78 to 60 percent for the PRC; from 57 to 49 percent for Hong Kong, China; from 15 to 11 percent for Japan; from 25 to 16 percent for Korea; from 65 to 34 percent for Malaysia; from 73 to 40 percent for the Philippines; and from 17 to 9 percent for India, although there were some increases for Indonesia (from 23 to 32 percent) and Thailand (from 50 to 60 percent). For PRC, Japan, Korea, Malaysia, and Philippines, the share of EU registered a major increase. North America was not the largest source of FDI among the three sources (ASEAN+3, North America, and EU) for any of these countries, except India. Thus the somewhat surprising picture of the US being the dominant partner of South Asia but not of East Asia seems to hold in the area of FDI as well as for trade.

Similarly, cumulated foreign bank loans to the region (PRC; Indonesia; Korea; Malaysia; Philippines; Singapore [offshore-center]; Taipei, China; and Thailand) increased from $199 billion in 1985 to $650 billion in 1995. Of these, 49 percent came from within the region, mostly Japanese banks, with the ratio varying from 12 percent for the Philippines to 63 percent for Thailand (see Figure 5). However, since the mid-1990s there has been massive withdrawals of Japanese bank loans from the region and by 2000, the share of East Asia in bank loans in the region (defined as above) was reduced to 26 percent, varying from 20 percent for Taipei, China to 47 percent for Thailand. By contrast the share of EU banks increased from 44 percent in 1995 to 62 percent in 2000.
Figure 4. Foreign Direct Investment in East Asia and India
(Relational Distribution of FDI as Percent of Total FDI Inflows), 1995 and 2002

Sources: National sources and CEIC.
Section III

Long-term Progress and Recent Retrogression on Regional Integration

Figure 5. Accumulated Foreign Bank Loans to East Asia from East Asia and European Union (as percent of Total Foreign Loans) 1995-2000

<table>
<thead>
<tr>
<th>Country</th>
<th>1995</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>East Asia</td>
<td>62.10</td>
<td>43.80</td>
</tr>
<tr>
<td>EU</td>
<td>66.2</td>
<td>62.5</td>
</tr>
<tr>
<td>East Asia</td>
<td>49.03</td>
<td>47.5</td>
</tr>
<tr>
<td>Thailand</td>
<td>63.1</td>
<td>57.2</td>
</tr>
<tr>
<td>EU</td>
<td>66.2</td>
<td>52.4</td>
</tr>
<tr>
<td>East Asia</td>
<td>53.9</td>
<td>42.5</td>
</tr>
<tr>
<td>Taipei, China</td>
<td>62.5</td>
<td>39.5</td>
</tr>
<tr>
<td>EU</td>
<td>58.3</td>
<td>48.2</td>
</tr>
<tr>
<td>East Asia</td>
<td>55.0</td>
<td>42.0</td>
</tr>
<tr>
<td>Singapore</td>
<td>55.0</td>
<td>47.1</td>
</tr>
<tr>
<td>EU</td>
<td>54.4</td>
<td>45.3</td>
</tr>
<tr>
<td>East Asia</td>
<td>54.4</td>
<td>42.0</td>
</tr>
<tr>
<td>Malaysia</td>
<td>53.9</td>
<td>39.3</td>
</tr>
<tr>
<td>EU</td>
<td>56.7</td>
<td>40.1</td>
</tr>
<tr>
<td>East Asia</td>
<td>56.7</td>
<td>32.1</td>
</tr>
<tr>
<td>Indonesia</td>
<td>52.1</td>
<td>52.1</td>
</tr>
<tr>
<td>EU</td>
<td>66.8</td>
<td>42.4</td>
</tr>
<tr>
<td>East Asia</td>
<td>66.8</td>
<td>42.4</td>
</tr>
</tbody>
</table>

Sources: Bank for International Settlements.
In the literature on regional integration, a great deal of attention is usually attached to promotion of intraregional trade through PTAs such as customs unions, free trade areas, or preferential trade areas. East Asia has by and large avoided falling for the fashion in such PTAs. The preferred route in Asia has been market-oriented regional trade promotion. Without much activism from the governments for regional trade arrangements, regional trade in Asia has grown rapidly, guided by the private sector and market forces. By and large, public policy has concentrated on reducing trade barriers in a nondiscriminatory fashion and reducing inherited impediments to trade connected with infrastructure of trade, promoting macroeconomic and fiscal stability, supporting FDI, and ensuring industrial production.

The region has followed the path of trade liberalization in the framework of multilateral trade rounds and unilateral liberalization encouraged and assisted by international financial institutions (IFIs). The progress has been quite impressive. Nondiscriminatory reforms contributed to trade creation rather than trade diversion. The average tariff rates in most of the region have been lowered from 30-40 percent in 1980-85 to 5-10 percent at present. However, nondiscriminatory trade liberalization affected regional trade both within itself and with the rest of the world. Thus it may not have contributed to the rise in intraregional trade between 1980 and 1995. More importantly, the recent retrogression in the intraregional trade ratio cannot be explained by this factor because there was no reversal of trade liberalization programs during this period.

The increased trade within the region has been often explained in the literature within the framework of the “flying geese model.” The flying geese model is not well articulated in the usual analytical terms. However in its poetic and holistic manner, it tries to capture the important elements of trade, investment, finance, technology, and development strategy in an integrated manner. During the 1960s and 1970s, the Japanese development approach along with other components was applied successfully in Korea and Taipei, China. From the early 1970s, the approach spread to Southeast Asian countries such as Indonesia, Malaysia, and Thailand with contributions not only from Japan but also from Korea and Taipei, China. From the 1980s, the approach was passed on to the PRC with contributions from all the forerunners in East Asia. With the rising prosperity of Japan and other newly industrializing countries, technology, investment, and finance spread to others and so did trade. It is this integrated package of development strategy, investment, finance, and technology that promoted regional integration in trade in East Asia. This pattern is significantly different from that in the Americas, where there was no comparable transfer of development strategy, investment, finance, and technology from the US to Latin America.

Since the early 1990s, the flying geese formation has been slowing down in Asia. With the weakening of the Japanese economy and in particular the Japanese banking system, the flow of finance from Japan has been slowing down, as has been the power of the Japanese economy to absorb exports from developing Asia. With the financial crisis of 1997, the whole nexus of trade, investment, and finance in East Asia has been weakened and this has contributed to the retrogression in regional cooperation noted above. The high growth in North America during the second half of the 1990s contributed to export growth of the region, but in the absence of the integrated package of trade-investment-finance, the region has not been able to revive its earlier growth momentum.
Thus understanding these broader factors behind the earlier economic resurgence of the region and the recent slump is crucial to understanding the ups and downs of regional cooperation. And revitalization of growth in the lead goose (which may in turn depend on restoration of faith in the Asian paradigm) may hold the key to revitalization of regional cooperation in Asia.

IV. THE GREAT ECONOMIC SLUMP IN EAST ASIA

At present much of Asia is going through an economic slowdown. The problem is particularly severe for East Asia. In view of the economic importance of East Asia for the entire continent, this section concentrates on the East Asian economic situation. The East Asian region is in the grip of the greatest slump in its history since the Great Depression. According to the Asian Development Outlook 2002 (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 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 PRC economy is the only one that grew at the erstwhile typical East Asian rate of over 7 percent (see Table 1).

The poor Asian performance of 2001 comes on top of the mediocre performance ever since the outbreak of the financial crisis in 1997. In Indonesia, per capita income in 2001 is 10 percent lower than in 1996; in Thailand 6 percent lower; and in Japan, stagnant. For Malaysia and the Philippines, annual growth rates in per capita income over the last five years has been less than 0.5 percent. Only the PRC and Korea have been able to register significant growth rates in per capita income. For the region as a whole, annual average growth rate in per capita income over the last five years (1997-2001) has been 4.9 percent in East Asia and –0.1 percent in Southeast Asia, the lowest recorded for these regions for any five-year period over the last 50 years.

Experience around the world shows that with growth in per capita income below 1 percent per year, incidence of poverty is likely to increase. Not surprisingly the same has been happening in the region over the last five years. Between 1996 and 2001, the number of the poor (defined as having an income of less than $2-a-day) has increased in Indonesia, Philippines, and Thailand. Similarly, the number of unemployed has increased significantly over this period in Hong Kong, China; Japan; Korea; Singapore; and Taipei, China. In Japan and Korea, the rate of unemployment was highest during the postwar period. Even in the PRC, the problem of unemployment is becoming serious: according to official statistics, the number of unemployed in urban areas in the PRC has risen from 5.53 million in 1996 to 5.75 million in 1999. The potential output lost in the region may be as high as $1 trillion per year.

A. A Trillion Dollar of Lost Output Every Year

As reported by the International Monetary Fund (IMF 2002), the growth of potential output in Japan during the 1990s has been about 2.6 percent 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 (see Table 2).

Similar IMF estimates of potential output for other countries in ASEAN+3 are not available. However, some rough estimates of potential output were made based on the use of Incremental-Capital-Output Ratios. As noted in Table 2, this approach suggests an estimated loss of potential output of over $300 billion (at 2000 prices) per year in developing Asia in 2001.

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

Table 1. GDP Growth Rates and Forecasts for Selected Asian Economies, 2001-2003

<table>
<thead>
<tr>
<th>Economies</th>
<th>2001</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASEAN+3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>PRC</td>
<td>7.3</td>
<td>7.0</td>
</tr>
<tr>
<td>Hong Kong, China</td>
<td>0.1</td>
<td>2.1</td>
</tr>
<tr>
<td>Indonesia</td>
<td>3.3</td>
<td>3.0</td>
</tr>
<tr>
<td>Japan</td>
<td>-0.5</td>
<td>-1.1</td>
</tr>
<tr>
<td>Korea</td>
<td>3.0</td>
<td>4.8</td>
</tr>
<tr>
<td>Malaysia</td>
<td>0.4</td>
<td>4.2</td>
</tr>
<tr>
<td>Philippines</td>
<td>3.4</td>
<td>4.0</td>
</tr>
<tr>
<td>Singapore</td>
<td>-2.0</td>
<td>3.7</td>
</tr>
<tr>
<td>Taipei, China</td>
<td>-1.9</td>
<td>2.8</td>
</tr>
<tr>
<td>Thailand</td>
<td>1.8</td>
<td>2.5</td>
</tr>
<tr>
<td>Southeast Asia</td>
<td>1.9</td>
<td>3.4</td>
</tr>
</tbody>
</table>

Note: Numbers for 2001 are actual growth rates while those for 2002 and 2003 are forecasts.
V. THE WAY FORWARD

A. Diminishing Returns from Trade Liberalization Per Se

Accelerated trade liberalization, including PTAs, are often mentioned as a possible instrument for recovery in the region. But upon reflection, it is not clear if regional trade blocs or other forms of trade liberalization can play any major role in stimulating recovery in the present situation.

Average tariff rates in most countries of East Asia have come down from 30-40 percent in the mid-1980s to about 10 percent by 2000. Thus the easy gains from trade liberalization have already been reaped. There is not much mileage to be obtained from further trade liberalization in general. In India, the peak tariff rates have been reduced from 365 to 35 percent, and the average rates from 87 percent in 1990/1991 to 20 percent by 1998/1999. In the coming years, the government intends to bring the tariff rates close to the ASEAN levels. And most of the quantitative restrictions in industrial imports have been phased out by April 2001.

Within the framework of 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 is 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 Lao PDR, Philippines, Thailand, and Viet Nam. The protection of transport equipment remains high for all the ASEAN countries.

Trade protection is now confined mainly to sensitive areas and there is need for domestic consensus before progress can be made in substantial reduction in these protection rates. External pressures, either regional or international, can be counterproductive. In any case, in view of the short-term adjustment costs of liberalization in these areas, irrespective of their longer-run impacts, the current economic slump in the region does not provide a propitious atmosphere for any major

<table>
<thead>
<tr>
<th>Economies</th>
<th>Potential Output Lost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>722</td>
</tr>
<tr>
<td>PRC</td>
<td>119</td>
</tr>
<tr>
<td>Hong Kong, China</td>
<td>26</td>
</tr>
<tr>
<td>Indonesia</td>
<td>32</td>
</tr>
<tr>
<td>Korea</td>
<td>55</td>
</tr>
<tr>
<td>Malaysia</td>
<td>18</td>
</tr>
<tr>
<td>Philippines</td>
<td>1</td>
</tr>
<tr>
<td>Singapore</td>
<td>17</td>
</tr>
<tr>
<td>Thailand</td>
<td>44</td>
</tr>
<tr>
<td>Total</td>
<td>1,034</td>
</tr>
</tbody>
</table>
effort for liberalization. With trade restrictions already lowered over the years, the marginal gains in trade and economic activity from the regional or bilateral FTAs are unlikely to be large enough to contribute significantly to lifting the East Asian economies out of their current slump.

A recent World Bank study (World Bank 2001) concluded that complete liberalization of trade between 2005 and 2010 could yield a 2 percent increase in East Asian income. Regional trade agreements for ASEAN+3 was estimated to lead to the following increases in GDP: 0.2 percent for PRC, 0.7 percent for Korea, 0.9 percent for ASEAN, 0.1 percent for Japan, and 0.0 percent for the US. These gains are just too small in relation to the task of recovery involved (with over 10 percent of potential output lost). Despite much fanfare about the so-called Development Round for new trade reforms under WTO, it is clear that multilateral trade negotiations are unlikely to be concluded before 2005 and the estimated gains are no more than 0.5 percent of GDP—not enough to provide significant help in the great slump facing the region. In general, at this point, the benefits of trade liberalization are likely to be too small and too late to help in the urgent task of recovery in East Asia. The same caveat applies to the proposal to form FTAs between ASEAN and the PRC within the next ten years as endorsed in the meeting of ASEAN in Brunei on November 2001.

B. Growing Importance of Liberalization in Labor Markets

As noted above, 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, 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.

The potential for such welfare gains can perhaps be illustrated with reference to possible cooperation between Japan and the Philippines. The Japanese economy is rapidly aging, with the elderly population in dire need of labor services from the younger population for domestic chores as well as nursing care, 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.

The main problem in this area arises from the 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 where the early fears of import liberalization proved unfounded, it is quite likely that the fears of liberalization in labor movements will prove unfounded. The time has perhaps come to try and articulate the possible fears on labor movements and discuss openly the control mechanisms that could be put in place to minimize these risks.

C. Greater Gains from Financial Cooperation

1. Instability in Exchange Rates among Asian Trading Partners

Despite its eminence in many other areas of economic policy, Asia has been far from following optimal exchange rate polices particularly during the last two decades. Exchange rates have gone through large gyrations that 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, the US dollar and the yen, have gone through great fluctuations. Adjusted for prices (consumer price index with 1995 as base), the dollar was worth 161 yen in 1980. Through some ups and downs, it depreciated sharply until it was only 94 yen in 1995, and since then it had appreciated to 120 yen in 2000. Over this period there were year-to-year variations of over 15 percent and a four-year variation of over 40 percent. 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. 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.

For individual countries in 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’s exchange rates have maintained a relatively stable link with the US dollar. In real terms (adjusted by consumer price indices), the Philippine peso declined steadily from $0.045 in 1980 to $0.028 by 2000, with a sharp depreciation of up to 20 percent as happened in 1983 and in 1998. However fluctuations with the yen were far greater: up to 45 percent depreciation in one year (1986) and up to 25 percent appreciation in another (1996). With respect to its regional trading partners, the Philippines has gone through some sharp fluctuations. Over the last 20 years, the peso has undergone mild appreciation with respect to the Malaysian ringgit and sharp appreciation (which hurts the Philippines’s regional exports) in relation to the PRC and Indonesia. With respect to the Korean won, Singapore dollar, and Thai baht, the peso has been relatively stable over the 20-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 1997-1998 from 2909 rupiah on average for 1997 to 10,014 rupiah for 1998 was a stark example of mismanagement of the exchange rate in a time of turbulence. It was a cruel blow to the economy that Malaysia was able to prevent by imposing capital controls, but which Malaysia also stood the risk of suffering had its leaders not had 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.

In the postcrisis period, there has been a move toward more flexible exchange rates in the region. However, as the empirical work done by Kwai (2001) shows, the “observed” exchange rate arrangements in East Asia indicate that the dollar’s role as the dominant anchor has become prominent once again since late 1998. Kwai also notes that for emerging East Asia, the US 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 US. Given the continued volatility of yen/dollar exchange rates, this results in excessive fluctuations in effective exchange rates of these countries, which go beyond what is dictated by economic fundamentals and which have harmful impact on trade, investment, and growth.

While it may be desirable for the region to move away from its anchor to the US dollar, it is not easy for any particular country to unilaterally move 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 that 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.

In view of the regional consensus of improving the exchange rate regime for the region, serious discussions are ongoing 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 form an ASEAN currency and exchange rate mechanism may take. 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 8 August 2001.

A second line is that suggested by Mundell (Mundell 2001), namely, creation of a parallel currency, which involves less of a political commitment. The idea of a parallel currency is that all or most of the East Asian countries could use it. 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 nonregional, and which can be used as a unit of account for current account and capital account transactions. Individual currencies can vary in relation to the ACU within a broad band depending upon the circumstances of the country (similar to the European currency unit).
While exploring the policy options for an ACU, it is advisable in the short run to develop policy harmonization on exchange rate policies among the countries in the region and create an institutional set-up to help the countries 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. With a general understanding at the regional level, this approach can be implemented at an individual country level (as is apparently being done in India for example) with some regulations on hot money flows and some financial security mechanism to help in the face of external or internal shocks.

2. Case for Capital Controls and Regional Financial Security Mechanisms

In the early 1990s there was rapid movement toward liberalization in capital accounts in Asia, particularly in Indonesia, Korea, Malaysia, Philippines, and Thailand. In retrospect it is widely agreed that this liberalization was premature. The financial institutions in these countries were not mature enough and the prudential practices not advanced enough to handle these liberalizations. Coinciding with this capital account liberalization in these countries there was a rapid growth of hedge funds in the developed countries, which could move huge funds to take advantage of interest rate spreads across the globe. The size of these funds was so large in relation to capital markets of many countries in Asia that they could swamp the operations of foreign exchange markets in these countries. The volatility of these funds was too great in relation to the endurance capacity of most of the Asian economies.

Net private capital flows into five countries (Indonesia, Korea, Malaysia, Philippines, and Thailand) tripled between 1993 and 1996 (from $22.5 billion to $67.4 billion). Then in 1997 the flow suddenly reversed and $15.6 billion flowed out of these economies, with an additional $28.2 billion outflows in 1998.

These capital flows comprised primarily short-term currency loans, which led to the double mismatch of maturity and currency as banks were lending long-term and in local currency for nontradables (primarily real estate). This in turn led to the twin crises in currency (resulting in devaluation) and in banking (resulting in banks becoming overburdened with nonperforming loans with many eventually failing).

The importance attached to capital movements in development policies in recent years is a curious phenomenon, particularly for the countries in East Asia. As noted above, most of these countries over the last ten years have had saving of more than 30 percent of GDP, which can be expected to yield GDP growth rates of 7 percent per year or more in East Asian conditions. In this context it is not obvious why the portfolio and loans from abroad are very important parts of the country’s development policy. One can understand the interest of international financiers and hedge funds managers to have this open account to benefit from variations in interest rates. But it is not clear why these Asian countries need these funds on any significant scale. In fact the most curious thing was that the large private capital inflows, because of their volatile character, also became an argument for keeping large foreign exchange reserves where the rate of return
was much lower than what the country had to pay to the foreign investors in portfolio and bank loans.

What applies to bank loans applies even more forcefully to portfolio investments. The activities of what has been called “Electronic Herd” are not moved by considerations of marginal productivity of capital in different countries but largely by speculative instincts. The large funds moved by this herd have been found to be highly destabilizing for developing countries and it is not clear why ASEAN+3 countries with high savings rate need these destabilizing resource flows. Prime Minister Mahathir’s characterization of these flows as “unproductive, unnecessary and immoral” may have a large grain of truth in it.

More generally, in the development literature there is now a growing acceptance of the need for caution on opening up of capital accounts. For most developing countries, the issue now is not whether but how to manage capital flows. The Chilean model of taxing short-term flows and the Malaysian practice of temporary restraints on capital outflows in the face of crisis, as well as a more generalized Tobin tax on capital movements, are becoming more acceptable features of capital account management in all countries, both developed and developing. There is a growing consensus in East Asia on more active management of capital flows, particularly short-term capital and portfolio investments. Policy harmonization on how to manage capital flows is an important potential area for regional cooperation.

With some controls on hot money flows, the task of managing exchange rates to maintain some stability in real effective exchange rates would be somewhat easier. However, as the recent experience with commodity prices and trade in IT sector has shown, developing countries in the region have to be prepared for external shocks in the trade account. Similarly even with some controls on hot money flows, sudden fluctuations in capital movements cannot be ruled out. As argued by Kwai (2001, 15), “Intra-regional exchange rate stability cannot be maintained and regional contagion cannot be prevented without co-operative action in the areas of international liquidity support to reduce the likelihood of or respond to, a currency crisis.”

Asian cooperation has not been effective in providing financial security to the countries subjected to financial shocks. An 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 $100 million for five members with a maximum of $40 million receivable per member, it was raised to $200 million or $80 million per member in 1978. The Executives’ Meeting of East Asia and Pacific Central Banks (EMEAP) was set up in 1991 with 11 members (Southeast 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, China; Japan; and Singapore) that was to review issues related to the stability of the region’s financial and foreign exchange markets. Also set up in 1994 was the APEC Finance Ministers Group that 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.
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. The AMF 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 PRC; Hong Kong, China; Japan; Korea; and Taipei, China. With lukewarm support from the PRC and vehement opposition from the US and IMF, the plan was scrapped a few months later. It was argued that the AMF will enhance the moral hazard problem, create a double standard (IMF and AMF), and challenge the IMF leadership.

In place of the AMF came the Manila Framework Group (MFG) in November 1997. This framework was totally subsidiary to the IMF and has been largely defunct in practice.

At the ASEAN Finance Ministers’ Meeting in October 1998 in Washington D.C., the ASEAN Surveillance Process (ASP) was officially established based on the principles of peer review for all member states. But this too was to be technical assistance and capacity building that were to come primarily from the Asian Development Bank.

In October 1998 came the New Miyazawa Initiative (NMI). This arrangement was implemented by Japan as a bilateral support mechanism focused on assisting Asian countries affected by the currency crisis to overcome their economic difficulties and on contributing to the stability of international financial markets. The support package consisted of $30 billion, of which $15 billion was to be 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 aiming 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) not tied to the IMF and annually renewable.

In the “second stage” of the NMI, Japan pledged its readiness to assist in mobilization of up to Y2 trillion 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.

Probably the most concrete and currently active regional financial arrangement to come out of the Asian crisis was the Chiang Mai Initiative (CMI). The CMI was established by the ASEAN+3 Finance Ministers at Chiang Mai, Thailand in May 2000 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 1997 amounting to $200 million. In November 2000 it was increased 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 percentage points higher than LIBOR has been mentioned by some. The purpose of repurchase agreements is to provide temporary foreign exchange liquidity to a country in need of foreign exchange liquidity support via the sale and buyback of appropriate securities.

Some see the CMI as a natural progression leading to the renewal of the old idea of an Asian Monetary Fund. However for this progression to take place some fundamental rethinking is necessary about the link of Asian programs to the IMF. Under present conditions, only about 10 percent of the resources available under the CMI can be used without IMF programs. Thus with all the initiatives noted above, the total amount of financial support that can be provided to Asian countries that do not want to take the IMF medicine is only about $2 billion—so small as to be inconsequential. On the basis of poor performance of the countries under IMF programs, we argue that so long as regional cooperation is linked to the IMF, it has, under current conditions, no chance of success in reviving growth momentum in the region.

**D. Promoting Regional Public Investment Activity: Regional Keynesianism**

Apart from stability in exchange rate mechanism and setting up of balance of payments safety nets, there is an urgent need to help the regional economies out of the current slump. Given the state of the 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.

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. Pump-priming efforts are being undertaken in several countries, though reluctance to accept the Keynesian framework in the conditions of a 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 that can help to increase capacity utilization in Japanese manufacturing and construction sectors.
And if a regional institutional mechanism could be developed to channel 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 Hong Kong, China; Singapore; and Taipei, China where there is large excess capacity in sectors such as IT for which there is not enough potential domestic demand but there is potential regional demand that can be transformed into effective demand through regional financing mechanisms.

In a report entitled *Infrastructure Development as Key to Economic Growth and Regional Economic Cooperation* (ESCAP 1994), it was estimated that the estimated increment in physical infrastructure facilities required between base period of 1990-1992 and 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.

More recent comprehensive estimates are not available. But country studies in many Asian countries clearly show that there are public investment 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. 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 cooperation.

One group of such investment needs relate to infrastructure investments for tackling the growing environmental problems in Asia. For the PRC alone additional (to the business as usual scenario) investment needs for environment-friendly development with high pay-offs are estimated to be in the order of about 1 percent of GDP (over $10 billion per year) during the next 20 years. Over the long term, the PRC 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 needs funds for implementation. There are large programs of watershed management and reforestation in the PRC that require huge construction activities. The trend toward urbanization is strong in the PRC and there are mega cities emerging in several parts of the country. 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 investments in several other East Asian countries such as Indonesia, Myanmar, Philippines, Thailand, and Viet Nam.
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 upgrading of roads and highways ($34 billion), ports ($7 billion), mass rapid transit systems for metros ($20 billion), and improvement in sanitation and water supply ($6 billion).

Regional cooperation 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 PRC, India, Japan, and Korea. 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:

(i) expanding rail transport of oil between Kazakhstan and Xinjiang, PRC as an interim solution to meeting the needs of both Kazakhstan and the PRC;
(ii) construction of an oil pipeline between western Kazakhstan and Xinjiang;
(iii) building electric transmission infrastructure between the Kyrgyz Republic and southern Xinjiang; and
(iv) completing and renovating the gas pipeline from Turkmenistan and Uzbekistan through the Kyrgyz Republic to Almaty, and eventually extending this pipeline to Urumqi.

These and such other projects are viable and essential for the 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.

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

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 promote IT industries in the region in particular in Japan; Korea; Malaysia; Philippines; and Taipei, China.
E. Mobilizing Regional Savings for Regional Investments

The region has adequate savings and productive capacity to make these investments a reality without depending on extraregional resources. The important insight of Keynesian economics that in the conditions of underemployment equilibrium, investment creates its own savings is particularly relevant for the region today. With increased utilization of capacity in Japan and other major economies in the region through pump-priming investment, incomes will increase and so will savings. The fear of excess demand due to increased investment is misplaced in the region at present.

However, even at the current levels of economic activity, the region has more savings than it is utilizing. During the last five years, annual average of current account surplus (excess of regional savings over regional investments) has been $174 billion per year. At end-2000, the region has foreign exchange reserves of $1 trillion, much in excess of its needs for transactions purposes and much above the reserve ratios maintained by other major regions such as Europe or North America. These excess reserves represent a clear case of misallocation of resources. Several countries in the region have a large part of their savings deposited in nonregional centers where the rate of return is several percentage points below what the regional borrowers have to pay to the lenders from outside the region. If an institutional mechanism can be developed to utilize a greater proportion of the regional savings for regional investment needs, the savings to the region can be in the tens of billions of dollars per year.

The development of viable domestic and regional bond markets is one important proposed means of putting the savings of the region to productive uses. Efforts should be made to develop bond markets denominated in local currency where the foreign investors will absorb the exchange risk in return for higher fees but in local currency. A great deal of work has yet to be done for harmonization of cross-border listing, trading, clearing and settlements, securities borrowing and lending, repo markets, etc. More efforts are needed for creating regional bond market infrastructures in Tokyo and other financial centers in the region. One of the key projects in the development of such infrastructures should focus on the creation of a single central securities depository (CSD) to perform safekeeping, clearance, and settlement functions for all securities available in the Asian and Pacific region. Another type of institution that can facilitate effective intermediation is rating agencies. The region is rather fragmented geographically and many of the economies do not have a critical mass of large business enterprises to justify a domestic rating agency capable of establishing the necessary professional reputation for objective analysis and in-depth understanding of the political, economic, and social development of the region. There may be a case for pooling resources of the region together to create an economically viable rating agency in the region.
VI. INSTITUTIONAL REFORMS: ESTABLISHMENT OF AN ASIAN RESERVE BANK AND STRENGTHENING OF ADB

A. Establishing an Asian Reserve Facility

For making regional monetary cooperation effective, it seems necessary to initiate some bold institutional reforms. We suggest establishment of a regional reserve facility, which we call Asian Reserve Bank. The ARB will have at least $100 billion of capital contributed by the member governments, of which perhaps only 10 percent need to be paid up. It will accept deposits from central banks of member countries and lend funds to the governments as needed to help the region achieve stability in real effective rates and help the countries in need of short-term and medium-term balance of payments assistance. Minimum deposit levels and maximum borrowing levels in several tranches will be decided according to the economic weights of the member countries. It would develop its own form of policy dialogue and conditionality (preferably through higher interest charges for higher levels of borrowing) based on regional realities. The ARB will pay interest on deposits close to rates of return currently obtained by Asian central banks on their deposits and will lend at rates linked to LIBOR. It will issue an Asian Currency Unit whose value will be the weighted average of the currencies of selected member countries. ACUs will be increasingly used as the unit of account, as unit for invoicing, and as reserve currency by countries in the region. The ACU will be freely convertible into international currencies.

Over time as ACUs become widely used as reserve currency in the region, ARB will be able to issue ACUs in multiples of its primary reserves and earn seigniorage, which could be in the tens of billions of dollars. These funds could be allocated to development agencies in the region at concessional rates to help build up regional public goods and help development of the region in general. With concessional funds coming from within the region, the taxpayers of non-Asian countries would be relieved of the burden of financing development in the less developed countries in the region.

The operations of ARB will be delinked from IMF conditionalities, as has been the case with EU monetary institutions. The proposed ARB does not require any financial or intellectual assistance from IMF or other nonregionals. In this situation, there is no basis for waiting for approval from IMF or nonregionals for setting up the regional mechanism, in particular since the record of developing countries under IMF programs in terms of growth and stabilization has been so disastrous. It can be argued that the probability of resuming the growth momentum in Asian countries with IMF programs (such as Indonesia) is extremely low, thus the ARB should certainly not be bound by IMF programs.

B. Strengthening ADB’s Role in Regional Cooperation

The establishment of ADB, as with other regional development banks, was inspired by a desire for collective self-help. As the 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 at that time, all regional banks acceded to the need for membership of developed countries, while retaining the majority vote in regional hands.

The rationale and modalities of ADB’s assistance to regional cooperation was recently elaborated in The Long-term Strategic Framework of the Asian Development Bank (2001-2015). The challenges of regional cooperation were defined to involve three related dimensions: (i) supporting the development of participating countries through cooperation; (ii) providing, protecting, and conserving key regional public goods; and (iii) ensuring regional economic and social stability.

ADB supports a number of broad-based regional and subregional cooperation initiatives to accelerate the development of participating countries, of which the Greater Mekong Subregion initiative is the most prominent example. ADB has also led regional cooperation efforts in South Asia. Subregional programs often involve poorer regions of individual countries (e.g., Mindanao in the Philippines, Yunnan in the PRC) and lagging economies (e.g., Cambodia, Lao PDR, Central Asian Republics, and isolated small Pacific Island economies), so they have potentially important implications for poverty reduction; they also contribute to regional stability.

Despite the mandate for regional cooperation and some sporadic efforts, ADB, like other regional banks, has in practice become largely a duplicate of the Bretton Woods Institutions. It has 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), it was unable to formulate its own strategy for assistance to regional members. During the financial crisis of 1997, 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 been 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.

On the issue of fulfilling its mandate for regional cooperation too, the performance of ADB has been lacklustre. 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 remained against regionalism for other regions, including Asia. In this overall environment of skepticism on regional cooperation, the support given by ADB for regional co-operation was sporadic at best.

During the last 35 years of its existence, less than 1 percent of ADB loans were given for regional projects. In the area of technical assistance (TA) the performance was better: over 20 percent of the TAs were in the form of regional TAs (RETAs). 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”, nor did it play a lead role in understanding the factors behind the so-called “Asian miracle” or behind the Asian financial crisis of 1997. 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.

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, 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 a practical manner by policy analysts in the region itself. Among the ideas to draw upon are: Malaysia’s management of foreign capital flows, the PRC’s strategy of gradualist and endogenous reforms, and ADB’s perspectives on promoting “competitive pluralism.” 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 the Meltzer Commission, which argues 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).

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 $100 billion over the near term (a stimulus similar in magnitude to that being spent in the US (whose GNP in purchasing power terms is similar to that of the region). 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 a regional investment company (drawing on for example, the experience of the corporation setup 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 infrastructure bond floats by member countries or by Pan Asian...
institutions for, say, a Pan-Asian Railway or Pan-Asian Highway, securitization of infrastructure facilities of member countries, and assistance in promoting build-operate-transfer, build-operate-own, etc. projects for infrastructure. Loans for ARB on concessional and nonconcessional terms can provide a basis for such expanded operations of ADB.

VII. OVERCOMING IMPEDIMENTS TO REGIONAL COOPERATION

If enhanced regional cooperation in Asia helps to restore the Asians' faith in the Asian model of development (with adaptations) and financial support is mobilized from within Asia to finance projects as discussed above, there is a high probability that the Asian economies will resume rapid growth and within the next two decades will make substantial progress toward eliminating poverty and becoming the new center of gravity of the world economy. The reward from regional cooperation, and the costs of noncooperation, are indeed high. The mechanics of proposed cooperation are also particularly demanding. In fact, the vision of regional economic cooperation presented here is not more (perhaps less) 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 20 years. The exchange rate regimes have been gradually harmonized with the eventual switch to Euro. Adjustment mechanisms have been set up to help countries reallocate labor 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.

Despite this precedent, the road to enhanced regional cooperation in East Asia is not likely to be easy. The level of trust among the major players—PRC, India, Japan, Korea, ASEAN—has not always been high. The fears of domination by one country or another are commonly expressed. In factual terms the tensions in Europe among the major players in the early 1950s 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 what 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 cooperation and forge a consensus in favor of accelerating the pace of cooperation in the region.²

The biggest problem in regional cooperation arises when the cooperation framework impinges on sovereignty of 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 Reserve Bank will essentially be just a repeat of what was done at Bretton Woods at the global level without any sacrifice of national sovereignty. Thus the extra regional efforts called for in this paper are for concerted actions for regional self-help without sacrifice of national sovereignty, and to that extent they should be easier to implement.

The gains to developing countries in Asia from regional cooperation 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 international financial institutions now. To the extent regionalism Keynesianism finances Pan-Asian projects, it should have positive effects on all Asian countries. Increased labor movements should benefit the exporting countries (such as Bangladesh, India, Indonesia, Myanmar, Pakistan, Philippines, Sri Lanka, and Thailand) as well as the labor-importing economies (such as Hong Kong, China; Japan; Korea; Malaysia; Singapore; and Taipei, China). 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 that 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, Philippines, and Thailand to emerge from their current slump, which they are unlikely to do under the current IMF-dominated policies.

If Asian economic cooperation is to be strengthened, Japan, the largest economy of the region, must play a lead role. In the past, serious efforts for regional cooperation were not forthcoming from Japan because it was not clear what Japan was to gain from such efforts. Regional cooperation 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 cooperation proposed here. The volatility in the yen’s exchange rate has been a major source of instability in the Japanese economy, and the proposed AMF with its help in maintaining stable real effective exchange rates for its members may be of enormous help to the economy. More important is the possibility of better utilization of Japan’s productive

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2 It is encouraging to hear from some prominent economists in the region that the prospects of such cooperation is increasing. For example, Park (2001) 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 Asia has also developed a large pool of skilled and experienced people capable of managing regional financial co-operation, and policy co-ordination.”
capacity through regional Keynesianism: Japan can gain several percentage points of its GDP and help the revival of its construction and machinery sectors, which are of vital importance to the country, both politically and economically.

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 US. In substantive terms there is very little doubt that the 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. Also if a more developed Asia can look after its financial needs and relieve taxpayers of non-Asian countries of the burden of development aid, it should be welcome news to the common man and to the finance ministries of these countries. The main losers will be global financial intermediaries that appropriate the seigniorage accruing from the current international financial infrastructure. There are some powerful voices in the international community (such as the Meltzer Commission) calling for such decentralization of aid institutions. But much work is needed to convince the international community that they should not undermine Asian efforts for economic and financial cooperation as they have been doing recently, and instead support them as they did for European cooperation. The proposed ARB will lead to some loss of seigniorage accruing to the US 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 US$2.7 trillion). Any checks to this profligacy should be seen as reducing the economic and financial vulnerability of the future generations of the country.

Will the arguments for 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 (Keynes 1936), on whose ideas the present proposals are based:

Is the fulfillment 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.

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