THE NEW ASIAN CHALLENGE

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The initial postwar challenge from East Asia was economic. Japan crashed back into global markets in the 1960s, became the largest surplus and creditor country in the 1980s, and was viewed by many as the world's dominant economy by 1990. The newly industrialized countries (Korea, Taiwan, Hong Kong, Singapore) followed suit on a smaller but still substantial scale shortly thereafter. China only re-entered world commerce in the 1980s but has now become the second largest economy (in purchasing power terms), the second largest recipient of foreign direct investment inflows, and the second largest holder of monetary reserves. Indonesia and most of Southeast Asia grew at 7 percent for two or more decades. The oil crises of the 1970s and the financial crises of the late 1990s injected temporary setbacks but East Asia has clearly become a third major pole of the world economy, along with North America and Western Europe.

The new Asian challenge will be political and especially institutional.[1] Alone among the large economic regions, East Asia has had no significant institutions of its own. For a series of reasons, its countries from Japan through China to Thailand are determined to rectify that anomaly. It will start, as have Europe and North America, with institutions to deepen economic cooperation within the region and to coordinate its economic relations with the rest of the world.

East Asian economic institutionalization is already underway. An East Asian Economic Group, as proposed a decade ago by Malaysian Prime Minister Mahathir Mohamad, has now held summit meetings for three consecutive years under the "ASEAN+3" rubric (the ASEAN

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[1] Paul Bracken argues in "The Second Nuclear Age," *Foreign Affairs*, Jan/Feb 2000, that "Just as Asia began asserting itself economically in the 1960s and 1970s, it now does so militarily… [and that] the world that the West has created is (thus) being challenged not just in military but in cultural and philosophical ways as well." Bracken emphasizes security issues and a group of countries that, except for China, is different from those featured here but his basic thesis is highly complementary to my own.

countries[2], China, Japan, and Korea). Its economic ministers are starting to gather annually. It is now considering a system of "sherpas" and other summit preparatory devices, modeled to an extent on the traditional G-7 of advanced industrial democracies, that will further institutionalize the process. It has created a "Vision Group" to help chart its future, like the Eminent Persons Group that developed the blueprint adopted by the Asia Pacific Economic Cooperation (APEC) forum.

In addition, the central banks of the region have met regularly since the early 1990s. China, Japan, and Korea are actively monitoring capital flows to and from their northeast Asian region. The ASEAN Free Trade Area (AFTA) already constitutes a subregional trade linkup and its members have now established a surveillance mechanism to monitor their economic performance and anticipate future crises. Free trade initiatives between Japan and Korea, and between Japan and Singapore, are being officially considered.

Much more ambitious ideas are also being seriously contemplated. Japan proposed an Asian Monetary Fund in the immediate wake of the financial crisis in 1997. China, after rejecting the idea then, is now "very supportive" of it (per Premier Zhu Rongji in November 1999). Japan has provided a down payment of $30 billion through the Miyazawa Plan. The southeast Asians have asked Japan to fund such a facility on a permanent basis. Japan is guaranteeing foreign borrowing by other Asian countries, and is actively promoting regional use of the yen. The Philippines and Hong Kong have proposed the creation of an Asian currency.

On the trade side, the President of the Philippines has called for an East Asian Free Trade Area. Analysts in China, Japan, and Korea are studying a Northeast Asia Free Trade Area, and Korea has suggested extending the earlier Japan-Korea talks to include China. Such a group could eventually join with AFTA to cover the entire region. The private sectors are weighing in as well; a high-powered Japanese mission to key Asian countries, led by the Chairmen of Toyota and Bank of Tokyo-Mitsubishi in late 1999, strongly endorsed new regional economic institutions. Mahathir talked vociferously about regionalization but the Asians are now quietly going about it.

It will undoubtedly take some time for East Asia to convert these desires, initial steps and proposals into meaningful institutional arrangements. The process of economic integration is difficult, as demonstrated by the postwar evolution of Europe, and the Asian situation is even more complicated than Europe's. Free trade areas and currency unions require both extensive technical cooperation and sustained political determination. The process is likely to evolve slowly over a number of years rather than emerge full blown in the short term.

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[2] The Association of Southeast Asian Nations (ASEAN) includes its original six members (Brunei, Indonesia, Malaysia, the Philippines, Singapore, Thailand) and four recent additions (Cambodia, Laos,

This East Asian determination to create new regional institutions, even in its early stages of formation, could nevertheless have a profound impact on global peace and prosperity in the new century. It could have a major effect on the global balance of power, producing the "three bloc world" that was so widely discussed a decade ago—at the height of Japan's economic success—but never materialized. It could alter the international financial, trade, and economic architecture more fundamentally than any of the current deliberations in the International Monetary Fund, the World Trade Organization and the G-7.

THE ROOTS OF CHANGE

East Asia's search for an institutional identity is not new. ASEAN has linked that subregional group for over 30 years. Prime Minister Mahathir has pushed regional unity for some time. Both serious analysts and popular pundits have frequently postulated the prospect of a "three bloc world" on the assumption that Asia's economic might would automatically translate into institutional cohesion.

But several factors conspired to preclude meaningful progress. Political rivalries and security tensions within the region were acute. So were historical antipathies, borne of past wars and frequently renewed antagonisms. The countries viewed each other largely as economic competitors rather than potential collaborators. Much of the region looked to an outsider, the United States, for protection rather than banding together to provide it themselves. The effectiveness of the global institutions, particularly in the economic sphere of paramount importance to most Asians, obviated the need for regional structures.

A number of new developments have begun to change this picture. The most dramatic was the Asian financial crisis and the response to that crisis that emerged during 1997-98. As seen in East Asia, by crisis and non-crisis countries alike, a chief lesson of this episode was that this gigantic region—accounting for about one third of the world economy and more than half the world's monetary reserves—was excessively dependent on the international financial institutions based in Washington, the authorities of the United States, and the private (predominantly Anglo-Saxon) markets that took their cues from both. It was the "Washington consensus" that guided the responses of all those crucial actors and therefore dictated policy requirements to the crisis countries. The pictorial symbol was of course the colonial posture assumed by the Managing Director of the International Monetary Fund as the President of Indonesia, with the world's fourth largest population, signed his *diktat*.

The contrast with the response to the European monetary crisis of 1992-93 could not have been greater. That crisis also forced a number of countries (Italy, the United Kingdom, Spain,

Myanmar, Vietnam).

and Portugal) to devalue. Regional contagion was severe. Huge amounts were spent in market intervention, both to try to avoid the devaluations and then to limit the instability that came in their wake.

But the crisis was handled at all stages by the Europeans themselves, quite successfully and ultimately with modest economic costs. There was no recourse to the International Monetary Fund or any other outsider.[3] To be sure, there were many key differences between the European and Asian situations. The European countries were much more developed. Europe's currency crisis was not accompanied by deep structural problems, notably the national banking crises and widespread failures of corporate governance that were so prevalent in Asia. The higher income Europeans retained their access to private capital markets throughout the period of difficulty. But Europe had clearly achieved a high measure of autonomy through regional integration. It had of course already done so on trade policy for some time, having realized that none of its individual countries was powerful enough to stand alone and resolving to act accordingly.

As the East Asian economies rebuild from their crisis, one of their resolutions for the New Millennium is "never again."[4] This resolve will hopefully spur them to complete their internal reforms, in order to obviate future crises and any need to again call in outside assistance.

But many Asians are also resolved to avoid again being in thrall to Washington. That resolve is strengthened by the successful recovery of Malaysia, which spurned key parts of the Washington consensus as well as the international institutions themselves, but has come back about as well as its neighbors who accepted those orthodoxies. It is also strengthened by the fierce debate among Western economists themselves as to whether those institutions helped or hurt the recovery and the widespread view that, at a minimum, they needlessly deepened the transitional trauma. It is abetted by the fact that the West, notwithstanding its desire to dictate the course of the crisis response, let the Asians down on key occasions—as when the United States opted out of the initial support package for Thailand, thereby weakening its credibility and enhancing the prospect of subsequent contagion (as occurred with a vengeance). It is powerfully reinforced by the desire of many Asians to avoid following through on the structural reforms demanded by the Washington consensus, some because they genuinely believe that such reforms are unnecessary and many because they simply do not want to accept the wrenching social and political adjustments that would be required.

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[3] The Mexican crisis of 1994-95, and the associated "tequila effect" in some parts of Latin America, lies somewhere between the Asian and European cases. The IMF eventually played a central role in Mexico, and in heading off substantial contagion elsewhere, but the United States clearly took the lead in the crisis response program—at least partly because of the NAFTA links between the two countries.

[4] Jusuf Wanandi, one of the most moderate and globalist Asian leaders, argues that "An East Asian regional institution is of critical importance to East Asia…otherwise they will be dictated and imposed upon by others." See his "Regionalism and the Asia Pacific," processed, February 2000.

Beyond the financial crisis lie even more fundamental East Asian concerns that are leading it to seek its own institutional identity. The global trading system, whose openness and dynamism were critical to the emergence and maintenance of the "Asian miracle," has been drifting since the conclusion of the Uruguay Round in 1994. Both the United States and the European Union, the erstwhile leaders of the multilateral regime, have become increasingly unwilling and/or unable to maintain the needed momentum of liberalization. In particular, the political stalemate over globalization within the United States has blocked the extension of new negotiating authority to the President and precluded the world's strongest and most open economy from providing its traditional systemic stewardship. The failure of the 1999 WTO Ministerial Conference in Seattle, which was a tremendous failure of US leadership, underlines these problems and will clearly accelerate the Asian push to create alternative institutions to restore dynamism to the trading system. An onset of recession in the United States, which is quite possible within the next few years, could sharply accelerate US protectionist pressures—especially with a trade deficit already approaching $400 billion annually—and intensify the Asian reaction.

The WTO's predecessor, the GATT, also faltered on numerous occasions and gave rise to a similar search for alternatives. The most salient for East Asia was the APEC forum, created in 1989 when the Uruguay Round was floundering and upgraded to the summit level in 1993 when final agreement on the Round was once again jeopardized by European intransigence (mostly over agriculture). APEC includes the United States and several other countries on the eastern rim of the Pacific, and was chosen over Mahathir's Asia-only proposal a decade ago because of America's critical importance to East Asia in both economic and security terms. But APEC has also lapsed into ineffectiveness, after a promising start, for some of the same reasons that have hamstrung the WTO—notably including policy drift in the United States. Hence it no longer provides much of a buffer against Asia-only alternatives. Its failures have been a major spur to the search for liberalization alternatives in Asia itself, such as the Japan-Korea and Japan-Singapore initiatives.[5]

The continued expansion of regional arrangements elsewhere in the world is another prod to East Asia. The European Union steadily expands its own network—adding new members, signing additional association agreements, and negotiating trade treaties with major players on other continents (most recently Mexico and Mercosur). The United States and Latin America continue to aim for agreement on a Free Trade Area of the Americas by 2005, perpetuating the

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[5] Wanandi, "Regionalism in the Asia Pacific," notes that "a feeling of letdown was palpable when it became clear that APEC's trade liberalization program was just not working."

"NAFTA extension" concept that threatens substantial trade diversion in Asia's largest external market and has stirred considerable concern there since its inception.

Events in other parts of the world, in addition to generating defensive reactions in East Asia, provide positive models that are stimulating Asian interest in pursuing regional integration. In particular, the successful launch of the euro has led some Asian leaders to ask why East Asia cannot work toward creating a common currency of its own. This event has had an especially significant resonance in Japan, which would have to play a central role in any serious financial cooperation in Asia. The Japanese could reluctantly accept a world in which the dollar dominated <u>all</u> other currencies. Their national pride has been deeply wounded, however, by the specter of a bipolar monetary system in which the euro moved up alongside the dollar with the yen a distant third and Japan as a junior partner in the resulting architecture.[6] Prime Minister Obuchi has made a major pitch for international monetary reforms that could enhance the role of the yen, and the new Japanese zeal for Asian financial cooperation is greatly motivated by this objective.

Another motivation for Asian regional initiatives is the failure of the existing international economic institutions to provide East Asia with a role consistent with its economic progress. This shortfall is most glaring in the IMF and IBRD, where both larger and smaller Asian countries are grossly under-represented. Japan's economy is more than half as large as America's or Europe's but its quota is one third ours and 20 percent of theirs; it was a protracted struggle even to move Japan into the second largest national position in the Fund, which lagged far behind its passing all of the European countries in output levels. China has the world's second largest economy (in purchasing power terms, seventh at market exchange rates) but is only eleventh in the quota lineup. Korea's quota is so small, despite its being the world's eleventh largest economy and trader, that its support package in 1998-99 had to be a record 1900 percent of quota to counter its crisis. Europeans hold six seats on the IMF's Executive Board while East Asians hold only three. The Bank for International Settlements in Basel has recently brought key Asians into its central banking activities, and the new Financial Stability Forum and G-20 offer East Asians (and other emerging market economies) a potentially more important leadership role, but even here the process has been extremely belated and the Europeans have clung fiercely to their dominant positions.

The top management situation is even worse. No Asian has even been considered for the top position at either the Fund or the Bank because Europe and the United States allocated these positions to themselves half a century ago and show no signs of relenting. Japan's proposal of a former Vice Minister of Finance to run the IMF, and his immediate endorsement by other Asians, is the latest expression of this frustration. So was the prolonged effort to elect a highly qualified

[6] C. Fred Bergsten. "The Dollar and the Euro", *Foreign Affairs*, July/August 1997.

Asian to head the WTO, which ended with the unsatisfactory compromise of a split term in which the Asian had to wait three years to take over. East Asia's desire to create its own institutions is driven importantly by its lack of adequate representation in the global bodies.

The East Asians are thus motivated by a large number of factors in moving toward creating their own institutional identity. Some of those considerations are substantive while others are largely political and even psychological. Some are quite old while others are very new. Part of the Asian motivation is defensive and reactive while part is positive and even visionary. Their determination is clearly serious, however. It is bound to accelerate as their economies recover, especially if they resume global growth leadership in the near future as is quite possible. East Asia's institutional initiatives could turn out to be one of the shaping forces of the world economy, and international relations more broadly, in the early part of the new millennium.

THE SEARCH FOR A MODEL

To date, however, there is no blueprint for East Asian institutional cooperation. Indeed, there are a large number of competing views about both the ultimate goals of the exercise and the paths along which to proceed.

Some of the most ambitious ideas focus on currency and monetary arrangements within the region. This is natural in light of the crucial catalytic role played by the financial crisis in escalating interest in the whole idea. It would also reverse the pattern of most previous integration efforts, however, which have tended to begin with trade and other "real" economic activities before embracing their financial counterparts.

In some ways, however, finance might be an easier place for East Asia to start. A number of central banks in the region had already established swap lines and repurchase ("repo") agreements before the crisis broke; they were activated to a modest extent at its outset before being overwhelmed by the magnitude of the private flows and hence requiring outside help. Japan and Australia organized the Executives' Meeting of East Asian and Pacific Central Banks (EMEAP), which gathers regularly. At the subregional level, ASEAN has now set up an ambitious surveillance mechanism that will attempt to foresee and forestall future crises. The Asian Development Bank has created a new division to support such activities.

Within the broader Asia Pacific framework, the APEC Finance Ministers have met annually since 1994. They created the Manila Framework Group (with a slightly smaller membership) in late 1997, in an early response to the crisis, to pursue regional consultation on economic performance and policy responses. As suggested by these APEC groupings, monetary institutionalization could be pursued without any discrimination against outsiders, unlike most forms of trade linkages, and would thus raise fewer problems with the rest of the world.

Proposals abound for going much further in the monetary area. As noted, elements of an Asian Monetary Fund are already in the process of formation. Both politicians (including the President of the Philippines) and technocrats (including the Chief Executive of the Hong Kong Monetary Authority) have called for an Asian Currency Unit (ACU), replicating the European Currency Unit (ECU) that was the forerunner of the euro.[7]

More modest ideas, that would enable East Asian monetary cooperation to start more quickly and with less contention, are also circulating actively. One, which predates the crisis but is widely viewed as gaining added urgency from it, is to create much more extensive Asian capital markets. A number of East Asian countries have very high domestic savings, as manifest in their buildup of national monetary reserves, and could directly finance the huge investment needs of other parts of the region. (The official monetary reserves of the region exceed $600 billion, almost twice those of Europe and almost ten times those of the United States.) Yet the region's borrowers have relied significantly on the American and European capital and money markets, which many Asians have viewed as contributing importantly to the panicky withdrawals and contagion when prospects soured in 1997. As part of the new Miyazawa Plan, Japan has already begun to guarantee the offshore borrowings of other Asian countries.

Another route is currency cooperation. Almost all countries in the region are seeking new exchange rate regimes. They surely do not want to restore the dollar pegs that contributed importantly to bringing on the crisis. But neither do they want to maintain the free floats to which they were forced, given the massive overshoots which resulted and the inherent instability of such systems. Indeed, most countries in the region are again managing their rates quite extensively. One possibility is to do so jointly, to help avoid competitive depreciations in the future. They could adopt a common currency basket, in which to denominate and reference their currencies (probably within wide bands), which would require some institutional machinery for information-sharing and coordination purposes.[8]

In short, there are numerous technical possibilities as well as motivations for East Asia to pursue its institutional cooperation initially in the financial arena. There is also a reasonably close analogy in this area with the Asian Development Bank (ADB). Since its creation in 1966, the ADB has operated alongside—and been a full partner of—the World Bank and the global development finance system. To be sure, the ADB has included the United States and in fact members from all over the world. It also includes South Asia and much of its lending has been

[7] In light of the absence of a dominant currency or country, Asia would almost certainly choose to create a synthetic currency. This was the pattern in Europe, which created the synthetic euro despite the de facto dominance of the DM. Any similar evolution in the Western Hemisphere, by contrast, would almost certainly evolve around the dollar and the United States ("dollarization").

[8] See John Williamson *Exchange Rate Regimes for East Asia: Reviving the Intermediate Option*, Institute for International Economics, forthcoming 2000.

channeled to India, Pakistan and others there. But it has been managed to a large extent by Japanese and other Asians, and is viewed by most East Asians as the closest thing to "an institution of our own" that now exists. It has in fact played an important role in the ASEAN initiative to create its new subregional surveillance mechanism. It suggests that a regional institution can be fully compatible with the global system in a related policy area.

At the same time, trade initiatives traditionally lead the process of economic integration. Serious proposals are starting to surface, for the first time, for an East Asia Free Trade Area that would be at least a partial counterpart to the European Union and the proposed Free Trade Area of the Americas. One intriguing idea that is being studied is initial creation of a Northeast Asia Free Trade Area, adding China to the Japan-Korea discussion already inaugurated by those countries' heads of state. Such a grouping could then link up with the existing free trade area in southeast Asia (AFTA) to form an all-Asia trading zone—and the trade liberalization discussions between Japan and Singapore, also now underway, could be a precursor of that development. This would follow the pattern in Europe, where the original Common Market and most of the European Free Trade Area (EFTA) merged into the European Community, and potentially in the Western Hemisphere where any FTAA would amount to an amalgamation of NAFTA and Mercosur.

There is thus no shortage of candidates for starting, evolving or ultimately completing a process of functional and institutional cooperation in Asia. Financial and trade initiatives could proceed either sequentially, in either order, or simultaneously. The initial steps could be modest and deliberately evolutionary or via a "big bang." Lessons and models abound, to some extent within Asia itself but in neighboring (Asia Pacific) and more distant (Europe) regions as well. The crucial question is whether the desire to move in this direction can overcome the enormous hurdles that the Asians inevitably face.

THE BARRIERS TO ASIAN INTEGRATION

These hurdles encompass both economic and political dimensions. On the economic side, there are huge disparities in the region. Per capita income in Japan, even with its stagnation in the 1990s, is more than 30 times greater than in Indonesia (at market exchange rates). Even Japanese who favor new regional initiatives thus tend toward financial rather than trade links, which they would limit to "horizontal integration" with countries that at least approach Japan's own living standards (to date, only Singapore and perhaps Korea).

Moreover, most of the East Asian countries continue to view each other as economic rivals more than potential partners. Pre-crisis efforts to persuade them to adopt cooperative exchange rate systems, to help head off precisely the contagion of competitive depreciations that eventuated in 1997-98, were uniformly rejected for that reason.

Political rivalries pose an even more daunting barrier to effective cooperation. At the highest level of geopolitics, China and Japan are now clearly competing for the leadership of Asia; Japan is still a larger and much richer economy but the time when it could have seized leadership may now have passed and China is clearly on the rise. At a more microeconomic level, Hong Kong and Singapore are vying to become the financial hub of East Asia. Korea and Taiwan and other country pairs compete vigorously in global markets.

Moreover, huge differences in political systems underlie these rivalries. Most importantly China, but also Vietnam and Myanmar, are trying to maintain highly authoritarian regimes even while they embrace market economics. By contrast, Japan has been a practicing democracy for 50 years. Most of the other East Asians come somewhere in between, tilting toward the democratic end of the spectrum but sometimes with relatively weak variants and usually without the development yet of deep roots. These systemic political differences, at a minimum, would complicate any Asian integration effort.

These contemporary differences of course reflect deep historical and cultural roots. The rest of Asia has yet to accept Japan as a true partner. Suspicions of China's intentions are widespread as it steadily expands its economic and military strength. Relations between China and Taiwan will continue to complicate, or even block, many avenues of potential cooperation. Samuel Huntington's "clash of civilizations" thesis posits the existence of distinct cultures in East Asia's three largest countries—Chinese, Islamic (in Indonesia), Japanese—and hence poor prospects for coalescence among them.

Relations with countries outside the region add further complications to regional integration efforts. Some Asian countries, such as Korea and Singapore (and perhaps Japan), would not want such initiatives to undermine their relations with the United States and might therefore insist on including it á la APEC. China, for all its skirmishing with the United States, might again come to take a more global perspective than Japan or its other Asian neighbors and thus resist excessive "Asianization." Some, particularly in ASEAN but also Japan due to extensive trade ties, might not want to exclude Australia and New Zealand (as already suggested by the recently launched negotiations to link AFTA and the CER by 2010) or even Canada and Mexico (both of which have been approached by Japan to consider new trade links). Some might even be reluctant to discriminate against Europe, in light of the new series of summit-level Asia-Europe Meetings (ASEM) and the desire in some Asian quarters to "lengthen the short leg" of the Asia-Europe-United States triangle by developing ties in that direction.

There are of course answers to all these questions. North-South trade integration has occurred quite successfully in Europe, with the addition of poorer Portugal and Greece to the European Union, and in NAFTA with the adoption of free trade between Mexico and the richer North Americans. Deep-seated political animosities have been overcome through economic integration in Europe, where the history of France and Germany is as bloody as that of China and Japan, and in Latin America, where Argentina and Brazil carried a nuclear rivalry into the early 1990s before launching Mercosur. The interests of non-regional countries could be accommodated either by including some of them from the outset, as with APEC or EMEAP or ASEM, or by working actively with them in the global institutions from the vantage point of the new regional entities, as the Europeans have done in the GATT/WTO since the creation of their original customs union.

ANOTHER "EUROPE"?

Indeed, the European model is increasingly referenced by East Asians as a possible point of departure. This is a striking change, indeed one of the most revealing of the new seriousness about regional initiatives. Until quite recently, the whole concept of "community" as embraced in Europe has been widely suspect in East Asia and the institutionalized bureaucracy of the European Commission in Brussels has been unanimously viewed as the worst possible nightmare that could befall that region. Even more fundamentally, Asians have never viewed themselves as "a region" in the way that Europeans, despite their wars, have done since the Holy Roman Empire; even the most thoughtful Asians have regarded European integration as "relatively easy" compared with the daunting task of forging cohesion across the expanses of East Asia.

There are of course both objective parallels and differences between the European and East Asian regional situations. Europe's overriding objective, brilliantly achieved, was political and military: to use economic integration to overcome the historic animosities of its chief protagonists and thus render future wars impossible. A similar process that could forever preclude conflict between China and Japan would be equally worthwhile. But there is no evidence that East Asia's new push for regional institutions is driven by such far-reaching political goals, and there is a serious question of whether the perceived risk of future confrontation is great enough to convert the wariness between the top Asian powers from a barrier to integration into a motivation for achieving it.

A second driving force in Europe was the common enemy embodied by the Soviet Union. There is no comparable threat to East Asia today. Russia could conceivably play such a role again, at least for Northeast Asia in some distant future, but would hardly motivate Asia-wide coalescence now.

An associated element in Europe's integration was the strong support from its main non-regional ally. The United States, driven by its own strategic priorities of deterring the Soviet Union and avoiding another fratricidal war in Europe itself, was willing to accept some negative economic effects from the European process and even the buildup of a potential future rival. No "outside cheerleader" is likely to support Asian regionalism now, however (though there is some feeling in France that the risk of American domination is so great that Europe needs a stronger Asian partner to help it resist, as China and Russia now attempt to build each other up as bulwarks against America's "hegemonic pretensions").

Despite US support for European integration, a subtext of the latter has been Europe's own quest for independence from the pervasive influence of the United States. The Europeans have understandably wanted to avoid instability emanating from America, a central consideration in the startup of the European Monetary System in the late 1970s when the dollar was plunging. They have also resented the affirmative use of American power, as when it successfully pressured the IMF to lend large sums to Mexico in 1995 and to Russia throughout the 1990s over their doubts (and those of many others). Concerns over excessive reliance on the United States and "its" international institutions, as described at the outset, represent one of East Asia's motivations today. Such concerns, and the likelihood of countervailing action by the East Asians, would be intensified if a future US recession provoked a surge of protectionism against Asian exports or if a new foreign policy configuration in Washington led to a reduction in the American security presence in the Pacific.

Another key factor in Europe was the prospect of large economic benefits from closer, eventually full, integration among countries that were already each others' main partners but where substantial barriers still existed among them. Political leaders were driven primarily by the geopolitical concerns cited above but voting publics in the member countries also had to be convinced of the gains from expanded trade, and subsequently complete economic and financial integration. The potential for large economic gains from freer trade, and especially deep integration, exists in Asia today as well.

Finally, all participants in the European integration process have been democracies. Indeed, several countries in the region—notably Spain and Portugal—were deliberately shunned until they shed their dictatorial regimes. Hence the politics of Asian integration, at least to any depth, would be extremely difficult at this point in time.

In sum, there is clearly a case for East Asian integration today. Equally clearly, that case is less compelling than the case for European integration 50 years ago. Moreover, the hurdles to full emulation of the European Union seem sufficiently large to deter a comparable effort.

There remains, however, a significant prospect that East Asia could adopt less ambitious strategies that would still realize its desire to forge greater regional independence without requiring it to overcome the barriers that probably preclude a bid for full integration at this time. Regional surveillance procedures that seek to prevent future crises should be fairly easy to establish. Creation of swap networks, and even an Asian Monetary Fund, to defend the region against external financial shocks should be feasible as well. Even the establishment of a free trade area, at least one limited to reducing tariffs and other external barriers, might be compatible with the current state of competitive and political relationships within East Asia. The beginning steps in all these directions suggest the feasibility of such a course.

In terms of its functional focus, the new East Asian regionalism may well proceed more expansively on financial than trade issues for some time. If it advances on trade, it seems much more likely—at least for a considerable period—to resemble NAFTA or Mercosur or the European Common Market in its early days than the European Union as it has evolved today. It is more likely to establish a free trade area (or several areas) á la NAFTA than a customs union, with a common external commercial policy. It will have two dominant members (China and Japan) rather than one (the United States) and in that sense look more like Mercosur (with Brazil and Argentina). It would also share with Mercosur the strange, perhaps unsustainable, juxtaposition of a flexible exchange rate system in its largest economy (Japan, Brazil) with fixed rates in its second largest (China, Argentina) and even a common currency board component (Hong Kong, Argentina).

THE GLOBAL IMPLICATIONS

What would such limited, yet significant, steps toward regional institutionalization in East Asia mean for the rest of the world? What would an Asian Monetary Fund or a "larger Mercosur" in Asia imply for the global economic system and world politics?

Even a modest beginning of East Asian economic institutionalization will raise a series of profound questions. First, how would the resulting three-bloc world of tomorrow differ from the two-bloc world of today? An East Asian grouping would have impressive assets, especially in the economic domain. Its total output would approximate that of Europe and North America (and exceed it in terms of purchasing power). Its trade with the rest of the world is almost as large as that of the other blocs. Its monetary reserves are far larger than theirs. (See Table 1.)

Game theory and history both suggest that three-player games are much more prone to instability than two-player games (or, of course, dominant-player games).[9] The basic reason is that each of the three perennially fears that the other two will coalesce against it, thus fostering constant insecurities and preemptive strikes in an effort to secure tactical advantage. For example, the United States and European Union might react to the creation of an East Asian Free Trade Area by reviving the idea of a Trans-Atlantic Free Trade Area. An incipient Asian Currency Union might develop close ties with the Economic and Monetary Union in Europe, both to learn from its example and to work together to counter the financial domination of the dollar.

The global trading system has basically operated as a two-player game, based on cooperation between the United States and Western Europe, throughout most of the postwar period. So has the international financial system, though to a lesser degree as Europe's lack of monetary unity until now has enabled the United States to maintain much greater influence in that domain. The Cold War was also a two-player game with its tense but stable competition between the United States and the Soviet Union. One of the basic rationales for APEC was to preclude a three-bloc world by linking the key countries on both sides of the Pacific, maintaining the bipolar configuration instead. Systemic instability could thus ensue from the creation of a meaningful East Asian economic entity.

Second, an effective East Asian regional grouping in the trade or financial spheres could produce fundamental changes in the systemic configuration of those domains. In the financial realm, for example, the Asians—driven by the examples of both China and Malaysia (as well as India)—would probably be much more supportive of using capital controls to try to avoid future financial crises. They might be more aggressive in monitoring, and even regulating, the activities of hedge funds and other highly leveraged institutions—as supported even by market-oriented economies like Hong Kong. They might extend credits during crisis periods with less conditionality than required by the IMF, the chief concern underlying the immediate US opposition to Japan's proposal for an Asian Monetary Fund in 1997.

In addition, regionalization in East Asia could marginalize the IMF. As noted above, Europe handled its monetary crises of the 1990s by itself (and no European country has drawn on the Fund for over 20 years). A similar withdrawal by Asia would further convert the IMF into an institution for the poorest (and perhaps the transition) economies—and maybe not even many of the latter as more of them associate with the EU. This would be even more true if, in response to East Asian regionalization, the Western Hemisphere rejuvenated its plans to create an FTAA and

[9] Paul Krugman. "The Move Toward Free Trade Zones," *Policy Implications of Trade and Currency Zones*, Jackson Hole, Wyoming: Federal Reserve Bank of Kansas City, 1991.

developed a financial counterpart as well. The US rescue of Mexico in 1995 already represented a de facto device of that type.

In such a world, the IMF could of course take on a crucial new role as manager of monetary relations among the three blocs. This would parallel the evolution of the GATT/WTO, whose central operational task is now the management of trade relations between the United States and the European Union (and which would, in a three-bloc world, add the East Asian dimension to its purview). Such a change would require the support of the three blocs themselves, which would in turn require far-sighted statesmanship on their part and is no sure thing.

A third key question would turn on whether East Asia decides to proceed solely on the trade or financial fronts, or on the two together. Europe's evolution demonstrates that the international implications of integration are very sector-specific. The original European Economic Community achieved effective veto power over the trading system as early as the Kennedy Round in the 1960s but even the creation of the euro has not yet provided Europe with full equality on the financial scene, given its failure to create an institution to represent it on overall economic policy with a single voice. There seems to be very little cross-cutting between the two domains; the only effective linkages, occurring mainly at the summit level, have come during periods of financial crisis (early 1970s, mid-1980s) when new multilateral trade rounds were launched partly to help counter the protectionist pressures generated (mainly in the United States) by large currency misalignments.

Another key issue, especially for the United States but systemically as well, is whether the new "East Asian regional institutions" would be limited to "truly Asian countries" and thus exclude the United States (and perhaps also Australia and New Zealand). One rationale in the region, as noted, is to escape domination by Washington. Some of the strongest proponents of the idea, notably Mahathir but even some in Tokyo, view it importantly (or even primarily) as "a declaration of independence" from the United States.

On the other hand, the key regional institution to date (APEC) includes, and to an important extent has been driven by, the United States. Some key players in the region—including Korea, many in Japan and the Philippines, Singapore and Hong Kong—would want to include the United States. Some of their reasons are economic: the United States remains the largest single market for most of the region's export-oriented economies, including China and Japan, and the long leadership and systemic experience of the United States would almost certainly make surveillance or a financial support mechanism work more effectively with its involvement. Some of the motives relate to politics and security: smaller countries and traditional US allies want to keep the Americans involved in the region, to help counter any local bids for dominance (notably from China but also potentially from Japan), and rightly fear that an Asian initiative that excluded the United States would be used by isolationists in Washington to promote its withdrawal from at least the security dimension of the relationship.

Yet another key element will be the interaction between the East Asian initiatives and the policies of the United States. As noted at the outset, US behavior has been an important motivator of the new Asian challenge. On the one hand, US dominance (especially when pursued with a triumphalist demeanor) is one of the major incentives for the entire Asian movement. On the other hand, the faltering of US leadership—especially on trade policy, as demonstrated by the debacle at Seattle but also revealed increasingly in both the WTO and APEC for several years—is also a key causal element. So is the disillusion over the perceived shortcomings of IMF responses—backed strongly, if not dictated by, the United States—to the region's financial crisis.

A serious Asia-only initiative would represent a major challenge to US influence in the Pacific. It would in essence repudiate the decision of a decade ago to create APEC with an Asia Pacific membership including the United States, rather than an Asia-only grouping á la Mahathir, largely to "avoid drawing a line down the middle of the Pacific" (in the contemporary words of Secretary of State James Baker, III). The United States could react either positively, in an effort to maximize the prospects for beneficial outcomes (notably the potential imbedding of China in a regional framework) and perhaps bowing to the inevitable, or negatively and defensively out of fear that both US economic and security interests would be seriously jeopardized.

For example, the United States could redouble its effort to forge economic integration in the Western Hemisphere, perhaps offering to cooperate in dollarization of those economies who wanted it (e.g., Mexico and Argentina) as well as a Free Trade Area of the Americas. It might revive the idea of a Transatlantic Free Trade Area (TAFTA) with the European Union, a predictable manifestation of the tendency in three-player games for each player to seek firm alliances with one of the others. But such reactions could turn out to be either positive for the world economy, ratcheting up the process of liberalization and leading to greater multilateral cooperation, or negative via the instigation of conflict among the new regional entities.

Leadership from the United States has played a central role in resolving the potentially conflicting implications for the world economy of regionalism and globalism. The two have, on the whole, reinforced each other positively throughout the postwar period. This result has largely been due to US leadership, however: insisting that each successive deepening of European integration (and hence trade diversion) be followed by a new multilateral reduction of barriers, initiating the Canada-US Free Trade Area and the NAFTA to prod first the launch and then the revival of the Uruguay Round, sharply accelerating the salience of APEC via its initial summit in 1993 to help bring that Round to a successful conclusion, and launching regional free trade initiatives in both the Asia Pacific and the Western Hemisphere in 1994 to maintain the momentum of liberalization and keep the pressure on the new WTO to sustain multilateral progress through the major sectoral agreements that followed the Uruguay Round.[10]

The new Asian challenge could galvanize a renewal of US leadership in the traditional direction, convincing it that reassertion of its global monetary and trade leadership was essential to protect the multilateral system it had worked so hard to create and to avoid direct harm to both its economic and security interests. For example, the United States could seek to revivify the IMF by working with the Asians to sharply increase both their quotas and their seats on the Executive Board—mainly at the expense of the Europeans, whose representation should in any event be consolidated with the creation of the euro. Even more ambitiously, it could build on its recent leadership in creating the G-20—which includes China, Indonesia and Korea as well as Japan—to play a central role in steering the international monetary system by bringing China into the core leadership group of the meetings of G-7 finance ministers and central bank governors (which should soon be transformed into a "finance G-4" of the United States, the European Union, Japan and China).[11]

On trade, the United States could make the Herculean effort necessary—through changes in both domestic adjustment policies and international negotiations on labor and environmental standards—to overcome its internal stalemate and hence resume its leadership of global and regional liberalization. Even if it renewed its push for an FTAA and launched a TAFTA, it could use those new initiatives to induce the new Asian grouping to participate in renewed global liberalization efforts in both the WTO and APEC—and thus to strengthen rather than weaken the multilateral system. America's best friends in East Asia clearly hope that the United States will adopt such constructive responses to the new Asian initiatives, accepting those efforts as legitimate but working with them to steer the outcomes in an outward-oriented rather than inner-directed manner.

[10] C. Fred Bergsten, "Fifty Years of the GATT/WTO: Lessons from the Past for Strategies for the Future," Working Paper 98-3, Washington, DC: Institute for International Economics.
[11] As proposed by C. Fred Bergsten and C. Randall Henning, *Global Economic Leadership and the Group of Seven*, June 1996, Washington, DC: Institute for International Economics. German Chancellor Schröder informally floated the idea of inviting China to the G-7 summits in 1999; in early 2000, Japanese Prime Minister Obuchi publicly suggested inviting China to the Okinawa summit in July 2000 but China subsequently rejected the idea.

But the antiglobalization forces that have brought US international economic policy to a stalemate over the past five years could use such a challenge from Asia—which they would call a “threat”—to push the United States in a defensive and reactive direction. So could the foreign policy isolationists. A US failure to extend permanent normal trade relations to China upon China’s accession to the WTO, presumably by the middle of 2000, would be an ominous harbinger of such a possibility.

At a minimum, leaders of the new Asian initiatives should maintain close consultations with the United States as their process unfolds to limit the risk of reactions that would have negative effects on all parties concerned. For its part, the United States will have to make a careful assessment of the likely evolution of the Asian initiatives and decide on the mix of support and resistance, and countervailing steps in other directions, that will maximize its interests in both narrowly national and broadly systemic terms.

NEEDED: AN ASIAN MONNET

Asia’s desire for institutional autonomy is fully understandable. Similar initiatives have been undertaken successfully in other regions. Asia is both too strong and too proud to remain dependent on global institutions run by the rest of the world, which has been largely unresponsive to legitimate Asian desires to play a larger role in those bodies.

Moreover, the creation of new Asian economic institutions could bring numerous positive results for the world as a whole as well as for Asia itself. Financial stability and economic progress could be enhanced. For example, it is now clear that contagion is largely a regional phenomenon and that regional responses might be more effective than global initiatives in avoiding it. Regional surveillance and peer pressure might therefore substantially improve the “early warning systems” that are needed to anticipate and head off financial crises—an area where the IMF and the global system have failed miserably. Security could be strengthened, both by reducing the risk of intraregional conflict and by permitting a much more united front toward any potential aggressors from outside.

On the other hand, Asian regionalism could backfire for the Asians themselves. Even a partial insulation from global norms, in such areas as banking reform and corporate governance, could weaken rather than strengthen the Asian economies—or at least the perception thereof in global financial markets. The result could be a generalization of Japan’s stagnation of the 1990s and renewed crises. The Asians will have to achieve their goal of institutional independence without hurting their economic welfare, or at least face that tradeoff squarely and recognize the need to tread carefully as they pursue their new objectives.

In addition, the creation of a third major economic bloc could significantly alter the global balance of power. New competition for relationships, and even alliances, would be set in train among all possible combinations of the three. The challenge and potential disruption would be greatest for the United States, with its experience of fighting three wars in Asia in the 20th century and its postwar tradition of extremely close ties with a number of key Asian countries.

Strong leadership will thus be needed in Asia itself both to realize the region's goals in a constructive manner and to avoid negative international repercussions that could be extremely costly, even catastrophic, to all parties. In essence, Asia needs a leader who will develop and begin to sell the concept of regional cooperation as Jean Monnet did in Europe during the 1950s. Lee Kwan Yew of Singapore might have been such a leader had he come to power a decade or so later and been from a larger country. Mahathir Mohamad of Malaysia has struck responsive chords throughout the region with his calls for regional autonomy, including from many who would never admit it publicly, but his stridency has approached paranoia and his authoritarian role in Malaysia limits his appeal in some quarters. It may be impossible for any Chinese or Japanese leader to overcome the fears of domination by their respective countries, though the late Saburo Okita in Japan was widely trusted and might have played such a role. A respected Indonesian or Thai might be best, or perhaps ASEAN as a group could take the lead.[12] The rapid development of NGOs in Asia may produce the needed catalyst. But there are no obvious candidates at present to launch an Action Committee for the United States of Asia.

It is clear, however, that Asia is determined to start creating its own regional institutions, at least in the economic sphere. It is not at all clear how fast that process will proceed, how far it will go, nor what forms it will take. But even serious movement in that direction could reshape the face of world politics as well as international economics, with profound implications for the rest of the world. The new Asian challenge could be one of the defining elements of the world of the early 21st century. It is imperative that Americans, Europeans and others, as well as Asians, begin to think hard about it now and work together to orient it in constructive directions that will enable the Asians to achieve their legitimate goals without disrupting security and stability around the globe.

[12] Wanandi, "Regionalism in the Asia Pacific," argues that "ASEAN has to push for an East Asian regional institution to be established, because economically ASEAN has become too small for its members, and ASEAN needs new external challenges to move forward." He argues that "cooperation between Japan and ASEAN is critical in developing the right idea and to be able to push the process and institutionalization of the idea of an East Asian regionalism."

TABLE 1

THE ECONOMIES OF THE THREE BLOCS

(in billions of dollars, 1997)

	Output (at market exchange rates)	Output (at purchasing power parity)	Trade (with rest of world)	Official Monetary Reserves
East Asia[1]	6,382	9,431	1,380	668
European Union	8,093	7,559	1,640	380
United States	7,834	7,665	1,586	71[2]

[1] ASEAN 10 plus China, Japan and Korea.
[2] With gold at official value of $42.42 per ounce. Total would be about $140 billion with gold valued at market price.