

Towards a tripartite world

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This week, the leaders of the big industrialised countries are preparing to meet in Okinawa. But a challenge to their dominance of the world's financial and trading systems is stirring right under their feet, argues Fred Bergsten*

WHEN it comes to international finance, two bodies like to think they are in charge of the architecture: the G7 group of industrialised countries (G8, when Russia is included), and the International Monetary Fund. Not quite so. In the medium term, at least, the most important changes to the world's financial architecture are likely to come from the new regional arrangements being fashioned in East Asia by Japan, China, South Korea and the ten members of the Association of South-East Asian Nations (ASEAN).

In trade, the same is true. The most striking changes in the world trading system, especially in the short run, are not likely to flow from the World Trade Organisation or the proposed "mega-regional" arrangements, such as a Free-Trade Area of the Americas or an expanded European Union. Instead, they will probably come from the host of sub-regional trade agreements now being busily negotiated by Japan, South Korea, Singapore and other countries in East Asia.

Virtually unnoticed by the rest of the world, East Asian countries are getting together to make their own economic arrangements. As a result, for the first time in history, the world is becoming a three-block configuration. Not only global economic relationships, but political ones too, will turn on the direction these new agreements take—and on how the United States, and others outside the region, decide to respond to them.

The early steps

It was Mahathir Mohamad, the prime minister of Malaysia, who first proposed an East Asian Economic Group (EAEG) a decade ago. Nothing happened, partly because Dr Mahathir was under suspicion as a protectionist, but largely because the United States feared "drawing a line down the middle of the Pacific". America pushed instead, successfully, for relying on the Asia-Pacific Economic Co-operation forum (APEC). With very little fanfare, however, Asia has now created the "ASEAN+3" with precisely the same membership (ASEAN, China, Japan and South Korea) envisaged by Dr Mahathir. The group has held its own summits for three years in a row, has set up a "vision group" to guide its work, and holds regular meetings of its finance ministers.

Structurally, at least, the ASEAN+3 is starting to look like the G7. It has become the most active regional grouping outside Europe, and already has more sophisticated machinery than the North American Free-Trade Agreement (NAFTA). But it is still at an early stage and, for reasons that will be discussed later, it does not yet have the substance or integration of these other partnerships.

The new Asian regionalism is proceeding more rapidly on financial issues than on trade. This looks unusual: in the European Union and other big precursors, the sequence was the other way round. But trade arrangements (as witness the vexed world trade rounds) are politically difficult and slow to organise. Monetary agreements can proceed without discrimination against outsiders, unlike most trade deals. Besides, financial problems lay at the heart of the East Asian implosion of a few years ago.

The ASEAN+3 have announced a region-wide system of currency swaps to help them deal with future Asian crises. This is similar to the network installed by the Group of Ten industrial nations in the early 1960s, when they faced the first global monetary hiccups of the post-war period. Sub-regional financial structures are developing as well: ASEAN has created a surveillance mechanism to try to anticipate and head off future crises, using sophisticated early-warning indicators, and the North-East Asian countries are jointly keeping an eye on short-term capital movements in the vicinity. There is much talk of common currency baskets and joint intervention arrangements, to replace both the discredited dollar pegs of the past and the costly free floats imposed by the crisis.

An Asian Monetary Fund (AMF) is thus beginning to evolve, only three years after the idea was rejected out of hand. China, which condemned the original Japanese proposal, supports the present initiatives. Hong Kong and the Philippines have proposed an Asian currency unit on the euro model: an idea that would obviously take years to come to pass, but would not even have been considered a little while ago.

Nor have the East Asians been idle on trade issues. There is no discernible movement towards the East Asian Free-Trade Area proposed by the Philippines. But a growing number of bilateral and plurilateral agreements are being negotiated, notably by Japan, the second-largest national economy in the world and by far the largest in the region. Japan had relied completely on the multilateral system, but it is now actively pursuing preferential arrangements with South Korea, Singapore, Mexico and Canada. South Korea, the third-largest economy in the region—and also opposed to preferential deals in the past—is negotiating with New Zealand and Chile as well as Japan.

Similarly, the South-East Asians are negotiating the linkage of their ASEAN Free-Trade Area (AFTA) with the existing FTA of Australia and New Zealand. A North-East Asia Free-Trade Area of China, Japan and South Korea is being studied in all three countries, and might merge with AFTA into a grouping that covers the whole of East Asia.

Frustration, inspiration

Why have Dr Mahathir's EAEG, Japan's AMF and the long-dormant Asian trading-group idea sprung back to life at the outset of the 21st century? There are four basic reasons: the East Asian financial crisis; the failures of the WTO and of APEC to make headway on trade liberalisation; the positive inspiration provided by European integration (especially the euro); and a broad disquiet with the behaviour of both the United States and the European Union.

The single greatest catalyst for the new East Asian regionalism, and the reason it is moving most rapidly on the monetary side, is the financial crisis of 1997-98. Most East Asians feel that they were both let down and put upon by the West. In their view, western banks and other lenders created much of the crisis by pulling out. The leading financial powers then either declined to take part in the rescue operations, as the United States did in Thailand, or built the much-ballyhooed "second lines of defence" so deviously that they could never be used.

At the same time, the IMF and the United States dictated much of the Asian response to the crisis. Fealty to the "Washington consensus" was seen as necessary to qualify for official help and to restore access to private capital markets. The visual symbol of all this, captured in a photograph sent round the world, was the managing director of the IMF looming over the president of Indonesia like some imperial tyrant from ages past. The widespread view that the IMF programmes made things worse, at least for a while—a view proclaimed by some economists in the West itself—makes Asians still more resentful. And Malaysia's recovery without the IMF implies that acceptance of the global norms may not have been so crucial after all.

This Asian perception of the events of 1997-99 is highly selective. Japanese banks were probably the biggest culprits in triggering the currency runs. Since most of the crisis countries are now recovering rapidly, the IMF programmes were basically successful. The United States kept its economy booming and its market open, accepting a huge further increase in its trade

deficit. By contrast, Japan fell into recession and the yen plummeted. Japan's record trade surplus therefore rose even higher, and made the Asians' problems worse. However, inept American diplomacy failed to capitalise on these stark contrasts; and Japan recovered, at least in part, by pouring in government money to meet Asians' most urgent needs.

Whatever the right and wrongs of its opinions, East Asia has decided that it does not want to be in thrall to Washington or the West when trouble hits in future. It is not rejecting the multilateral institutions, let alone opting out of the international capital markets or the globalisation of trade—which it knows would weaken rather than strengthen its prospects. It seems to want to work with, and within the framework of, existing bodies.

But East Asia also clearly feels that multilateral institutions, on which it was previously willing to rely, are no longer infallible. It notes that its aggregate economy and external trade are about as large as those of the United States and the EU, and that its monetary reserves are much larger (see [table](#)). Hence it wants its own institutions, and a central say in its own fate. As East Asia regains its strength, it is determined never to be totally dependent again.

1997, \$bn	Output		Trade with rest of world	Official monetary reserves
	market exchange rates	purchasing-power parity		
East Asia*	6,382	9,431	1,380	668
EU	8,093	7,559	1,640	380
United States	7,834	7,665	1,586	71†

*ASEAN 10 plus China, Japan and South Korea
†With gold at official value of \$42.42 per ounce; total would be about \$140bn with gold valued at market price
Source: F. Bergsten

A bombshell from Seattle

Added impetus for this feeling comes from the failures of the global trading system. Unfortunately, all the East Asians, including China and Japan, continue to depend heavily on export expansion for their economic growth. The crisis countries have become even more dependent on exports as they struggle to recover.

In consequence, all these countries want better access to foreign markets. Moreover, they realise that there is a constant risk of a relapse towards protectionism if the system does not continue to liberalise. They know that the threat is particularly acute in the United States, their largest market, where domestic support for new liberalisation has been bogged down for five years despite a buoyant economy, and where the trade deficit is heading towards \$500 billion. They see the EU, too, as distinctly unenthusiastic about further liberalisation.

Not only Seattle failed. Trade talks through APEC have stalled for similar reasons, including American domestic drag and sharp differences between the United States and Japan. East Asians cannot envisage a revival of American leadership, or even active American participation, without the imposition of new conditions they strongly oppose, including serious agricultural reforms (resisted by Japan, South Korea and China) and trade-related labour and environmental standards (rejected by virtually all developing countries in the region). They note that the United States failed to follow up its own "P5" initiative (with Australia, Chile, New Zealand and Singapore) at last year's APEC summit, though those countries were hand-picked to minimise grumbling at home.

For all these reasons, a growing number of Asians are turning to sub-regional trade pacts to get the liberalisation, and the insurance policies, they need. As yet, none of these pacts poses a particular threat to American or European trade interests. For that reason, they have not attracted much attention. But continued paralysis in the WTO and APEC could lead to a broadening of the new East Asian trade framework and a comprehensive East Asian FTA; or, at the least, a hook-up between China, Japan and South Korea in North-East Asia. Either of these would alter the structure of world trade.

This East Asian evolution is not happening in isolation. It is part of a broader pattern of preferential trade negotiations: for example, transatlantic ones between the EU and Mexico and the EU and Mercosur, and transpacific pairs such as Chile and South Korea and Canada and Singapore. These pacts are being negotiated around the United States, since America is unable, for the moment, to take part in new liberalising itself. Any new outbreak of American (or European) protectionism would of course give East Asia's efforts an extra push.

Wasn't Monnet a painter?

Yet those efforts are also meeting obstacles. The region contains vast differences in cultures, political systems and levels of economic development. There are at least as many designs and strategies for an East Asian partnership as there are countries in the region. And the atmosphere is charged with political distrust and even hostility, notably between China and Japan.

Moreover, most of the countries, even those in South-East Asia that have been linked institutionally through ASEAN for three decades, continue to see each other as competitors rather than partners. Protectionists in East Asia are no keener to liberalise with neighbours than on a broader scale. No leaders, individual or collective, have emerged to guide the process. Asians themselves joke that most of their compatriots think Monnet was a painter and Schuman a composer.

But not many observers, only a few years ago, would have predicted even the present modest degree of co-operation. And many Asian leaders are serious about going much farther. The European model is now widely admired, rather than disparaged for its bureaucracy. The rest of the world should realise what this evolution means, if it continues: eventual regional alignments which, even if they fall far short of Europe's integration, will be sufficiently advanced to create the tripartite world that has been expected, or feared, for some time.

An East Asian economic grouping could have many implications for the global system. At one extreme, it could reproduce much of the European experience. China and Japan, which have warred as viciously as France and Germany, could obliterate the possibility of future military rivalry and assure stability in what is, potentially, the world's most volatile area. Asian economic integration would create a formidable competitor, but also a huge stimulus to global growth, trade and investment. A uniting East Asia would be more likely to do its bit to ensure international peace than individual Asian countries acting alone, and could become an effective trilateral partner with the United States and Europe in managing the world economy.

At the other extreme, a unifying East Asia could become a highly disruptive force. With huge national savings and over \$800 billion in monetary reserves by now, it could develop its own capital markets and increasingly ignore the advice, let alone the dictates, of the global financial institutions (as Europe has been able to do). East Asia is easily large enough to pursue regional development strategies and discriminate against outsiders (as Europe has also been able to do); and some of its trade deals will probably violate WTO rules by excluding agriculture and other sensitive sectors. The other big powers could decide to respond in kind, perhaps by reviving the idea of a Transatlantic Free-Trade Area that would discriminate against Asia. Any sign that East Asia is rejecting transpacific co-operation could strengthen isolationists in the United States and trigger an American retreat, from security arrangements as well as economic ones.

So Asian regionalism, like regionalism elsewhere, could go either way. The outcome will be determined by policy, both in East Asia and in other countries as they work out a response. The most likely result is an intermediate, quasi-European one: an East Asia with sufficient autonomy to allow independent action at times of crisis, but still co-operating with the rest of the world, in both economic and security terms, in normal times. It would probably side with the United States against Europe on some issues and with Europe against the United States on others, inducing each of the three to seek a permanent alliance with one of the other two. This, of course, exposes the inherent instability of a three-part configuration.

A first requirement for achieving cooperative evolution is for East Asians and outsiders to consult actively and candidly, perhaps with the United States in APEC and with Europe in ASEM (the Asia-Europe Meetings). Even Asians and non-Asians of an internationalist outlook are extremely wary of each others' intentions at this early stage. East Asians need to tell the world clearly what they think they are doing, and how they believe it fits in with the global and mega-regional (APEC) systems. Outsiders need to listen carefully and prod them, if possible, in an outward-looking direction.

The other obvious course is to energise and modify the existing global institutions in ways that would answer the complaints of East Asians and make them less eager to go off on their own. Reform of the international financial architecture needs to go deeper, and the multilateral trading system needs to be cranked into forward motion again. In addition, East Asia deserves a much larger presence in the IMF and the World Bank, where Europeans are ridiculously over-represented. The appointment of the deputy prime minister of Thailand as the next director-general of the WTO is a good sign, and Asians need to be increasingly considered for top posts in all the key institutions.

East Asian regional pacts and the global system could nonetheless work well together. Early warning and early action to prevent crises may be easier at the regional level; near neighbours tend to know the situation better, and may have more legitimacy when they ask their colleagues to take preventive measures. Contagion is largely a regional phenomenon, and standby financial facilities, used in conjunction with IMF lending, would avoid the need to cobble together ad hoc rescue packages. A properly structured Asian Monetary Fund could do much for the international financial system, just as the Asian Development Bank (and other regional development banks) have done for global development finance for over 30 years.

Sub-regional, and even East Asia-wide, trade agreements could catalyse the global trading system in the same way. Successive milestones in European integration, from the creation of the common market to the coming of the single market, did much to stimulate the three big post-war multilateral trade negotiations (the Kennedy, Tokyo and Uruguay Rounds). The creation of NAFTA and APEC helped persuade Europe to conclude the Uruguay Round. Positive responses by the United States and Europe to the new Asian trade pacts could both limit their discriminatory effects and embed them in revitalised global and Asia-Pacific regimes.

East Asia may be on the brink of an historic evolution, as Europe was half a century ago. Of course, Asians themselves must steer their efforts in directions that promote international stability. But it would be tragic if these initiatives were rejected rather than respected. The rest of the world must accept a global role for East Asia, and modify its own institutions with East Asia in mind. The success or failure of this process will do much to shape the world for the next 50 years.

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