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Asian Cooperation and the End of Pax Americana

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It has been said by many, particularly in the United States, that the world will never be the same again after September 11, 2001. Nevertheless, it is hard to believe that one incident, however grave, could so suddenly and drastically affect the entire world. Indeed, September 11 has changed our perception of the world, but the process seems to have originated earlier – in the latter half of the 1990s.

This change in perception is particularly noticeable in the United States. To the Americans, the terrorist attacks on the World Trade Center and the Pentagon brought home powerfully that they, too, are vulnerable to a direct foreign attack and that the far-flung web of forward bastions the United States maintains around the globe is no longer sufficient for its defense. The Americans, in other words, recognise that they are in the same boat as the rest of the world.

With regard to the global governance system, there are some irreversible aspects of this ongoing change. First, the age of international economics, or the age of global capitalism, seems to be moving toward the age of international politics. In other words, we are witnessing the beginning of the end of “Pax Americana”, or global capitalism under American hegemony. True, the United States is still a dominant power, both militarily and economically, but it is apparent that the international governance system that was led by the United States, the G-7, and international organisations, such as the IMF and the World Bank, has started to change.

Just as in 1914 or 1915 World War I signalled the end of Pax Britannica, the new global war against terrorism seems to be the symbolic event that historians may one day designate as the beginning of the end of Pax Americana. However, in my view we have been witnessing the beginning of the end of Pax Americana since the mid-1990s. The United States is gradually losing its position as the hub of the world. This has consequences for other regions of the world, including Asia, and may act as another stimulus for the promotion of regional cooperation.

In this chapter, I will discuss what type of regional cooperation is feasible in Asia. But before getting into the current state of, and future prospects for, regional cooperation in Asia, I would like to share with you my long-term perspective on the Asian economy. I wish to do this not only because I am proud of Asia's history, but also because I think it is quite important to understand the legacy of Asia in building a new regional cooperative scheme.

1 Asia as the Centre of the World

As you may know, between the 8th and 18th centuries, Asia was the centre of the world economy and of world trade. According to Angus Maddison, even as late as 1820, that is some decades after the industrial revolution started in Europe, China and India together accounted for as much as 46 percent of world GDP and 55 percent of the world's population.¹

Except for the last 150 years when the West and later Japan were dominant, Asian countries, especially China, India and the Islamic empires, were the centre of the world economy. I am not saying this out of arrogance as an Asian, but am emphasising this historical fact to remind you that the infrastructure for global trading and investment was created in Asia a long time ago.

Hard and soft infrastructure for global trading and investment has been present in Asia for centuries. Hard infrastructure has existed in the form of well-organised ports, sea lanes, roads, and various kinds of river transportation, while the equally important soft infrastructure has been there in the form of entrepreneurship, commercial

¹ Angus Maddison, *The World Economy: A Millennial Perspective*, OECD Development Centre, Paris, 2001.

minds, and networks of Chinese and Indians living overseas (i.e. diasporas). Even during the period of colonisation, the British and others used the existing infrastructure quite skilfully to engage in global trading. So, historically Asia has been the hub of globalism.

We have already begun to see a shift in economic power to countries like China and India. China's economy has been growing at almost 10 percent a year since the late 1970s. India is expected to register a 4.4 percent growth rate in 2002, surpassing the expected ASEAN growth rate of around 3 percent. China, India, and a few other Asian countries combined account for more than half of the world's population and generate a significant portion of world savings. It will not be long before production in these countries increases commensurate with the size of their populations and savings. From a long-term perspective, these developments point to a reorientation of the world economy from West to East.

China should not be overestimated in the area of technology, but in manufacturing China will no doubt emerge as a major force and will fundamentally change the international division of labour both in Asia and in the rest of the world. China will become a key player in the Asian economy as well as in the world economy. The Chinese have been sleeping for the last 200 years, but they have now awakened and have the capacity and the entrepreneurship to again become the centre of the world.

Since World War II, particularly in the 1970s and 1980s, Asian countries have used very well their existing hard and soft infrastructure to establish Asia as a global economic entity. If you look at the export-import structure and direct investment patterns in Asian countries, you will notice that they are quite global. This is not unnatural. In addition to a dramatic increase in intra-regional trade and investment over the last few decades, investment from and trade with the United States and Europe have risen significantly. Asia has become virtually a global manufacturing site for the world.

2 Asian Cooperation and the Role of China

There are some regional organisations in Asia (for example, ASEAN) whose formation was politically motivated. ASEAN was formed in the 1960s, at the time of the Vietnam war, as a political coalition against communism. Eventually, the ASEAN organisation came to

promote two types of cooperation – political and economic. Although an ASEAN Free Trade Area (AFTA) has been established, in general the integration process has been very slow. ASEAN remains essentially a political forum for discussions among heads of state under the principles of the “ASEAN way”, which is characterised as voluntary, non-binding, and consensual.

There is another regional forum, APEC, which comprises the United States and other Pacific-rim countries, including Australia and New Zealand. This is not a genuine regional organisation either. APEC’s major function has been to promote global deregulation, the GATT and the WTO, an activity wherein it has played a significant role. But the enthusiasm for APEC has subsided since the Clinton Administration lost interest in the organisation.

Until two years ago, China, Korea, and Japan were the only major countries in the world that were not involved in any regional cooperative scheme. We were excluded from Asian regionalism because we functioned as its hub.

Why have intra-regional trade and investment increased in Asia despite the global nature of Asian countries? Basically this was triggered by Japan’s investment in East and South Asian countries in the late 1980s, followed by similar moves of the so-called Asian Tigers (i.e. Korea, Taiwan, Hong Kong, and Singapore). This phenomenon was called the “Flying Geese Formation” with Japan at the forefront followed by the Four Tigers and then by the ASEAN countries. It established a fairly exquisite division of labour in manufacturing in the Asian region.

This Flying Geese Formation existed up until quite recently and has resulted in an increase in intra-regional trade, which naturally followed the direct investment. Intra-regional trade was preceded by the direct investment of, first, Japanese corporations and, then, the multinationals of the United States, Europe, Korea, Taiwan, and others. This investment was the major stimulus for a dramatic increase in intra-regional trade over the course of the last few decades. And regional integration will progress as Taiwan, Japan, Singapore, Hong Kong, and others invest in China and in other Asian countries. However, the global nature of Asia’s trade and investment will not change, but will continue as before.

Except for Japan, most of the East Asian and South Asian countries have an export-to-GDP ratio of more than 20 percent. Countries like Singapore and Malaysia have an even higher ratio of

over 100 percent. Asian countries are very open and global, and because of that, there has not been much interest in regional cooperation in Asia until recently. Globalisation has benefited Asia. Asia has probably been the major beneficiary of global deregulation and liberalisation that took place in the 1960s, 1970s and 1980s. That was most likely the major cause of what has been called the “Asian miracle”.

As I stated before, the global nature of trade and investment in Asia will not change – even though there has been an increase in intra-regional trade and investment. China will continue to attract investment both from Europe and the United States, because these major global players need to have factories in China. About a month ago, I was told by the CEO of Thyssen, the German Steel Company, that they have developed the technology for a high-speed train that can run 500 km per hour – double the speed of the Eurostar and the Japanese Bled train. The original intention was to connect Munich and Cologne by this high-speed train, but for some reason the company was unable to do that. So they reached an agreement with the Chinese government to construct a network for the train between Shanghai and other major cities. The operation was to start January 1, 2003, and by 2008, the year the Olympics is to be held in Beijing, the high-speed train, which runs at half the speed of an airplane, would connect Shanghai and Beijing.

China has been very savvy in importing technology which cannot be used in Europe, so China is not only a country of labour-intensive industries but also one with a variety of high-tech industries that drive a number of regional industrial clusters in the country.

A major change that has been witnessed over the last four or five years is, as I already mentioned, the emergence of China as a global manufacturing centre. The Flying Geese Formation is now being quickly realigned – with China in the lead. A number of industrial clusters are being created in China, e.g. in Shanghai, Hong Kong, Beijing, and Dalian. Furthermore, those industrial clusters have started to interact with the rest of Asia resulting in increased contact between Asia and various regions within China.

Most major Taiwanese companies have now established a foothold in mainland China. Singapore has gone into China as well. And many Japanese corporations are now relocating their production sites to various parts of China.

Recently, I was told by the CEO of a very well-known Japanese

company, “Until now, Sakakibara, we have been very successful in China, but all those goods produced in China were for export while we have continued to produce goods for consumption in Japan in our Japanese factory. However, the quality of the goods produced in China is the same as that in Japan, but the cost is about one-third in China.” Naturally I asked him why he continues to produce goods for Japanese consumers in Japan, to which he replied, “It is a social obligation for the corporation to maintain employment in Japan.”

His company is very famous for its lifetime employment system and is profoundly concerned for its employees’ security and the quality of their employment. But even he has had to change his mind and confessed to me that from now he must move his Japanese factories to China.

This is the major structural change that is now taking place in Asia, including Japan, and it will eventually reach Europe as well. It is very likely that China will fundamentally change the division of labour in manufacturing in Asia and the world. As I said, the Chinese have been sleeping for the last 200 years, but they have now awakened and have the capacity and the entrepreneurship to again become the centre of the world.

It is important to understand the key concept for China, which is competition. There is strong competition taking place everywhere in China. Japan and Germany are more socialistic than China. There exists a higher degree of entrepreneurship and competition in China than in these two countries. China is a very energetic country.

Of course, the Chinese have many problems; e.g. non-performing asset problems and SOE problems. At the time of the Cultural Revolution China was a communist country without any competition. It has transformed that structure within a matter of 10 to 15 years and, in the process, has created huge problems in some areas. The non-performing asset problem is much larger than that of Japan. However, China is undergoing major structural changes.

3 Lessons of the Asian Crisis

After the East Asian crisis of 1997-98, Asian countries strongly perceived the vulnerability of their region, which does not have any viable regional cooperative scheme. They recognised that there is no global lender of last resort, that international organisations like the

IMF and the World Bank were not of much use in preventing or addressing the crisis, and that the United States did not infuse much in the way of resources into Asian countries when the crisis broke. The United States provided resources to Brazil and Mexico, of course, but never to Korea or Indonesia.

The United States has its own national and regional interests, and that is understandable. But we in Asia did not realise this fact before the East Asian crisis erupted. I am not critical of the United States, because the United States is not a lender of last resort. The United States is a nation-state which has its own national interest. So the East Asian crisis brought to Asian people the awareness that the so-called hub-and-spoke relationship does not have a genuine hub. The hub country is a nation-state which has its own interests – national and regional.

The East Asian crisis of 1997-98 has also given rise to the recognition of imperfections or the lack of governance in globalised markets. The Asian miracle, to a significant degree a result of the open and global nature of this region, suddenly turned into the Asian crisis. Not only global institutions, like the IMF and the World Bank, but also regional organisations, like ASEAN and APEC, were unable to play a useful role in stopping the contagion of the crisis.

Also, initial prescriptions by the IMF were misguided and might have actually aggravated the crisis rather than arresting it. It is not only the policy recommendations made during the crisis, but also those made before the crisis, that need to be re-examined. The strong pressure to deregulate, particularly in international finance, without comparable strengthening of financial supervision, exposed many countries in the region to a degree of risk unmanageable by national governments. International organisations could not substitute for national governments in managing these new market risks. What is necessary is not the substitution of market for government but rather the redefinition of the role of government in view of the rapidly changing international environment. In his book, *Rethinking the East Asian Miracle*, Joseph Stiglitz correctly points out what needs to be done in the future.

“Just as before they were misled by the chimera of deregulation – they should have asked instead what is the *right* regulatory structure for their current situation – so too in the future, they will have to resist accepting without question the current mantras of

the global marketplace of ideas. There will have to be *strengthened* regulation of securities markets and an improved overall legal environment, especially in areas such as corporate governance and bankruptcy. The legal structures will have to comport with international standards, yet be adapted to their own special situations; wholesale borrowing will not work.”²

Policy efforts must be largely national. However, the question here in relation to regional cooperation is whether genuine regional institutions, similar to the EU, would help national governments in Asia to accelerate their efforts in the right direction. Or should we leave these matters to global international organisations, such as the IMF and the WTO.

I endorse the establishment of a genuine regional organisation in Asia, or at least in East Asia, on several grounds. First, existing global institutions are strongly biased toward market fundamentalism or the neoclassical paradigm, and their past records in international capital and finance are very poor. The establishment of a genuine regional organisation could provide a countervailing force and would contribute to reforming international institutions. Indeed, international institutions are necessary, but healthy competition among global and regional institutions would help improve their performance.

Second, international organisations, politically dominated by Western countries and staffed largely by Western economists, often lack sufficient knowledge of regional values, culture, and history and tend to impose their own views on, or try to “Westernise”, the country in question. Indeed, international standards need to be adhered to, but standards should reflect existing diversities of culture and institutions. Regional organisations can supplement global ones effectively in such areas.

Third, as in the case of the EU, necessary structural reforms, such as those mentioned by Stiglitz, can be more smoothly and willingly implemented if such reforms are deemed essential for regional integration. There has been increasing resistance to externally

² Joseph Stiglitz, “From Miracle to Crisis to Recovery: Lessons from Four Decades of East Asian Experience,” In: Joseph Stiglitz and Shahid Yusuf (eds.), *Rethinking the East Asian Miracle*, Oxford University Press, New York, 2001, p. 523.

imposed reforms. Regional cooperation or integration (even slow integration) is a more effective way to internalise reforms.

Fourth, the lack of global governance, including a global lender of last resort and international financial regulation, is not expected to be remedied in the near future. However, rather than relying solely on national governance, there seems to be a role for regional governance, even though in a region like Asia where there is enormous diversity, regional governance is more difficult than in Europe, for example. However, more flexible and softer cooperation could be developed.

Fifth, regional integration has been proceeding quickly in Europe and a little more slowly in the Americas, although there also it is rapidly accelerating. Is it politically feasible or desirable for Asia to be as open and global as in the past? Might not Asia be victimised by these two predatory empires in the future, as it was in the 19th and 20th centuries? This is a rather defensive posture, but it has been a major driving force recently for regional cooperation in Asia.

4 Financial Cooperation in Asia

In Asia, there is a strong case to be made for expediting financial cooperation by way of foreign exchange cooperation. This may seem strange, because usually financial cooperation comes at the end of the regional integration effort – as the process in Europe illustrates. But in the case of Asia, the creation of a common currency, or some kind of currency union, is the type of regional cooperation that should be pursued. Because as regional interaction in trade and foreign investment accelerates, Japan, Korea, and China will become not only complementary but also competitive in their imports.

At this moment, Korea and Japan are competing in steel and ship building. Depending upon the movements of the dollar-yen rate or the won-yen rate, industries in both these countries have at times been hit very hard. In this case, stabilising the won-yen rate would alleviate the situation. This could also apply to the emerging steel market in China. Korea, China, and Japan will be the major players in the global steel market, along with Brazil and a few other countries. This supports the case for stabilising intra-regional exchange rates.

Of course, it is difficult to immediately create an Asian currency

union, but regional coordination of monetary intervention policy, at least, is possible now. As a matter of fact, Yung Chul Park informed me recently that when Japan aggressively intervened in the market during the last two weeks of June 2002, the Japanese government had consulted with both the Korean and Chinese governments concerning the intervention. It is probable that the Koreans and the Chinese imposed some restrictions on the mode of the intervention. To my knowledge, this is the first time the Japanese authorities had consulted the Korean and Chinese authorities concerning an intervention.

Having been deeply involved in the foreign currency market myself, I have never believed in the concept of “free floating”, because every floating currency is managed to some extent. The degree of management differs depending upon the country, but the floating rate is always managed. In attempting to coordinate the management of floating rate currencies, the major difficulty at this point is with China’s currency which still has a *de facto* fixed rate. But as China gradually deregulates foreign exchange controls and starts to move to a managed float, cooperation between China, Japan, and Korea could develop. China most likely does not need technical assistance because the Bank of China is well known for its delivery operations in the foreign markets, which indicates its familiarity with the technology. Thus, coordination among the three countries would be most beneficial in the area of foreign exchange.

Initial moves have already taken place. A target of 10-15 years from now could be set for the formation of a currency union among the three countries. At this point it is important to start by exchanging information. In my time, when we intervened in the yen-dollar market, the only financial authority we informed was the US Federal Reserve because it was an intervention vis-à-vis the dollar. Likewise, when the intervention involved the yen and the euro, we informed only the European Central Bank. Never did we contact Korean or Chinese authorities. However, officials are beginning to take that step now.

We have discussed in this conference the issue of formulating an exit policy for the currency board system and have agreed that this could be very difficult. Hong Kong has a currency board system, and China seems to cooperate with Hong Kong in that system. So, some kind of exit policy is necessary both for China and Hong Kong. A regional cooperative effort could facilitate the exit from a currency board.

The currency board system in Hong Kong is based on the US dollar. For a cooperative scheme among China, Japan, and Korea we should target the formation of some kind of Asian Monetary System, similar to the EMS, within 10 to 15 years. I agree with Charles Wyplosz that creating a common basket of currencies is not desirable. Instead, we should move directly to a currency union or to pragmatic cooperation among the authorities in coordinating our exchange rates. We could start there and later target the formation of a currency union, but not a common basket.

I don't know why so many Japanese economists like the common currency basket. It does not make sense because the yen would be included in the basket with the dollar and the euro; however, the yen has to be coordinated with the won and the yuan. We need to jointly float our currencies vis-à-vis the US dollar and the euro, thus, the Japanese yen must be on the side of the Asian currencies, not on the dollar/euro side.

One other thing that has been pointed out in our discussions relative to regional cooperation is that it is necessary to have the political will to form a regional cooperative scheme, particularly if a common currency is the goal. Not a great deal has been accomplished yet in this area, but some gradual progress has been made.

China and Japan together are the key to developing a common political will in Asia. The role of China and Japan in East Asia's integration process is synonymous with that of France and Germany in Europe's integration process. Korea could be a very effective mediator in the cultivation of a common will between China and Japan. In a broader context, the cultivation of a common will involving a wider group of Asian countries would necessitate the inclusion of Japan as a counter-balancing power vis-à-vis China. This is because most Asian countries fear being absorbed by China based on experiences of 150 years ago. That is another historical legacy.

The formulation of a common policy among China, Japan, and Korea would be the key to regional cooperation in the monetary and foreign exchange area in this region. Another key issue concerns the type of institution that is appropriate for the region – which countries should be its members and what issues should it address? A survey of existing regional institutions in East Asia seems to indicate that ASEAN+3 (ASEAN countries plus China, Korea and Japan) may be the appropriate one for development into a genuine regional organisation.

ASEAN+3 could be extended to include Australia and New Zealand. The complementary nature of these two economies with those of Japan, Korea, and China could make cooperation and integration more rewarding than if only ASEAN+3 countries were involved.

In terms of coverage, regional interest is quite strong in the area of international finance, as evidenced by the Chiang Mai Initiative, in addition to trade. It is my view that cooperation, and ultimately integration, should proceed simultaneously rather than sequentially in trade, FDI, and international finance, which differs from the process that took place in Europe.

China and the ASEAN countries agreed in late 2001 to form a free trade area within ten years, allowing for some preferential treatment for less developed ASEAN countries. Korea and Japan could join that arrangement making it an ASEAN+3 free trade area. Given the diverse nature of the participating countries, the free trade area could, and should, include some exceptions and preferential treatment at least in the initial stage. A pragmatic rather than purist approach is required here. The formulation of parallel and reciprocal FDI agreements should proceed simultaneously with trade liberalisation.

In the area of international finance, there are two major items on the agenda for the Asian region. First, coordination of foreign exchange policies to stabilise the relationship among currencies of the region seems long overdue. If the won-yen rate, yuan-yen rate and baht-yen rate, for example, move within a relatively narrow range, coordinating the foreign exchange policies of Korea, China, Thailand, and Japan could contribute to the stability of these economies. Eventually, cooperation should progress to the formation of an Asian currency unit (ACU) with a flexible snake around the central value, similar to the ECU and the snake – that is, the joint floating of Asian currencies vis-à-vis the US dollar and euro with a relatively wide band around the central rate. Although the creation of a common currency à la the euro may not be feasible in the short run, a soft and flexible form of currency union with an ACU should be possible and beneficial. It would enhance and accelerate integration through trade and FDI.

Speculative attacks are a realistic possibility, but with a wide and flexible band Asian countries should be able to fend off such speculation using the huge foreign reserves at their disposal, as long

as effective coordination of macro policies accompanies joint foreign exchange interventions.

The need to jointly defend an ACU with a wide band logically leads to the extension of the Chiang Mai Initiative into an Asian Monetary Fund (AMF), which would pool a portion of the foreign reserves of participating countries and conduct macroeconomic surveillance. Participating countries can conduct joint intervention and coordination of macro policies with the AMF as the Secretariat. Articles of the AMF can provide the modality and modus operandi of coordination and intervention.

We could designate a different name for the AMF, but I would propose to have some kind of a G-7-like regular meeting among ASEAN+3 countries. We need some type of forum to coordinate the exchange rate policies and macro policies and should have regular meetings three or four times a year. The Asian Monetary Fund should perform in a manner similar to that of the G-7 and provide a similar kind of surveillance of the countries involved.

Let me emphasise that the concrete proposal I have outlined is just one possibility, and the process of forming a genuine regional organisation should be gradual and pragmatic. As in the case of China's national policy, structural reform needs to proceed simultaneously with opening or liberalisation. The moves need to be gradual and simultaneous on all fronts.

5 Conclusions

In concluding, let me reiterate that in the medium- to long-term the spotlight of the world economy seems to be shifting from West to East, and Asian countries need to build appropriate institutional infrastructure to pave the way for this change. Establishment of regional mechanisms consistent with existing global institutions seems to be the best strategy, at least for the immediate future.

Given the global nature and historical legacy of the countries in this region, it would be advisable for regional cooperation to focus on foreign exchange and monetary policies. The eventual target in 10 to 15 years is the creation of a common currency. Immediate steps to be taken are the initiation of some form of effective coordination of foreign exchange policies among Korea, Japan, and China and other advanced Asian countries and the development of some type of new

forum for an Asian G-7, including the creation of a Secretariat. The Secretariat could be small and named something other than “Asian Monetary Fund”, if that is preferred.

At the height of the crisis in East Asia, I proposed the formation of an Asian Monetary Fund (AMF). There was considerable enthusiastic support for the idea among Asian countries, but I made a strategic mistake. I had to draft the proposal in haste and, as a result, did not consult the Chinese as would have been sensible. I probably hurt their pride and that was a major mistake on my part. Another problem was that the United States did not favour the idea. When I talked about the idea with Kunita Saito, then head of the IMF’s regional office for Asia and the Pacific, he initially agreed with me but was later swayed by some lobby causing him to reject the “Asian Monetary Fund” name.

However, even after the AMF idea was abandoned, primarily because of opposition from the United States for their own good reasons, there remains in Asia an interest in regional financial cooperation. What is more crucial than anything else, is the formation of a commonwealth among China, Korea, and Japan.