ADB

EMERGING ASIAN REGIONALISM

A Partnership for Shared Prosperity

Asian Development Bank

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Use of the term “country” does not imply any judgment by the authors or ADB as to the legal or other status of any territorial entity. The symbol “$” represents the United States dollar unless otherwise indicated. “Asia” refers only to ADB’s Asian member economies. The 16 “integrating Asian economies” are Brunei Darussalam; Cambodia; People’s Republic of China; Hong Kong, China; India; Indonesia; Japan; Republic of Korea; Lao People’s Democratic Republic; Malaysia; Myanmar; Philippines; Singapore; Taipei,China; Thailand; and Viet Nam.

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EMERGING ASIAN REGIONALISM

A Partnership for Shared Prosperity

A Study by the Asian Development Bank

Asia learned the hard way in 1998 that the absence of regional cooperation can cost an economic misfortune. We now understand how enhancing regional integration and cooperation is important to build stronger and more resilient economies.

This excellent study summarizes well the important issues related to Asian regionalism. It is a book everybody will enjoy reading, from policy makers, to business leaders, scholars, and anyone interested to understand the dynamics of Asian economic interdependence.

Sri Mulyani Indrawati
Minister of Finance, Republic of Indonesia

Foreword

Asia today is an economic dynamo. But Asia's success story is about more than rapid development, poverty reduction, and an ever-expanding middle class. It is more than the production and distribution networks that place Asian goods within easy reach of consumers around the globe. It is more than labor-intensive industries, high-tech production of intermediate goods, or the final products assembled in Asia's myriad plants and industrial estates.

Part of Asia's success story is also growing integration—a phenomenon that is increasingly garnering the attention of observers outside the region and, more importantly, the policy makers and the public they serve. The trend toward integration is gaining momentum through enhanced dialogue between countries and people—from the simple contact brought about by intraregional tourism to formal meetings of government officials, ministers, and political leaders. Intraregional trade and investment are expanding rapidly, financial markets are becoming closer and more efficient, and economies are becoming more interdependent. Regional infrastructure projects are increasing connectivity, and countries are working together to provide regional public goods in areas such as the environment and health.

Emerging Asian regionalism offers a new platform for economic development that is good for individual economies, good for Asia, and good for the world. It is a "partnership for shared prosperity."

The evolving approach to integration in Asia is market-friendly, multitrack, and multispeed, allowing for a healthy dose of pragmatism among a collegial group of economies. This approach is workable for a region of such size and diversity, and holds several advantages. First, any group of territories, economies, or subregions can integrate according to its particular levels of development and the specific opportunities that regionalism offers. Second, as partnerships strengthen, smaller groups are more likely to merge into larger ones, leading to wider and deeper relations across an ever-growing swathe of Asia. Third, this approach ensures that Asia's economic integration remains market-friendly—that its framework continues to be responsive to private sector needs as expanding business and open markets power Asian economies ahead.

Subregional cooperation is the building block of Asia's regional integration, and a logical way to move forward, given the region's diversity and size. Whether in the Greater Mekong Subregion, East Asia in its entirety, South Asia, Central Asia, or the Pacific Island nations, the scope and speed of regional cooperation will inevitably differ. As partnerships develop, bridges naturally form across subregional boundaries, leading eventually to wider and more comprehensive cooperation and integration. Such cooperation and integration have been seen most clearly in the aftermath of the Asian financial crisis, which triggered a period of significant progress in regional cooperation as much out of necessity as opportunity.

This study analyzes the nature of Asia's emerging regionalism, providing a basis for understanding its dimensions and further discussion on ways to move forward. The dynamic and outward-looking style of Asian regionalism can have a significant impact in an increasingly globalized world. Regionalism can be a stabilizing factor when shocks arise, whether region-based or externally imposed. Being pragmatic and flexible does not mean taking a laissez faire outlook. Regionalism carries the responsibility of proper management, effective communication, and (when required) policy coordination or the creation of common regional institutions. Regionalism can also be an effective policy tool to help markets adjust and adapt when a crisis looms.

Whether providing new regional public goods, managing natural disasters and epidemics, easing trade in products and services, moving capital and people, building common positions in international forums, or working together in correcting global market failures, emerging Asian regionalism will rely on the sort of experience, research, and analysis that make up this study so they can develop and properly manage strategies that can effectively deal with the challenges Asia will face.

This study, led by the Office of Regional Economic Integration, is a flagship project of the knowledge departments of the Asian Development Bank. It builds on the Eminent Persons Group report of March 2007, which suggests as one of its three complementary themes that ADB shift its focus from a primarily national one to a regional and ultimately global focus. It also contributes to the achievement of ADB's long-term strategic framework by helping to define the relevance of regional integration and cooperation as a platform for poverty reduction and promotion of economic development.

The study has greatly benefited from the work and contributions of many people. I wish to express deep appreciation to the excellent team of authors, advisers, reviewers, and editors, both outside and within ADB, who worked on the report and provided guidance and innovative ideas. The principal consultant, Peter Petri, coordinated the work of chapter authors and drafted the introduction, the chapter on deepening interdependence, the conclusion, and the *Highlights*. Michael Plummer drafted the chapter on integrating production; Jenny Corbett and Maria Socorro Gochoco-Bautista, that on financial systems; Shinji Takagi, that on macroeconomic links; Shiladitya Chatterjee and Aniceto Orbeta, that on social and environmental issues; and Peter Drysdale that on the architecture of cooperation. Philippe Legrain served as economics editor. The study was conceived and led by an ADB team comprising Masahiro Kawai, Jong-Wha Lee, Srinivasa Madhur, and Giovanni Capannelli. The financial contribution of the Government of Japan for this project is gratefully acknowledged.

How Asian regionalism evolves will affect the lives of the 3.7 billion people who inhabit the region, and will impact the world as a whole. Asia's contribution to the global economy is growing faster than that of any other region. The emergence of Asian regionalism, powered by new generations of Asians who have been raised amid exceptional economic progress and cooperation among nations, will help establish a lasting prosperity and peace.

H. Kuroda

Haruhiko Kuroda
President
Asian Development Bank

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This study was conceptualized, managed, and finalized by an Asian Development Bank (ADB) team comprising Masahiro Kawai (Dean, ADB Institute) and Jong-Wha Lee, Srinivasa Madhur, and Giovanni Capannelli (respectively Head, Director, and Senior Economist of the ADB Office of Regional Economic Integration).

An international group of consultants and ADB staff drafted the chapters. Peter Petri of Brandeis University served as principal consultant. He was overall coordinator of the study and played a pivotal role in drafting the final report, especially chapters 1, 2, and 8. Chapter 3 was drafted by Michael Plummer of the Johns Hopkins University, and Chapter 4 by Jenny Corbett of the Australian National University and Maria Socorro Gochoco-Bautista of the University of the Philippines (with the assistance of R. V. Fabella, M. Debuque-Gonzales, M. S. Milo, and R. E. Reside). Shinji Takagi of Osaka University drafted Chapter 5. ADB's Shiladitya Chatterjee and Aniceto Orbeta of the Philippine Institute for Development Studies drafted Chapter 6. And Peter Drysdale of the Australian National University drafted Chapter 7. Philippe Legrain prepared the executive summary and was economics editor for the study.

Many from ADB management and staff contributed to the book. Overall guidance was provided by a steering committee including Bindu Lohani, Rajat Nag, Kunio Senga, Kazu Sakai, Ifzal Ali, and Ann Quon. A working group—comprising Jaseem Ahmed, Ian Anderson, Indu Bhushan, Bruno Carrasco, Padmini Desikachar, Klaus Gerhaeusser, David Green, Frank Harrigan, Shigeko Hattori, Jayant Menon, Rita Nangia, Cyn-Young Park, Ashok Sharma, and Shahid Zahid—read manuscripts and provided detailed comments. William James, Sabyasachi Mitra, Donghyun Park, Avonechith Siackhachanh, and Lotte Schou-Zibell drafted some of the boxes, with two consultants, Albert Guangzhou Hu and Hai Troung Pham, drafting the rest. Guy Sacerdoti provided additional contributions to the final report.

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Abbreviations and Acronyms

ABF	–	Asian Bond Fund
ABMI	–	Asian Bond Markets Initiative
ADB	–	Asian Development Bank
AFTA	–	ASEAN Free Trade Area
AMC	–	asset-management company
APEC	–	Asia-Pacific Economic Cooperation
ASA	–	ASEAN Swap Arrangement
ASEAN	–	Association of Southeast Asian Nations
ASEAN+3	–	ASEAN plus People's Republic of China, Japan, and Republic of Korea
ASEM	–	Asia-Europe Meeting
BCP	–	Basel II Core Principles
BIMP-EAGA	–	Brunei Darussalam-Indonesia-Malaysia-Philippines – East Asia Growth Area
BSA	–	bilateral swap arrangement
CMI	–	Chiang Mai Initiative
EAS	–	East Asian Summit
EASG	–	East Asian Study Group
EMEAP	–	Executives' Meeting of East Asia and Pacific Central Banks
ESCAP	–	Economic and Social Commission for Asia and the Pacific
EU	–	European Union
FDI	–	foreign direct investment
FTA	–	free trade agreement
GATT	–	General Agreement on Tariffs and Trade
GDP	–	gross domestic product
GMS	–	Greater Mekong Subregion
HIV/AIDS	–	human immunodeficiency virus/acquired immunodeficiency syndrome
IA	–	Integrating Asia
IAIS	–	International Association of Insurance Supervisors
IMF	–	International Monetary Fund
IOSCO	–	International Organization for Securities Commission

MDG	–	Millennium Development Goal
MNC	–	multinational corporation
NAFTA	–	North American Free Trade Agreement
NIE	–	newly industrializing economy
NTB	–	non-tariff barriers
OECD	–	Organisation for Economic Co-operation and Development
PCT	–	parts and components trade
PPP	–	purchasing power parity
PRC	–	People's Republic of China
ROORs	–	rules-of-origin requirements
SARS	–	severe acute respiratory syndrome
SWF	–	sovereign wealth fund
US	–	United States
VAR	–	vector autoregression
WHO	–	World Health Organization
WTO	–	World Trade Organization

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Executive Summary

Asia's economies are increasingly vital to each other—and to the world. Asia's output today roughly equals that of Europe or North America, and may well be 50% larger than theirs will be by 2020, in terms of purchasing power parity. The challenge for a prosperous and interdependent Asia is to strengthen and spread the benefits of regional cooperation while playing a substantial, constructive role in global economic leadership.

As Asia's economies have grown larger and more complex, they also have become more integrated—through trade, financial flows, direct investment, and other forms of economic and social exchange. Today, Asia trades about as much with itself as Europe and North America do with themselves. This study found that six measures of interdependence tracked for 16 major Asian economies have increased markedly since the 1997/98 Asian financial crisis. And a survey conducted for the study found that the region's opinion leaders welcome this interdependence and place a high priority on regional cooperation and integration.

Where markets lead, governments are following. The 1997/98 crisis underscored Asia's integration and shared interests and exposed weaknesses in the global policy architecture. The crisis gave impetus to emerging Asian regionalism and has already led to major intergovernmental initiatives. But Asia's official cooperation is still nascent. In time, Asia's institutions will need to address a wide range of problems that cannot be adequately handled by markets. The challenges include providing regional public goods, managing spillovers among economies, exercising Asia's influence in global economic forums, liberalizing trade and investment, and helping to improve national policies in which the region has a vital stake. Regional cooperation should not be pursued as a goal for its own sake, but as a tool for coping with the consequences of interdependence.

Dynamic and outward-looking Asian regionalism, consistent with the region's diversity and mindful of its stake in open global markets, will help to stabilize and power the world economy. Such regionalism is in everyone's interest. Indeed, in the global economic slowdown that is unfolding as this study goes to press, Asian cooperation—particularly on financial sector and macroeconomic policies—could provide an early example of Asia's growing capacity to contribute to economic progress both regionally and globally.

Integrating production

Asia's trade and investment ties are particularly advanced, and the regional integration of production has become central to Asia's leadership in global manufacturing. As production chains are broken into smaller steps, with each step produced in the most cost-efficient location, Asia's interconnectivity has become a key asset in attracting global investment and production. Asia is endowed with major production advantages—large and diverse labor forces, ample investment resources, and advanced technological capabilities—and can combine them efficiently due to low trade barriers and well-developed transport and communications links. Asia's intraregional trade has increased sharply, with parts and components trade playing an especially large role. The People's Republic of China (PRC) is often the hub of such production networks, but most regional economies participate in them. Asia's efficient production system is also closely tied to the global economy: a large share of the region's final goods exports is ultimately destined for European and North American markets.

The challenge for regional cooperation is thus twofold: to support the integration of Asia's production networks and to sustain an open, rules-based global system of trade and investment. This argues for using the region's influence vigorously to ensure the continued development of the global trading system. Yet with the World Trade Organization's Doha round deadlocked, many Asian economies have also turned to negotiating bilateral and plurilateral free trade agreements (FTAs). Substantial gains could be realized from consolidating the many FTAs into a single, region-wide one and from adopting best practices to guide future regional and subregional FTAs. Fostering integration to connect the region's economies also requires further investments in cross-border infrastructure—transport, communications, and energy systems.

Integrating financial markets

Asia is less integrated in finance than in trade. However, its financial markets are larger, deeper, and more sophisticated than they were a decade ago, and its legal and regulatory frameworks have improved. By several measures, Asia's financial integration has also progressed. However, most Asian funds are intermediated through distant global markets, despite the region's large savings and ample investment opportunities. A surprisingly low share of Asia's financial resources is invested in Asian assets. Deeper financial integration will depend on further improvements in the region's financial systems, including regulatory structures that generate confidence in financial institutions and protect investors. These improvements could lead to a virtuous cycle: greater investments in regional markets, including by Asian investors, would generate new products and services that make markets more efficient and attractive. Such a virtuous cycle could benefit many sectors, notably small and medium-sized enterprises, infrastructure development, and households.

Regional financial cooperation has increased markedly since the Asian financial crisis, notably through innovations such as the Asian Bond Markets Initiative (ABMI) and the Asian Bond Funds (ABF). But weaknesses remain. An immediate priority is to strengthen supervision, surveillance, and dialogue on financial markets; to this end, consideration should be given to creating a new, high-level "Asian Financial Stability Dialogue" to bring together finance ministries, central bank authorities, and other supervisors and regulators. This new institution would be useful to address financial market vulnerabilities and regulations, and to engage in dialogue with the private sector. Other priorities include steps toward the harmonization of financial regulations and the adoption of minimum standards that permit early mutual recognition of the standards, at least among subsets of economies. It will be also important to deepen and expand the ABMI and ABF, and to build a strong regional infrastructure for payments, settlement, and information exchange systems. And efforts should intensify to make national financial systems more efficient through the measured and prudent liberalization of capital accounts and cross-border financial service flows where these are still controlled.

Managing macroeconomic interdependence

With the growth of trade and financial ties, Asia's macroeconomic interdependence has also increased. The region's sensitivity to regional output shocks is rising and there is evidence of converging price movements. Over time, these trends are likely to reduce the extent to which Asia's economies are interconnected with those of Europe and North America, but so far the region's sensitivity to global shocks remains significant. Asia's macroeconomic policy settings currently show little evidence of cooperation—the region's strong and stable macroeconomic results in recent years reflect, in part, a favorable global environment. A challenging period may lie ahead. Global payments imbalances that appear increasingly unsustainable must be resolved. This will require major adjustments around the world; in Asia, it will mean reorienting output from exports outside the region to consumption and investment within it. And these shifts may need to occur rapidly if, for example, the current credit market turmoil and global slowdown deepen. The shifts could also be associated with large and potentially disruptive exchange rate adjustments. The challenge to Asian policy makers is to monitor global and regional developments closely, and to be prepared to act together if region-wide responses are appropriate.

Given its interdependence, Asia would benefit from strengthening its mechanisms for monitoring and potentially coordinating macroeconomic and exchange rate policies. Consideration should be given to a new central structure—such as an "Asian Secretariat for Economic Cooperation"—to support these and other functions with qualified, permanent staff. The current Economic Review and Policy Dialogue under the ASEAN+3 process should be further strengthened with agreements on the tools, indicators, and standards used to monitor economic activity. Governments might also explore early initiatives in policy coordination—for example, through ad hoc actions to manage a particular wave of exchange rate adjustments against third currencies, perhaps first by a subset of economies. To provide stronger tools for times of crisis, the Chiang Mai Initiative, the region's short-term financing facility, should be enhanced by making its arrangements multilateral and by easing constraints on their activation. The Secretariat could oversee the region's pooled foreign exchange resources and, in a crisis, negotiate economic policies with governments seeking support.

Making growth inclusive and sustainable

Asia's development has had a massive, positive impact on people's lives—most Asian economies have made remarkable progress in reducing poverty. Nevertheless, benefits have failed to reach significant numbers of people; in some countries, progress has lagged, especially on non-income measures; and sharp income disparities have emerged in some countries. Nearly all developing countries in the region share the challenge of making growth more inclusive. The policies that best address these issues are often national in scope, but the challenges also have important regional dimensions. Regional integration fosters inclusive development, both by boosting economic growth and by providing the resources for pro-poor policies. And the least developed countries in the region typically gain the most from it.

The battle for better lives begins with creating high-productivity jobs. Governments need to connect the poor to the thriving regional economy by eliminating labor market barriers, investing in workers' capabilities, and building infrastructure to connect disadvantaged regions with economic centers. Agricultural trade and aid focused on stimulating trade activities can play an especially important role, as the experience of the Greater Mekong Subregion shows. Rapid economic change also requires cost-effective and innovative social protection systems. And labor migration—within and among countries—can benefit both migrating workers and their hosts. Labor migration also needs to be managed carefully to ensure migrants' rights and to prevent human trafficking and forced labor.

Regional cooperation is equally essential for addressing a range of threats, including epidemics, natural disasters, and environmental degradation. Densely populated and closely integrated Asia needs world-class systems to monitor, prevent, and contain epidemics. It needs to cooperate to make responses to natural disasters faster, more effective, and less costly. And it needs to launch a common regional effort to control a wide range of cross-border environmental problems that are emerging as a consequence of rapid development.

Creating an architecture for cooperation

The case for greater cooperation in Asia is broad, deep, and compelling. The region's cooperative architecture today spans many forums, from subregional to interregional ones. They offer capabilities for addressing issues ranging from technical cooperation (such as on infrastructure projects) to broad global and interregional agreements (such as on information technology). These efforts are often centered on the Association for Southeast Asian Nations (ASEAN), which has a long history of and an advanced framework for regional cooperation. Together, the forums offer a multitrack, multispeed architecture that is well matched to the region's varied challenges and great diversity. This architecture also creates healthy competition among forums to prove their effectiveness.

It is premature to consider firm assignments of institutional functions to specific forums within the architecture—each has distinctive areas of comparative advantage. But ASEAN+3 (ASEAN and the PRC, Japan, and the Republic of Korea) is emerging as an especially useful coordinating unit: it benefits from ASEAN's experience and institutional support, incorporates Asia's three largest economies, and is generally closely integrated. ASEAN+3 is a logical venue for the proposed Asian Secretariat for Economic Cooperation. Asia's integration needs to remain flexible to accommodate groups with different or changing priorities and to absorb new economies and issues into the process. It also needs to focus on physical connectivity to ensure that, for example, the initiatives of ASEAN+3 or the East Asian Summit (ASEAN+3 and Australia, India, and New Zealand) are consistent with infrastructure plans of subregional groups and with the global policy framework emerging in interregional and global forums.

Eventually, Asian economies may have a single market with common regulations, a common currency, and substantial freedom of movement for workers. But immediate policy requires both a long-term vision and pragmatic initiatives that will show early, step-by-step results. Asia is likely to adopt some of the options identified in this study to facilitate integration, to manage its side effects, and to make growth more inclusive and sustainable. Asia's regionalism is becoming more confident in its potential to contribute to both regional and global welfare.

We are witnessing the beginnings of a strong, prosperous, outward-looking Asian economic community, regionally integrated yet connected with global markets, and with responsibility and influence to match its economic weight. Emerging Asian regionalism is a powerful historic force—a partnership for regionally and globally shared prosperity.

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Chapter 1

Why Asian regionalism?

The center of gravity of the global economy is shifting to Asia. The region's economy is already similar in size to those of Europe and North America, and its influence in the world continues to increase. In many Asian countries, the cycle of poverty has been broken; in others, this historic aim is within sight. Asia's extraordinary success has brought new challenges—while rapid economic growth remains a priority, citizens demand that it also be sustainable and more inclusive. And Asia is now so important to the world economy that it must also play a larger role in global economic leadership. Regional economic cooperation is essential for addressing these challenges.

Asia's economic rise is unprecedented. The region is home to over half the world's population, produces three tenths of global output (in terms of purchasing power), and consistently records the world's highest economic growth rates. The Asian "miracle" (World Bank 1993) did not end with the 1997/98 financial crisis a decade ago; for some countries, it marked the beginning of renewed acceleration. The question is no longer whether Asia will be central to the 21st century economy, but rather how it will exercise its prominent role and how its dependence on the rest of the world has decreased.

Regionalism is a relatively new aspect of Asia's rise.[1] Asia's economies are increasingly connected through trade, financial transactions, direct investment, technology, labor and tourist flows, and other economic relationships. This study focuses on 16 Asian economies that are already, in some respects, as closely intertwined as Europe's single market. This "Integrating Asia" (see definitions in the appendix to this chapter) accounts for 87% of the region's population and 96% of its output (Table 1.1)—hence, it is often

[1] "Regionalism" and related terms used in this study are defined in the Glossary.

referred to simply as Asia[2]—and conducts more than half of its trade with itself. It includes some of the world's wealthiest economies and some of its poorest, large continental powers as well as small city-states, continuously independent countries and former colonies. Its strength derives from the openness, diversity, and dynamism of its interconnected economies.

Asian economies are principally connected through markets—but where markets lead, governments are following. Asian leaders have committed to work together more closely and have already taken concrete steps in some areas. The 1997/98 financial crisis, in particular, was an important catalyst for this new regionalism and gave rise to a range of new initiatives. These have not sought to replicate the institutions of the European Union (EU), but have rather focused on finding new and flexible forms of cooperation that reflect the region's diversity and pragmatism. Nor are Asia's regional initiatives intended to replace global relationships, but rather to complement them. It is not a matter of pulling up the drawbridge, but of building bridges that connect Asian economies together as well as to the rest of the world.

The stakes could not be higher. A dynamic and outward-looking Asian regionalism could bring huge benefits not just to Asia, but to the world. It could help sustain the region's growth, underpin its stability, and—with the right policies—reduce inequality. And it could help marshal a common response to major new challenges that often arise suddenly and unexpectedly. As this study goes to press, for instance, Asia is grappling with the wrenching economic and financial uncertainty sparked by the global credit crunch since August 2007, several devastating natural disasters, and the pressing need to ensure affordable food supplies throughout Asia. A vibrant, integrated Asia could bring the region's immense intellectual and economic resources to bear on these and tomorrow's challenges. And it could help power and stabilize the global economy by boosting productivity, raising living standards, and reducing poverty everywhere. A stable, cohesive, and productive Asia is thus in everyone's interest.

This study draws on the 42 years of experience of the Asian

[2] East Asian economies dominate the list of Integrating Asia because of their long-standing commitment to outward-oriented development. Their regional links are deeper than those of South, West, or Central Asia. However, this is changing. India has substantially realigned its policies toward integration with global and Asian markets, and other Asian countries are also following suit.

Table 1.1. Integrating Asia: basic indicators 2007

Economy	Population (million)	Gross domestic product (GDP) $ billion (2007)	$ billion Average growth rate (1986–2006)	per capita (2007)	per capita Average growth rate (1986–2006)	Trade/GDP (2006, percent)
Brunei Darussalam	0.4	12	1.5	30,750	-1.1	90.4
Cambodia	14.2	8	8.5	579	6.2	120.5
China, People's Republic of	1,321.5	3,241	9.7	2,452	8.6	66.0
Hong Kong, China	6.9	207	5.3	29,846	4.2	346.9
India	1,138.0	1,166	6.3	1,025	4.4	32.5
Indonesia	225.4	433	5.2	1,922	3.7	50.0
Japan	127.9	4,380	2.2	34,246	1.9	28.2
Korea, Republic of	48.5	970	6.5	20,246	5.7	71.5
Lao People's Democratic Republic	5.8	4	6.0	696	3.6	60.8
Malaysia	27.2	187	6.4	6,868	3.8	195.7
Myanmar	57.0	11	5.2	193	3.6	56.9
Philippines	88.7	145	4.1	1,634	1.8	84.7
Singapore	4.6	161	7.0	35,076	4.5	386.2
Taipei,China	23.0	383	5.6	16,680	4.7	130.3
Thailand	65.7	246	6.1	3,737	4.8	125.7
Viet Nam	86.4	71	7.0	824	5.2	138.0
Integrating Asia	**3,241.4**	**11,626**	**4.1**	**3,587**	**2.6**	**62.5**
Total Asia	3,714.0	12,081	4.0	3,253	2.5	62.9
European Union	461.3	16,586	2.4	35,958	2.0	64.3
United States	301.1	13,841	3.1	45,963	2.0	22.4
World	**6,615.0**	**50,609**	**3.8**	**7,651**	**1.7**	**50.5**

GDP = gross domestic product.
Notes:
GDP growth rates are calculated at constant 2000 US dollar prices.
World GDP for 2007 was estimated by ADB staff based on IMF 2008.
Total Asia includes Integrating Asia plus Afghanistan, Bangladesh, Bhutan, Fiji Islands, Georgia, Kiribati, Kyrgyz Republic, Marshall Islands, Federated States of Micronesia, Mongolia, Nepal, Pakistan, Papua New Guinea, Samoa, Solomon Islands, Sri Lanka, Tajikistan, Tonga, Uzbekistan, and Vanuatu.
Sources: Data from ADB 2007a. *Asian Development Outlook 2007*. Available: http://www.adb.org (accessed March 2008); and World Bank 2007b. World Development Indicators Online. Available: http://www.worldbank.org (accessed March 2008).
GDP data for Brunei Darussalam for 2006 and 2007 are ADB staff estimates based on national sources.
GDP data for Myanmar for 2005, 2006, and 2007 are ADB staff estimates based on the Economist Intelligence Unit 2008.
GDP data for Taipei,China are sourced from the Directorate General of Budget, Account and Statistics, Executive Yuan. Available: http://eng.stat.gov.tw (accessed March 2008).
GDP series for Cambodia start from 1994.

Development Bank (ADB) in financing, analyzing, and advising on Asian economic growth. This knowledge base provides a unique perspective on Asia's economic integration and the potential contributions of its emerging regionalism. The report examines the drivers of integration, explores options for cooperation, and develops realistic strategies for building a dynamic and open Asian economic community. It thus provides insight on the great issues that will help to shape Asia's future.

How regionalism can benefit Asia

Regional cooperation, effectively structured and implemented, is a powerful new tool in Asia's policy arsenal. It can help Asia address regional challenges as well as provide stronger foundations for its global role. An integrated Asia can

- link the competitive strengths of its diverse economies in order to boost their productivity and sustain the region's exceptional growth;
- connect the region's capital markets to enhance financial stability, reduce the cost of capital, and improve opportunities for sharing risks;
- cooperate in setting exchange rate and macroeconomic policies in order to minimize the effects of global and regional shocks and to facilitate the resolution of global imbalances;
- pool the region's foreign exchange reserves to make more resources available for investment and development;
- exercise leadership in global decision making to sustain the open global trade and financial systems that have supported a half century of unparalleled economic development;
- build connected infrastructure and collaborate on inclusive development to reduce inequalities within and across economies and thus to strengthen support for pro-growth policies; and
- create regional mechanisms to manage cross-border health, safety, and environmental issues better.

The opportunities are clear, which is why regional integration deserves a high priority in national policy making. Yet the challenge of cooperation should not be underestimated; it will require trust, innovation, and compromise—and, most likely, time. Policy makers at the highest levels appear committed to pushing the regional agenda forward, but considerable leadership and energy are needed to achieve results.

These benefits from cooperation could extend also to developing Asian economies that are not yet part of the region's integrating core. Indeed, in relative terms, newcomers to regional integration have the most to gain from the expanded opportunities for economic development that it provides. Hence, an important aim of this study is to make the case for integration to countries that have not yet adopted an outward-oriented development strategy and to provide guidance on how to build stronger regional connections.

How Asian regionalism can benefit the world

The rest of the world could benefit, too. So long as Asia's economies continue to integrate not just with each other, but also with the rest of the world, sustained Asian dynamism, strengthened by regional cooperation, could bolster Asia's role as a new and stabilizing engine of global economic growth. There are many reasons why Asia is likely to remain outward-looking—not least because its economy is in large part built on economies of scale and scope in manufacturing and so requires global markets to perform at its potential. Indeed, because an integrated Asia will continue to have a powerful stake in the global economy, it would have both an incentive and the leverage to play a bigger role in keeping global markets open and vibrant. An integrated Asia can

- generate productivity gains, new ideas, and competition that boost economic growth and raise incomes across the world;
- contribute to the efficiency and stability of global financial markets by making Asian capital markets stronger and safer, and by maximizing the productive use of Asian savings;
- diversify sources of global demand, helping to stabilize the world economy and diminish the risks posed by global imbalances and downturns in other major economies;
- provide leadership to help sustain open global trade and financial systems; and
- create regional mechanisms to manage health, safety, and environmental issues better, and thus contribute to more effective global solutions of these problems.

While Asian regionalism is primarily motivated by the desire to advance welfare in the region, it would not do so by detracting from development elsewhere. On the contrary, Asian regionalism can help to sustain global economic progress at a time when other major regions are reaching economic maturity.

1.1. The economics of regionalism

The economics of regionalism have a complex and troubled history. In the 1930s, countries created preferential trade blocs in an attempt to shelter their economies from the Great Depression. Several countries established discriminatory currency blocs with strict exchange controls against outsiders. Far from helping, these arrangements led to the collapse of international trade and financial flows, accelerating the downward spiral of economic activity. This experience was foremost in the mind of the architects of the post-war global economic system as they adopted the principle of nondiscrimination as a central pillar of the General Agreement on Tariffs and Trade (GATT), the forerunner of the World Trade Organization (WTO). Many economists and policy makers remain skeptical about regionalism because of its potentially negative impact on the multilateral trade and financial system.

The case for regionalism therefore has to be carefully formulated. Regionalism must not lead to protectionist blocs—a "fortress Asia" is no more desirable than a "fortress Europe" or a "fortress North America" would be. But the open, outward-oriented regionalism that is emerging in Asia can avoid posing such a threat. Just as the absence of barriers to commerce within national economies—that is, among the states and provinces of countries such as the People's Republic of China (PRC), India, Germany,[3] and the United States (US)—is generally beneficial, so too is the creation of a market spanning several national economies.[4] Much of the evidence assembled in this report suggests that Asia has—and will continue to have—a fundamental stake in both regional and global integration.

The case for collective action arises from market failures that reduce economic welfare in the absence of official measures. The case for regional cooperation is still more specific: it addresses problems that are inherently regional in scope or, for other reasons, cannot be solved at a global or national level. Rapid regional growth and integration generate new commercial opportunities and demands for governmental cooperation and institutional development. But

[3] The 1834 Zollverein, a customs union of the 18 small states that eventually formed Germany, is an early example of the elimination of barriers in territories that later also formed a political union.

[4] The potential value of this approach is recognized in the multilateral trading system: Article XXIV of the General Agreement on Tariffs and Trade (GATT) permits the establishment of free trade areas, provided that they encompass "substantially all the trade between the constituent territories" and do not increase the barriers faced by excluded countries.

because regional action could introduce new distortions, global cooperation is often preferable. In practice, though, reaching and implementing global agreements is difficult, and international market failures that ideally ought to be addressed globally often are not. Regional solutions can be better targeted and are often more achievable. Important priorities for regional collective action are as follows:

- **Provide public goods that are unlikely to be produced by markets or individual economies.** These include measures to head off international epidemics, respond to natural disasters, and develop and disseminate knowledge, including technological and scientific findings as well as policy experience in areas such as financial regulation, pensions, and poverty reduction.
- **Manage the spillover effects of economic activity and policy among connected economies.** These inevitably grow with deeper economic integration. The regional contagion observed during the 1997/98 financial crisis is an important example, as concerns about liquidity and financial management in one country led to runs, speculative attacks, and dislocation in others. But routine macroeconomic changes—such as interest rate or currency movements—can also have significant impacts. This calls for monitoring regional macroeconomic activity as well as for policy dialogue. Cross-border effects may also be significant in many other policy areas, notably the environment and migration.
- **Coordinate regional policy approaches to projects or decisions that affect several economies.** Such efforts can range from the palpable need to cooperate on investments in trade-oriented transport, communications, and policy infrastructure links to more complex initiatives, such as harmonizing regional approaches in international forums. For instance, the combined efforts of Asian economies could significantly enhance the prospects for a successful conclusion of WTO's Doha Round, an outcome that would benefit Asia and the world at large.
- **Liberalize trade and investment beyond levels achievable through global negotiations.** This can be accomplished by establishing rules and institutions that enable countries to further integrate markets and by helping to harmonize standards, regulations, and processes so that businesses can operate more effectively in different economies.

- **Add value to national policy making**. Efforts can include sharing best practices and highlighting priorities that may run counter to domestic special interests, such as measures to enhance competition and regulatory oversight, reduce poverty and inequality, and control environmental externalities.

The case for regionalism is neither automatic nor self-evident; goodwill among countries does not necessarily make for good economic policy. Regional cooperation may be less desirable than global cooperation, and it may even be worse than inaction. Theoretically, removing some barriers could reduce welfare rather than increase it. Regional cooperation is therefore not a goal to be pursued for its own sake; it is a means for achieving more fundamental objectives. But, subject to these cautions, concerted regional action is a powerful—and, in some cases, essential—tool for promoting efficient regional economic development.

1.2. The challenge of cooperation

Asia's growing economic interdependence provides many opportunities for cooperation. These are divided into four major areas in this study: (1) trade, investment, and the integration of "real" economic activity; (2) financial integration; (3) macroeconomic policy links; and (4) shared social and environmental concerns. The study analyzes the progress of market-based integration in each of these areas. It also explores opportunities for intergovernmental cooperation—or, in economic terminology, identifies potential market failures and coordination problems that are best addressed through regional collective action. It additionally examines the architecture of arrangements that might enable such collaborations. The framework of this analysis is summarized in Table 1.2.

Despite the compelling case for cooperation, marshaling governments' efforts across this vast, diverse region is a daunting challenge. The examples of the EU and, to a lesser extent, the North American Free Trade Agreement (NAFTA) highlight some of the difficulties involved. But Asia is not Europe or North America; its economy, history, and politics are different. Some types of integration—for example, trade—are deeper in Asia today than they were in Europe in the early stages of European regionalism in the 1950s and 1960s. But other areas—monetary policy, for instance—still involve largely independent national decisions. While Asia can draw on other regions' experience, Asian regionalism is ultimately likely to

Table 1.2. Analytical framework for regional cooperation

	Manage regional spillovers and externalities	Provide regional public goods	Address regional coordination problems
Trade and investment	• Establish compatible product standards.	• Maintain an open, predictable, and fair framework for trade and cross-border investment.	• Represent regional views in global trade and investment forums. • Facilitate investment in infrastructure (hard and soft) for connectivity.
Financial markets	• Establish rules to protect regional markets against financial contagion. • Establish compatible financial regulations.	• Establish institutions and reserves to avert and manage financial crises. • Improve the legal and informational environment for regional investment.	• Represent regional views in global financial forums. • Develop compatible trading platforms and institutions.
Macroeconomic policy	• Coordinate macroeconomic and exchange rate policies.	• Monitor macroeconomic activity, trends, and risks.	• Facilitate solutions to global imbalances and other macroeconomic issues.
Social and environmental policy	• Control cross-border environmental externalities. • Ensure fair treatment of migrant workers.	• Prevent or manage spread of diseases and other public threats. • Pool know-how and experience on policy making. • Share environmental technology.	• Generate concerted commitment to Millennium Development Goals. • Promote social progress through regional initiatives.

Source: Asian Development Bank.

follow a distinctive blueprint, building on Asian economic priorities and based on an Asian vision for building a regional community.

Asia's complexity

This vision is just beginning to take shape, amid spirited debate. Asia comprises several powerful countries and centers of economic activity, with many shared economic priorities, but also some diverging ones. At times, these differences are amplified by history and politics. The price of cooperation is the loss of some national sovereignty and the narrowing of policy options for pursuing purely national objectives. It is understandably difficult for large, successful, and independent economies to make such compromises, and ultimately to pool some sovereignty within regional institutions. Cooperation is therefore likely to evolve gradually, with different groups of countries progressing at varying speeds, using several frameworks and forums to address subsets of policy interests. Such a multitrack, multispeed approach is likely to offer the most efficient framework for cooperation in Asia.

Asia's approach to regionalism is likely to have other distinct characteristics as well. The region's policy-making style is typically pragmatic and cautious. Cooperation is primarily aimed at making markets work better and tends to be limited to specific initiatives and objectives. Although intergovernmental dialogue at all levels has greatly increased, formal regional institutions remain relatively underdeveloped. These are likely to gain traction only insofar as they promise and, eventually, deliver tangible benefits—not just to elite groups, but to the population as a whole. The public appears to have positive expectations of regionalism. A study conducted for this report, based on a region-wide survey of opinion leaders, indicates that Asians generally see regional integration as beneficial, a strategy for enhancing the welfare of participating countries while leaving others no worse off. The survey is discussed in Box 1.1.

Box 1.1. Perceptions of economic interdependence in Asia

Are Asian leaders positive about regional cooperation? Yes, according to a recent survey of 600 Asian opinion leaders conducted by the Asian Development Bank. Respondents believe that the advantages of closer economic relations within Asia outweigh the costs, and they support the creation of an Asian economic community. Their approach is pragmatic: they favor a step-by-step approach to integration and believe that regionalism provides opportunities for "win-win" outcomes throughout the region (Capannelli 2008).[1]

[1] The survey was conducted in August–September 2007 and collected responses from 600 Asian opinion leaders in business, media, government, and academia. The study covered 12 countries, with roughly equal representation from East Asia, Southeast Asia, and South Asia.

Assessment of current economic interdependence

Asian opinion leaders see regional economic relations as strongest in trade and investment, and reasonably significant in money and finance. They believe that governments are not sufficiently active in developing regional mechanisms for coping with health, environmental, and other cross-border challenges. And they see great potential, but relatively little progress, in developing cross-border infrastructure. Respondents from Southeast Asia generally see economic relations with neighbors as more intense than those from other subregions do.

Regional integration is viewed as benefiting Asia through faster economic growth, deeper integration with the world economy, and a

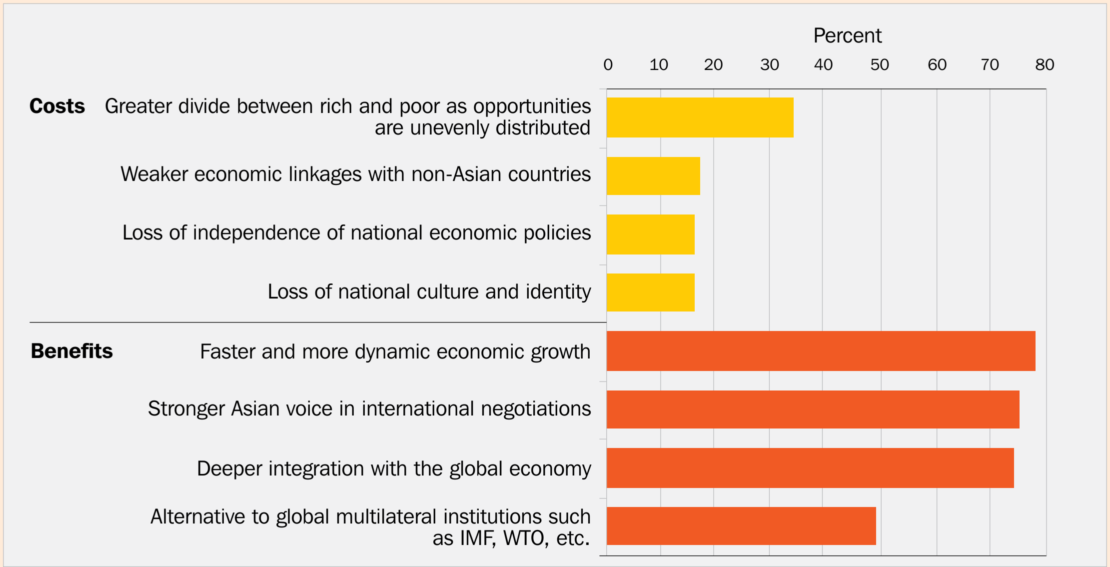
Box 1.1. continued

stronger Asian voice in global economic forums (Figure B1.1). The potential costs of integration—such as a greater economic divide between rich and poor and the loss of some autonomy in national economic policy making—are judged to be substantially smaller than its benefits.

Moving ahead: a path for integration

Respondents see market forces as the main driver of regional integration. But they believe that intergovernmental forums can complement them and see value in creating new regional institutions and strengthening existing ones. These institutions should focus on macroeconomic surveillance and facilitating regional economic policy dialogue, providing liquidity and other financial support in times of crisis, and developing a regional common market. They also favor common solutions to environmental problems; developing regional infrastructure in

Figure B1.1. The benefits of regional integration outweigh its costs
Asian opinion leaders' replies to survey questionnaire (Aug–Sep 2007)
Percent of respondents answering "high" or "very high"



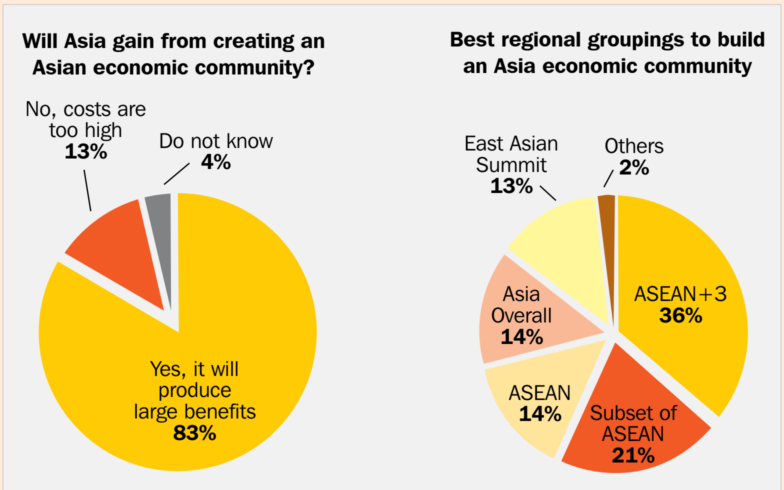
transport, energy, and telecommunications; and bilateral and plurilateral free trade agreements among Asian economies.

While over four fifths of respondents favor creating an Asian free trade and investment area and an Asian economic community, less than two fifths support a common Asian currency. Among potential regional groupings, ASEAN+3 was considered in the best position to build an Asian economic community (Figure B1.2).[2]

While the survey mainly focused on economic issues, respondents were also asked about their sense of belonging to the region. Most rated their attachment to their own country as strongest, and that to the global community as their weakest. A sense of belonging to Asia or its subregions was not usually particularly strong, suggesting that for now regional cooperation is mainly favored for pragmatic reasons.

[2] ASEAN+3 comprises the ASEAN members Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam—plus the People's Republic of China, Japan, and the Republic of Korea. The East Asian Summit includes ASEAN+3 members plus Australia, India, and New Zealand.

Figure B1.2. Creation of an Asian economic community
Asian opinion leaders' replies to survey questionnaire (Aug–Sep 2007)
Percent of responses



ASEAN = Association of Southeast Asian Nations.
Note: Asian Development Bank staff elaborations of the perception survey (Capannelli 2008).

Risks

Asia's bright economic prospects provide a supportive environment for regional cooperation. But building an Asian economic community is a long-term undertaking, and the economic climate cannot be expected to remain consistently favorable.

Some risks are known. Global demand and financial stability are important to Asia and could be compromised by a deepening credit crisis; a falling dollar; a sudden unwinding of current account imbalances; and/or rapidly rising energy, food, and other commodity prices. Other shocks, including adverse effects of global warming, could become more severe over time. In Asia as well, after a long period of economic expansion (in some countries stretching back nearly two decades), there are bound to be financial reversals and economic slowdowns due to business cycles whether they originate in the region or elsewhere, and to longer term challenges such as excess savings and population ageing. New health or security threats could make the flow of people and goods more difficult and expensive. Environmental damage could result in radical changes in economic policies. Social instability could generate tensions and uncertainty that overwhelm economic progress. Many of these risks can be diminished with adequate foresight and cooperation, and some strategies for doing so are addressed by this study. But not all risks can be known, and the unexpected often has the greatest impact.

Unanticipated developments could set Asian regionalism back—or accelerate it. The 1997/98 financial crisis stimulated greater regional cooperation and a greater commitment to integration. Asian governments now realize more clearly that they face a wide range of common challenges—such as financial contagion as well as deadly diseases like severe acute respiratory syndrome (SARS) and avian flu—and have much to gain from addressing them jointly.

In some respects, regional cooperation is a form of insurance. Potential problem areas can be monitored, for instance, through Asia's new mechanisms for macroeconomic policy surveillance. Coordinated policy responses can head off problems or at least minimize their impact. Cooperative mechanisms can even limit the impact of risks that cannot be identified in advance. The dense network of consultative arrangements that Asia is building can provide an early warning system and rapid response mechanism for emerging threats.

1.3. Plan of the study

This study examines the economic rationale for Asian regionalism, with a focus on trade, financial, macroeconomic, social, and related issues such as the environment and population ageing. It assembles evidence on deepening ties among Asian economies and offers options for regional policy, including the architecture of regional cooperation. These are challenging tasks, in part because the ties that bind the region together are complex and interdependent. Regional cooperation must be viewed as a comprehensive strategy for achieving wide economic and social goals. The time horizon of the study is 2020, but it will be also necessary to look further ahead to set the context for the region's policy in the longer term.

Chapter 2 provides an overview of Asian regional integration and opportunities for regional cooperation. The subsequent four chapters address the functional channels that connect Asian economies: trade and investment (Chapter 3), financial markets (Chapter 4), macroeconomic policies (Chapter 5), and social and environmental issues (Chapter 6). These threads are brought together in an analysis of the architecture of regional cooperation (Chapter 7). The concluding chapter (Chapter 8) considers the implications of the study for the way ahead.

Chapter 1: appendix

Integrating Asia: a definition

How far might an Asian economic community extend? Asia's geographical boundaries are not generally agreed, and geography alone will not determine the locus of regional cooperation. Rather, the shape of "Integrating Asia" will be determined by the economic and political ties that connect its members and by the commitment that its governments make to cooperation. This study does not prejudge those patterns, although Chapter 7 provides an overview of some of the options. Cooperation is likely to remain fluid for some time, with different groups of countries using different structures to address shared interests.

This study focuses on a group of 16 economies that represent Integrating Asia in the sense that they already have substantial regional economic ties. The group includes the 10 members of the Association of Southeast Asian Nations (ASEAN)—Brunei Darussalam, Cambodia, Lao People's Democratic Republic, Indonesia, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam—as well as People's Republic of China; Hong Kong, China; India; Japan; the Republic of Korea; and Taipei,China.

This group is somewhat arbitrary. Some scholars might argue that it should include other West and South Asian economies, even though their primary economic connections are so far with other regions. A case could also be made for including countries in Central Asia that are developing subregional ties but are still only loosely integrated with the region as a whole. Some might also wish to include Australia, New Zealand, and the Pacific, because their economic ties to the region are very strong, even though they lie some distance from the Asian landmass. Indeed, all of these countries participate in one or more cooperative arrangements involving Asian economies.

Chapter 2

Asian Regionalism: Context and Scope

Chapter 2

Asian regionalism: context and scope

Asian regionalism is the product of economic interaction, not political planning. As a result of successful, outward-oriented growth strategies, Asian economies have grown not only richer, but also closer together. In recent years, new technological trends have further strengthened ties among them, as have the rise of the PRC and India and the region's growing weight in the global economy. But adversity also played a role. The 1997/98 financial crisis dealt a severe setback to much of the region, highlighting Asia's shared interests and common vulnerabilities and providing an impetus for regional cooperation. The challenge now facing Asia's policy makers is simply put yet incredibly complex: Where markets have led, how should governments follow?

In the early stages of Asia's economic takeoff, regional integration proceeded slowly. East Asian economies, in particular, focused on exporting to developed country markets rather than selling to each other. Initially, they specialized in simple, labor-intensive manufactures. As the more advanced among them graduated to more sophisticated products, less developed economies filled the gap that they left behind. The Japanese economist Akamatsu (1962) famously compared this pattern of development to flying geese. In this model, economies moved in formation not because they were directly linked to each other, but because they followed similar paths. Since these development paths hinged on sequential—and sometimes competing—ties to markets outside the region, they did not initially yield strong economic links within Asia itself.

Now, though, Asian economies are becoming closely intertwined. This is not because the region's development strategy has changed; it remains predominantly nondiscriminatory and outward-oriented. Rather, interdependence is deepening because Asia's economies have grown large and prosperous enough to become important to each other, and because their patterns of production increasingly depend on networks that span several Asian economies and involve wide-ranging exchanges of parts and components among them. Asia is at the center of the development of such production networks because it has efficient transport and communication links, as well as policies geared to supporting trade. As these new production patterns tie Asian economies closer together, they also boost the international competitiveness of the region's firms.

Against this background, the financial crisis that swept through Asia in 1997/98—in this chapter, referred to simply as "the crisis"—put the region's interdependence into harsh new focus. Emerging Asian economies that had opened up their financial markets—Indonesia, the Republic of Korea, Malaysia, the Philippines, and Thailand—were worst hit, but nearly all Asian economies were eventually affected. Most then used the crisis as an opportunity to pursue wide-ranging reforms in finance as well as in other areas of weakness that the crisis exposed. Asia emerged with a greater appreciation of its shared interests and the value of regional cooperation. Since the crisis, Asia has become not only more integrated, but also more willing to pull together.

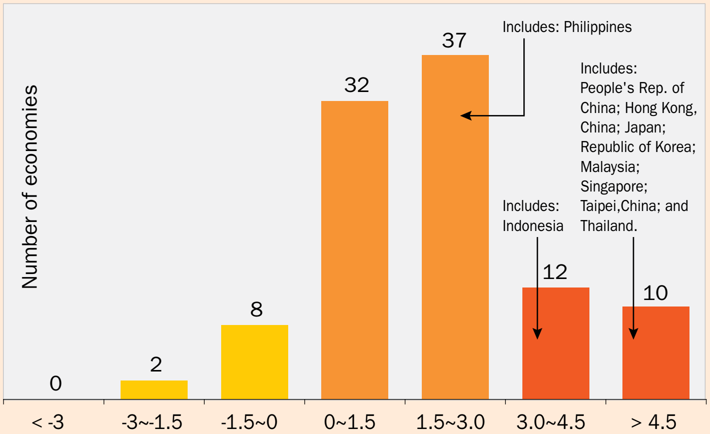
This chapter traces the progress of Asian integration and explores its implications for the future. It begins by exploring the connections between Asia's development patterns and economic integration. It then examines the challenges interdependence poses for policy, setting the stage for subsequent chapters.

2.1. Growth and integration

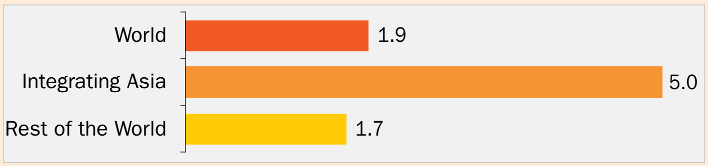
Asian regionalism is emerging against the backdrop of a remarkable half century of economic development. In the four decades from 1956 to 1996, East Asian living standards—as measured by real (inflation-adjusted) output per person—rose at a rate faster than has ever been sustained anywhere else. Of the 10 economies that recorded average rises of 4.5% a year or more during that period, 8 were in East Asia—as were all four that exceeded 5.0%. Other Asian economies rank in the upper tiers of the world's growth distribution. Over those four decades, living standards in the 16 integrating Asian economies analyzed in this study grew at an average of 5.0% a year, while the world as a whole averaged only 1.9% (Figure 2.1). Although many other countries have experienced rapid growth over several years (Hausmann, Rodrik, and Pritchett 2004; Jones and Olken 2005), this cluster of sustained, consistent outperformance is unprecedented.

Figure 2.1. Asia's exceptional growth record
World distribution of economies by long-term per capita growth rate

a. Average per capita GDP growth rate, 1956–1996



b. Average per capita GDP growth rate, 1956–1996



GDP = gross domestic product.
Source: CICUP 2007. Penn World Tables. Available: http://pwt.econ.upenn.edu/ (accessed October 2007).

These extraordinary results were achieved by economies that differed widely in size; incomes; endowments of natural, human, and capital resources; specialization patterns; political organization; language; culture; and history. While the economies' development has not resulted from a uniform strategy, the evidence suggests that their policies and growth trajectories involved basic similarities (World Bank 1993).

Flying in sequence

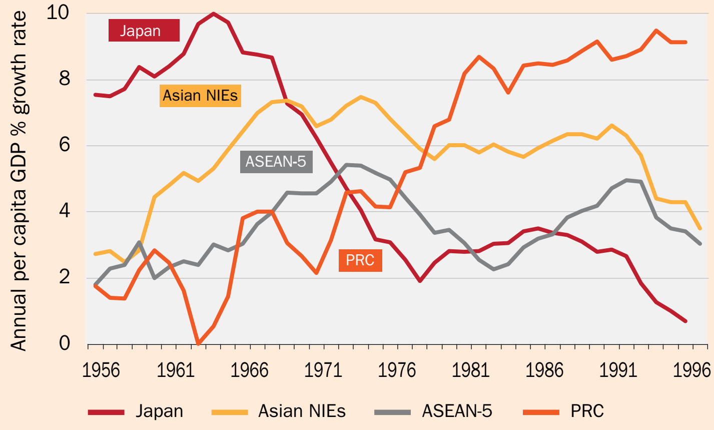
Competition in global markets is at the heart of what is now understood as the East Asian development model (Kuznets 1988). When the model emerged in the 1950s, its focus on labor-intensive exports was new; the prevailing "big push" development strategy favored large, coordinated investments in a bid to achieve economies of scale, usually in import-competing industries. East Asian development instead relied on the region's abundant asset of relatively well-educated, low-wage labor and in time leveraged it with ample savings and investment. At first, East Asia exported simple, labor-intensive manufactures at low prices to meet its urgent need for foreign exchange. Subsequently, it created a framework for sustained growth as economies imported, adapted, and eventually developed internationally competitive technologies. The region moved from labor-intensive products into many sophisticated activities—principally in manufacturing—which now include world-class process capabilities and prestigious global brands. Asia is also becoming competitive in service industries.

The model emerged in Japan in the aftermath of World War II. Although Japan was already industrialized, the war had devastated its economy and sharply lowered its wages. Access to markets in the US enabled Japan to develop labor-intensive exports, fuelling a dramatic rise in savings, investment, and economic growth. As Japan's exports shifted to more advanced products, East Asia's newly industrializing economies—Hong Kong, China; the Republic of Korea; Singapore; and Taipei,China—filled the gap for labor-intensive exports. In time, Southeast Asia and the PRC followed a similar trajectory. Although these waves differed in some respects, they produced dramatic spurts of growth, as Figure 2.2 shows. Average per capita income growth in Japan exceeded 5% a year from the 1950s on. The newly industrializing economies entered a similar high-growth phase in the early 1960s, followed by several Southeast Asian economies in the early 1970s and the PRC in the late 1970s. A new wave is now taking shape in other South and Southeast Asian economies.

These remarkable successes were achieved thanks to receptive global markets as well as sound national policies. Since the establishment of the GATT in 1947, eight rounds of international negotiations have slashed developed countries' barriers to manufactured imports. World trade has expanded 27-fold since 1950, three times faster than world output growth (WTO 2007). In this favorable environment, Asian economies took advantage of a wide range of global opportunities, and their connections with markets both inside and outside the region grew very rapidly.

By the time the East Asian model had become widely celebrated (World Bank 1993), it had been at work for four decades. Use of the model had raised incomes in many Asian countries and was widely emulated around the world. Opportunities for regional transactions

Figure 2.2. Successive waves of rapid development
Growth rates of per-capita GDP of selected Asian economies



ASEAN=Association of Southeast Asian Nations, GDP=gross domestic product, NIE=newly industrializing economy, PRC=People's Republic of China.
Asian NIEs include Hong Kong, China; Republic of Korea; Singapore; and Taipei,China.
ASEAN-5 economies include: Indonesia, Malaysia, Philippines, Thailand, and Viet Nam.
Source: CICUP 2007. Penn World Tables. Available: http://pwt.econ.upenn.edu/ (accessed October 2007).

increased, but so did the potential for intensified competition among exporters and resistance to exports in external markets.

As more countries adopted labor-intensive growth strategies, multinationals became adept at shifting production from one low-cost economy to another. The emergence of the PRC, given its sheer size, unsettled regional trading patterns. By the mid-1990s, the PRC accounted for 20% of Asian trade and 70% of the region's foreign direct investment (FDI) inflows. While the PRC emerged as a vigorous competitor, its growth also created new market opportunities for the region's finished products, raw materials, and especially intermediate inputs. In effect, the growth of the PRC helped to catalyze the development of regional production networks. Thus, while the PRC caused large and often difficult adjustments in the region's exports (Loungani 2000, Eichengreen and Tong 2006), it also injected new energy into Asian trade. Asian exports soared again after the crisis and came to be increasingly directed toward regional markets.

While East Asia's real sector grew more sophisticated, its financial sector remained relatively underdeveloped. In many countries, the financial sector had initially served as a conduit for official investment policies, with funds channeled to companies mostly through banks rather than through capital markets. With some notable exceptions, including two—Hong Kong, China and Singapore—the region's capital markets lagged behind their peers in other parts of the world (McKinnon 1993, Arestis and Demetriades 1997). Close banking relationships in turn led to high corporate leverage, and neither banks nor companies developed extensive expertise in managing risk.

The reform of East Asia's financial systems began well before the crisis, but the legacy of financial repression persisted. In the mid-1990s, several Asian economies deregulated their financial sectors and opened their capital accounts (Park and Bae 2002), following what was then a near-consensus strategy. Liberalization was widely advocated in the economic literature and by international organizations, and was embedded in the new services agreements of WTO. Liberalization unfolded initially in the benign context of booming economies and strong global financial markets, and it appeared to work—even without rigorous prudential regulation. Asian securities became desirable to international investors both because they were seen as intrinsically valuable and because they were thought to carry implicit government guarantees.

While financial deregulation promised substantial long-term benefits, in the short term, it created vulnerabilities. Capital account liberalization, in particular, complicated macroeconomic management. To stimulate investment and exports, East Asian governments had traditionally pursued mildly expansionary fiscal and monetary policies, along with stable exchange rates. Over time, these policies tended to lead to inflation and real exchange rate overvaluation. Most East Asian economies had experienced such cycles, usually ending in devaluation (Kim, Kose, and Plummer 2003).[5] But the liberalization of capital accounts made this policy mix riskier. When a government sought to defend its currency peg by raising interest rates, it would attract substantial inflows of money brought in for speculation, which could quickly flow out if the peg's viability came into doubt. Speculative attacks could force rapid devaluations and, through interactions with a vulnerable financial sector, severe financial and economic downturns.

The crisis and its legacy

Even with hindsight, though, the events of 1997/98 seem improbable. The crisis struck some of the world's most successful economies and,

[5] For example, Indonesia in 1978 and 1982, Thailand in 1979, the Republic of Korea in 1980, and Malaysia and Singapore in 1985.

in short order, brought down governments, threatened seemingly well-established firms and institutions, and imposed severe hardship on hundreds of millions of people. Yet it proved to be short, and economic activity rebounded quickly. The crisis also had a silver lining. It stimulated difficult policy and institutional reforms to remedy the structural weaknesses in East Asian economies that it had exposed. It also highlighted Asia's growing interdependence, weaknesses in the global financial system, and thus the benefits of Asian cooperation.

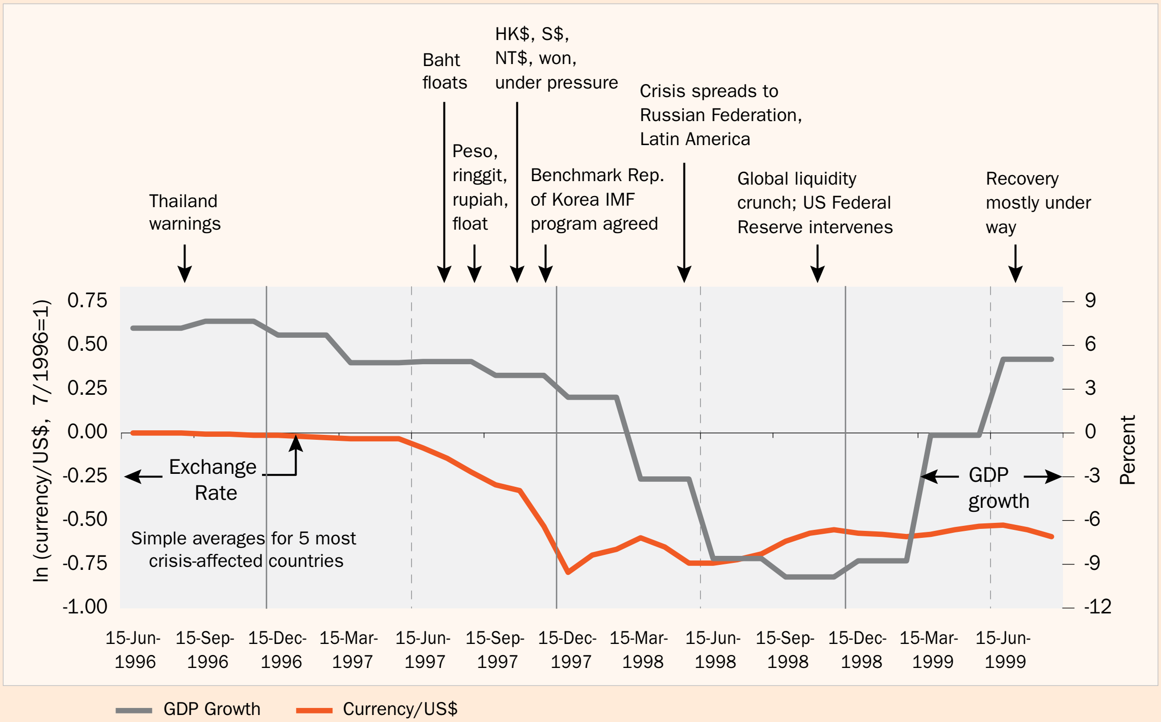
The details of the crisis, which are summarized in Figure 2.3, have been extensively analyzed.[6] On 2 July 1997, Thailand abandoned its short but costly defense of the baht against speculative attack. The baht plunged. The attacks then spread to Indonesia, Malaysia, the Philippines, and eventually Hong Kong, China; the Republic of Korea; and Taipei,China. Only the PRC and Hong Kong, China withstood the pressure to float or devalue. The attacks soon ended. Most East Asian currencies bottomed out in January 1998, although the repercussions of these events reverberated around the world and eventually led to a global liquidity crisis in October 1998. After an emergency cut in US interest rates, global liquidity returned almost immediately and the crisis was over (Marshall 2001).

The economic impact of the crisis was severe. The currency crisis led to a banking crisis in several economies, and the resulting collapse in credit led to deep recessions. These developments were exacerbated, in some countries, by a controversial deflationary policy mix (adopted in the context of International Monetary Fund [IMF] programs). The programs included monetary tightening, fiscal restraint, and prompt structural reform, accompanied by actions that closed failing financial and nonfinancial companies (Berg 1999). As Figure 2.3 shows, once credit markets recovered and macroeconomic policies were loosened, output rebounded. All of the affected economies—except Hong Kong, China; Indonesia; and Japan—expanded in 1999. Deep scars remained; poverty rates rose in many countries and, in most, growth did not return to precrisis levels.

Debate continues on whether the crisis was triggered by macro- or micro-economic fundamentals, or simply by too many investors "rushing for the exit" (Radelet et al. 1998). The suddenness, rapid geographic spread, and brevity of the crisis suggest that financial panic was important—perhaps dominant—but, as in most complex

[6] Good summaries of the chronology of the crisis are provided by Berg (1999), Joosten (2004), and World Bank (1998 and 2000).

Figure 2.3. Timeline of the Asian financial crisis
June 1996–June 1999



GDP = gross domestic product, HK$ = Hong Kong dollar, IMF = International Monetary Fund, ln = logarithm (natural), NT$ = New Taiwan dollar, S$ = Singapore dollar, US$ = United States dollar.
Source: Data from IMF various years. International Financial Statistics. Available: http://www.imfstatistics.org/ (accessed October 2007).

economic phenomena, multiple causes played a role (World Bank 1998). Stronger macroeconomic policies and financial systems in the affected economies might have prevented it; more decisive and appropriate action by the international financial community could have limited its damage (Ito 2007); and, had an Asian regional financing facility existed, it might have provided more timely and better-tailored support.

On the eve of the crisis, Indonesia, the Republic of Korea, and Thailand all faced macroeconomic imbalances and fragile financial sectors. Their current-account deficits—in the range of 1–3% of gross domestic product (GDP)—were perhaps not indefinitely sustainable, but could have been corrected gradually, given their histories of essentially sound fiscal policies and sustained economic growth. There is little doubt, however, that the vulnerability of the region's financial sector contributed to sudden and widespread liquidity concerns. The combination of capital account liberalization and new, untested, and inadequately supervised domestic financial institutions generated a "double mismatch." In effect, short-term, foreign currency debt was used to fund long-term, local currency assets (Kawai, Newfarmer, and Schmukler 2005). Once currencies began to depreciate and foreign lenders withdrew funds, a downward spiral ensued.

There were no "circuit breakers"—national or regional—to halt the downturn. As the double mismatch problem came to be widely understood, currency runs followed, saddling companies and financial institutions with unmanageable foreign currency liabilities. Because their debt was held by banks, bank runs followed. And because several countries shared these structural characteristics, bad news about one quickly led to a loss of confidence in others. The region, as a whole, lacked institutional arrangements or resources to tackle the crisis. So, despite the limited geographic extent of the crisis, only global institutions were in a position to help. The adequacy of their response, as already noted, is still debated, but the interventions clearly failed to restore confidence in the short run, and may even have aggravated the panic.[7]

While other Asian economies plunged into deep recession, the PRC was barely affected because its capital account was closed. Rather than devaluing or pursuing austerity, the PRC sustained aggregate demand by replacing exports with public investment. Growth scarcely dipped. To gain similar room for maneuver, Malaysia also restricted capital movements in September 1998. The precise impact of this decision is difficult to assess; by the time the capital controls were imposed, currency markets were stabilizing across the region. In any case, the controls did not prevent Malaysia from continuing to attract investment capital and may well have created additional space for expansionary policies that accelerated its recovery (Athukorala 2007a).

Asia soon turned the crisis into an opportunity for reform. At a national level, most of its economies gained experience in coping with financial distress and, as evidence in Chapter 4 will show, developed institutions to facilitate corporate restructuring and to make their financial sectors less vulnerable. Regionally, they established new mechanisms to provide emergency resources for future crises. The

[7] These initiatives were under the stabilization programs negotiated with the International Monetary Fund (IMF). Thailand closed 56 nonbank financial institutions in the early months of the crisis and took control of four domestic banks, Indonesia closed 23 banks, and the Republic of Korea closed 14 banks.

lessons of the crisis are summarized in the appendix to this chapter.[8] Two broad conclusions stand out.

- First, rapid development inevitably creates structural tensions, such as the lagging development of East Asia's financial sector, which tend to be masked by strong growth. Economic development requires the parallel development of sound institutions and good governance, but this does not happen automatically.
- Second, Asian economies have deeper connections with each other and a larger stake in their common macroeconomic stability than was previously understood. Integrating Asia requires strong cooperative mechanisms that aim to avoid crises (through surveillance) and to manage and contain those that arise (through liquidity support).

Renaissance

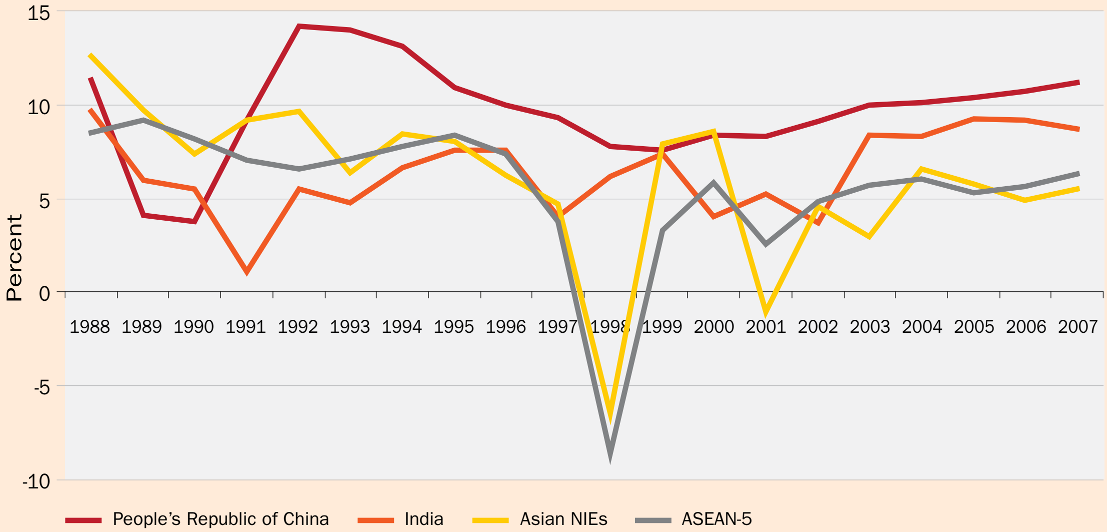
Since the crisis, Asia has reemerged as the world's most dynamic region, experiencing what a new World Bank study has called the East Asian renaissance (Gill and Kharas 2007). But the pattern of Asian development has changed. The PRC, India, and Viet Nam are now the region's—and the world's—fastest growing economies. Because the PRC and India are also the world's most populous countries, their rise dramatically changes the regional and global economic landscapes. Most other countries in the region are also growing solidly, if less spectacularly than before the crisis. Growth in the directly affected economies of the Association of Southeast Asian Nations (ASEAN), though disappointing compared to earlier periods, is also gradually strengthening (Figure 2.4).

The slowdown of growth in most crisis-affected economies reflects a decline in their rates of investment.[9] In the newly industrializing economies, for example, the share of investment in GDP fell from

[8] Much literature exists on lessons from the crisis. Some articles involve studies by IMF (2003) and individuals involved in the management of the crisis (Furman and Stiglitz 1998, Berg 1999, Fischer 2002). Others represent an Asian perspective (Kawai, Newfarmer, and Schmukler 2005; Ito 2007; Lee and Rhee 2007; Sussangkarn and Vichyanond 2007).

[9] This experience is consistent with recent research that finds that the aftereffects of a crisis can linger for many years, and that few economies make up the ground they lose during the crisis itself (Cerra and Saxena 2005). In more favorable cases, output growth returns to precrisis levels, but even then the output trajectory tends to remain permanently lower due to slow or negative growth during the crisis. In less favorable cases, the post-crisis growth rate also declines (Becker and Mauro 2006).

Figure 2.4. Asia's robust recovery
Real GDP growth rates of selected Asian economies



ASEAN = Association of Southeast Asian Nations, GDP = gross domestic product, NIE = newly industrializing economy.
Asian NIEs include Hong Kong, China; Republic of Korea; Singapore; and Taipei,China.
ASEAN-5 economies include Indonesia, Malaysia, Philippines, Thailand, and Viet Nam.
Source: ADB 2008c. Statistical Database System. Available: https://sdbs.adb.org/sdbs/index.jsp (accessed April 2008).

31% to 25%; in the largest ASEAN economies, from 30% to 23%. These declines are not due to a drop in the productivity of investment (at least as measured by the incremental capital-output ratio) or to inadequate savings. Rather, they reflect increased investment abroad. The cause of this investment shift remains a puzzle (Kramer 2006). It could be a decline in profitable investment opportunities at home, perceptions of continuing high risks at home, or a desire by governments to accumulate foreign exchange reserves as insurance—or perhaps a combination of all three. In the more advanced economies—Malaysia; Singapore; and Taipei,China—the decline in investment may represent a natural deceleration from rates that were unsustainably high. The investment slowdown (and prospects for its reversal in countries with potential for rapid growth) is further analyzed in Chapter 5.

Meanwhile, the PRC, India, and some smaller Asian countries have emerged as the region's growth engines (Srinivasan 2004). The PRC's true "great leap forward" since the late 1970s is without historical parallel (Lin 2004). This economy of 1.3 billion people has for the past 30 years grown at an annual rate of 9.7%—over three times faster than the world's. Within a generation, the PRC has been transformed from an inefficiently planned economy into a major, dynamic, mostly market-based economy. In 2005, the PRC accounted for 5% of the world economy at market exchange rates and 10% in terms of purchasing power. It is already the second-largest exporter in the world.

India's acceleration, although more recent, is also impressive. With 1.1 billion people and rapid population growth, India appears set to be the world's most populous country within two decades. Its economy has grown by 6.3% a year since major reforms were enacted in 1991, and almost as fast in the previous decade, following the reforms of 1980 (Ahluwalia 2005). In 2003–2006, growth averaged 8.5%. Yet India still accounts for only 2% of world output at market prices and less than 5% at purchasing power parity (PPP). As a relatively closed economy, it also contributes only 1% of world trade. But at current growth rates, these shares will increase rapidly. India's economy is not yet on a par with the PRC's, but its global impact is already significant, notably in services. India's infrastructure needs are vast and are likely to become a major driver of regional investment.

There are good reasons to be optimistic about the PRC's and India's prospects. Their large markets and low-cost, relatively well-educated labor forces make them top investment targets. They are especially attractive sites for new industrial clusters and production networks. And their growth is likely to energize industrial development throughout the region in sectors such as electronics, information technology, business services, textiles, chemicals, and pharmaceuticals (Ando 2005).

To compete with the PRC and India, as well as the other integrating economies of the EU, NAFTA, and other regional groups, the governments of smaller Asian economies—particularly in Southeast Asia—are now intent on building larger economic zones with transparent internal borders. In announcing ASEAN's commitment to a single market, senior officials explicitly noted the need to make markets large enough to compete with those of the PRC and India (*The Times of India* 2006). The absorption of Asia's giant economies into the regional and global trading systems presents one of the central challenges and opportunities facing Asia and the world in coming decades (Eichengreen 2006a).

Asia in 2020

Asia's outlook is bright. While long-term projections are inherently speculative and contested, Asia is likely to continue to outperform over the next decade. Whether the PRC and India can sustain the torrid pace of their recent growth is more debatable. While the investment firm Goldman Sachs expects the PRC to continue to grow by 10% annually and India by 9% annually, most other forecasters expect growth to moderate. The Japan Center for Economic Research, for instance, projects annual growth of 6% in the PRC and 5% in India. Projections by ADB (2007c) fall in between (Table 2.1). According to these projections, Asia's share of world output and income will expand from 28% in 2005 to 35% in 2020 in purchasing power parity (PPP)

Table 2.1. Population and GDP projections for 2020

Economies	Population (million)		GDP at market prices ($ billion)		GDP at market prices Average growth rate	GDP at PPP ($ billion)		GDP per capita (at market prices)	
	2005	2020	2005	2020	2005–2020	2005	2020	2005	2020
Cambodia	13.8	18.6	6	15	6.3	20	48	454	806
China, People's Rep. of	1,303.7	1,422.8	2,244	5,877	6.6	5,333	13,970	1,721	4,131
Hong Kong, China	6.8	7.1	178	353	4.7	243	483	26,094	49,718
India	1,101.3	1,295.7	779	1,748	5.6	2,341	5,255	707	1,349
Indonesia	218.9	259.5	287	611	5.2	708	1,506	1,311	2,355
Japan	127.8	123.3	4,549	5,806	1.7	3,870	4,939	35,604	47,088
Korea, Republic of	48.1	50.5	791	1,580	4.7	1,027	2,052	16,441	31,287
Lao People's Dem. Rep.	5.7	7.2	3	5	3.7	10	18	508	694
Malaysia	26.1	31.1	137	313	5.7	300	682	5,250	10,064
Philippines	85.3	103.3	99	166	3.6	250	421	1,158	1,607
Singapore	4.3	4.9	117	240	4.6	180	371	26,879	48,980
Taipei,China	22.7	24.4	355	641	4.0	590	1,067	15,674	26,270
Thailand	64.8	69.5	176	347	4.6	445	877	2,721	4,993
Viet Nam	83.1	97.5	53	117	5.5	178	394	637	1,200
Integrating Asia	**3,112.7**	**3,515.9**	**9,783**	**17,839**	**4.1**	**15,514**	**32,120**	**3,143**	**5,074**
European Union	450.6	472.1	13,568	19,176	2.3	12,743	18,011	30,111	40,619
United States	296.4	331.2	12,376	19,904	3.2	12,376	19,904	41,754	60,097
World	**6,128.1**	**7,462.1**	**44,309**	**75,001**	**3.6**	**54,976**	**93,057**	**7,230**	**10,051**

GDP = gross domestic product, PPP = purchasing power parity.
Note: "Integrating Asia" and "World" rows are not totals of columns above them.
Sources: Asian Development Bank staff projections based on International Comparison Program data from ADB 2007c. Available: http://www.adb.org (accessed March 2008); and World Bank various years. World Development Indicators. Available: http://www.worldbank.org (accessed March 2008).

terms, even though Japan's output is projected to grow by under 2% annually. By 2020, Asia's GDP (PPP—terms) is set to be more than 60% larger than the EU's or North America's. The PRC would account for much of this gain: its share of world output is expected to rise from 10% to 15%. At market prices, these increases are less dramatic but still very substantial.[10]

Asia's average per capita income would rise from some $3,000 in 2005 to about $5,000 (in 2005 dollars) in 2020, a level roughly equivalent to Malaysia's today. Per capita incomes would more than double in some countries, including the PRC, but would still fall far short of those in the world's wealthiest economies. Clearly, rapid income growth will remain a high priority for Asian countries in the foreseeable future.

These trends also suggest that regional integration will become increasingly important for Asia's growth. On the demand side, Asia will benefit from its own expanding spending power. On the supply side, its productivity will be enhanced by the advantages of its larger, more integrated economy. Asia's economic scale will offer exceptional opportunities for efficient production, including opportunities for production networks to connect varied cost-saving locations.

The wide-ranging implications of Asian growth are explored in subsequent chapters. Trade and financial activities are of particular interest because these sectors usually expand faster than output. Since trade and finance are also key drivers of regional integration, their continued development will increase interdependence. And because the region's growth and integration feed on each other, opportunities for cooperation should continue to expand rapidly, not just on regional issues but also with respect to the region's role in the world economy.

2.2. The rise of regionalism

Regionalism is multidimensional—it encompasses deepening interdependence in various spheres of economic activity, widening cooperative efforts, and a growing commitment to international collaboration. How is regional integration progressing in different areas? Which countries are participating most actively? Which

[10] The long-term projections were prepared by Asian Development Bank (ADB) staff in 2006 as background for strategic analysis. They have been adjusted to take account of new purchasing power parity (PPP) estimates (ADB 2007f). The underlying growth rates lie within a fairly broad range of estimates recently published by private and public research organizations.

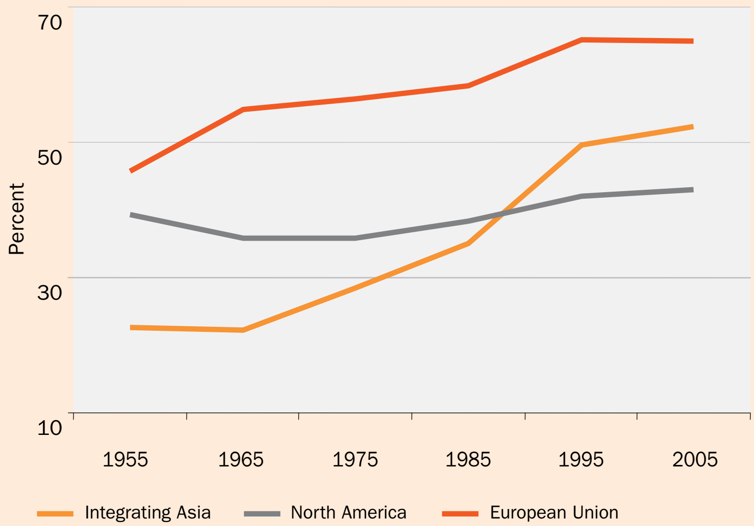
represent the region's strongest links to external markets? The evolution of Asian regionalism can be assessed on a wide range of measures, but each confirms a remarkable coming together of diverse economies.

Measuring interdependence

The most common measure of interdependence—the share of a region's total trade conducted within it—has risen in Asia from around a fifth in the aftermath of World War II to a third or so in the 1980s, and to over half in recent years (Figure 2.5). Asia is now broadly as interdependent in trade as the EU and North America each is. Indeed, Asia now trades more with itself than either the EU or North America did at the outset of their integration efforts.

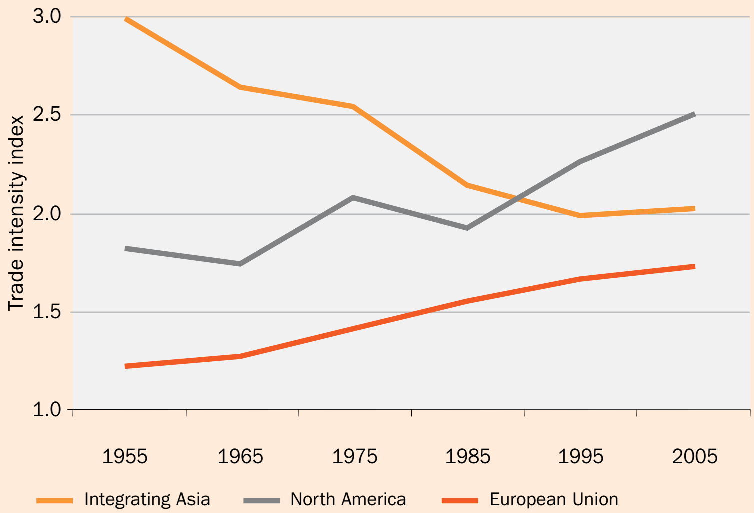
Figure 2.5. Increasing intraregional trade shares

Long-term trend: 1955–2005



Notes:
European Union includes all 25 members as of 2005.
Integrating Asia includes Brunei Darussalam; Cambodia; People's Republic of China; Hong Kong, China; India; Indonesia; Japan; Republic of Korea; Lao People's Democratic Republic; Malaysia; Myanmar; Philippines; Singapore; Taipei,China; Thailand; and Viet Nam.
The intraregional trade share is defined as: $(X_{ii} + M_{ii}) / (X_{i\cdot} + M_{i\cdot})$ where X_{ii} is exports of region i to region i; M_{ii} is imports of region i from region i; $X_{i\cdot}$ is total exports of region i; and $M_{i\cdot}$ is total imports of region i.
Source: Data from IMF various years. Direction of Trade Statistics. Available: http://www.imf.org (accessed October 2007).

Figure 2.6. Adjusting intraregional trade intensities
Long-term trend: 1955–2005



Notes:
European Union includes all 25 members as of 2005.
Integrating Asia includes Brunei Darussalam; Cambodia; People's Republic of China; Hong Kong, China; India; Indonesia; Japan; Republic of Korea; Lao People's Democratic Republic; Malaysia; Myanmar; Philippines; Singapore; Taipei,China; Thailand; and Viet Nam.
Intraregional trade intensity is defined as: $[(X_{ii}+M_{ii}) / (X_{i}.+M_{i}.)] / [(X._{i}+M._{i}) / (X..+M..)]$ where X_{ii} is exports of region *i* to region *i*; M_{ii} is imports of region *i* from region *i*; $X_{i}.$ is total exports of region *i*; $M_{i}.$ is total imports of region *i*; $X._{i}$ is total exports of region *i* to the world; $M._{i}$ is total imports of the region to the world; $X..$ is total world exports; and $M..$ is total world imports.
Source: Data from IMF various years. Direction of Trade Statistics. Available: http://www.imf.org (accessed October 2007).

A more demanding indicator of interdependence—the intensity of regional trade or the region's bias for trading with regional partners[11]—is plotted in Figure 2.6. Unlike the share of intraregional trade, the intensity indicator does not rise just because the region's weight is increasing in the world economy; it rises only if the share of a region's trade with itself rises more rapidly than its share of world markets. The regional intensity of trade started out high in the aftermath of World War II. While Asian economies were too small to trade much, they traded disproportionately with their neighbors; Asia's trade with Asian partners was around 4½ times as large as its trade with similarly-sized partners outside the region. This bias then

[11] The index is calculated by dividing the share of intraregional trade in its overall trade by the share of its trade in global trade.

declined until well into the 1990s, as Asian countries successfully penetrated markets around the world and acquired the means to import from them. Since about the time of the crisis, however, the regional intensity of Asia's trade has also begun to rise.

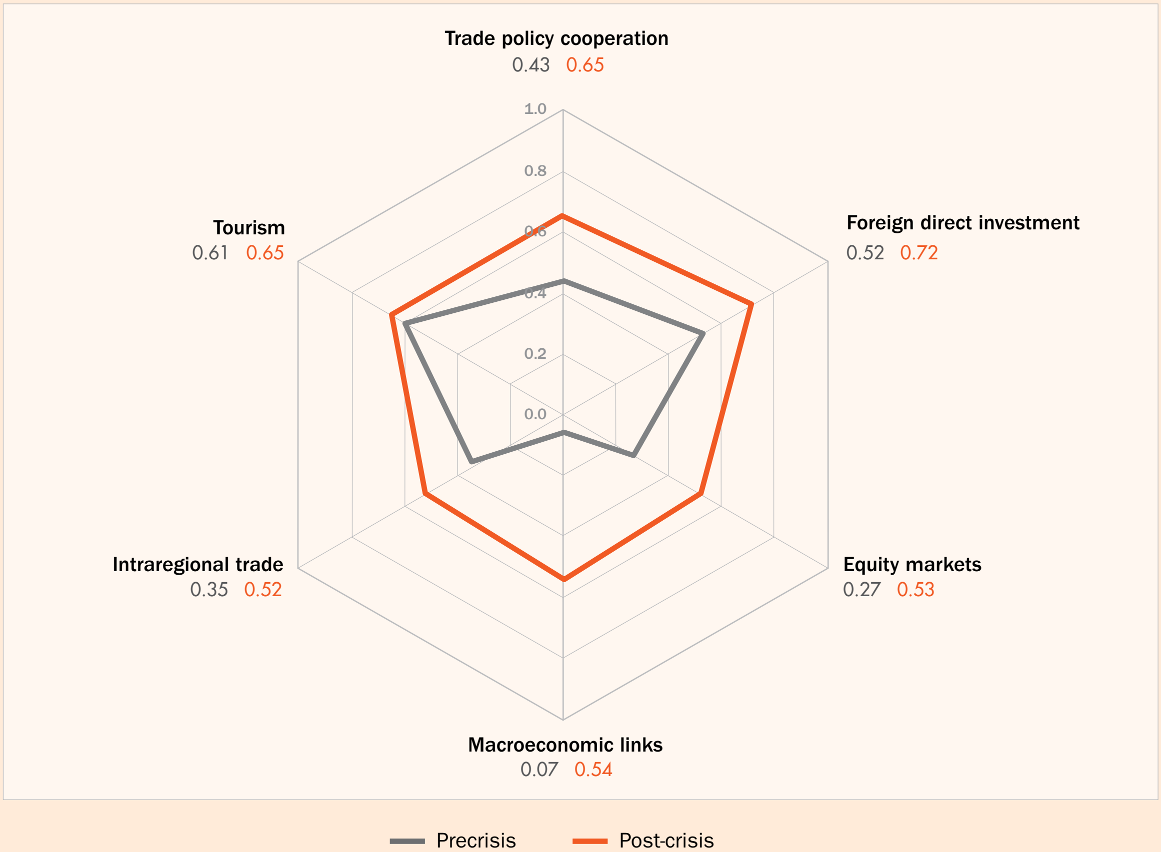
A still broader measure of interdependence needs to include other important channels such as direct investment, financial flows, macroeconomic links, and personal contacts (Chua 2004). To this end, data on six indicators of Asian economic integration were collected for each Asian economy before and after the crisis. These provide insight into Asia's integration by country and channel—a summary of the dimensions of regional relationships that will be explored in later chapters.

As with any summary measure, this evidence needs to be interpreted cautiously. Proxies for complex processes may be oversimplified; for example, the trade-policy-cooperation indicator does not capture the depth or significance of trade agreements nor the variety of other cooperative policies. And, of course, statistical correlations—used as indicators of co-movements in output growth rates and equity returns—could reflect common reactions to global forces rather than regional relationships.

Results for the six indicators, averaged across Integrating Asia, are presented in Figure 2.7. In analyzing these results, one should bear in mind that regional integration is not an inevitable outcome of economic development. Indeed, the extent of regional integration suggested by Figure 2.7 is somewhat surprising, given the importance of globalization as a contemporary trend. Rapidly developing economies—especially large or highly specialized ones—require, and usually develop, strong global connections. In addition, declining trade barriers, falling transport and communication costs, and the harmonization of world business practices could be expected to tilt the balance toward distant (global) rather than nearby (regional) ties. Yet this does not appear to be the case; on average across Integrating Asia, all six indicators have increased from the pre- to the post-crisis period. The likely explanation is that the region's exceptional growth and its network-based production systems, as well as the investment and labor flows associated with these, have increased the relative importance of regional relationships.[12]

[12] Regional integration is not confined to Asia. Although technological change is supposedly making the world "flatter," around the world regional trade flows are increasing more rapidly than extraregional ones (Mansfield and Milner 1999, Ravenhill 2003).

Figure 2.7. Advancing integration: regional indicators, pre- and post-crisis



Notes:
Data are calculated for the 16 integrating Asian economies, except as noted below.
Trade policy cooperation: Density of free trade agreements among integrating Asian economies (share of pair-wise trade relations that are under a free trade agreement, with a weighting of 1.0 for concluded agreements, 0.5 for agreements under negotiations, 0.25 for agreements under study)—precrisis, until 1997; post-crisis: 1998–2007)
Foreign direct investment: Intraregional foreign direct investment share among integrating Asian economies—precrisis, 1982–1996; post-crisis, 1999–2002.
Equity markets: Correlation of detrended quarterly equity price changes, with simple average for integrating Asian economies—precrisis, 1990:Q2–1996:Q4; post-crisis, 2000:Q1–2007:Q2. Data not available for India and Viet Nam.
Macroeconomic links: Correlation of detrended quarterly growth rates of gross domestic product, with a simple average for integrating Asian economies—precrisis, 1988–1996; post-crisis, 1999–2007. Data not available for India and Viet Nam.
Intraregional trade: Intraregional trade share—precrisis, 1980–1996 average; post-crisis, 2000–2006 average.
Tourism: Share of intraregional tourist inflows and outflows—precrisis, 1994–1995 average; post-crisis, 2004–2005 average.
Sources of data:
Trade policy cooperation: Asian Regional Integration Center. FTA Database. Available: http://aric.adb.org (accessed February 2008).
Foreign direct investment: UNCTAD. FDI Statistics. Available: http://www.unctad.org (accessed February 2008).
Equity markets: Asian Development Bank staff elaborations from Bloomberg data.
Macroeconomic links: Oxford Economics 2008. Forecasting and Analysis. Available: http://www.oef.com/OE_FA_Int_Mac.asp (accessed February 2008); and Bureau of Economic Analysis, United States, 2008. National Income Accounts. Available: http://www.bea.gov/national/index.htm
Intraregional trade: International Monetary Fund various years. Direction of Trade Statistics. Available: http://www.imf.org (accessed February 2008).
Tourism: United Nations World Tourism Organization. Various years. *Yearbook of Tourism Statistics*. Available: http://www.un.wto.org/ (accessed February 2008).

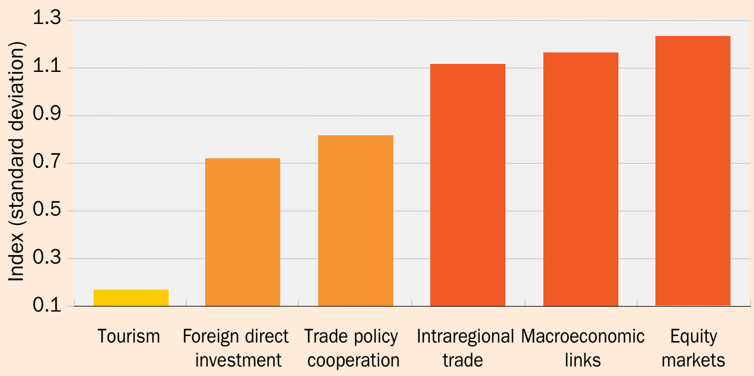
Which areas of interdependence have been strengthened the most? Figure 2.7 shows all interactions deepening, but does not provide a basis for comparing changes across indicators. To help judge how an indicator has changed over time and the extent to which it differs across economies, it is useful to "normalize" the indicator, that is, to assess its changes relative to the benchmark of typical economy-to-economy variations in the region. The normalized indicators (as defined and presented in Figure 2.8) show the deviations of the indicators from their long-term, region-wide averages, expressed in units of standard deviation. For example, Hong Kong, China conducted 66% of its trade with intraregional partners in the post-crisis period compared with a long-term average of 46% for all Asian economies, with a standard deviation of 10%. Thus, Hong Kong, China's normalized, post-crisis regional trade indicator is +2, because its measure of trade interdependence exceeded the regional mean by two standard deviations. In most cases, the normalized indicators show substantial increases between the pre- and post-crisis periods, suggesting broad, rising integration across the region.

Among the six indicators, equity co-movements—the correlation of an economy's equity returns with the region's—show the most significant increases between the pre- and post-crisis periods; increasing by a full standard deviation on average. Output co-movements increased nearly as much. The indicators for intraregional trade and trade policy cooperation also rose, but typically by only a half standard deviation. The intraregional FDI and tourist indicators increased least significantly, perhaps because they were already high before the crisis. Importantly, all six indicators show positive movements over time.

How has regional integration differed across Asian economies? To make such general comparisons possible, the six normalized integration indicators were further combined into an "aggregate integration index" (AII), defined and presented in Figure 2.9. The AII is built from highly eclectic components, and so gives an impressionistic, rather than a theory-based, view of integration. Even so, it provides insight into how each economy is linked to Integrating Asia and how its links have changed over time.[13] Particularly high positive AII values are evident for the ASEAN economies and Hong Kong, China in the post-crisis period. Broadly, their underlying measures of integration

[13] This is expected; the perception that integration was well under way became the basis for selecting economies included in Integrating Asia.

Figure 2.8. Rising relative indicators of integration by channel
Average change in relative indicators from pre- to post-crisis



Note: The figure shows the average pre- to post-crisis change in Asia for "relative integration indicators." The relative indicators are derived from the original indicators defined in Figure 2.7 using the transformation: $x'_{ijt} = (x_{ijt} - A_i)/s_i$, where x_{ijt} is the value of indicator *i* in economy *j* at time *t*, *Ai* is the average of the i_{th} indicator x_{ijt} over all *j* and *t*, and s_i is the standard deviation of the i_{th} indicator over all *j* and *t*. See Figure 2.7 for definition of indicators and data sources.
Source: Asian Development Bank staff elaboration of data in Figure 2.7.

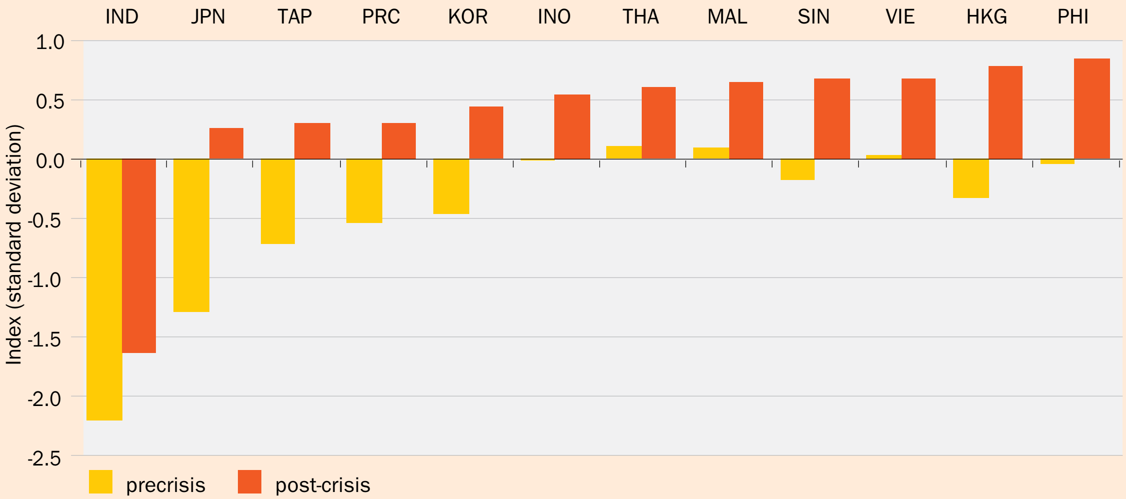
were roughly equal to long-term regional averages before the crisis, but were typically one-half or more standard deviations above these averages after the crisis. The AII values are in some cases negative in the precrisis period for the region's largest economies (the PRC, the Republic of Korea, and Japan), indicating that the regional ties of these economies were not as strong as those of other Asian economies—presumably reflecting their relatively strong global connections. India has the lowest AII—understandably, since Integrating Asia so far consists mainly of East Asian economies. But in every economy in the region, including the large ones, the AII has increased over time.

How markets drive integration

Regional integration in Asia is partly a result of the region's rapid growth and increasing weight in the world economy. But, as we have seen, regional relationships are also becoming more intense than growth by itself would explain. Asia is not alone in displaying such an increasing regional bias; technology and policy seem to be generating new opportunities for regional integration, even in the context of a rapidly globalizing world economy.

The key technological explanation—the development of production networks, often also described as "production

Figure 2.9. Rising indicators of Asian integration by economy
Average aggregate integration index (AII), pre- and post-crisis



PRC=People's Republic of China; HKG=Hong Kong, China; IND=India; INO=Indonesia; JPN=Japan; KOR=Republic of Korea; MAL=Malaysia; PHI=Philippines; SIN=Singapore; TAP=Taipei,China; THA=Thailand; VIE=Viet Nam.
Notes: See Figure 2.7 for definition of indicators and data sources.
The aggregate integration index (AII) is the average of the six integration indicators (see Figure 2.7) calculated for each Asian economy.
Source: Asian Development Bank staff elaboration of data in Figure 2.7.

fragmentation"—is the result of advances in information technology, falling trade barriers, and declining transport costs. These developments have made it possible to allocate various steps of a manufacturing production process to sites in different countries (Athukorala and Yamashita 2005, Ando 2006,). Although these trends could, and to some extent do, lead to a broad, global dispersion of production, in any one industry they appear to favor links with nearby countries more strongly than with those further away. This empirical finding is somewhat surprising. It appears that no matter how good electronic coordination is, it needs to be supplemented with personal interactions and networks, which are much less costly to conduct among nearby sites than among far-flung ones. And even electronics-based coordination—such as transactions in financial markets and other services—is simpler within similar time zones, and among people who meet face-to-face periodically.

Such regional relationships tend to reinforce each other over time. For example, dense regional economic connections increase the return on the transport and communications investments that support them. Investments in "soft" infrastructure—such as familiarity with business conditions, practices, and customs in foreign markets—also bring higher returns in integrated regions. As investments accumulate in such supporting functions, doing business in a regional setting becomes even more attractive. Although trade theory has little to say about the pattern of regional relationships (beyond identifying transport costs as a determinant), they tend to be stable, suggesting that they depend on significant fixed investments.

Given its relatively recent emergence as a major trading power, the PRC's relations with the rest of Asia are not yet as intensely developed as the region's more established partnerships. Indeed, the PRC is still strengthening its economic ties to other parts of the world, and the intensity of its regional trade links is, for now, declining relative to its international connections. Even so, as the hub of production networks that involve components manufactured throughout East Asia (Athukorala 2007b), the PRC has become a major force driving regional integration. Its trade with the region now accounts for half of trade within Asia, up from 29% in 1996.[14] And, as noted, the PRC and India are also shaping regional integration by encouraging smaller economies to combine their markets in order to achieve competitive scale.

How policy makers are responding

Asia's deepening connections are beginning to be reinforced by policy. Until recently, formal economic cooperation among Asian governments lagged behind market-driven integration. This is consistent with the region's cautious policy making style, but it has also reflected Asian trade patterns; in the past, the region's most important economic partners have been outside Asia. As this is changing, so are the region's policy priorities.

Asia's earliest regional organizations emerged within the United Nations network—such as the United Nations Economic and Social Commission for Asia and the Pacific (ESCAP) and the Mekong River Commission—as well as in the security framework of the Cold War, notably the Southeast Asia Treaty Organization (SEATO). ADB was established in 1967. More recently, the Asia-Pacific Economic Cooperation (APEC) embraced economies within and outside the region. The longest-standing wholly regional grouping is ASEAN,

[14] Based on IMF 2007b. If transactions among the People's Republic of China (PRC); Hong Kong, China; Macao, China; and Taipei,China are excluded from East Asian trade because they resemble intra-economy rather than intraregional transactions, this group of economies was involved in 39% of all intra-East Asian trade.

which has become a crucial element of the region's emerging policy architecture.

The structure of regional cooperation has since expanded to a rich network of forums with overlapping memberships (discussed later in Chapter 7, see Table A7.1). Some (for example, the Central Asia Regional Economic Cooperation [CAREC]) have focused on the special requirements of geographical subregions, such as infrastructure for facilitating energy and transport flows. Some (for example, ASEAN) seek to transform their economies into a "single market" through policies that affect many sectors of the economy. Some (for example, ASEAN+3 [ASEAN countries plus the PRC, Japan, and the Republic of Korea]) have addressed functional areas of integration, such as bond market development and reserve pooling. Others (for example, APEC) have been most effective in facilitating trade and investment and reducing regulatory barriers among markets. In other words, the region's cooperative mechanisms are evolving on multiple tracks and are gradually developing unique comparative advantages.

ASEAN countries have been at the forefront of Asian regionalism, individually and collectively. The ASEAN framework provides an advanced model of international cooperation and a framework for exploring new integration strategies (Chapter 3 provides a fuller discussion). ASEAN has also been active in expanding the scope of regional cooperation, initially through relations with dialogue partners, beginning with Japan in 1973 and now including Australia, Canada, the PRC, the EU, India, Republic of Korea, New Zealand, Russian Federation, and the US. More recently, ASEAN invited the PRC, Japan, and the Republic of Korea to develop the ASEAN+3 group, and, at its 1998 summit, set up the East Asian Vision Group to make the case for "East Asia moving from a region of nations to a bona fide regional community where collective efforts are made for peace, prosperity, and progress" (East Asian Vision Group 2001). An ambitious agenda for cooperation is emerging from this process, as discussed in the following section.

Alongside regional integration, Asia is witnessing a wave of bilateral and smaller plurilateral cooperation initiatives. As of December 2007, 44 such agreements had been signed involving one or more economies in Integrating Asia (nearly all were signed since the crisis); 90 more are under study or negotiation. The agreements vary widely in objectives, partners, and trade coverage—some are limited in scope, others go well beyond WTO coverage in terms of sectors and issues addressed. As Chapter 3 will discuss, the proliferation of these agreements could lead to an inconsistent "noodle bowl" of narrow agreements or could establish—with regional leadership—the foundations for substantially larger gains from a consolidated, region-wide free trade system.

The political context is favorable. Since the crisis, governments throughout the region have responded through broad commitments to work together, as well as through specific initiatives. Although differences in ambitions and viewpoints remain, Asia is mostly at peace and cooperates on common security threats, while its historical divides are gradually being reconciled. Of course, Asia's larger economies remain cautious about regional integration and have large stakes in maintaining healthy relations with global markets. They have emphasized that they are seeking an open regional community and continue to develop economic and political relationships outside the region. For example, the Republic of Korea recently negotiated a free trade agreement with the US, and Japan has expressed interest in following suit. These varied interests will make it more challenging to achieve consensus, but will also increase the likelihood that Asian regionalism will make substantial contributions to both regional and global welfare.

The positions of the PRC, India, Japan, and the Republic of Korea—the region's largest economies—will be particularly important, as will ASEAN's. All are committed to an active role. Many observers were surprised when the PRC accepted an invitation to join the 2001 ASEAN meetings, and by its rapid engagement in a process to establish a free trade area with ASEAN (Ren 2007). The PRC's premier, Wen Jiabao, stated:

> China's future is inextricably linked to that of other East Asian countries. Stability and prosperity in East Asia provide an important guarantee for China's development, and China's development also offers opportunities to other East Asian countries. … We will continue to implement the opening-up strategy based on mutual benefit, enhance economic and technical cooperation with other countries, and strive for common development in East Asia (Wen 2007).

India has likewise indicated a strong desire to integrate with East Asia. As part of its "Look East" policy, India has joined the East Asian Summit and has requested APEC membership. In the words of India's Prime Minister Manmohan Singh (2004):

> [India] envision[s] an Asian Economic Community, which encompasses ASEAN, China, Japan, Korea, and India. Such a community would release enormous creative energies

> of our people. One cannot but be captivated by the vision of an integrated market, spanning the distance from the Himalayas to the Pacific Ocean, linked by efficient road, rail, air and shipping services. This community of nations would constitute an "arc of advantage," across which there would be large-scale movement of people, capital, ideas, and creativity. Such a community would be roughly the size of the European Union in terms of income, and bigger than NAFTA in terms of trade. It would account for half the world's population and it would hold foreign exchange reserves exceeding those of the EU and NAFTA put together. This is an idea whose time is fast approaching, and we must be prepared for it collectively.

Yet Asian governments have been reluctant to undertake commitments that may not last, or that restrict their autonomy. They also want to ensure that the institutions that develop in Asia complement their broad global objectives. The implications for the architecture of regional cooperation are explored in Chapter 7.

2.3. The emerging regional agenda

Asia's growing interdependence presents a compelling case for regional cooperation—to deliver regional public goods, manage regional externalities, and help coordinate policies within the region, as well as acting together to ensure an open global economic environment. A first effort to define such a regional agenda was undertaken by the East Asian Study Group (EASG), established in 2001 by the ASEAN+3 process. The EASG's recommendations, summarized in Table 2.2, include institutional developments—one of which, the establishment of the East Asian Summit (EAS), was implemented in 2004—as well as specific proposals on trade, investment, and financial cooperation.[15] This study will assess the progress made on these issues as well as prospects for future cooperation. On the whole, the EASG's proposals provide a timely, thoughtful road map for cooperation.

The subsequent chapters of this report explore the progress and policy options in five areas of regional links: (1) production, (2) financial markets, (3) macroeconomics, (4) social and environmental issues, and (5) cooperation. In the following pages, questions that will motivate this analysis are briefly examined.

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15 The East Asian Summit's membership includes, in addition to ASEAN+3, Australia, India, and New Zealand.

Table 2.2. Recommendations of the East Asia Study Group (2001)
For the creation of an East Asian Economic Community

Short-term measures
• Form an East Asia Business Council.
• Establish Generalized System of Preferences (GSP) status and preferential treatment for the least developed countries.
• Foster an attractive investment environment for increased foreign direct investment.
• Establish an East Asian Investment Information Network.
• Develop resources and infrastructure jointly for growth areas and expand financial resources for development with the active participation of the private sector.
• Provide assistance and cooperation in four priority areas: infrastructure, information technology, human resources development, and ASEAN regional economic integration.
• Cooperate through technology transfers and joint technology development.
• Develop information technology jointly to build telecommunications infrastructure and to provide greater access to the Internet.
• Build a network of East Asian think tanks.
• Establish an East Asia Forum.
• Implement a comprehensive human resources development program for East Asia.
• Establish poverty alleviation programs.
• Take concerted steps to provide access to primary health care for the people.
• Strengthen mechanisms for cooperation on nontraditional security issues.
• Work together with cultural and educational institutions to promote a strong sense of identity and an East Asian consciousness.
• Promote networking and exchanges of experts in the conservation of the arts, artifacts, and cultural heritage of East Asian countries.
• Promote East Asian studies in the region.
Medium- and long-term measures, and those that require further studies
• Form an East Asian Free Trade Area.
• Promote investment by small and medium enterprises.
• Establish an East Asia Investment Area by expanding the ASEAN Investment Area.
• Establish a regional financing facility.
• Pursue a more closely coordinated regional exchange rate mechanism.
• Pursue the evolution of the ASEAN+3 Summit into an East Asian Summit.
• Promote closer regional marine environmental cooperation for the entire region.
• Build a framework for energy policies and strategies, and action plans.
• Work closely with nongovernment organizations in policy consultation and coordination to encourage civic participation and state-civil society partnerships in tackling social problems.

ASEAN = Association of Southeast Asian Nations.
Source: Asian Development Bank.

Production

Access to markets, in the region and beyond, is critical to Asia and thus a high priority on the regional agenda. In low-income economies, trade facilitates the movement of workers into high-productivity jobs; in middle- and higher income countries, it provides incentives for innovation and productivity. Regional cooperation can strengthen Asia's trade by creating vast regional markets, building a seamless production base that makes the region even more competitive in the world economy, and enhancing Asia's role and bargaining position in global economic policy.

Which initiatives could further integrate Asian production? How could regional integration reinforce Asia's stake in global trade and investment flows? As we have noted, with multilateral liberalization efforts at an impasse, Asian countries have concluded, or are negotiating, numerous bilateral trade agreements. Policy makers need to address the challenge posed by these independent initiatives—and ultimately shape what might otherwise become a tangled "noodle bowl" of agreements into a streamlined regional strategy. Chapter 3 will explore how the region could develop markets free of restrictions on the cross-border flow of goods, services, and investment while helping to strengthen the global trading system.

Financial markets

Since the crisis, Asian financial systems have improved dramatically. They have shaken off nonperforming loans and low capitalization levels, developed stronger supervision, and expanded equity and bond markets. Nevertheless, the financial systems of several important Asian economies are still dominated by banks; their regulatory systems remain patchy; and their international flows, to the extent that they are liberalized, are mainly intermediated by financial centers outside the region. Building safer, deeper, and more integrated financial markets remains a high priority for Asia.

What role can the region play in strengthening and integrating Asian financial markets? Is there merit in deepening the Asian Bond Markets Initiative and building regional payments and clearing systems? Should regional forums target the harmonization of regulations or the adoption of standards that permit mutual recognition of financial institutions? These questions will be addressed in Chapter 4, in the context of building an integrated regional financial market.

Macroeconomics

Interdependence generates spillover and enhances the need for cooperation (Kuroda and Kawai 2002). Some experts argue that Asia is in fact "decoupling" from the world economy. Whatever the eventual outcome, for now, Asia clearly has a significant role in shaping global economic activity and especially regional activity, and this role will increase with the region's growth and wealth. Policy makers need new, more sophisticated tools to monitor regional economic developments and set policies that will dampen economic fluctuations and exchange rate volatility.

Which instruments are needed to manage interdependence—to monitor economic performance and to coordinate policy? If crises arise, will the region be prepared to fight them—for example, with the tools of the Chiang Mai Initiative? Which alternatives to holding large national foreign exchange reserves could it develop? Long-standing global imbalances pose additional challenges; indeed, the falling US dollar and the unfolding credit crisis may be signaling that the resolution of the imbalances has begun. Could regional initiatives help to manage the adjustments required—for example, by easing Asia's transition from exporting to markets outside the region to producing more for regional consumption and investment? Chapter 5 will examine policies designed to reduce the region's vulnerability to regional as well as external shocks.

Social and environmental issues

As well as driving Asian dynamism, regional cooperation could help ensure that its benefits are sustainable and widely shared. In countries where public finances are tight, governments seek targeted ways to reduce poverty, decrease income disparities, and address environmental concerns—and regional markets and policy experience offer solutions. Asian economic growth is arguably the most powerful engine ever devised for social progress. In the PRC alone, 500 million people have escaped extreme poverty during the past 30 years. But the remaining challenges are daunting; they include significant pockets of poverty, widening income disparities within several economies, patchy social safety nets, rapidly ageing populations, and widespread environmental degradation.

Which policies could connect poorer populations more directly to the region's dynamic growth processes? Could the region increase flows of workers among countries—and improve social support for them where they work—in order to distribute the fruits of regional progress more broadly? Should it develop mechanisms that provide technical, financial, and political support for national environmental policies? Should it attempt to mobilize region-wide political support for its best practice social policies? These questions are explored in Chapter 6, in the context of developing a regional social and environmental agenda for shared prosperity.

Cooperation

Marshaling collective efforts across Asia's vast, diverse economies is a huge challenge. The examples of the EU and, to a lesser extent, NAFTA offer insight, but Asia's economics, politics, and history are different—and call for new, distinctive solutions. Asian institutional development will likely remain pragmatic and gradual, and the region's policy architecture will likely feature multitrack and multispeed solutions. But as this architecture evolves, many questions will need to be addressed. What are the comparative advantages of different cooperative forums? To what extent should they compete or be consolidated? Which formal institutions will need to emerge to make them effective? These questions will be explored in Chapter 7.

The logic for Asian economic cooperation is powerful. The region is already highly integrated, and its governments are aware of their common interests and obligations. Increasingly, they are working together. Asia has returned to stability and growth, and goals that seemed daunting a few years ago—the elimination of systematic poverty and the absorption of large masses of people into a prosperous middle class—are within reach. To be sure, important problems remain, and regional cooperation will require complex and delicate decisions. But Asia has begun the search for common solutions to its shared challenges. This report sets out why and how.

Chapter 2: appendix

Lessons from the crisis

The crisis offers valuable lessons on the vulnerabilities that can lead to crises, approaches to manage them, and institutions and policies that become necessary in their aftermath (for example, World Bank 1998).

Sources of vulnerability

The crisis highlighted the risks of maintaining pegged exchange rates with open capital accounts. In the absence of very large foreign exchange reserves, even modest macroeconomic imbalances can become destabilizing. In some affected countries, these problems were exacerbated by the inadequate supervision of deregulated financial institutions, which led, among other outcomes, to a severe "double mismatch" problem of funding long-term domestic projects with short-term foreign currency loans.

Policy responses

Managing an international crisis requires timely, well-structured support from the international community. In retrospect, early efforts to contain the crisis may have involved excessively deflationary macroeconomic policies and rushed efforts to address long-term structural problems through measures (such as bank closures) that contributed to the loss of confidence.

Crisis resolution mechanisms

Economies confronted with a crisis need strong mechanisms to speed resolution and minimize impact. An essential "economic security framework" needs to provide safety nets for individuals as well as mechanisms to help corporations survive temporary financial stress, such as institutions to protect viable firms from losing access to credit, resolve impaired loans, and recapitalize banks.

These lessons suggest a range of recommendations for policies at the national, regional, and global levels (Table B2.1).

Table A2.1. Policy recommendations derived from the Asian financial crisis

National measures	Regional measures	Global measures
Preventing or reducing the risk of crises		
Adopt sound macroeconomic management		
Pursue noninflationary monetary policy Pursue sound fiscal policy Limit public debt Limit current account deficits Maintain data transparency	Strengthen regional policy dialogue Maintain early warning system	Strengthen IMF surveillance and policy advice Strengthen private-sector monitoring (rating agencies)
Adopt sustainable exchange rate regime		
Adopt viable exchange rate regime Ensure consistency between exchange rate regime and macroeconomic policy	Strengthen regional exchange rate coordination	
Manage risk in the national balance sheet		
Maintain adequate foreign exchange reserves Monitor short-term capital flows Liberalize capital account cautiously	Monitor short-term capital flows and remove regulatory biases that favor short-term external lending	Monitor short-term capital flows and remove regulatory biases that favor short-term external lending
Manage risk in the financial and corporate sectors		
Strengthen financial regulation and supervision Improve disclosure and information transparency Strengthen governance in financial and corporate sectors Develop capital markets	Help develop regional capital markets Support international standards and codes in regulation and supervision Support best practice governance	Strengthen financial sector monitoring Implement international standards and codes Support best practice governance
Managing crises effectively		
Mobilize timely and adequate external liquidity		
Adopt consistent policy packages Minimize moral hazard	Establish regional liquidity support	Expand and accelerate IMF liquidity support
Tailor macroeconomic and structural policies to crisis specifics		
Tailor monetary and fiscal policies to specifics of the crisis and the economy	Strengthen regional capacity to advise on adjustment	Streamline IMF conditionality on macroeconomic and structural policies
Bail-in private international investors		
Impose official standstills If necessary, impose private sector involvement	Establish international rules for private sector involvement	Establish international rules for private sector involvement
Resolving the systemic consequences of crises		
Resolve impaired bank assets and corporate liabilities		
Establish procedures for bank exits and recapitalization Establish procedures for corporate workouts Include insolvency clauses in debt issues	Help finance bank and corporate restructuring	Establish international procedures for the resolution of non governmental debt Help finance bank and corporate restructuring
Support vulnerable groups through social sector policies		
Strengthen safety nets and support hard-hit populations	Provide support to finance social sector programs	Provide support to finance social sector programs

IMF = International Monetary Fund.
Source: Based on Kawai 2007b.


Serantau Integrasi
Komunidad ng Asyano
CỘNG ĐỒNG CHÂU Á
HỘI NHẬP KHU VỰC
Regional Integration
Masyarakat Asia
Pag-uugnayang Panrehiyon
Asian Community
INTEGRASI REGIONAL
KOMUNITAS ASIA
एशियाई समुदाय
การรวมตัวทางภูมิภาค
ประชาคมเอเชีย

Chapter 3

Integrating production

Asia's economies are becoming ever more closely intertwined, particularly through trade and investment. As they expand and prosper, they are buying more of each other's products. And as production chains are increasingly split into small steps, with each assigned to the most cost-efficient location across the region, Asia's economies are also tied together by a dense network of parts and components trade. This "fragmentation" of production—sometimes organized through a network of small, independent firms but more often by a big multinational corporation (MNC) that uses the region as a production base—is driven largely by technological change. But it is also made possible by the low trade barriers, excellent transport links, and other connections that make it cheap, quick, and easy to ship goods across Asia. These new production networks make the most of each Asian economy's advantages to boost productivity and cut costs, while also bolstering investment and fostering the transfer of technology. In effect, thanks to its openness and connectedness, Asia's diversity is its strength, and its integration is a vital new comparative advantage in the global economy.

The regional hub of these global production networks is increasingly the PRC, whose spectacular rise has given further impetus to Asian integration.[16] As smaller Asian economies have been displaced by the PRC from some of their traditional export markets, they have found new niches, often as links in global supply chains through the PRC. They have therefore sought closer trading ties with the PRC, as well as with each other. By forming a larger and more diverse integrated market that spans several economies in a

[16] ADB (2007a) also noted that the PRC has benefited significantly from these trade patterns—its successful participation in international production networks has enhanced its technological capabilities.

region or subregion, smaller Asian economies can become a more attractive location for investment in production facilities and can reap greater gains from specialization, economies of scale, and increased competition. Thus, while the PRC's rise has unsettled the region, it has also helped to draw it closer together.

Until recently, Asia's integration was driven mostly by market processes. No major preferential trade agreements—apart from the then-incomplete ASEAN Free Trade Area (AFTA)—were in force. But since 2000, bilateral and plurilateral accords have proliferated, with many more in the pipeline. The many reasons for this—global and regional, good and bad—will be discussed in Section 3.3. But such arrangements suggest an increased interest in regional trade and investment cooperation and could weave Asia's economies together into a closely integrated regional market that is a more attractive platform for MNCs' global production networks.

But while free trade agreements (FTAs) may have advantages, they also potentially have serious drawbacks. Some claim that they are largely a distraction, pointing out that use of their preferential terms by trading firms seems remarkably low. Others argue that they divert trade and stifle it with red tape, rather than freeing it. In order to maximize the gains from FTAs and to minimize their costs, Asian governments need to think ahead and adopt best practices. While pushing forward with deeper integration where possible, they should also seek to stitch together the increasingly tangled web of preferential agreements into a comprehensive and outward-looking regional framework. Their aim should be free trade throughout Asia—a single Asian market, seamlessly connected to the global economy.

This chapter is organized into five sections. Section 3.1 provides an overview of increasing interdependence in the region and the forces driving it. Section 3.2 analyzes policies, particularly measures to promote a favorable business climate and trade rules that support economies' regional integration. Section 3.3 evaluates current trends in economic cooperation in Asia. Section 3.4 proposes regional strategies and solutions. Section 3.5 concludes.

3.1. Production networks and regional trade

Nearly all Asian economies have internationalized in recent years—dramatically so in Viet Nam, where total trade (exports plus imports) has soared from 24% of GDP in 1985 to 142% in 2006. In the PRC, trade has risen from 42% of GDP to 66% during the same period, while in India it has doubled from 17% of GDP to 34%. These are very large increases, especially given the size of the two economies. Liberalization, particularly of trade, is driving this trend—and, as noted in Chapter 2, trade openness and globalization in Asia have been historically correlated with higher living standards. As transition economies, in particular, have opened up to international trade in recent decades, living standards, as measured by GDP per capita, have soared—not just in the PRC, but also in Cambodia and Viet Nam. India has also notched up impressive gains.[17]

Asian economies are at various stages of a far-reaching structural transformation from agriculture to manufacturing and, eventually, services. More than 90% of East Asia's exports are now manufactured goods (mostly electronics), and their technological content is increasingly sophisticated. Some Asian economies such as India, however, already export a considerable amount of outsourced services (Box 3.1).

Asia has developed a global comparative advantage in manufacturing. This is based in part on low wages, but more importantly on high rates of productivity growth. It is driven by the scale of Asia's markets and the ability to combine the benefits of diverse production sites through "fragmented" production and trade. In Japan; the Republic of Korea; Taipei,China; and Singapore productivity has already caught up with the Organisation for Economic Co-operation and Development (OECD) average, while the PRC, India, and several ASEAN members—notably Malaysia and Thailand—are closing the gap quickly. While Indonesia and the Philippines have made less progress (ADB 2007a, 272),[18] recent trends are encouraging. These countries differ somewhat from the typical East Asian model because of their large primary resources, and (in the case of the Philippines) the early development of service sector exports.

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[17] Using gross domestic product (GDP) data at constant 2000 prices, between 1997 and 2007, per capita GDP increased by 128% in the PRC, 102% in Cambodia, 77% in Viet Nam, and 69% in India.

[18] The *Asian Development Outlook* distinguishes between relative and absolute productivity gaps. In Malaysia, for instance, productivity rose from 16% of the Organisation of Economic Co-operation and Development (OECD) average in 1980–1985 to 21% in 2000–2004, while the absolute productivity gap rose. The *Asian Development Outlook* calculates that if relative trends are sustained, the absolute gap between Malaysia and the OECD average should start to narrow when its productivity reaches one third of the OECD's.

Box 3.1. India's emergence as an exporter of outsourced services

In the past decade, Asian economies such as the People's Republic of China, India, the Philippines, and Thailand have become increasingly important exporters of services outsourced by foreign companies. Such services include the design of information technology programs and applications, call center and surveying activities, back office administrative work, scientific research operations, processing of radiological and other medical tests, and financial operations related to venture capital and other businesses. Large wage differentials across countries and dramatic developments in information and communication technology have driven the growth of services' outsourcing in Asia, as have market-oriented reforms and trade liberalization (Bhagwati and Panagariya 2004).

With its advanced capacity in information technology and software-related knowledge, large skilled and inexpensive labor force, and strong English language skills, India has become a leader in exports of outsourced services not only in Asia but among developing countries. Other factors behind its success include the maturity of its judicial system, a record of conformance to World Trade Organization (WTO) obligations, and a history of successful private firms with a talent for initiating and managing complex service projects.

Estimates from several sources suggest that India's services outsourcing market has been growing at 25% a year. Although the rupee's recent appreciation against the United States dollar may have reduced India's cost advantage, the outsourcing market is forecasted to nearly quadruple to $60 billion by 2010, from about $17 billion in 2005. By 2010, the outsourced services sector is expected to employ 2.3 million people directly and to support a further 6.5 million jobs indirectly (NASSCOM and McKinsey 2005; Dossani and Kenney 2007).

The sector's growth initially resulted mainly in new jobs and price cuts, since entry barriers were typically low and automation easy. Many firms, however, were soon able to exploit economies of scale, expand their product range, develop brand names, and enter new business areas. Thus, although most exported services remain low value added and relatively low skilled, several Indian firms are now among the top global providers of outsourced services.

More recently, as a new wave of second-generation providers has emerged, the traditional model is facing new challenges. Indian firms are responding to increasing competition by diversifying their range of services and opening offices in other developing countries to reduce costs and meet clients' demand. This, in turn, is allowing newcomers to follow in their footsteps.

The economics of production networks

Asia's vertically integrated production networks operate by separating a production chain into small steps and then assigning each to the most cost-efficient location. This pattern is often described as fragmented production and trade.[19] Some steps take place within a single firm (or firms of the same group) that has operations in different countries,

[19] The theoretical and empirical literature on trade due to fragmented production is growing rapidly. Important recent contributions include Jones and Kierzkowski (2001), Athukorala and Yamashita (2005), Ando (2005 and 2006).

while others involve arms length transactions among different firms in several countries. This is a relatively new aspect of international trade, made possible by a combination of rapid improvements in information and communication technology and more open markets. Such fragmented production has proved a particularly beneficial strategy in Asia, thanks to the large range of development levels across the region, its strong intraregional and international links, and its adeptness at transferring and absorbing new production technologies. By enabling economies to specialize in narrower niches, production networks allow them to enter international markets with a more limited range of skills than previously.[20] They thus facilitate the participation of outward-oriented least developed countries in the regional and global economy.

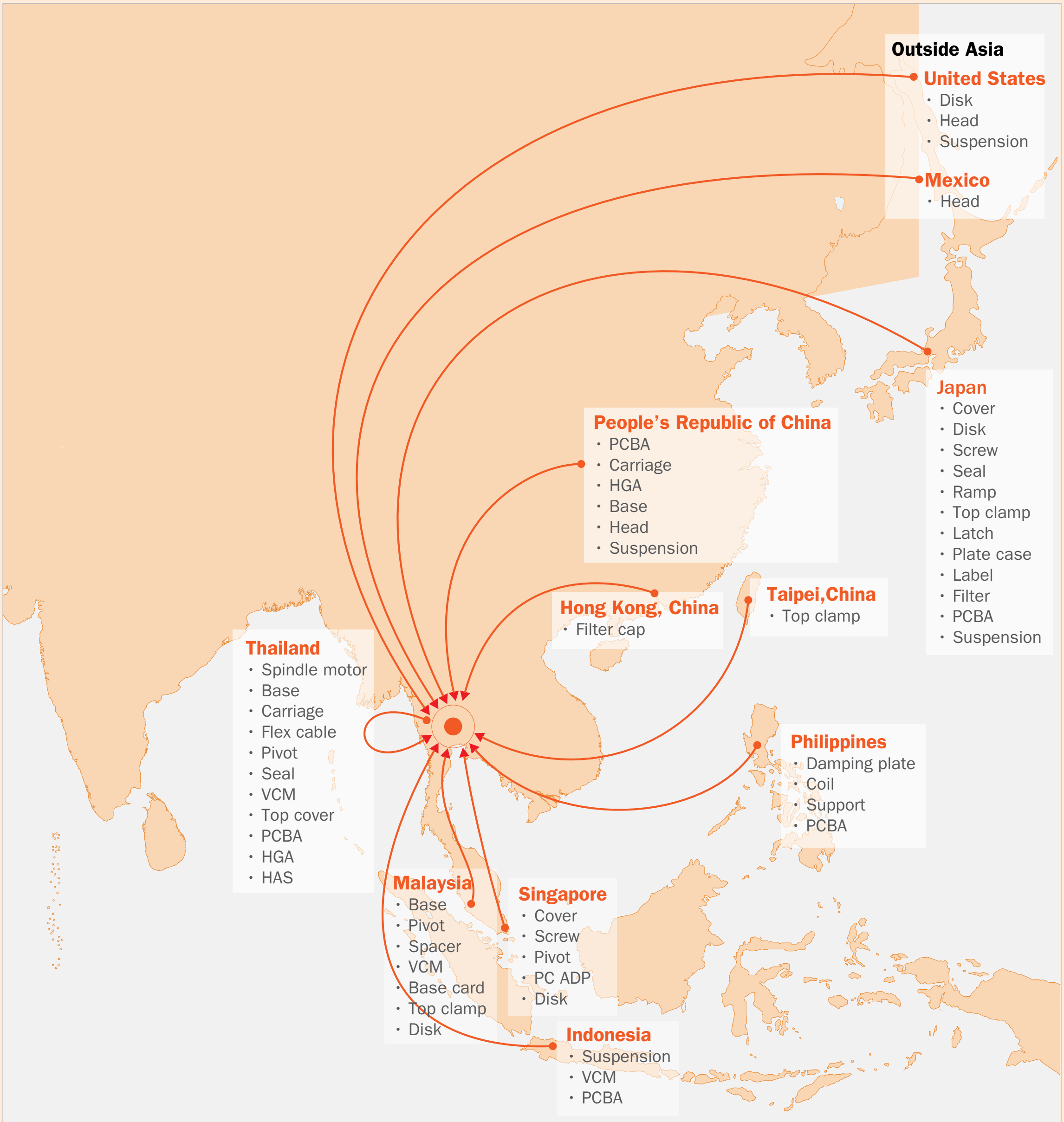
While the region's largest investments in production facilities are now centered on the PRC, complex networks are emerging throughout the region. One striking example—of the links involved in the manufacture of disk drives in Thailand—is shown in Figure 3.1. The network behind this relatively simple product spans nine Asian economies (with many different parts coming from each) as well as Mexico and the US. This is one of many such supply chains focusing on ASEAN economies, a selection of which is set out in Table 3.1. For example, as of February 2007, the ASEAN Industrial Cooperation Scheme, a program created in 1996 while AFTA was being implemented, approved 140 regional supply projects in ASEAN countries alone, centered on MNCs from both Asian and non-Asian countries.[21]

Production networks have greatly boosted Asia's intra-industry trade, particularly in machinery, electrical goods, and electronic parts and components. While economic statistics provide only a limited measure of the incidence of such trade—until recently, trade classification systems were not refined enough to measure such detailed specialization—evidence is mounting that it is transforming the industrial landscape, especially in Asia (Ando 2005, Athukorala 2005). As Figure 3.2 shows, in Integrating Asia, the share of parts and components trade (PCT) in manufacturing trade shot up from 24.3% in 1996 to 29.4% in 2006. That is a remarkable rise, not least since

[20] Extensive literature is available on this topic, but one particularly influential work is Dobson and Chia (1997).

[21] The scheme has successfully promoted production networks, especially for the automobile and electronics industries, by reducing the preferential tariff rate to 0–5%, liberalizing equity restrictions for foreign investors, and offering dispute settlement facilities. Source: ASEAN Secretariat 2007.

Figure 3.1. Networking: sourcing of parts and components for a hard disk drive



Note: The production of hard disk drives requires several parts and components. The example shows the actual sourcing of parts and components of a hard disk drive assembly firm in Thailand. The largest majority of parts and components are sourced from other integrating Asian economies. Hard disk drives are used in several electronic products. The hard disk drive assembler in Thailand exports a large share of its production to electronic firms mostly in other integrating Asian economies.
Source: Adapted from Hiratsuka 2006.

Table 3.1. Regional production networks in ASEAN
Selected multinational corporations, 2006

Multinational corporation	Product/industry	Extent of network
Universal Consumer Products	Detergent	Indonesia, Singapore
PT Indo Sukses Makmur	Detergent	Indonesia, Singapore
Sanden	Automotive	Singapore, Thailand
Denso	Automotive	Indonesia, Malaysia, Philippines, Thailand
Toyota	Automotive	Indonesia, Malaysia, Philippines, Thailand
Honda	Automotive	Indonesia, Malaysia, Philippines, Thailand
Volvo	Automotive	Malaysia, Thailand
Ford	Automotive	Philippines, Thailand
Sony	Electronics	Singapore, Thailand, Viet Nam
Matsushita	Electronics	Indonesia, Malaysia, Philippines, Thailand
Nestlé/Goya	Food processing	Indonesia, Malaysia, Philippines, Thailand
Samsung	Electronics	Malaysia, Viet Nam
Clipsal/Bowden	Electrical	Indonesia, Malaysia
Yanmar	Agriculture machinery	Indonesia, Thailand

ASEAN = Association of Southeast Asian Nations.
Source: ASEAN Secretariat 2007. Available: http://www.asean.org (accessed July 2007).

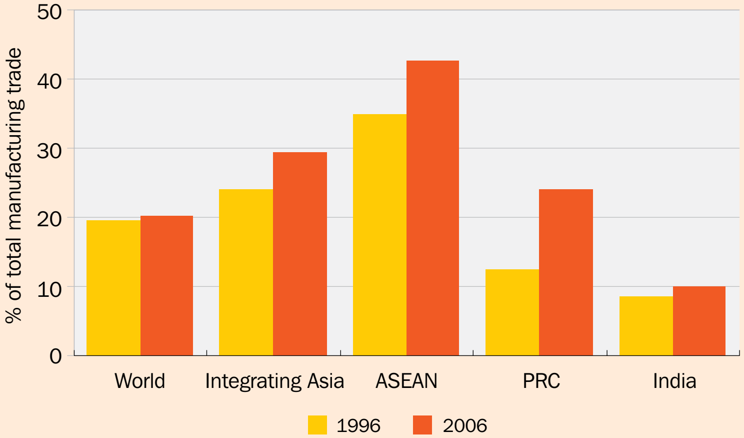
worldwide its share has scarcely increased, edging up from 19.6% to 20.2% over the same period (Figure 3.2a).

As a share of GDP, PCT is among the highest in the world in the ASEAN (especially in Malaysia, the Philippines, Singapore, and Thailand) and in Taipei,China, perhaps because the relatively small size of their economies makes specializing in small niches of comparative advantage particularly important. Broadly speaking, the success of these economies is based on policies that welcome foreign companies, encourage technological upgrading, and build strong connections with world markets, as well as on their proximity to Asian neighbors following similar strategies. PCT is particularly significant among ASEAN countries: it rose from an average of 35% of manufacturing trade in 1996 to 43% in 2006. The PCT share in the PRC nearly doubled over the same period, from 12.5% to 24.0%, while in India it remained at around 10.0%.

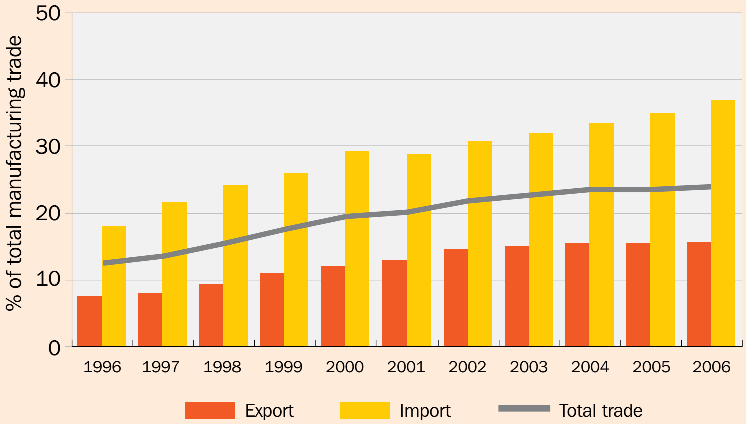
Integrating Asia remains a net importer of parts and components, especially because of its deficit with the EU and US in high-tech intermediate products. The PRC's deficit is particularly large (Figure

Figure 3.2. Share of parts and components trade in total manufacturing trade

a. Asia and world trade, 1996 and 2006



b. People's Republic of China, 1996–2006



ASEAN = Association of Southeast Asian Nations, PRC = People's Republic of China.
Note: Parts and components are calculated from a list of 225 product categories at Standard Trade International Classification five-digit level. The criterion to separate parts and components from final manufacturing products is based on product lists provided by Athukorala 2005.
Source: UN 2008. Comtrade database. Available: http://comtrade.un.org/db/default.aspx (accessed April 2008).

3.2b). In 2006, the PRC's imports of parts and components were 37.0% of its total manufacturing imports, while exports were only 15.5% of the manufacturing total. Final goods account for a correspondingly larger share of its manufacturing exports, highlighting the PRC's role as Asia's assembly factory.

Increased regional integration is also associated with technological upgrading, as the establishment of regional production networks through foreign direct investment (FDI) by MNCs often generates positive technology spillovers for recipient economies such as investment aimed at generating new technologies through research and development, as well as at better absorbing technology transfers (Belderbos, Capannelli, and Fukao 2001).

Productivity and technology

Technology development and economic integration are interconnected. Cross-border flows of capital, goods, and people accelerate the diffusion and development of new technologies, while making it easier for economies to adapt to changing patterns of comparative advantage, ride the product life cycle, and move up the value chain.

Countries upgrade their technology base by adopting existing foreign technologies and inventing new ones. These two channels feed on each other (Cohen and Levinthal 1989). By adopting existing technologies—often through imitation—countries acquire capabilities that can eventually help them to become innovators. But to make the leap from imitator to innovator, countries need to invest in research and development. This, in turn, improves their ability to assimilate existing technologies as well as to create new ones.

The relative importance of these two mechanisms varies depending on a country's stage of economic development. The East Asian experience (following the flying geese model described in Chapter 2) suggests that adapting and imitating existing technologies is the main means of upgrading technology in the early stages. But while imitation is more profitable than innovation when the technology gap with developed countries is wide, the returns from indigenous innovation increase as countries approach the global technology frontier.

While technology development across Asia is generally perceived to be highly uneven, quantifying cross-country differences is a major challenge. As the nature of technology upgrading varies substantially according to the stage of development, it is difficult to summarize the degree of it with any single indicator.

The United Nations Development Programme (UNDP) has formulated a measure of an economy's overall technological development, the Technology Achievement Index (UNDP 2001). This consists of four equally-weighted component measures: (1) technology creation, (2) the diffusion of new technologies, (3) the diffusion of established technologies, and (4) the level of human skills. In constructing the index for Integrating Asian economies, some of the variables used in the original UNDP index were replaced with similar variables due to data constraints. The specific variables used for each component measure of the composite Technology Achievement Index are described as follows:

- **technology creation:** US Patent and Trademark Office patents granted per capita, and receipts of royalties and license fees from abroad per capita;
- **diffusion of new technologies:** Internet users per 1,000 people, and the share of high- and medium-technology products in manufacturing exports;
- **diffusion of established technologies:** telephones per 1,000 people and electricity consumption per capita; and
- **human skills:** adult literacy rate, and researchers engaged in R&D per 1,000 people.

Technology Achivement Index scores and its component indexes are shown in Table 3.2 using 2004 data for 11 integrating Asian economies.[22] The scores are indicative of economies' relative position within the region rather than of absolute differences. Along with Singapore, Northeast Asian economies (Hong Kong, China; Japan; the Republic of Korea; and Taipei,China) stand out as the most technologically developed. Integration with these economies increases the possibility of benefiting from technology spillovers.

The vast differences in technology development across Asia suggest ample opportunities for knowledge diffusion. Hu (2008) traced knowledge diffusion in East Asia using patent citations made by the US Patent and Trademark Office, with patents granted as an indicator of knowledge flow. The study found that while Japan and the US remain the dominant sources of knowledge diffusion for East Asia, knowledge flows from the Republic of Korea and Taipei,China are increasing, reflecting their rising technological sophistication as well as their role in regional economic integration. For example,

[22] Although the table reports the consolidated value for the People's Republic of China (PRC), available data show the presence of pronounced disparities between the more advanced coastal regions and the rest of the country.

Table 3.2. Sources of Asia's technological progress

Rank	Technology achievement index		Component indexes							
			Technology creation		Diffusion of				Human skills	
					New technology		Established technology			
1	JPN	0.888	JPN	0.974	TAP	0.905	TAP	0.987	JPN	1.000
2	TAP	0.816	TAP	0.553	KOR	0.865	SIN	0.916	SIN	0.876
3	SIN	0.743	SIN	0.382	SIN	0.797	JPN	0.887	TAP	0.817
4	KOR	0.697	KOR	0.285	HKG	0.734	KOR	0.864	KOR	0.773
5	HKG	0.598	HKG	0.285	JPN	0.690	HKG	0.811	HKG	0.561
6	MAL	0.339	MAL	0.012	MAL	0.438	MAL	0.525	PRC	0.446
7	THA	0.303	INO	0.004	THA	0.393	THA	0.389	THA	0.428
8	PRC	0.292	THA	0.002	PRC	0.358	PRC	0.361	PHI	0.405
9	PHI	0.238	PRC	0.001	PHI	0.263	PHI	0.283	INO	0.392
10	INO	0.175	PHI	0.001	INO	0.174	INO	0.130	MAL	0.379
11	IND	0.002	IND	0.000	IND	0.000	IND	0.000	IND	0.007

HKG=Hong Kong, China; JPN=Japan; IND=India; INO=Indonesia; KOR=Republic of Korea; MAL=Malaysia; PHI=Philippines; PRC=People's Republic of China; SIN=Singapore; TAP=Taipei,China; THA=Thailand.

Sources: UNDP. *Human Development Report*. Various issues. Available: http://www.hdr.undp.org (accessed March 2008); World Bank 2002. Knowledge Assessment Methodology. Available: http://www.worldbank.org/kam (accessed March 2008); and CBRC 2007. Available: http://www.cbc.gov.tw (accessed December 2007).

controlling for the much larger stock of Japanese and US patents, the study found that patents from the PRC and Malaysia cite patents from the Republic of Korea and Taipei,China more frequently than they do Japanese and US patents. However, countries with a more sophisticated technological capability, such as Singapore, cite the US as often as they do the Republic of Korea. These patterns of knowledge diffusion also support the notion that Integrating Asian economies should adopt technology that is appropriate to their level of economic and technological development.

Technology upgrading requires appropriate public policies to make up for the shortcomings of market forces. Policies and institutions that help to connect domestic producers and individuals with those from more developed economies are likely to expedite technology diffusion. For example, in the past decade, the PRC's semiconductor industry, particularly the foundry sector, has caught up remarkably with, for instance, those of Japan; Malaysia; and Taipei,China. The PRC's decision to liberalize the sector and open it up to foreign investors played a crucial role in stimulating a large inflow of investment and managerial and engineering personnel from Taipei,China, accelerating the catch-up process.

Technology upgrading has been—and will continue to be—a vital part of successive waves of economic development in Asia. Developing regional mechanisms that help encourage and accelerate technology diffusion could thus bring huge benefits to the region. Box 3.2 sets out in greater depth how to promote technology diffusion and upgrading in Asia.

Box 3.2. Promoting technology upgrading and diffusion

To graduate from learning and imitation to innovation, an economy has to invest in the necessary resources. Such investments are risky and generate social returns higher than private ones. Government policies may therefore need to bear some of the excess risk that the private sector may not be willing to shoulder. Singapore's wafer-fabrication-specialist manpower program—whereby the Government subsidizes the training of college students to prepare them for employment in the semiconductor foundry sector—is a good example of such a government intervention.

Two major challenges in technology upgrading are (1) the harmonization of intellectual property rights (IPRs) protection—following the World Trade Organization's Trade-Related Aspects of Intellectual Property Rights (TRIPS) Agreement—and (2) Asia's shortage of human capital. The extension of developed countries' higher standard of IPR protection to developing ones increases the cost of technology diffusion and imitation. Asian governments have to balance the need to enforce IPRs with that of ensuring adequate technology diffusion. And while Asia's primary and secondary education is generally good and widely available, the tertiary-level science and engineering training that is becoming crucial to technology upgrading is still poorly developed in most Integrating Asian economies.

Integrating Asian economies could alleviate this shortage by tapping into the large diaspora of scientists and engineers of Asian origin living and working in developed countries. Table B3.1 shows that 56% of immigrant scientists and engineers in the United States in 2003 were of Asian origin. Those from the Philippines outnumber those from the Republic of Korea; Taipei,China; and Japan combined. This pool of human capital could provide a huge boost to technology upgrading in Asia.

Table B3.1. Resources abroad: Asian scientists and engineers in the United States

Birthplace of immigrant scientists and engineers in the United States in 2003

Birthplace	Number ('000)	Percent
All countries	**3,352**	**100.0**
Asia	1,873	55.9
India	515	15.4
China[a]	326	9.7
Philippines	304	9.1
Korea, Republic of	120	3.6
Taipei,China	120	3.6
Viet Nam	97	2.9
Japan	46	1.4
Thailand	19	0.6

[a] China includes the People's Republic of China; Hong Kong, China; and Macau, China.

Source: National Science Foundation 2008. Science and Engineering Statistics. Available: http://www.nsf.gov/statistics/ (accessed March 2008).

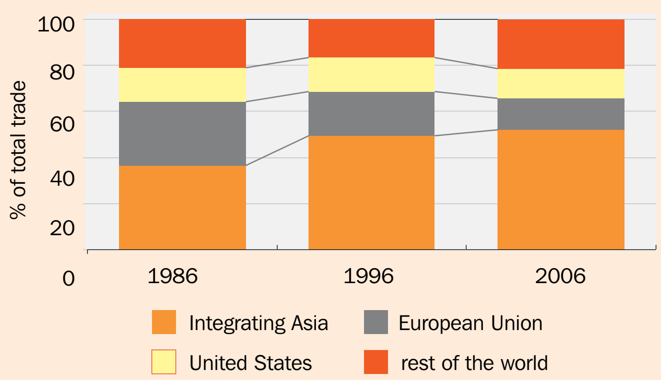
Trade integration

In large part due to the growth of production networks just discussed, trade within Asia has increased from 37% of its total trade in 1986 to 52% in 2006 (Figure 3.3). The share of trade with Europe has risen somewhat, while that with the US and the rest of the world has fallen. As set out in Chapter 2, Asia's intraregional trade share is now midway between Europe's and North America's. It is also higher than Europe's was at the outset of its integration process in the early 1960s.

But trade has not been diverted from the rest of the world. On the contrary, trade with each of Asia's four main partner groups has increased in the last two decades—not just absolutely, but also relative to Asia's GDP (Figure 3.4). For example, Asia's trade with the EU has more than doubled as a share of its GDP, from 2.6% in 1986 to 6.0% in 2006. The increase is even larger as a share of the EU's GDP. The aggregate trade data thus suggests that Asia is steadily integrating both regionally and globally.

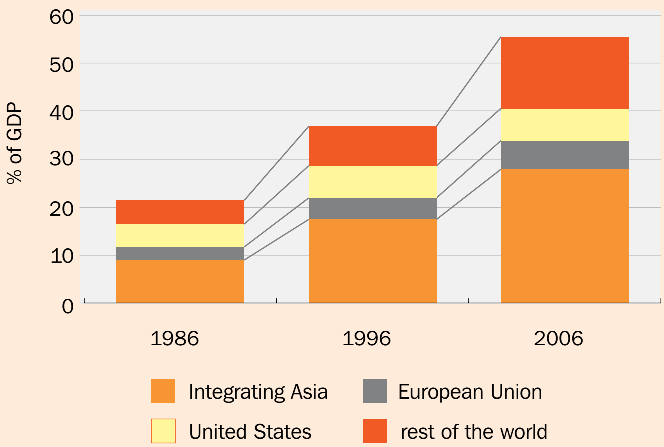
While intraregional trade is intensifying, external trade remains vital for Asian economies. Indeed, the increase in the share of Asia's exports destined for global markets understates their importance.

Figure 3.3. Increasing intraregional trade
Trade of Integrating Asia by destination



Notes:
Trade is import+export.
European Union includes the 25 countries that were members as of 2006.
Integrating Asia includes Brunei Darussalam; Cambodia; People's Republic of China; Hong Kong, China; India; Indonesia; Japan; Republic of Korea; Lao People's Democratic Republic; Malaysia; Myanmar; Philippines; Singapore; Taipei,China; Thailand; and Viet Nam.
Source: Data from IMF various years. Direction of Trade Statistics. Available: http://www.imf.org (accessed October 2007).

Figure 3.4. Increasing trade links
Trade of Integrating Asia as a share of GDP by destination



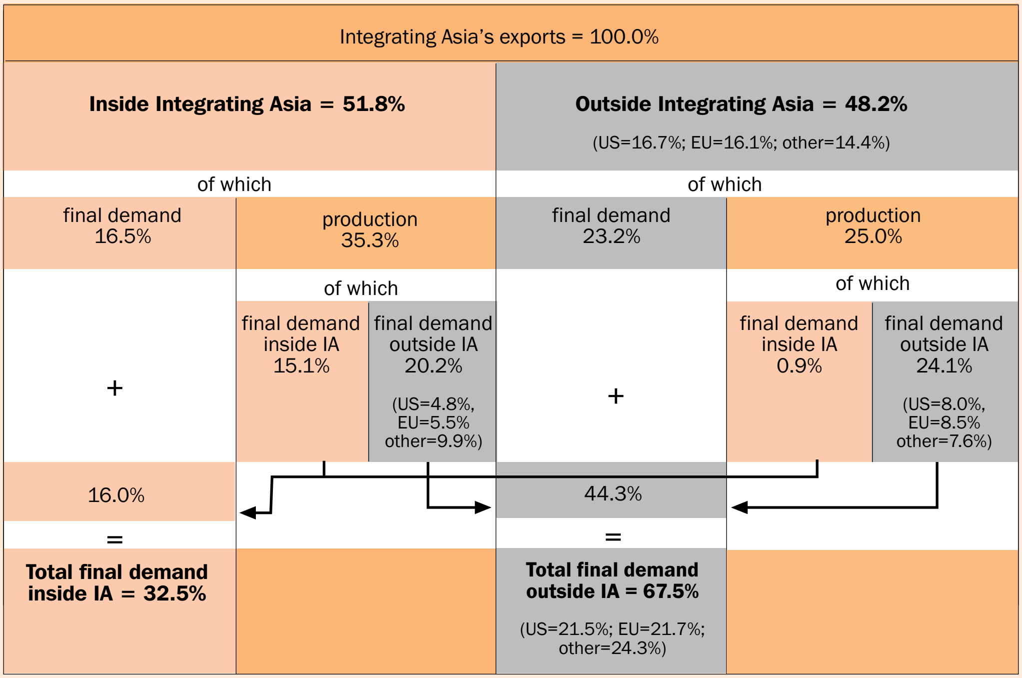
GDP = gross domestic product.
Notes:
Trade is import+export.
European Union includes the 25 countries that were members as of 2006.
Integrating Asia includes Brunei Darussalam; Cambodia; People's Republic of China; Hong Kong, China; India; Indonesia; Japan; Republic of Korea; Lao People's Democratic Republic; Malaysia; Myanmar; Philippines; Singapore; Taipei,China; Thailand; and Viet Nam.
Source: Data from IMF various years. Direction of Trade Statistics. Available: http://www.imf.org (accessed October 2007).

The pattern of fragmented production blurs where exports are ultimately destined: PCT within Asia is often incorporated into final goods shipped to Europe and North America. A detailed analysis of Asia's intraregional exports in 2006 reveals that while 48.2% of Asia's exports are directly shipped to Europe and North America, 67.5% ultimately end up there, when the parts and components content of exports is fully taken into account (Figure 3.5).

Evidence presented in Chapter 5 underscores the importance of Asia's global links. It shows that the transmission of short-term output fluctuations—another measure of production interdependence—has increased among Asian economies, as well as between Asia and the rest of the world.

In effect, Asia's regional and global relationships reinforce each other—its intraregional PCT, for instance—is partly driven by global final goods exports, and is also an important source of the region's

Figure 3.5. Asia's exports depend significantly on non-Asian final demand
Direct and indirect links, 2006



EU = European Union, IA = Integrating Asia, US = United States.
Methodological note:
The methodology was designed to determine to what extent the demand for exports of IA was due to direct and indirect final demand of IA, and to final demand in other world regions. Exports of IA are divided between those destined within IA (intraregional exports) and those destined outside IA. Exports outside IA are divided between exports to the United States, the European Union, and other areas. Total exports are divided between those destined for final demand and for production. Exports destined for production are divided between those destined for IA final demand and for final demand for the rest of the world. Exports destined for final demand are obtained as the sum of those destined directly for final demand and those destined for production but for the use of final demand. See also Hertel 1997.
Source: ADB staff estimates calculated using input-output tables from the Global Trade Analysis Project (GTAP) database. (GTAP version 6.2a, released in 2007). Available: http://www.gtap.agecon.purdue.edu/ (accessed March 2008).

competitiveness. As neither regional nor global trade patterns could be sustained independently, the policies that Asia adopts to manage its growing trade and investment interdependence will also have to support its global ties.

Integration through investment

Technological upgrading and connections with world markets are essential elements of Asia's manufacturing competitiveness. Most

Asian economies have relied for decades on FDI to tap technologies, capital, foreign exchange, and ready-made access to external markets. Japan and the Republic of Korea, by contrast, attempted to bypass foreign ownership by promoting technology transfer through international trade—through imports of advanced capital goods, licensing, and other approaches, for instance. Both groups, though, have used international competition to set benchmarks for product quality and drive innovation.

FDI is particularly important in the context of production networks. Often, this trade-investment nexus is based on the FDI strategy followed by MNCs; but even when arms length transactions are involved, the business connections and technologies associated with FDI represent valuable assets for countries as they attempt to focus on niche markets, especially in technology-intensive sectors such as electronics and automobiles.

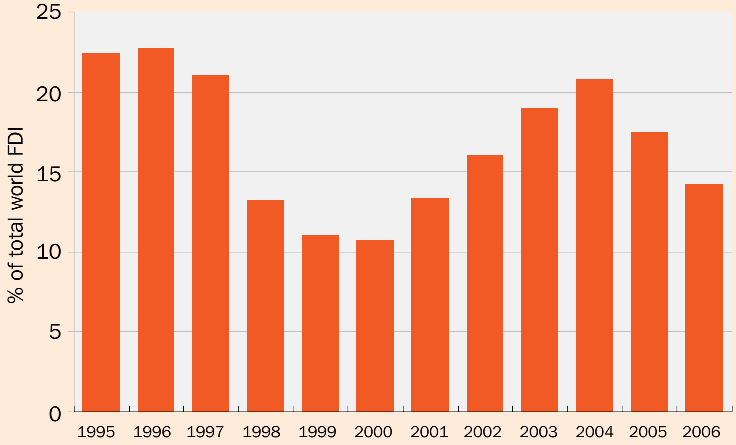
Before the 1997/98 financial crisis, FDI flowed into Asia at a record pace, with the region attracting nearly a quarter of global inflows and the largest share of FDI to non-industrialized countries. These were less affected by the crisis than other types of capital flows and, except for a burst of activity at the height of the "Internet bubble" in 1999–2000, remained relatively steady afterward (see Figures 3.6 and 3.7 and Table A3.1 in the appendix to this chapter).[23] Since 2004, however, FDI has soared again, with the PRC attracting record inflows.

Over the past decade, the PRC and Hong Kong, China together accounted for between 53% and 68% of Asia's FDI inflows. A large share of PRC exports is undertaken by affiliates of foreign MNCs, which are often reckoned to be assembly hubs with relatively low domestic value added. For instance, Chen (2007) finds that while the PRC's aggregate exports to the US are four times those of the US to the PRC, in terms of domestic value added they amount to less than half that amount. In addition, Athukorala (2007b) finds that the value added in the PRC's high-tech exports is relatively low, despite the rapid upgrading of its technological capabilities.

Despite fears that the PRC is diverting FDI from other Asian economies, there is little evidence of this. On the contrary: Busakorn, et al. (2005) find that, controlling for other factors, FDI flows to the

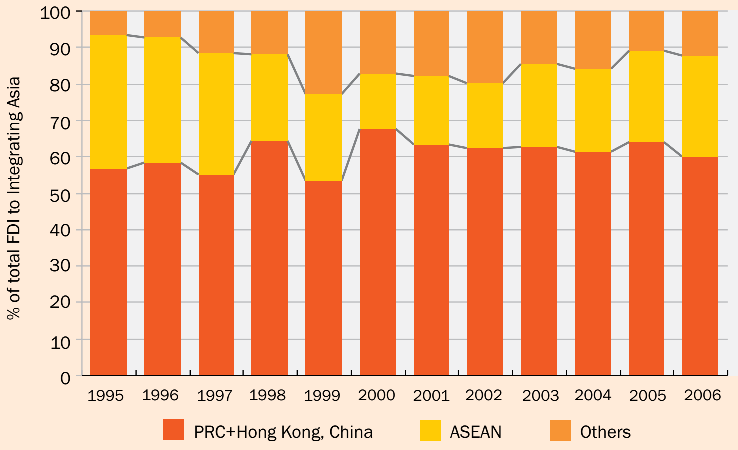
[23] Asian FDI data are difficult to read because some of the foreign investment flows into Hong Kong, China, including from the PRC, may involve projects in the PRC. This may lead to the misassignment of destinations and possible double counting in the data.

Figure 3.6. Integrating Asia's net foreign direct investment flows, 1995–2006



FDI = foreign direct investment.
UNCTAD = United Nations Conference on Trade and Development
Source: UNCTAD various years. FDI Statistics Online and World Investment Report 2007 database. Available: http://stats.unctad.org/FDI/ (accessed April 2008).

Figure 3.7. Foreign direct investment to Integrating Asia
Share of total investment by groups of countries, 1995–2006



ASEAN = Association of Southeast Asian Nations, FDI = foreign direct investment,
PRC = People's Republic of China.
UNCTAD = United Nations Conference on Trade and Development.
Others: India; Japan; Republic of Korea; and Taipei,China.
Source: UNCTAD various years. FDI Statistics Online and World Investment Report 2007c database. Available: http://stats.unctad.org/FDI/ (accessed April 2008).

PRC are positively correlated with those to other Asian countries—a 10% increase in the former leads to a 2–3% rise in the latter. Plummer and Cheong (2007) also find a positive "China effect," while Athukorala (2007b) shows that the PRC's integration into cross-border production networks has created new opportunities for other East Asian economies to specialize in parts and components production and assembly. Yet competition from the PRC is also prodding ASEAN economies to pursue bolder national reforms, seek deeper regional integration, and develop closer links with the PRC—notably through the ASEAN-China FTA —in order to connect to supply chains in which it serves as the regional hub.

3.2. Policies for sustained growth and integration

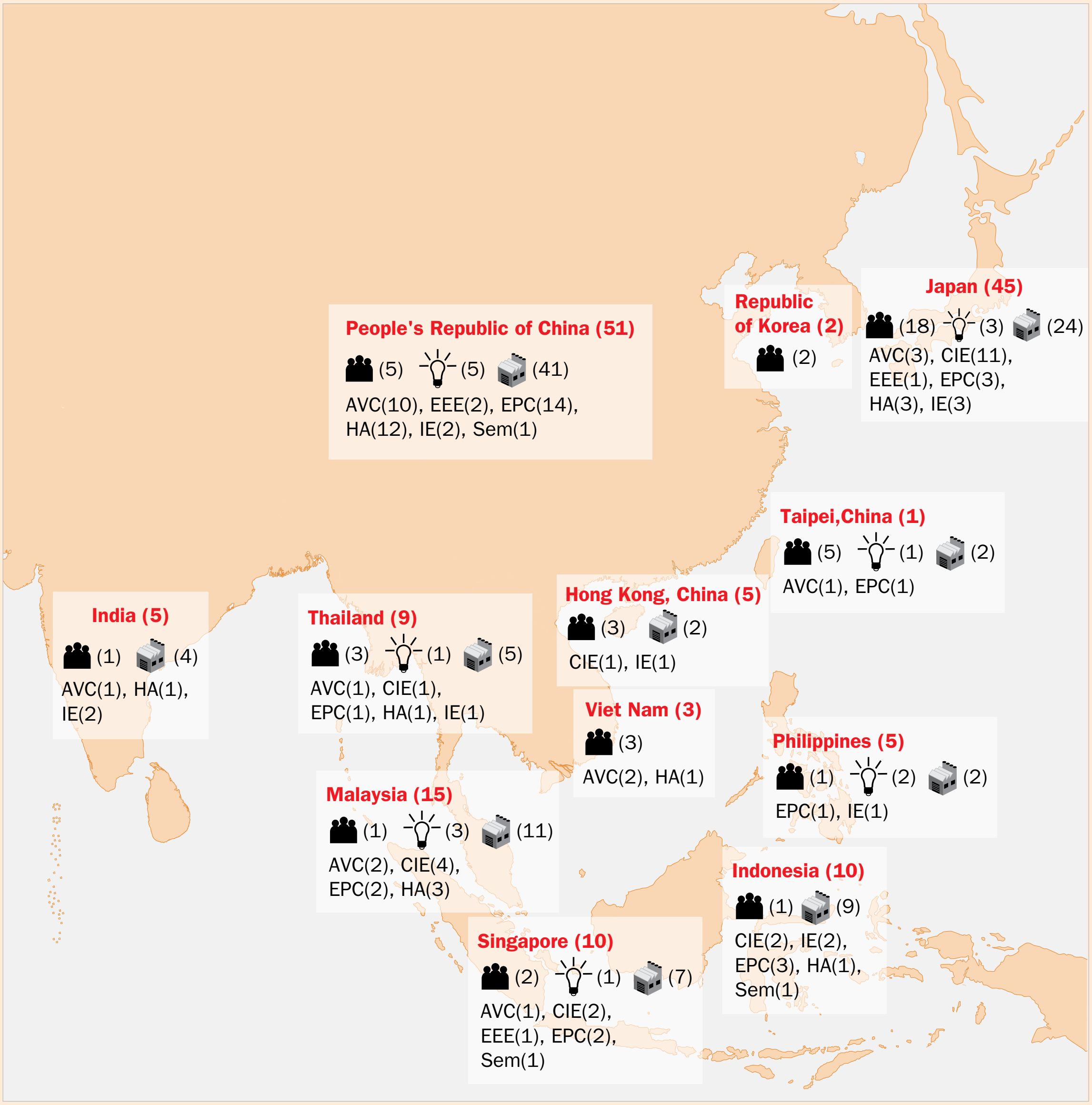
Several MNCs have established extensive production networks in Asia, which are contributing not only to the development of economies that receive FDI, but also to the region's integration in production and trade. Following the flying geese pattern of industrial development and transfer in the region described in Chapter 2, Asian MNCs tend to locate their production facilities in Asia according to a number of factors. These include the degree of technological sophistication of the FDI-receiving country; the presence of a subcontracting industry for parts and components; the development of economic infrastructure; local regulations and the treatment of foreign firms; and the availability, cost, and quality of the labor force (Belderbos, Capannelli, and Fukao 2001).

While MNCs' location strategies vary, firms also tend to diversify their production locations in order to benefit from comparative advantages and reduce production risks, as well as to offset exchange rate fluctuations. As trade is liberalized, FDI regulations are improved, and technological capabilities are upgraded, MNCs are finding it easier to diversify their presence in Asia. The span of the Asian production networks created by a Japanese electronics firm and a Korean automotive firm are shown in Figures 3.8 and 3.9.

While production fragmentation is a global phenomenon, its extent and effects have been particularly pronounced in Asia. Why is this so, given that the factors that gave rise to it, including ICT, often originated elsewhere?

Asia's fundamentals—notably the diversity of its economies, the vast size of some of them, and its relatively low intraregional transport

Figure 3.8. Locations of a large Asian multinational company: electrical and electronics industry, 2008



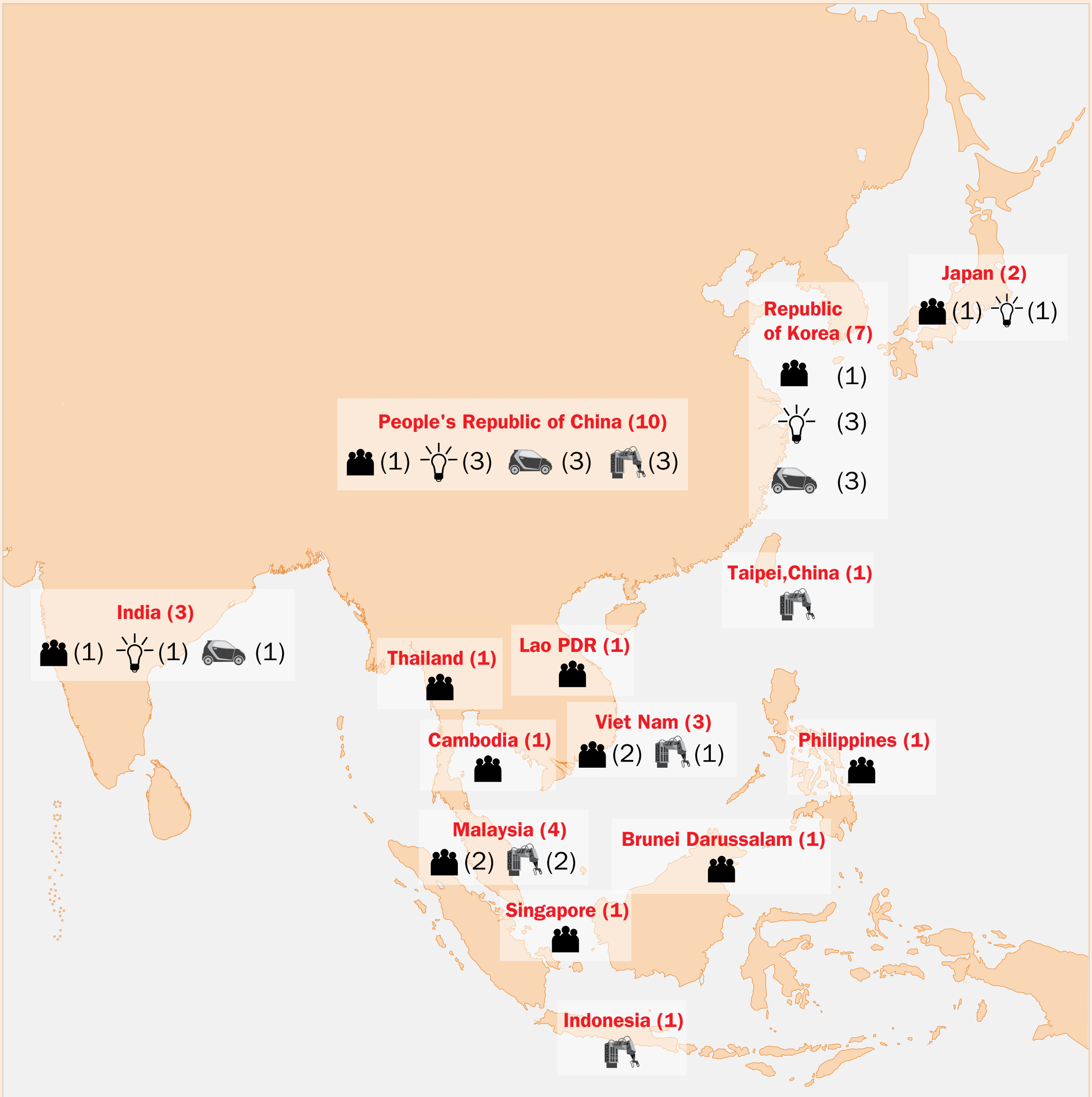
Notes: Number of offices, centers, and production sites in parenthesis (). AVC = audio-video and communication; CIE = consumer and industrial electronics; EEE = electrical and electronic equipment; EPC = electrical and electronic parts and components; HA = home appliances; IE = industrial electronics; Sem = semiconductors. Consumer electronics include AVC and home appliances. Industrial electronics include electrical and electronic parts, components, and equipment.

Source: Panasonic Global website. 2008. Corporate Profiles. Available: http://www.panasonic.net/corporate/global_network/ (accessed 28 February 2008).

Legend

- Sales and administration
- Research and development
- Production plant

Figure 3.9. Locations of a large Asian multinational company: automotive industry, 2008



Lao PDR = Lao People's Democratic Republic.
Source: Hyundai Global CSR Company. 2008. Global Operations.
Available: http://www. hyundai-motor.com (accessed 5 March 2008).
Also updated by Global PR Team, Hyundai Motor Company.

Legend

- Sales and administration
- Research and development
- Production plant
- Assembly plant

costs—are part of the answer. But the region's policy environment has arguably been even more important. Asia's liberal trade policies have fostered PCT, notably in the upstream capital goods required for integrating production processes spanning several countries. Domestic policies have also made it progressively easier and cheaper for both domestic and foreign firms to invest and do business. Combined with the region's natural advantages, such far-sighted policies have created exceptional opportunities for developing manufacturing centers and clusters.

For sure, this environment is still far from perfect. Trade could be liberalized further, and the infrastructure—both physical and bureaucratic—on which trade depends improved. Domestic reforms—notably in the areas of regulation, competition policy, and corporate governance—are also essential. This is especially true for countries that are just beginning to deregulate their economies and build the institutions of a market economy, as well as for those still resolving legacies of government intervention and cartelized or monopolistic markets.

Making it easier to do business

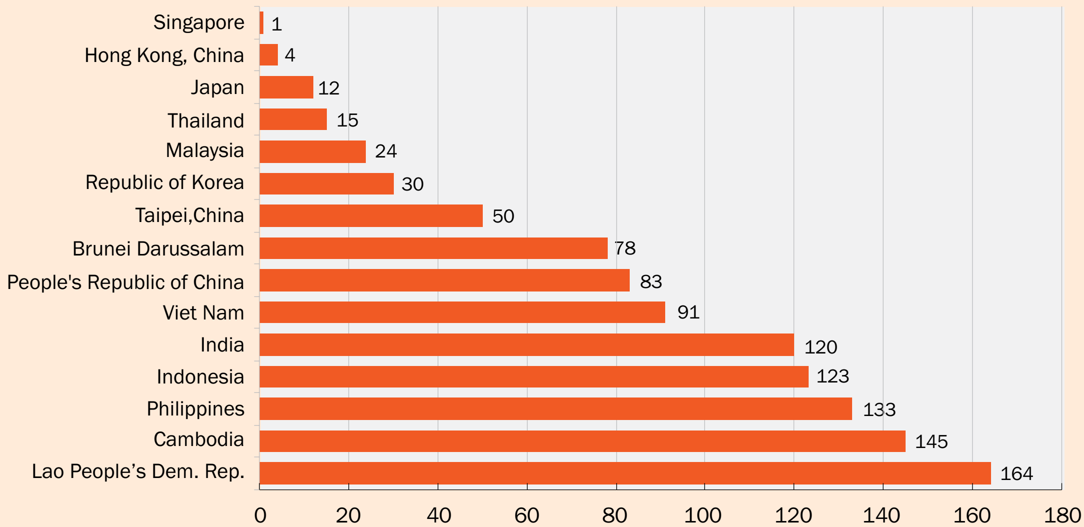
Among the national reforms that are most important for fostering regional supply chains are measures to make it easier to do business.[24] The World Bank's annual Doing Business survey, which gauges business regulations and their enforcement, seeks to provide an objective measure of the success of such policies. It covers 175 countries, including almost all of those covered by this report. Each is ranked according to an overall indicator of "ease of doing business" (Figure 3.10) as well as in the 10 specific areas listed in Table A3.2 in the Appendix to this chapter.[25]

Asian economies range from very liberal—Hong Kong, China; Japan; Singapore; and Thailand are in the world's top 20—to very restrictive. Five rank outside the top 100. Asia's strongest areas

[24] Results from Dee (2007) suggest that domestic regulatory reform should be a top priority for most developing Asian economies, not just to improve domestic efficiency, but to increase their attractiveness as locations for fragmented production.

[25] Under each of these general areas are subcategories. For example, under "starting a business", the survey includes rankings for the number of procedures required to start a business, the number of days it takes to complete these procedures, the cost as a percentage of per capita income, and minimum capital requirements as a percentage of per capita income. These subcategories are interesting, but this chapter focuses on the general categories. For greater detail, see http://www.doingbusiness.org/.

Figure 3.10. Ease of doing business varies across Asia
Rankings of 178 economies by the World Bank, 2007



Note: Economies are ranked on their ease of doing business, from 1 to 178, with first place being the best. A high ranking on the ease of doing business index means the regulatory environment is conducive to the operation of business. This index averages the country's percentile rankings on 10 topics, made up of a variety of indicators, giving equal weight to each topic.
No data available for Myanmar.
Source: World Bank 2008a. Doing Business 2008. Available: http://www.doingbusiness.org/economyrankings/ (accessed April 2008).

include "trading across borders," "getting credit," and "protecting investors"; its weakest involve "paying taxes," "starting a business" (in which the former planned economies still do poorly), and "dealing with licenses."

Such rankings are inevitably incomplete, and basing policy decisions on them would be erroneous. Yet they suggest plenty of scope for regional policy dialogue and reform. Not only do Asia's advanced economies score highly on all attributes, developing Asia also has world leaders in virtually every area of business policy. This represents a tremendous base of experience for informing policy and reform. Malaysia, for example, has one of the world's top-ranked investor protection systems; the Republic of Korea and Thailand have good licensing policies; while business exit is particularly well handled in Taipei,China. Sharing best practices ought to be a regional priority.

Improving market access

Asian economies have liberalized their trade policies considerably—sometimes remarkably so. In part, this has been driven by WTO accession, as well as by multilateral liberalization more generally. But many economies have also liberalized unilaterally as part of their outward-oriented development strategy.[26] Table 3.3 provides an indication of tariff levels in Integrating Asian economies in 2005 and shows how they have freed up their trade during the past two decades.[27]

Perhaps most significantly, the table shows how sharply the PRC reduced its tariffs between 1992 and 2005; it now compares favorably to most ASEAN countries. Much of this reduction occurred in a short period of time, reflecting the PRC's wide-ranging reforms as it intensified its outward-oriented development strategy and acceded to the WTO. India's liberalization has been less extensive so far, but is still significant, particularly since the 1991 crisis. Average tariffs in all manufactured sectors have fallen by more than half since 1990—in some cases, by much more—although tariff spikes persist in politically sensitive industries. In ASEAN, tariffs on manufactures have also generally come down, sometimes significantly. Save for modest exceptions, average tariffs are now less than 10% in all sectors. While Viet Nam's tariffs have been stable since 1994, its nontariff barriers have been slashed. Two economies—Hong Kong, China and Singapore—are essentially free-traders, and some regional economies are planning to follow suit. Brunei Darussalam has cut its tariffs to essentially zero except for machinery and miscellaneous manufactures. Cambodia and the Lao People's Democratic Republic are also likely to follow this path, in order to overcome the limitations of their small domestic markets. The more advanced economies of Japan; the Republic of Korea; and Taipei,China are also quite open, except in agriculture.

Yet tariff averages are an imperfect measure of openness to trade. Calculating tariff equivalents for import quotas is tricky enough,

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[26] For sure, to take advantage of international markets requires many other factors, such as macroeconomic stability, the capacity to provide correct microeconomic signals, the presence of economic infrastructure, forward-looking government policy (in terms of developing human capital, disseminating information on international markets, and overcoming market failures), and a well-prepared private sector.

[27] Given that this report focuses on changes in sectoral production more than on overall average production, data are shown for ten product categories (based on one-digit Harmonized System classification, aggregating from the five-digit classification).

while assessing the impact of discretionary licensing requirements and antidumping duties is even more so. The GATT's (WTO) Uruguay Round made some progress in addressing nontariff barriers (NTBs), notably by converting agricultural quotas into tariffs and phasing out "orderly-marketing arrangements" such as the Multi Fibre Arrangement. Increases in tariffs—particularly in agriculture—are often due to the conversion of NTBs into more transparent and less problematic tariffs, which are now being normalized and (it is hoped) will thus become easier to liberalize. EU and US import quotas on textiles and clothing from the PRC, for example, were permitted only as part of the PRC's WTO accession agreement and will have to be phased out in 2008.

Efforts to measure the comprehensive impact of all trade restrictions yield interesting but varied results. Feridhanusetyawan (2005) has produced trade restrictiveness indexes that suggest that Hong Kong, China; Singapore; and Taipei,China have the lowest restrictions. Most other Asian economies, including Cambodia, the PRC, India, and the five largest ASEAN economies, are ranked "intermediate"; only three (the Lao People's Democratic Republic, Myanmar, and Viet Nam) are described as "restrictive." In some of these countries, substantial changes have since occurred. An index by Kee, Nicita, and Olareaga (2006) yields somewhat different outcomes; for example, most Asian economies rank ahead of Singapore in their study's overall trade restrictiveness index (Figure 3.11). The study also finds that Asian economies generally offer better import access than their trading partners offer to Asian exports.

Perhaps the most impressive feature of Asia's trade policy over the last decade is what did not happen. Rather than restraining imports during the 1997/98 financial crisis and its difficult aftermath, Asian economies continued to open up. Indeed, tariff indicators may understate the progress made. The region's transitional economies have introduced new, trade-oriented commercial policy regimes, and most economies have adopted the more rigorous NTB framework developed in WTO's Uruguay Round. Yet there are still high average tariffs in some sectors, significant tariff spikes, and problematic NTBs in some countries. In short, while Asia's trade liberalization has been impressive, much remains to be done.

3.3. Trade cooperation

Asian economies have broadly liberalized their trade; their progress compares favorably with most other regions. The trend for trade

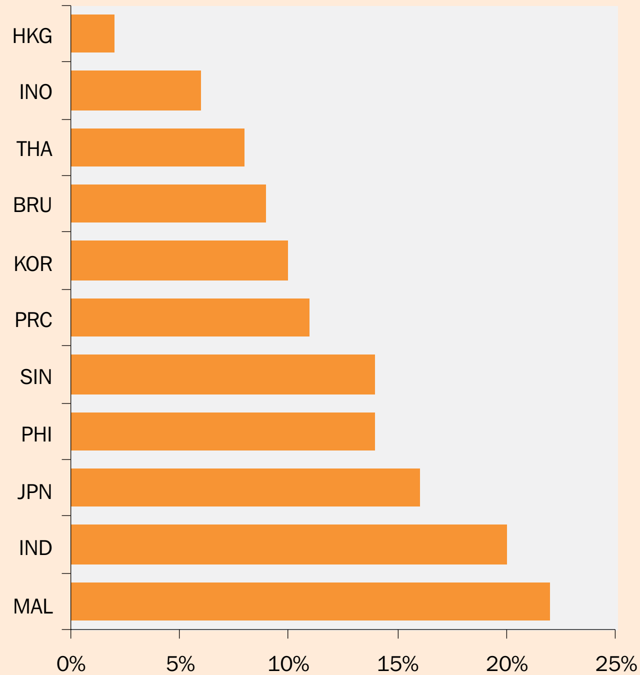
Table 3.3 Trade policy in Integrating Asia: ad valorem applied tariffs, various years

Economy	Year	Food and animals	Beverages and tobacco	Crude materials	Mineral fuel, lubricants, etc.	Animal and vegetable oil
Brunei Darussalam	1992	0.0	24.2	3.8	0.0	0.0
	2005	0.1	0.0	0.6	0.0	0.0
Cambodia	2001	9.7	9.8	7.9	22.4	7.0
	2003	12.2	9.0	7.6	21.6	7.0
China, People's Republic of	1992	13.8	105.5	13.7	8.2	27.2
	2005	12.5	12.2	3.5	1.6	13.2
Hong Kong, China	1988	0.0	0.0	0.0	0.0	0.0
	2005	0.0	0.0	0.0	0.0	0.0
India	1990	40.7	284.3	66.5	4.0	116.8
	2005	46.0	83.7	12.4	11.0	82.3
Indonesia	1990	9.3	18.5	4.3	3.6	18.6
	2005	5.8	31.5	1.8	3.8	3.8
Japan	1990	12.6	13.9	1.0	1.6	8.0
	2005	16.9	3.9	0.6	0.6	3.4
Korea, Republic of	1990	11.9	37.9	3.6	5.5	8.9
	2004	93.3	21.9	23.4	4.0	7.2
Malaysia	1991	4.4	44.1	3.0	3.6	1.9
	2005	3.0	19.8	1.1	1.2	2.1
Philippines	1990	19.5	27.1	11.8	10.3	24.6
	2005	7.7	9.6	3.2	4.8	10.5
Singapore	1989	0.1	0.0	0.0	4.3	0.0
	2005	0.0	4.0	0.0	0.0	0.0
Taipei,China	1989	16.7	42.5	1.7	10.6	11.2
	2005	10.6	16.7	0.4	1.1	1.7
Thailand	1991	47.4	19.0	14.5	24.9	20.0
	2005	10.0	59.3	4.4	0.4	15.7
Viet Nam	1994	17.5	119.8	0.6	36.6	15.4
	2005	17.7	77.0	1.8	14.8	33.9

Note: Ad valorem equivalents calculated using the United Nations Commission on Trade and Development (UNCTAD) Method 1.
Source: UNCTAD 2007b. Trade Analysis and Information System (TRAINS). Available: http://wits.worldbank.org/witsweb/ (accessed December 2007).

Chemical products	Manufactured goods	Machinery and transport equipment	Miscellaneous manufacturers	Other commodities	Year	Economy
2.3	1.6	6.2	4.3	0.0	1992	Brunei Darussalam
1.1	1.6	11.4	3.7	0.0	2005	
6.8	16.9	18.9	20.8	0.3	2001	Cambodia
5.9	16.8	18.8	21.0	0.4	2003	
22.2	41.8	34.0	50.2	36.5	1992	China, People's Republic of
7.3	6.4	4.0	7.6	5.6	2005	
0.0	0.0	0.0	0.0	0.0	1988	Hong Kong, China
0.0	0.0	0.0	0.0	0.0	2005	
93.5	71.7	74.0	66.5	93.7	1990	India
14.7	16.1	9.8	11.3	15.0	2005	
7.1	13.3	19.5	16.0	18.8	1990	Indonesia
5.7	8.6	5.6	9.3	0.5	2005	
4.3	3.0	0.1	6.2	0.3	1990	Japan
1.9	1.8	0.1	4.8	1.0	2005	
11.4	10.7	11.5	12.8	3.4	1990	Korea, Republic of
7.4	4.0	3.5	6.3	2.8	2004	
9.9	13.4	10.3	12.4	2.5	1991	Malaysia
4.9	15.5	2.8	4.8	0.1	2005	
12.7	19.8	13.4	21.2	28.7	1990	Philippines
5.0	6.0	1.8	5.7	3.8	2005	
0.0	0.0	0.9	0.8	0.0	1989	Singapore
0.0	0.0	0.0	0.0	0.0	2005	
6.5	9.1	12.8	9.1	0.9	1989	Taipei,China
1.9	1.9	2.7	2.2	0.0	2005	
31.3	18.3	37.4	42.8	35.1	1991	Thailand
6.8	5.5	6.1	11.2	0.2	2005	
2.5	18.6	12.0	20.3	0.6	1994	Viet Nam
3.9	18.0	13.2	21.7	6.6	2005	

Figure 3.11. Overall trade restrictive index in Asia



BRU=Brunei Darussalam; HKG=Hong Kong, China; IND=India; INO=Indonesia; JPN=Japan; KOR=Republic of Korea; MAL=Malaysia; PHI=Philippines; PRC=People's Republic of China; SIN=Singapore; THA=Thailand.
Note: The restrictiveness indexes are estimated using 2005–2006 tariff schedules.
Source: Data adapted from Kee, Nicita, and Olareaga. 2006.

liberalization reflects unilateral policies as well as a sustained commitment to global liberalization. But the world is changing. As of May 2008, an agreement on the WTO's Doha Development Agenda remains elusive, and new or deeper regional or subregional arrangements are emerging. Until the establishment of AFTA in 1992, Asia had not participated in any regional trade agreements, but bilateral and other preferential trade agreements have now taken hold in Asia, too. This poses a great challenge to the region's traditional model of cooperation, which has relied on unilateral and global approaches to trade policy.

The rise of free trade agreements

Given Asia's large stake in global markets, the region's new interest in bilateral and plurilateral FTAs is a surprising departure from its earlier trade policies. Such agreements could lead to preferential blocs that undermine the global trading system and make it particularly difficult to accommodate the rise of the PRC and India. Yet in the absence of global agreements, more limited regional agreements could be effective—both in sustaining progress toward more open markets and in fostering deeper regional integration among outward-oriented countries.

There is good reason to expect that Asia's bilateral and regional trade agreements will prove to be consistent with globally-oriented integration strategies. They are primarily motivated not by the pursuit of protectionist preferences, but by frustration at the slow pace of global liberalization. Since the Doha Round is stalled, economies that wish to pursue deeper integration need to take the regional route. Asian economies could thus benefit from well-designed regional agreements that are consistent with WTO and include best practices for minimizing trade diversion. Such outward-oriented regional agreements could set a model for other regions and ultimately lay the groundwork for further multilateral liberalization.

Regionalism in Asia is partly defensive. Virtually all developed countries are pursuing preferential trading arrangements that could divert trade and investment away from Asia. European integration has deepened greatly since the 1990s—notably through the creation of a single EU market and the successful launch of the euro—while the EU has also admitted transition economies in Central and Eastern Europe that could potentially compete with Asia for trade and investment. In addition to NAFTA, the US has pursued many FTAs around the world. Since Asia's final exports often go to Europe and the US, the rules of origin requirements (ROORs) built into the new FTAs could have an important bearing on MNCs' sourcing in Asia. Asian economies understandably feel compelled to conclude their own agreements with these critical markets. Another factor behind FTAs' popularity is the perceived success of deeper integration in the EU as well as in NAFTA. Each involves a wide range of provisions that go beyond trade liberalization, such as the national treatment of investment. International agreements are seen as a means to remove domestic impediments to market integration and reduce international transaction costs.[28]

Somewhat paradoxically, the PRC's admission to the WTO in December 2001 may also have given an impetus to regional FTAs. Joining the WTO has forced the PRC to enact many rules-based policies, open its markets, and create new opportunities for FDI and trade—and thus made it an even more effective exporter. The fear of increased competition from the PRC has made some WTO members reluctant to liberalize "too much" and encouraged them to seek more limited agreements instead.[29] At the same time, the rise of the PRC and India has also drawn attention to the benefits of large integrated domestic markets. The decision to accelerate the development of the ASEAN Economic Community to 2015 (discussed in Chapter 7) may also have been partly motivated by these factors. A single ASEAN market would be closer in size to the PRC's and India's, allowing it to achieve greater scale economies and other dynamic effects that would enhance its competitiveness and attract investors.

Within ASEAN, the many bilateral FTAs under negotiation provide a further rationale for integration. Members' external agreements threaten to undermine ASEAN solidarity and even its integration, since the resulting FTAs could be deeper than those within ASEAN itself. One solution is to pursue deeper integration in ASEAN; another is to maximize members' leverage by negotiating FTAs collectively. ASEAN is pursuing both options: it has negotiated an FTA with the PRC and is in talks with India, Japan, and the Republic of Korea. Negotiations with Australia and New Zealand, as well as with the EU, are also proceeding.

A summary of Asia's FTA initiatives (Table 3.4) shows that nearly twice as many agreements are being negotiated or have been proposed as have been concluded. As of December 2007, integrating Asian economies had concluded 44 FTAs, while 49 were under negotiation and a further 41 had been proposed. While Singapore has concluded the most (11) and has 10 FTAs under negotiation and five proposed, the PRC, India, and the Republic of Korea each have 15 or more in the pipeline. One reason why these economies are more active in negotiating FTAs may be their superior trade negotiating capacity. Less developed economies (Cambodia, the Lao People's Democratic

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[28] Menon (2007) defines "market restoring" as the first motivation and "sector expanding" the second one.

[29] This was explicitly noted as a motivation for Brazil's initiation of free trade agreement (FTA) negotiations with the EU (Miller 2007).

Table 3.4. Integrating Asia's free trade agreements
Status as of December 2007

Negotiating body	Concluded	Under negotiation	Proposed	Total	of which	
					inside IA	Outside IA
ASEAN	2	4	0	6	4	2
Brunei Darussalam	3	0	4	7	3	4
Cambodia	1	0	2	3	2	1
China, People's Republic of	7	6	9	22	8	14
Hong Kong, China	1	1	0	2	1	1
India	8	10	12	30	8	22
Indonesia	3	1	6	10	4	6
Japan	8	7	4	19	12	7
Korea, Republic of	6	5	11	22	9	13
Lao People's Dem. Rep.	3	0	2	5	3	2
Malaysia	4	5	4	13	5	8
Myanmar	1	1	2	4	2	2
Philippines	2	0	4	6	3	3
Singapore	11	10	5	26	6	20
Taipei,China	4	2	1	7	0	7
Thailand	6	6	6	18	7	11
Viet Nam	1	1	2	4	3	1
Total	**44**	**49**	**41**	**134**	**30**	**104**
Concluded					14	30
Under negotiation					8	41
Proposed					8	33

ASEAN = Association of Southeast Asian Nations, IA = Integrating Asia.
The total avoids double counting and does not correspond to the vertical sum of agreements by status.
Notes on status of free trade agreements:
Concluded = Signed and/or under implementation.
Under negotiation = Under negotiation with or without a signed framework agreement.
Proposed = Involved parties are considering creating an agreement, establishing joint study groups or joint task forces, and/or conducting feasibility studies for an agreement.
Source: Data from Asia Regional Integration Center. 2008. FTA Database. Available: http://www.aric.adb.org (accessed March 2008).

Republic, Myanmar, and Viet Nam) tend to rely more heavily on AFTA- and ASEAN-negotiated FTAs instead. In any case, most of the agreements involve non-Asian countries: of the total 134 FTAs, 104 were with countries outside the region.[30] In short, while the pattern of regional agreements is still fluid, a great many deals are happening.

FTAs' coverage and depth vary significantly. The deepest and most wide-ranging are typically bilateral deals with developed partners, in particular Japan and the US. The US–Singapore FTA, for example, is being used as a model for other FTAs with ASEAN countries under the Enterprise for ASEAN Initiative.[31] It includes chapters stipulating WTO-plus features in intellectual property rights and foreign investment; government procurement; e-commerce; technical barriers to trade; environment and labor; and financial services, telecommunications, and cross-border services.

As FTAs proliferate, the question of whether greater benefits could be achieved by integrating them naturally arises. The consolidation of Asia's bilateral and regional FTAs has been explored in ASEAN+3[32] meetings and at the East Asian Summit (EAS). While no decisions have been taken, high interest in such efforts is significant. Similar initiatives could eventually be considered with partners outside Asia, too—for example, in the context of APEC, which has recently begun to explore the option of a "Free Trade Area of the Asia-Pacific," or through the ASEAN–EU FTA, which is under negotiation.

The economics of Asian free trade agreements

The strongest arguments for FTAs in Asia relate to their dynamic effects, which are cumulative and pervasive.[33] Asian tariffs are low and falling, so the trade diversion usually associated with discriminatory agreements is limited. If FTAs can reduce the transaction costs of trading and investment, they can create a production base of unparalleled scale and diversity. Regional production and trade networks are the principal drivers and beneficiaries of this process.

[30] Japan is the only large Asian economy with a significant positive regional bias. For all other Asian economies, the sum of FTAs that have been concluded, are under negotiation, or are proposed with economies outside Integrating Asia is higher than that for inside the region, with the exceptions of Cambodia, the Lao People's Democratic Republic, and Viet Nam.

[31] For details, see Naya and Plummer (2005), Chapter 4.

[32] Association of Southeast Asian Nations (ASEAN) countries plus the People's Republic of China (PRC), Japan, and the Republic of Korea.

[33] A detailed review of these dynamic effects would be beyond the scope of this text. For a more detailed review, see Plummer (2007).

By boosting FDI inflows, FTAs could promote technology transfer and make it easier to adopt trade- and investment-facilitating measures, such as harmonized customs classifications and procedures, compatible product standards, and best practices in accounting and management—all of which bolster efficiency and attract investment. Such deep integration can be difficult to implement because it involves domestic measures that require complementary national policies in several countries. Yet progress may arguably be easier in Asia because of its shared commitment to outward-oriented growth.

The traditional objection to FTAs focuses on static trade effects. While FTAs remove discrimination among partner countries (and thus create trade), they discriminate in favor of members at the expense of nonmembers (and thus divert trade to less productive suppliers located within the FTA). This worsens an economy's terms of trade, since it implies purchasing imports from a higher-cost source. It also worsens the terms of trade of efficient outside producers, since they are left with smaller markets for their products.

Preferential FTA sourcing can also generate "investment diversion," that is, FDI inflows into a protected market. However, if an FTA expands the coverage of goods and services that are open to international competition and involves deeper liberalization, it may discriminate less across products than would be the case with multilateral liberalization, causing fewer ultimate distortions.[34] And since agreements among a few countries may be easier to conclude than at the WTO level, FTAs might deliver wider, deeper, and faster results than multilateral liberalization.

Are, then, FTAs building or stumbling blocks to global free trade? It depends on the context and structure of each FTA. An agreement that seeks to bolster inefficient regional industries will be harmful. But this is not what most Asian economies are seeking to achieve. They have long pursued outward-looking policies and their levels of protection are low and falling. Indeed, preferential arrangements may accelerate reductions in Asian economies' barriers to third countries, as they seek to avoid losses associated with trade diversion. In effect, this could lead to the multilateralization of regional concessions.[35] More generally, FTAs can be specifically designed to remain outward-

[34] For example, WTO's Article XXIV states that FTAs should generally reduce tariffs to zero.

[35] For example, as ASEAN Free Trade Area (AFTA) began to be implemented, the Philippines proposed, with a good deal of support, that AFTA cuts should be multilateralized.

oriented and embrace best practices, as described in the following section.

The most serious concern with recent FTAs involves their ROORs, which stipulate that a certain percentage of value added, or a substantial transformation of a product, take place within the FTA members. These rules are often product-specific and involve costly bureaucratic requirements that protect home producers. NAFTA, for example, requires that 62.5% of the value added of most products be produced in North America; in the case of textiles, the rate is essentially 100%, because of the "yarn forward" rule. Worse, a country that concludes many FTAs could end up with different rules for a product in each of its FTAs, creating confusion and distortion in input sourcing decisions.

Kawai and Wignaraja (2008) have examined the consistency of ROORs across various Asian FTAs. Considering the six major four-digit Harmonization Schedule codes in autos and auto parts, they find that ROORs in the Japan–Malaysia, Japan–Singapore, and Japan–Thailand FTAs are not consistent in any product line, and that the Japan–Malaysia and Japan–Thailand agreements are consistent in only two. James (2006) also finds that Asian FTAs generally lack consistency. Compliance costs present a further problem. Estevadeordal and Suominen (2003) estimate that an FTA's special reporting requirements may cost 3–5% of the value of exports. Indeed, Baldwin (2007) argues that "almost no one uses AFTA preferences" and that the AFTA utilization rate is less than 3%.[36] Other studies tend to confirm this view and find that the utilization rate of FTAs by firms across the integrating Asia region is usually below 10%. While this tendency is closely related to Asia's already relatively low average tariff rates, a strong advantage of the multilateral WTO framework is that it mostly avoids the effect of inconsistent and/or expensive ROOR compliance problems.

FTAs have advantages and drawbacks, and it is too early to tell what their overall impact on Asia will be. Ex ante models (such as ADB 2006a) predict positive effects, but find that the benefits of a

[36] Intra-ASEAN trade constitutes about a quarter of the region's total trade, and much of this is either in petroleum—in which there are not only low or zero tariffs but also much double counting—and intra-industry electronics trade, where tariffs are eliminated by the World Trade Organizations (WTO) Information Technology Agreement and by export processing zone duty waivers and drawbacks. Singapore accounts for the largest share of intra-ASEAN trade, a large percentage of which is entrepot trade and not eligible for preferences. Hence, the low (but much-quoted) utilization rate underestimates the effectiveness of AFTA.

typical bilateral agreement are dwarfed by those of region-wide accords. Wider, deeper agreements produce bigger gains than more limited ones, and following best practice policy guidelines can minimize the negative side effects of discriminatory trade practices. Plummer and Wignaraja (2007) find that, as theory predicts, both Asia and the rest of the world would gain most from multilateral trade liberalization. However, so long as the Doha Round remains stalled, Asian economies would gain most from tariff reductions at an ASEAN+3 or EAS-wide level, and very little from a disparate collection of bilateral agreements.

3.4. Regional strategies and solutions

The world economy is in flux. The economics of trade relations is changing, and the coalitions that built the global trading system are splintering. While Asia is becoming more interdependent, it also relies on global markets for its exports, notably of manufactures. Asia therefore needs to strike a careful, creative balance between promoting regional integration as a driver of economic growth and promoting multilateral cooperation and liberalization to sustain its broad, global trading interests. Asia's choices matter: its growing weight and interdependence are increasingly helping it shape its own—and the world's—destiny.

Championing global agreements

Asian regionalism has both global and regional dimensions. Asia's global interests call for nesting regional policies in a multilateral framework that ensures continued close cooperation with Europe, North America, and other regions. As discussed in Chapter 7, Asia's engagement in WTO and pan-regional forums such as APEC and the Asia-Europe Meeting (ASEM) provides a basis for strong relationships with the rest of the world. At the same time, Asia's regional interests require new frameworks to promote deeper integration across a wide range of areas, often beyond the purview of WTO and other global institutions. These three tracks—regional, pan-regional, and global—can all contribute to Asia's development if their efforts are strategically selected and complementary.

Asia's broad trade policy framework needs to recognize the primacy of WTO in managing the global trading system, and thus ensure that agreements within Asia are consistent with the letter and spirit of WTO rules. But it is in Asia's interest to go well beyond this minimum and to actively support the deepening of WTO, including by providing leadership to help overcome the deadlock in the Doha Round. Asia—and the world—has a large stake in achieving a "deep" Doha agreement, to produce balanced and ambitious results in agriculture as well as nonagricultural market access, with significant liberalization and as few excluded sectors as possible. Such an agreement should include progress in services, particularly in areas that affect FDI and international labor mobility; improved rules on contingent protection; clearer provisions for FTAs; and effective trade facilitation.[37] As an eventual Doha deal may take a decade to implement, its ambition must match its long time horizon.

Consolidating regional free trade agreements

In any case, regional approaches will remain useful. Deeper and wider integration may sometimes be more possible bilaterally and regionally than multilaterally. Progress may be possible on a range of issues that are not covered by WTO (including the "Singapore issues" of investment protection,[38] competition policy, transparency, and government procurement) and on policies that extend beyond national treatment to domestic regulation (Dee 2007).

Yet Asia's bilateral and subregional agreements are ripe for consolidation, to reap broader gains and to eliminate some of the distortions that they inevitably cause. If bilateral FTAs involving integrating Asian economies were based on a common template, their proliferation would make consolidation more likely—but, unfortunately, most are not. Meanwhile, the multiplication of bilateral agreements erodes the value of each of them; the benefits to each party are reduced when its partner extends similar privileges to third countries. At the same time, the cost to the private and public sectors of maintaining numerous unconnected agreements rises. All of this makes it increasingly attractive to consolidate smaller agreements into a region-wide FTA (Petri 2006).

How might such regional FTAs be configured? While even a system of bilateral FTAs may have positive welfare effects, economic analysis and intuition both suggest that wider arrangements would bring far larger gains than bilateral or disparate FTAs. An expansion of the area covered by an FTA can also mitigate the harmful "noodle-bowl effect" caused by a tangled web of agreements with overlapping ROORs and varying coverage, not least of services and investment-related provisions. Projections of welfare gains from consolidating FTAs in Asia

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[37] See, for example, ADB (2006a) for a complete discussion of these issues.

[38] The "Singapore issues" are so named because, at the WTO Ministerial in Singapore in 1996, four working groups pertaining to these issues were set up. They were taken off the agenda at the Cancún Ministerial in 2003 after protests from some developing countries that these were deemed to be too sensitive. Some progress, however, has been made on trade facilitation.

are discussed in Kawai and Wignaraja (2008). Using a global computable general equilibrium model they show that welfare gains for Asia increase with wider agreements (such as those that are ASEAN+3 or EAS-wide) in comparison with ASEAN+1-type FTAs.

Substantial additional research confirms this. Harrigan et al. (2007) note that large trade areas minimize trade diversion and that creating hub-and-spoke systems that "fail to connect the spokes" is very costly. Kawai and Wignaraja (2008) make a strong case for a single East Asian FTA to reduce the costs associated with overlapping ROORs and other inefficiencies. They find that an EAS arrangement would generate the largest gains, while costs to nonmembers from trade diversion would be small.

Best practices for subregional free trade agreements

The structure of a potential regional FTA is critical. Best practices for FTAs are examined in detail by Plummer (2007) and can be summarized in terms of 10 objectives: (1) comprehensive goods coverage, (2) comprehensive services coverage, (3) low and symmetrical rules of origin, (4) best practices in customs procedures and related measures, (5) strong trade-related intellectual property rights, (6) national treatment of FDI, (7) transparent and fair antidumping procedures and dispute resolution, (8) open and nondiscriminatory government procurement policies, (9) competition policies to create a level playing field, and (10) nondiscriminatory and transparent technical barriers. In effect, the more a regional FTA approximates global free trade, the greater its benefits and the smaller its costs. It should thus aim for the broadest possible coverage and the most far-reaching liberalization, with as little discrimination against nonmembers as feasible.

Using these rules, Plummer (2007) evaluates existing Asian FTAs, scoring them from A (generally conforms to best practices) to C (does not conform and could be inward-looking). Asian FTAs have shortcomings, notably in their ROORs (for accords in which at least one developed country is a signatory) and comprehensiveness (for developing country accords), but are generally more outward-oriented and conform better to best practice rules than FTAs in other regions (Table 3.5).

The issue of FTA design has also attracted considerable attention from APEC and the Pacific Economic Cooperation Council (PECC), which have developed general principles and guidelines.They stress that FTAs should embrace nondiscrimination, comprehensiveness,

Table 3.5. Grading selected free trade agreements involving integrating Asian economies

Free trade agreement	GOODS	SERV	ROO	GOVPRO	COMP	INV	IPR	MON	TBT
ASEAN Free Trade Area	A	C	A-	n.a.	n.a.	A-	n.a.	C	n.a.
India–Singapore Comprehensive Economic Cooperation Agreement	B	B	C	C	C	B+	C	A	A
Japan–Mexico Economic Partnership Agreement	A	B	C	A	A	A	A	A	A
Japan–Singapore Economic Agreement for New-Age Partnership	A	A	C	A	B	A	A	A	B
Republic of Korea–Chile Free Trade Agreement	B	B	C	A	A	A	A	A	A
Republic of Korea–Singapore Free Trade Agreement	B	B+	C	A	A	A	A	A	A
Singapore–Australia Free Trade Agreement	A	A	C	A	A	A	A	A	A
Singapore EFTA–Free Trade Agreement	C	A	C	B+	B	A	A	A	B
Singapore–New Zealand Closer Economic Partnership	A	B	A-	B+	A	A	A	A	A
Singapore–United States Free Trade Agreement	A	A	C	A	A	A	A	A	A
Thailand–United States Free Trade Agreement	A	B	C	B-	A	A	A	A	A

ASEAN = Association of Southeast Asian Nations, EFTA = European Free Trade Association, FTA = free trade agreement, n.a. = not applicable.
Notes:
In column headings, GOODS = trade in goods; SERV = trade in services; ROO = rules of origin; GOVPRO = government procurement (chapter/clauses); COMP = competition (chapter/clauses); INV = provisions for foreign direct investment; IPR = intellectual property protection (WTO Agreement on Trade-Related Aspects of Intellectual Property Rights [TRIPs] plus related conventions); MON = monitoring and dispute settlement provisions; TBT = technical barriers to trade.
Grading assigned by M. Plummer based on (1) consistency with World Trade Organization and outward orientation, (2) best practices, and (3) scope.
Source: Adapted from Plummer 2007.

flexibility, consistency with WTO, transparency, and cooperation. These principles are consistent with the best practice rules discussed previously, and as Scollay (2004) has noted, they are similar to the relevant clauses in the 1994 WTO Understanding on Interpretation of GATT Article XXIV. Unfortunately, there is little international oversight of FTAs, and many agreements—including some in Asia—have not followed best practice requirements.

Recent work by Harrigan, et al. (2007) assesses the benefits of "good practice agreements" in three dimensions: (1) their restrictiveness, (2) the extent to which "spokes" of an FTA hub are connected, and (3) the diversity of the members involved. They characterize differences using two parameters: the utilization rate (high for good practice FTAs; low for others), and the costs of complying with rules of origin and other requirements. They simulate a number of potential FTA configurations—for example, ASEAN+3 and EAS FTAs are compared with an "ASEAN hub" approach, in which ASEAN has FTAs with each of the three or six partners individually—and find that shallow FTAs yield far smaller gains than good practice arrangements. Again, region-wide FTAs generate the greatest gains. For example, while an ASEAN FTA increases GDP by 0.6%, adding the PRC nearly triples the gains to 1.6%, while an ASEAN+6 agreement boosts the gains by a further 50%. Rather than attempting to stop subregional and regional trade agreements, the thrust of international dialogue ought to shift to fostering broader agreements and to maintaining compatibility with multilateralism.

Investment, infrastructure, and labor

Regional investment agreements could further enhance integration. They reinforce domestic liberalization gains (for example, by ensuring rights to invest) and provide legal security for cross-border investment. Indirectly, their provisions often also protect investment from nonsignatories, and thus stimulate inflows from a wide range of potential partners. Their key features are legal and policy frameworks that make it easier, cheaper, and safer to invest. They have previously been used to develop industrial clusters and special economic zones, but, given Asia's rapid development, they could now be applied more widely. In its November 2002 report to the ASEAN+3 Summit, the East Asia Study Group recommended that East Asia explore expanding the ASEAN Investment Area into an East Asia investment area. Because many of the region's economies are now both important investors as well as host countries, such an agreement could stimulate FDI inflows as well as ensure the safety and productivity of investment outflows.

Infrastructure—transport, communication, and energy links among Asian economies and with regions that are poorly integrated into Asian production chains—is also critical to regional integration. Cost estimates of Asia's needs for new infrastructure by 2015 top $4.7 trillion, much of it to facilitate cross-border connectivity. According to an internal ADB estimate, developing the region's infrastructure will require $4.7 trillion in investment during 2006–2015—$3.1 trillion for new capacity and $1.6 trillion for replacing existing infrastructure. Investment in power and roads would account for about two thirds of total needs. Spurred by their blistering growth, the PRC and India would account for 80% of total investment needs.

Production networks across Asia were initially supported by governments with national economies in mind and typically prioritized links with distant global markets. Fortunately, the ports and airports associated with long-distance trade have also been able to serve intraregional flows. But Asia's regional transport requirements have grown so fast that its logistics is beginning to lag behind its competitors'. Surveys indicate a need not only for additional physical infrastructure, but also for improved processes to ensure the smooth flow of goods, services, and people. These include legal and regulatory frameworks; human and institutional capacities; and trade facilitation measures, such as streamlining customs, transit rules, and other regulations that govern transactions. Regional cooperation is needed—and is emerging—on these issues. Cooperation on infrastructure may not be glamorous, but it is vital.

Last but not least, the economic case for greater labor mobility is also strong, particularly given the region's demographic challenges. While political factors are clearly important, the complements between countries whose populations are ageing and those with rapid population growth are compelling. Migration could raise incomes both in source countries (where wages are relatively low) and in host countries (where migrants complement higher productivity workers). Flows of skilled labor represent the least controversial form of migration. Because such flows are often complementary to FDI, technology transfer, and other important productivity gains, they have already been prioritized in some countries, and some restrictions have been loosened (such as simpler processes for granting visa permits or waiving them altogether for business professionals). The ASEAN Economic Community aims to free up skilled labor flows by 2015, and many ASEAN nationals already benefit from easier access to short-term visas. Some aspects of migration are further explored in Chapter 6.

Supporting deeper integration

Asia's competitiveness is increasingly based on production networks—and, more fundamentally, on the diversity and deepening connections of Asian economies. Improvements in Asian competitiveness, in turn, require open global markets. The region has an overriding stake in sustaining this dynamic. This requires reducing impediments to trade and investment and adopting domestic reforms that facilitate market-led integration. Globally, it requires a continued commitment to open markets and approaches that complement and support WTO. This is why subregional initiatives in ASEAN, for example, explicitly recognize consistency with the global framework as a foundation for regional and subregional integration efforts.

Global liberalization remains the ideal context for Asian trade, and thus the top priority of the region's integration strategy. Asia now has the leverage to project its commitment to the world trading system in the global policy arena. It could help lead the successful conclusion of the Doha round and continue to foster and strengthen an open, global trading system.

Against the background of slow global progress, however, regional initiatives may also add value, because they may be able to go beyond issues addressed in global negotiations, and because they may accelerate progress among interdependent neighbors. A second priority, therefore, is to pursue regional liberalization on the widest scale possible, consistent with WTO obligations. Even bilateral FTAs, which are less likely to generate significant benefits (and may even have negative results), tend to work positively in actual Asian practice. A third priority, therefore, is to define best practices for regional FTAs, and to pursue their consolidation into a region-wide FTA. These efforts can ensure that the current wave of bilateral initiatives ends in significant gains, rather than a patchwork of inconsistent results.

Support for regional connections needs to go beyond trade. Complementary policies include developing connective infrastructure—such as transport systems that connect poorer regions and the region's poorest subregions to the core of Integrating Asia—and regional cooperation to help upgrade technology. Policies that make international investment easier and safer are also beneficial, especially in the context of production networks. The region's enormous pool of talented workers should have increased opportunities to fill gaps where skills and labor are short, and thus to enhance the productivity of the region as a whole.

These initiatives will require widespread political support. A comprehensive international study of the benefits of creating an Asian economic community could help. The efforts of the East Asian Study Group are an important first step, and its work, which has been carried forward in this report, needs to be continued. Because regional cooperation has broad, dynamic consequences—increased competition, innovation, and productivity growth—its effects are often underestimated. When the momentum of European integration began to flag in the 1980s, a special study known as "The Cost of Non-Europe" (or Cecchini Report) was commissioned. This produced compelling evidence that a single market could boost Europe's output by as much as 6%, and raise its trend growth rate. Based on careful work by a thoroughly international team, the results were widely circulated and accepted, and the report played a significant role in persuading the public of the urgency of a single market. The benefits of Asian integration could be even greater—and thus deserve similar analytical attention.

Chapter 3: appendix

Table A3.1. World net foreign direct investment flows, 1997–2006 ($ billion)

Economy	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Brunei Darussalam	0.7	0.6	0.7	0.5	0.5	1.0	3.4	0.3	0.3	0.4
Cambodia	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.4	0.5
PRC	45.3	45.5	40.3	40.7	46.9	52.7	53.5	60.6	72.4	69.5
Hong Kong, China	11.4	14.8	24.6	61.9	23.8	9.7	13.6	34.0	33.6	42.9
Japan	3.2	3.2	12.7	8.3	6.2	9.2	6.3	7.8	2.8	(6.5)
India	3.6	2.6	2.2	3.6	5.5	5.6	4.3	5.8	6.7	16.9
Indonesia	4.7	(0.2)	(1.9)	(4.6)	(3.0)	0.1	(0.6)	1.9	8.3	5.6
Korea, Republic of	2.6	5.1	9.9	9.0	4.1	3.4	4.4	9.0	7.0	5.0
Lao PDR	0.1	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.2
Malaysia	6.3	2.7	3.9	3.8	0.6	3.2	2.5	4.6	4.0	6.1
Myanmar	0.9	0.7	0.3	0.2	0.2	0.2	0.3	0.3	0.2	0.1
Philippines	1.2	1.8	1.2	2.2	0.2	1.5	0.5	0.7	1.9	2.3
Singapore	13.8	7.3	16.6	16.5	15.6	7.2	11.7	19.8	15.0	24.2
Taipei,China	2.2	0.2	2.9	4.9	4.1	1.4	0.5	1.9	1.6	7.4
Thailand	3.9	7.5	6.1	3.3	5.1	3.3	5.2	5.9	9.0	9.8
Viet Nam	2.6	1.7	1.5	1.3	1.3	1.2	1.5	1.6	2.0	2.3
Integrating Asia	102.7	93.6	121.4	152.0	111.3	100.2	107.1	154.4	165.2	186.6
United States	103.4	174.4	283.4	314.0	159.4	74.5	53.1	135.8	101.0	175.4
European Union	142.4	281.0	502.6	695.2	381.6	307.3	256.7	204.2	486.4	531.0
World	489.2	709.3	1,098.9	1,411.4	832.6	622.0	564.1	742.1	945.8	1,305.9

FDI = foreign direct investment, Lao PDR = Lao People's Democratic Republic, PRC = People's Republic of China.
European Union includes the 25 countries that were members as of 2006.
Source: UNCTAD various years. FDI Statistics Online. Available: http://stats.unctad.org/fdi/ReportFolders/ReportFolders.aspx?CS_referer=&CS_ChosenLang=en (accessed April 2008).

Table A3.2. Diversity in business policy in Integrating Asia: Global rankings of private sector efficiency, 2007

Economy	Overall rank	Starting a business	Ease of doing business			
			Protecting investors	Dealing with licenses	Paying taxes	Employing workers
Brunei Darussalam	78	117	121	66	28	4
Cambodia	145	162	64	144	21	133
China, People's Republic of	83	135	83	175	168	86
Hong Kong, China	4	13	3	60	3	23
Japan	12	44	12	32	105	17
India	120	111	33	134	165	85
Indonesia	123	168	51	99	110	153
Korea, Republic of	30	110	64	22	106	131
Lao People's Dem. Rep.	164	78	176	111	114	82
Malaysia	24	74	4	105	56	43
Philippines	133	144	141	77	126	122
Singapore	1	9	2	5	2	1
Taipei,China	50	103	64	128	91	148
Thailand	15	36	33	12	89	49
Vietnam	91	97	165	63	128	84

Note: Economies are ranked on their ease of doing business, from 1 to 178, with first place being the best. A high ranking on the ease of doing business index means the regulatory environment is conducive to business. This index averages the country's percentile rankings on 10 topics, using a variety of indicators and giving equal weight to each topic.
Source: World Bank 2008a. Doing Business Report 2008. Available: http://www.doingbusiness.org/economyrankings (accessed April 2008).

Ease of doing business				
Trading across borders	Registering property	Enforcing contracts	Getting credit	Closing a business
36	178	158	97	35
139	98	134	177	178
42	29	20	84	57
3	58	1	2	15
18	48	21	13	1
79	112	177	36	137
41	121	141	68	136
13	68	10	36	11
158	149	111	170	178
21	67	63	3	54
57	86	113	97	147
1	13	4	7	2
29	24	92	48	13
50	20	26	36	44
63	38	40	48	121

Table A3.3. Status of free trade agreements involving integrating Asian economies

Integrating Asia's total free trade agreements as of December 2007	Concluded	Under negotiation	Proposed	of which Inside IA	Outside IA
ASEAN Free Trade Area (1)	✓			✓	
ASEAN-Australia and New Zealand Free Trade Agreement	✓			✓	
ASEAN-China Comprehensive Economic Cooperation Agreement	✓			✓	
ASEAN-European Union Free Trade Agreement		✓			✓
ASEAN-India Regional Trade and Investment Area			✓		✓
ASEAN-Japan Comprehensive Economic Partnership			✓		✓
ASEAN-Korea Comprehensive Economic Cooperation Agreement		✓			✓
Asia-Pacific Trade Agreement (2)	✓				✓
Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation Free Trade Area (3)			✓		✓
East Asia Free Trade Area (4)			✓	✓	
East Asia Summit Free Trade Area (5)			✓		✓
Preferential Tariff Arrangement-Group of Eight Developing Countries (6)	✓				✓
Shanghai Cooperation Organization Free Trade Agreement (7)			✓		✓
South Asian Free Trade Area (8)	✓				✓
Trade Preferential System of the Organization of the Islamic Conf. (9)		✓			✓
Trans-Pacific Strategic Economic Partnership Agreement (10)	✓				✓
Brunei Darussalam-Japan Free Trade Agreement	✓			✓	
Brunei Darussalam-Pakistan Free Trade Agreement			✓		✓
Brunei Darussalam-United States Free Trade Agreement			✓		✓
Hong Kong-New Zealand Closer Economic Partnership		✓			✓
Hong Kong-People's Republic of China Closer Economic Partnership Arrangement	✓			✓	
India-Afghanistan Preferential Trading Agreement	✓				✓
India-Australia Free Trade Agreement			✓		✓
India-Chile Preferential Trading Agreement	✓				✓
India-Colombia Preferential Trading Arrangement			✓		✓
India-Egypt Preferential Trade Agreement		✓			✓
India-European Free Trade Association Free Trade Agreement			✓		✓
India-European Union Free Trade Agreement		✓			✓
India-Gulf Cooperation Council Free Trade Area		✓			✓
India-Japan Economic Partnership Agreement		✓		✓	
India-Indonesia Comprehensive Economic Cooperation Arrangement		✓	✓		
India-Israel Preferential Trade Agreement			✓		✓
India-Korea Comprehensive Economic Partnership Agreement		✓		✓	
India-Malaysia Comprehensive Economic Cooperation Agreement		✓	✓	✓	
India-Mauritius Comprehensive Economic Cooperation and Partnership Agreement	✓			✓	

Integrating Asia's total free trade agreements as of December 2007		Under		of which	
	Concluded	negotiation	Proposed	Inside IA	Outside IA
India-MERCOSUR Preferential Trade Agreement	✓				✓
India-Nepal Treaty of Trade	✓				✓
India-New Zealand Free Trade Agreement			✓		✓
India-People's Republic of China Regional Trading Arrangement			✓	✓	
India-Russian Federation Comprehensive Economic Cooperation Agreement			✓		✓
India-Singapore Comprehensive Economic Cooperation Agreement	✓			✓	
India-Southern African Customs Union Preferential Trade Agreement		✓			✓
India-Sri Lanka Free Trade Agreement	✓				✓
India-Thailand Free Trade Area		✓		✓	
India-Uruguay Preferential Trading Arrangement			✓		✓
India-Venezuela Preferential Trading Arrangement			✓		✓
Indonesia-Australia Free Trade Agreement			✓		✓
Indonesia-European Free Trade Association Free Trade Agreement			✓		✓
Indonesia-Japan Economic Partnership Agreement	✓			✓	
Indonesia-Pakistan Free Trade Agreement		✓			✓
Indonesia-United States Free Trade Agreement			✓		✓
Japan-Australia Economic Partnership Agreement		✓			✓
Japan-Canada Free Trade Agreement			✓		✓
Japan-Chile Economic Partnership Agreement	✓				✓
Japan-Gulf Cooperation Council Free Trade Agreement		✓			✓
Japan-Korea Free Trade Agreement		✓		✓	
Japan-Malaysia Economic Partnership Agreement	✓			✓	
Japan-Mexico Economic Partnership Agreement	✓				✓
Japan-Korea-People's Republic of China Free Trade Agreement			✓	✓	
Japan-Philippines Economic Partnership Agreement		✓			✓
Japan-Singapore Economic Agreement for a New-Age Partnership	✓			✓	
Japan-Switzerland Economic Partnership Agreement		✓			✓
Japan-Thailand Economic Partnership Agreement	✓			✓	
Japan-Vietnam Economic Partnership Agreement		✓		✓	
Korea-Australia Free Trade Agreement			✓		✓
Korea-Canada Free Trade Agreement		✓			✓
Korea-Chile Free Trade Agreement	✓				✓
Korea-European Free Trade Association Free Trade Agreement	✓				✓
Korea-European Union Free Trade Agreement		✓			✓
Korea-Gulf Cooperation Council Free Trade Agreement			✓		✓
Korea-Malaysia Free Trade Agreement			✓	✓	
Korea-MERCOSUR Preferential Trading Agreement			✓		✓

Table A3.3. continued.

Integrating Asia's total free trade agreements as of December 2007	Concluded	Under negotiation	Proposed	of which Inside IA	of which Outside IA
Korea-Mexico Strategic Economic Complementation Agreement		✓			✓
Korea-New Zealand Closer Economic Partnership			✓		✓
Korea-People's Republic of China Free Trade Agreement			✓	✓	
Korea-Singapore Free Trade Agreement	✓			✓	
Korea-South Africa Free Trade Agreement			✓		✓
Korea-Thailand Free Trade Agreement			✓	✓	
Korea-United States Free Trade Agreement	✓				✓
Laos-Thailand Preferential Trading Arrangement	✓			✓	
Malaysia-Australia Free Trade Agreement		✓			✓
People's Republic of China-Gulf Cooperation Council Free Trade Agreement	✓			✓	
People's Republic of China-Iceland Free Trade Agreement		✓			✓
People's Republic of China-Macao Closer Economic Partnership Arrangement	✓			✓	
People's Republic of China-New Zealand Free Trade Agreement		✓			✓
People's Republic of China-Norway Free Trade Agreement			✓		✓
People's Republic of China-Pakistan Free Trade Agreement	✓				✓
People's Republic of China-Peru Free Trade Agreement			✓		✓
People's Republic of China-Singapore Free Trade Agreement		✓		✓	
People's Republic of China-South Africa Free Trade Agreement			✓		✓
People's Republic of China-South African Customs Union Free Trade Agreement	✓			✓	
People's Republic of China-Thailand Free Trade Agreement	✓			✓	
Philippines-Pakistan Free Trade Agreement			✓		✓
Philippines-United States Free Trade Agreement			✓		✓
Singapore-Australia Free Trade Agreement	✓				✓
Singapore-Bahrain Free Trade Agreement			✓		✓
Singapore-Canada Free Trade Agreement		✓			✓
Singapore-Egypt Comprehensive Economic Cooperation Agreement		✓			✓
Singapore-European Free Trade Association	✓				✓
Singapore-Gulf Cooperation Council Free Trade Agreement		✓			✓
Singapore-Jordan Free Trade Agreement	✓				✓
Singapore-Kuwait Free Trade Agreement		✓			✓
Singapore-Mexico Free Trade Agreement		✓			✓
Singapore-New Zealand Closer Economic Partnership	✓				✓
Singapore-Pakistan Free Trade Agreement		✓			✓
Singapore-Panama Free Trade Agreement	✓				✓
Singapore-Peru Free Trade Agreement		✓			✓

Integrating Asia's total free trade agreements as of December 2007	Concluded	Under negotiation	Proposed	of which	
				Inside IA	Outside IA
Singapore-Qatar Free Trade Agreement	✓			✓	
Singapore-Sri Lanka Comprehensive Economic Partnership Agreement			✓		✓
Singapore-Ukraine Free Trade Agreement	✓			✓	
Singapore-United Arab Emirates Free Trade Agreement			✓		✓
Singapore-United States Free Trade Agreement	✓				✓
Taipei,China-Dominican Republic Free Trade Agreement		✓			✓
Taipei,China-El Salvador-Honduras Free Trade Agreement	✓				✓
Taipei,China-Guatemala Free Trade Agreement	✓				✓
Taipei,China-Nicaragua Free Trade Agreement	✓				✓
Taipei,China-Panama Free Trade Agreement	✓				✓
Taipei,China-Paraguay Free Trade Agreement		✓			✓
Taipei,China-United States Free Trade Agreement		✓		✓	
Thailand-Australia Free Trade Agreement	✓				✓
Thailand-Bahrain Free Trade Agreement		✓			✓
Thailand-Chile Free Trade Agreement			✓		✓
Thailand-European Free Trade Association Free Trade Agreement		✓			✓
Thailand-MERCOSUR Free Trade Agreement			✓		✓
Thailand-New Zealand Closer Economic Partnership Agreement	✓				✓
Thailand-Pakistan Free Trade Agreement			✓		✓
Thailand-Peru Free Trade Agreement		✓			✓
Thailand-United States Free Trade Agreement		✓			✓

MERCOSUR = Southern Common Market: includes Argentina, Brazil, Paraguay, and Uruguay.
Notes:
(1) ASEAN Free Trade Area members include Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic (Lao PDR), Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam.
(2) Asia-Pacific Trade Agreement members include Bangladesh, People's Republic of China (PRC), India, Republic of Korea, Lao PDR, and Sri Lanka.
(3) Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation Free Trade Area member countries include Bangladesh, Bhutan, India, Myanmar, Nepal, Sri Lanka, and Thailand.
(4) East Asia Free Trade Area members include all the ASEAN countries plus the PRC, Japan, and Republic of Korea (i.e., ASEAN+3).
(5) East Asia Summit Free Trade Area members include all ASEAN+3 countries plus Australia, India, and New Zealand.
(6) Preferential Tariff Arrangement–Group of Eight developing countries' members include Bangladesh, Egypt, Indonesia, Islamic Republic of Iran, Malaysia, Nigeria, Pakistan, and Turkey.
(7) Shanghai Cooperation Organization Free Trade Agreement members include the PRC, Kazakhstan, Kyrgyz Republic, Russian Federation, Tajikistan, and Uzbekistan.
(8) South Asian Free Trade Area members include Bhutan, Bangladesh, India, Maldives, Nepal, Pakistan, and Sri Lanka.
(9) Trade Preferential System of the Organization of the Islamic Conference members include Bahrain, Bangladesh, Cameroon, Egypt, Guinea, Islamic Republic of Iran, Jordan, Lebanon, Libyan Arab Jamahiriya, Malaysia, Pakistan, Senegal, Syrian Arab Republic, Tunisia, Turkey, Uganda, and United Arab Emirates.
(10) Trans-Pacific Strategic Economic Partnership Agreement members include Brunei Darussalam, Chile, New Zealand, and Singapore.
Source: Data from Asia Regional Integration Center. ADB. Available: http//www.aric.adb.org (accessed March 2008).

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Chapter 4

Integrating financial markets

Financial integration has had a troubled history in Asia. Decades of bank-dominated and highly directed lending have left financial markets relatively underdeveloped, while the 1997/98 financial crisis has left an understandable wariness of the risks of open capital markets. Unsurprisingly, then, this study finds that Asia's trade—and hence its trade-related bank claims—is much more integrated than its bond and equity markets.

Since the crisis, Asian policy makers have undertaken various reforms aimed at developing more stable and efficient financial systems. They have also recognized the importance of regional financial integration—in part as a safeguard against the vagaries of global markets, but also as a platform for regional development. Important initiatives have been launched, such as the ASEAN Surveillance Process, the Chiang Mai Initiative (CMI), the Asian Bond Markets Initiative (ABMI) established by ASEAN+3[39], and the Asian Bond Fund (ABF) initiative set up by the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP). Despite these efforts, regional financial integration remains patchy. This study finds that Asian financial markets are more integrated with global ones than with each other—and that Asia is less integrated than Europe in both respects.

Asia's limited financial development and integration carry clear and mounting costs. The absence of adequate regulatory and supervisory frameworks makes financial systems more vulnerable to risks. Asia's overdependence on bank finance is an additional risk; by providing an alternative financing source, efficient bond markets could act as a "spare tire." The lack of liquid and well-functioning bond markets also limits the availability of long-term local currency

[39] ASEAN countries plus the PRC, Japan, and the Republic of Korea.

funding for viable and profitable investment projects. This reduces the efficiency of capital allocation—and thus economic growth. With the rise of PRC and India, rapid growth in Asia generally, burgeoning regional trade, and Asia's vast savings and investment needs, the case for bolstering the development and integration of Asian financial markets is growing ever stronger.

Asia's financial underdevelopment is increasingly a constraint on the region's growing trade and investment links (set out in Chapter 3) and firms' resulting financing needs. Asia's huge savings are not invested as productively as they might be, while many of the region's pressing investment needs, notably in infrastructure, go unmet. Often, finance remains resolutely local; in other cases, it is intermediated and frequently invested outside the region. While the latter is not necessarily problematic, it is symptomatic of Asia's limited financial development. If Asian capital markets were more sophisticated and integrated, a greater volume of financial transactions would naturally be intermediated and invested in a region with such high savings rates and so many attractive investment opportunities.

4.1. The case for Asian financial integration

The case for Asia's financial development and integration is clear-cut, yet the rationale for regional, rather than global, financial integration requires careful nuance. In theory, global financial integration is preferable. If, say, Japanese investors seek more profitable opportunities overseas, they would do better to weigh up the merits of American, European, and even African assets, rather than focus on Asian ones alone. Likewise, if firms from the PRC are to seek funds from foreign investors, they would stand to gain most by tapping global markets, rather than limiting themselves to regional ones. In other words, there are potentially more opportunities for diversification—and thus higher risk-adjusted returns—from investing globally. Global financial markets tend to be deeper, more liquid, and more diversified.

In most of the world, though, practice does not conform to this (perhaps too) simple theory. A strong own-country and own-region effect in investment is often observed. While some of the regional bias to financial integration is doubtless due to inefficient regulations and harmful protectionism, geographic proximity may also have important advantages. Investors may have better information about opportunities in their own region, or may simply feel more comfortable investing within it. Intermediation may be cheaper and easier in a regional financial center. Time zones still matter, as do personal contacts, while regional intermediaries may generate research that helps match local investors to local companies.

Yet the regional effect is surprisingly weak in Asia. Whereas European investors favor investing in Europe, Asian ones often prefer to invest outside the region. Perhaps Asian investors, scarred by the crisis, are particularly wary of regional risks and therefore keen to diversify outside Asia. Perhaps they have more information about opportunities in transparent global markets than in opaque Asian ones. This may have become a vicious circle—because Asian investors tend to invest outside the region, Asia may have less incentive to invest in improving the information, legal, and technical infrastructure of its capital markets than otherwise.

That is damaging in itself. But it also prevents Asia from reaping the broader benefits of deeper and more liquid regional markets. These could stimulate improvements in market information, oversight, and corporate governance. They could also eventually generate more sophisticated investment vehicles—such as venture capital funds—that would expand the range of financing options for fledgling companies, for instance, as well as for infrastructure projects.

In large part, though, the lack of regional integration can be traced back to deeper causes, such as the underdevelopment and weaknesses of national financial systems, and the patchiness of market opening and capital market liberalization across Asian economies. Given that most national bond markets remain fragmented and lack liquidity, it is perhaps not surprising that an integrated Asian market in government and corporate bonds has yet to develop. The consolidation of equity markets remains a proposal.[40] Asia is home to highly sophisticated global financial centers: notably two—Hong Kong, China and Singapore—which by some measures are ranked third and fourth in the world, respectively (see Section 4.4, Box 4.3). However, Asian economies remain hobbled by bank-dominated financial intermediation, underdeveloped capital markets, and the legacy of financial repression.

Clearly, financial-market development is a national, as well as a regional, priority. Regional financial institutions may help national

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[40] Eichengreen and Park (2004); Sheng and Teng (2007) also suggest the need to integrate the region's stock exchanges.

authorities develop and reform their financial sectors—and thus permit greater financial integration. Priorities include improving access to financial markets, boosting competition, and abolishing inefficient regulations. Carefully sequenced capital account liberalization is also vital. National capital markets need to be developed and connected to improve liquidity. Such measures may be easier and more rewarding regionally rather than nationally.

Regional institutions could also foster dialogue, information sharing, and peer pressure that promote financial development and integration, as well as best practices in financial regulation and supervision. They might also seek to upgrade and harmonize regulations and market practices and develop mutually recognized regional standards. Examples include providing technical support in implementing the Basel II international banking regulations, fostering domestic credit bureaus and rating agencies, sponsoring further training for supervisors and regulators, and encouraging the development of academic expertise in finance in the region. This would also facilitate financial integration, not least in securities markets, and could stimulate demand for regionally-oriented financial services and products.

The prize is huge. Cheaper, more efficiently allocated capital; faster economic growth; better risk sharing; more activity in established as well as emerging regional financial centers; better research; more sophisticated funding options; better investment decisions—all are vital given Asia's huge investment needs, not least in infrastructure. The upshot will be greater financial flows within the region.

Inevitably, though, more open financial markets entail risks as well as benefits. Rapid financial liberalization may make economies more vulnerable to financial contagion. It must therefore be accompanied by more effective regulation and supervision—sometimes national, sometimes international—as well as greater cooperation among regulatory and supervisory bodies. This may provide some insurance against the vagaries of international capital markets. Because the global financial architecture and international financial institutions remain largely unreformed since the crisis, there is scope for regional bodies and regional integration to step into the breach (UNCTAD 2007a, 35–6). Regional financial cooperation can—and should—complement global efforts, feeding off each other constructively.

One example is recent discussions among ASEAN+3 to develop a regional bond market. This would channel Asia's vast savings to rewarding long-term investments within the region, notably in infrastructure. Investing the region's savings within the region would also help alleviate the global imbalances and the risks associated with the nature and timing of their unwinding. And it would be more profitable than accumulating vast foreign exchange reserves: instead of earning low yields on US Treasury bonds, central banks could achieve higher returns by investing a share in well-managed vehicles within the region. In short, Asia's financial integration could both bolster the region's economic growth and reduce its vulnerability to global shocks. Strengthening financial stability regionally would also bolster it globally.

The structure of the rest of the chapter is as follows. Section 4.2 charts Asia's financial development and reform since the crisis. Section 4.3 examines its financial integration, while Section 4.4 considers regional cooperation initiatives. Section 4.5 concludes with an agenda for future reform and cooperation.

4.2. Financial development and reform

The crisis had many causes, as discussed in Chapter 2. But it was partly rooted in major financial sector weaknesses common to economies across the region generally and to the larger ASEAN countries in particular. Among these were

- the banking sector's predominance in financial intermediation, the lack of long-term credit, and the underdevelopment of capital markets, especially of bond markets;
- weaknesses in regulatory and supervisory frameworks;
- a lack of strong domestic credit bureaus, the absence of a ratings-dependent culture among domestic debt issuers, and a reliance on weak accounting and reporting standards;
- a lack of competition in the domestic financial sector (banking, insurance, and bond markets);
- a lack of skilled financial operatives and agents; and
- poor corporate governance.

Since the crisis, reforms have focused on strengthening financial systems and aligning them with best practices, with a view to reducing their vulnerability to financial crisis.[41] For the most part, they have been quite effective. Financial markets are more sophisticated and better regulated than before.

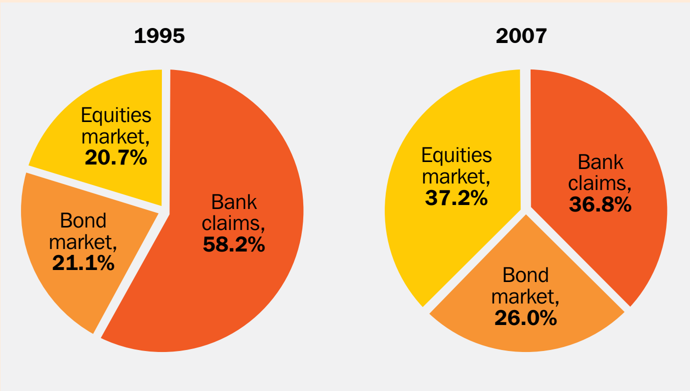
[41] See Kawai (2000) on the attempts of crisis-affected countries to restructure and strengthen their financial systems.

Attempts have been made to broaden access to credit by reforming banks and strengthening capital markets. Greater competition has been fostered, subject to prudent capital requirements. Increased private sector ownership and the entry of reputable foreign banks have also been encouraged. A healthier balance between banks and capital markets has also been sought, with a view to encouraging innovation and technology-based competition. Banking regulation and supervision have improved. Prudential banking regulations have been strengthened, as have governance and disclosure rules. Deposit insurance has been introduced and payments systems improved.

Financial market development

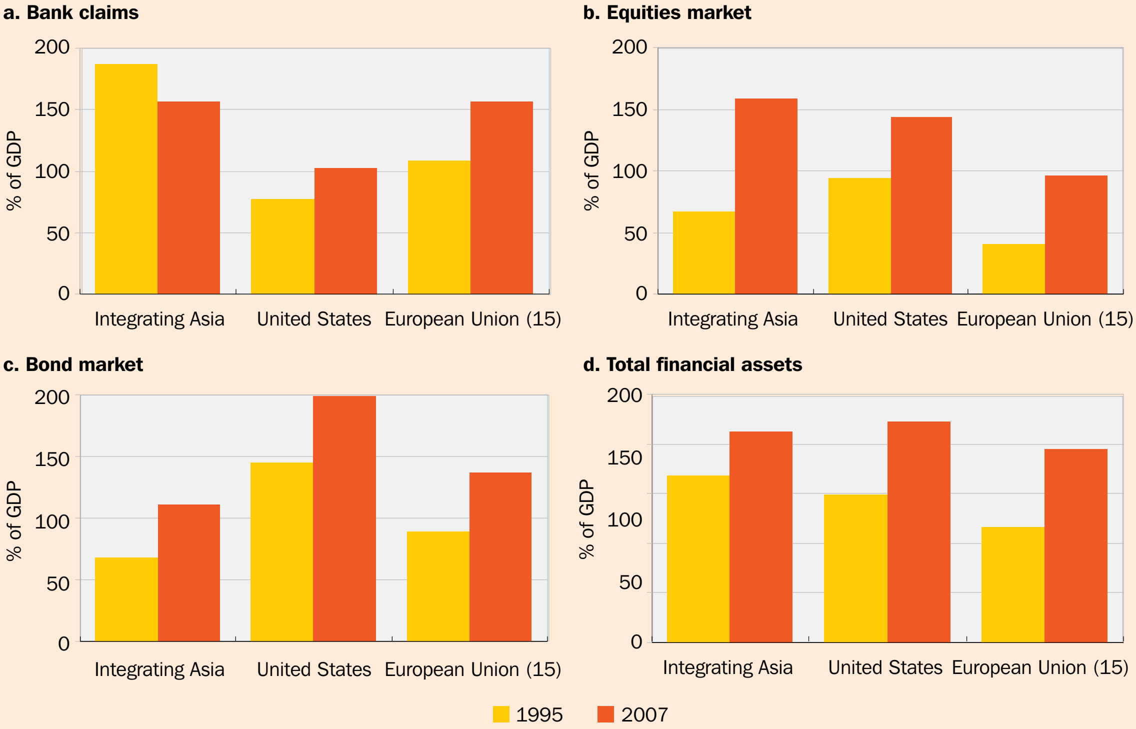
Capital markets have grown rapidly since the crisis, in absolute terms, as a share of total financial assets, and as a share of GDP (figures 4.1 and 4.2 and Table A4.1 in the appendix to this chapter). This financial broadening and deepening has occurred faster in Asia than in the EU or US—albeit from a lower base. But while bond and equity markets have grown fast since the crisis, domestic banking systems still

Figure 4.1. Increasing share of capital markets
Share in total financial assets in Integrating Asia



GDP = gross domestic product.
Integrating Asia = 11 economies for which data on financial markets are available: the People's Republic of China; Hong Kong, China; India; Indonesia; Japan; Republic of Korea; Malaysia; Philippines; Singapore; Taipei,China; and Thailand.
European Union includes its first 15 members.
Sources: Data from AsianBondsOnline 2007. Available: http://www.asianbondsonline.adb.org; IMF 2007b. Direction of Trade Statistics. Available: http://www.imf.org; BIS 2008. Available: http://www.bis.org/statistics; World Bank 2008a. Doing Business. Available: http://www.doingbusiness.org; and World Federation of Exchanges 2008. Available: http://www.world-exchanges.org (accessed May 2008).

Figure 4.2. Trends in financial deepening, 1995 and 2007



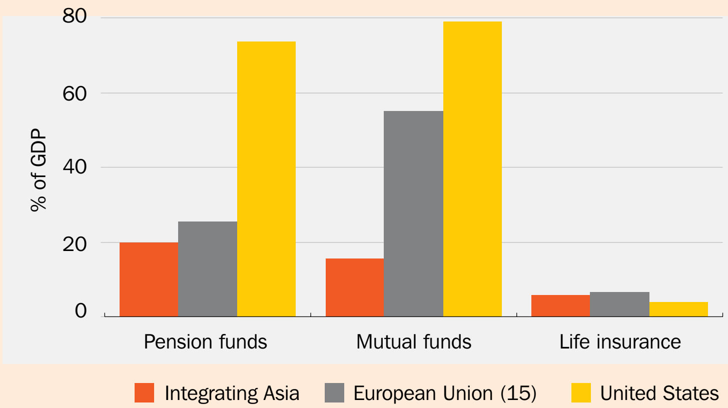
GDP = gross domestic product.
Integrating Asia = 11 economies for which data on financial markets are available: the People's Republic of China; Hong Kong, China; India; Indonesia; Japan; Republic of Korea; Malaysia; Philippines; Singapore; Taipei,China; and Thailand.
European Union includes its first 15 members.
Sources: Data from AsianBondsOnline 2007. Available: http://www.asianbondsonline.adb.org; IMF 2007b. Direction of Trade Statistics. Available: http://www.imf.org; BIS 2008. Available: http://www.bis.org/statistics; World Bank 2008a. Doing Business. Available: http://www.doingbusiness.org; and World Federation of Exchanges 2008. Available: http://www.world-exchanges.org (accessed May 2008).

play a dominant role in Asian financial systems.[42] This reliance on bank intermediation makes the real sector unhealthily vulnerable to financial-sector shocks.

Some of Asia's financial markets are as large as—or even larger than—those of economies at similar income levels. Yet financial sector growth is uneven. Markets are often shallow and fragmented. Except in Japan and the Republic of Korea (and, to a lesser extent, Malaysia),

[42] Figure 4.2 shows that as a share of GDP, Asia's financial markets are large compared to those of the EU and US. However, the shares are much lower if Japan is excluded from Integrating Asia. In 2007, in fact, Japan accounted for 47% ot Integrating Asia's total financial assets, and its ratio of total financial assets to GDP was 52% (see Table A4.1b in the Appendix to this chapter).

Figure 4.3. Growing markets for institutional investors, 2006



GDP = gross domestic product.
Notes:
Integrating Asia includes 11 economies for which data are available: People's Republic of China; Hong Kong, China; India; Indonesia; Japan; Republic of Korea; Malaysia; Philippines; Singapore; Taipei, China; and Thailand.
European Union includes its first 15 members.
Source: Economist Intelligence Unit. 2008. Country Finance Reports 2008. Available: http://www.eiu.com (accessed May).

bond markets account for a smaller share of GDP than in the EU or US. While the importance of institutional investors has been rising—a sign of greater financial sophistication—it remains much lower than in Europe and the US (Figure 4.3 and Table A4.2 in the appendix to this chapter). The further development of insurance companies, pension funds, and mutual funds—which provide improved investment choices for small investors and a wider pool of capital for firms—needs to be encouraged.

Financial sector reforms

Financial regulation and supervision have improved dramatically since the crisis, but much remains to be done. Reforms have focused on strengthening financial systems and aligning them with best practices to bolster their efficiency and reduce their vulnerability to crisis. First, attempts have been made to broaden access to credit by reforming banks while strengthening bond and equity markets as a platform for allocating capital to larger institutions. Such reforms have also sought to bolster financial sector efficiency and innovation. Second, competition in the banking sector has been increased by easing entry rules, notably for foreign banks, and encouraging greater private sector ownership, subject to prudent capital requirements. Third, reforms have sought to promote appropriate business conduct and greater financial integrity. Sound and independent regulatory regimes have been established, prudential banking regulations strengthened, the private monitoring of banks encouraged, corporate governance and financial disclosure improved, and deposit insurance and sufficient protections for debt and equity holders introduced. Payments systems have also been improved.

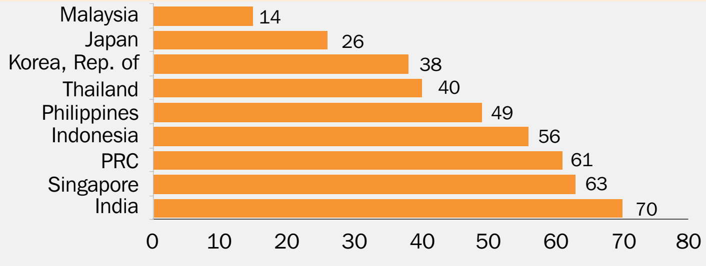
Many Asian economies have committed themselves to a variety of globally accepted standards and codes. They have adopted the Bank of International Settlements' Basel banking rules, International Organization of Securities Commission (IOSCO) standards for bond and equity markets, International Association of Insurance Supervisors (IAIS) rules for insurance, and Committee on Payments and Settlement Systems (CPSS) regulations for payments systems. Asia complies fairly well with these standards compared to other regions. Many Asian economies are now aiming to comply with the new Basel II Core Principles (BCP).[43]

Even so, much remains to be done. Still dominant, state-owned banks require overhauling, and privatization needs to continue. Incentives for the private monitoring of banks by international rating agencies need to be enhanced. Banking regulators also need strengthening, especially in preparation for adopting the more stringent Basel II risk-based supervisory standards. Implementing Basel II requires regional cooperation, but it cannot proceed at the same pace across Asian economies because of their varying financial sophistication and development and differing commitment to change. Ongoing liberalization efforts and emerging regional financial integration may help drive further regulatory and governance reforms.

[43] Reports on Observance of Standards and Codes provide added evidence on improvements in supervision, regulation, and compliance with BCP, IOSCO, IAIS, and CPSS standards. Advanced economies in Asia outperformed their Organisation for Economic Co-operation and Development (OECD) peers in all categories. However, less developed Asia (India, Indonesia, Philippines, Sri Lanka, and Thailand) exhibited lower compliance with BCP than the average for middle-income countries. Most less developed Asian countries were noncompliant with respect to information sharing between supervisors, ownership, prudential regulation and requirements, on- and off-site supervision, remedial measures, and cross-border banking. Further, no supervisor in the IMF sample practiced consolidated supervision or incorporated country risk control. In contrast with compliance with BCP, Asian economies exhibited marginally higher compliance with IOSCO and IAIS. In general, assessed Asian systems exhibited deficiencies similar to those of other regions.

Figure 4.4. Banking efficiency is improving

Overall ranking among 95 countries in 2006



PRC = People's Republic of China.
Source: World Bank. 2008b. Financial Sector Development Indicators. Available: http://www.fsdi.org/ (accessed April 2008).

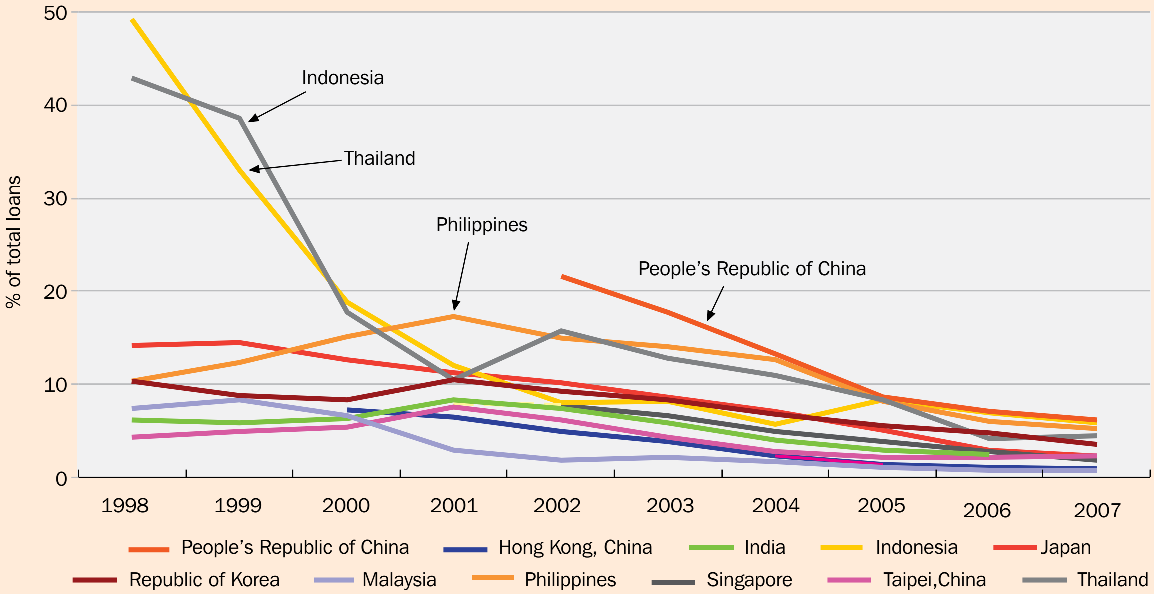
Financial and prudential reforms have improved banking sector performance across the region. Banks' operating efficiency has improved. According to World Bank indexes, some Asian banking systems now rank quite highly internationally (Figure 4.4).[44]

Banks' asset quality has also markedly improved—as seen in the decline in nonperforming loans (Figure 4.5)—as have capital-adequacy ratios. These improvements have boosted banks' bottom lines, with sectoral returns on equity returning to precrisis levels. Part of the improvement in asset quality and profitability may be traced back to the creation of asset management companies (AMCs) in several Asian countries to liquidate the recoverable assets of insolvent (or illiquid) banks in the aftermath of the crisis. AMCs enabled banks to strengthen their balance sheets (and income statements) by allowing them to pool bad loans and sell lower quality assets (in the form of AMC-structured securities backed by cash flows from these assets), boosting liquidity and, in principle, encouraging banks to continue lending.

While Asian banks may have become more efficient, securities markets have not improved much, as the World Bank's indicator of stock market efficiency highlights. This is a composite index that measures price synchronicity, trading based on private information,

[44] Banking efficiency is a composite index covering traditional measures of bank profitability and efficiency (such as the ratio of operating expenses to total assets) but also information on the structure of banking systems and measures of competitiveness.

Figure 4.5. Declining nonperforming loan ratios



Notes:
Reported nonperforming loans (NPLs) are gross classified loan ratio of retail banks. The measurement of NPLs follows official definitions and differs across economies depending on loan classification (for example, whether a 3- or 6-month rule is used), the treatment of accrued interest, and whether specific provisioning is deducted from the NPL measure. The table excludes NPLs transferred from bank balance sheets to asset management companies. For Malaysia and the Philippines, reported NPLs are net of specific provisioning.
Sources: CEIC Data. 2008. Available: http://www.ceicdate.com; IMF. 2007b. Global Financial Stability Report. Available: http://www.imf.org/external/pubs/ft/GFSR/index.htm; World Bank 2008b.

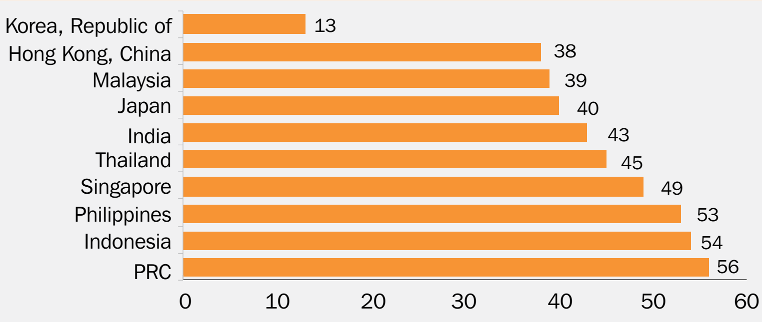
and real transactions costs.[45] Figure 4.6 shows that markets in Asia generally still rank poorly internationally.

The lack of price synchronicity may reflect markets' vulnerability to manipulation—and thus regulatory and supervisory weaknesses. Information issues may also be a function of the relatively small size of individual Asian markets, as it may not be profitable to spend large sums gathering data on the few issuers of securities. There may also be a lack of competition in the brokerage sector.

A recent ADB study suggests that in the immediate future, Asian equity markets have greater potential for development than bond

[45] Price synchronicity measures the extent to which daily stock prices are informative about individual firms' performance. Trading based on private information refers to the prevalence of trading influenced by privileged information. Real transactions costs measure barriers to efficiency by assessing daily returns data for listed stocks.

Figure 4.6. Stockmarket efficiency still lags
Efficiency ranking among 58 countries in 2006



PRC = People's Republic of China.
Source: World Bank 2008b. Financial Sector Development Indicators. Available: http://www.fsdi.org/ (accessed April 2008).

markets (Lindgren 2006). But significant constraints exist. Individual Asian developing stock markets are inefficiently small and fragmented. This makes them more vulnerable to internal and external shocks and makes trading more expensive, stunting their growth and preventing them from becoming deeper and more liquid.

To bolster their efficiency, Asia's stock exchanges need to be integrated more closely. Together, they could develop a wider product base, increase liquidity, and lower transaction costs. Perhaps initially through bilateral links—but possibly ultimately through deeper, even multilateral, ties—the exchanges should provide a platform for cross-border trading in stocks listed on domestic Asian exchanges, as well as consolidating exchange and after-trade services. This will not be easy: challenges, notably logistical and political-economy considerations, abound. And because Asia's economies are at different stages of development, the product base, sophistication, and institutional structures of their equity markets will inevitably vary. In any case, systemic reforms of securities markets need to continue to bolster financial stability and soundness, and complement banking sector reforms.

Securities markets also depend on the soundness of individual issuers and are stymied by weak corporate governance rules. Extensive reforms have already been introduced. These include improving the frequency and quality of information that management is required to disclose to shareholders and the general public, strengthening auditors' independence, enhancing minority shareholders' participation in corporate decision making, making boards of directors more effective and independent of management, reducing the likelihood of related-party transactions that would hurt minority shareholders, imposing and enforcing harsher penalties for inappropriate corporate conduct, making banks more efficient and more responsible as lenders, and reforming bankruptcy proceedings. But further reforms remain to be implemented, notably in improving external auditing and disclosure.

Governments also need to continue to facilitate improvements in trading, payments, and settlement systems to reduce operational risks, improve investor protection, and develop secondary markets for private and government bond trading. The development of local currency bond markets—which ensure the availability of long-term investment funds

Box 4.1. Reforming India's financial sector

Sustaining India's rapid growth requires an increasing supply of efficiently intermediated capital. But the economy is still suffering from the vestiges of financial repression. Pervasive government intervention in the financial sector was manifested in heavy state ownership, high statutory reserve requirements, extensive directed lending to priority sectors (including mandatory holdings of government securities by banks), regulated interest rates, credit ceilings, and other controls. Capital markets were underdeveloped, with stock markets fragmented across the country and the main one acting in the interest of its members. Derivative markets did not exist and comprehensive capital controls prevented companies from circumventing domestic controls by borrowing abroad.

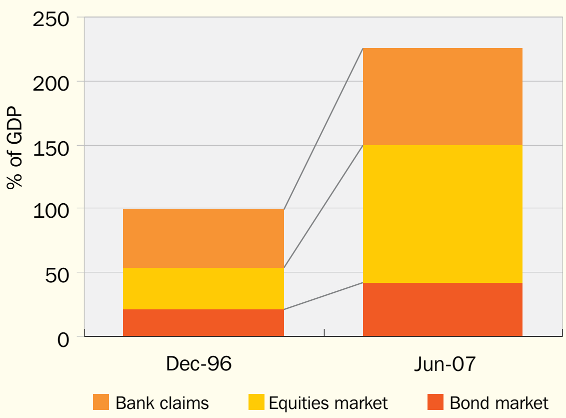
Financial market reform began in the wake of the balance-of-payments crisis in 1991. This sought to promote a diversified, efficient, and competitive financial system. The Government has allowed the exchange rate to gradually float (as opposed to a crawling peg), and full current account convertibility has been introduced, with de facto capital-account convertibility for nonresidents and calibrated liberalization for residents.

Reform of the banking system has been gradual and sequenced, focusing on improving prudential control, recapitalizing public sector banks, and introducing greater competition. Work to introduce the new Basel II regulatory system is under way. A dozen private Indian banks have been created, and some 30 new foreign banks had started operations by the end of 2006. Prudential reforms have been undertaken. These include the establishment in 1994 of a board of financial supervision within the Reserve Bank of India, substantially tightened rules on bad loans, and the convergence of regulatory norms with international best practices. Various legal and technology-related measures have likewise been introduced, such as the strengthening of credit information and creditors' rights, and the development of a dedicated communication backbone for banks. Interest rates have also been deregulated.

Much effort has gone into strengthening India's capital markets, particularly through the creation of institutions such as the country's securities and exchange board in 1992, an while avoiding maturity and currency mismatches—is particularly important. Regulatory capacity needs to be continually strengthened to promote stability and innovation. Supervisory capacity also needs to be improved, notably in crisis prevention and resolution.

To sum up, while Asian financial markets are deeper, more sophisticated, and better regulated than they were a decade ago, huge progress is still needed, both for its own sake and as a prerequisite for greater financial integration. A summary of the financial sector reforms undertaken in selected Asian countries since the crisis and of the challenges ahead is presented in Table A4.3 in the Appendix to this chapter. The challenges that India faces in developing its financial sector are discussed in Box 4.1.

Figure. B4.1. Trends in financial deepening in India: December 1996 and June 2007



GDP = gross domestic product.
Sources: Data from AsianBondsOnline 2007. Available: http// asianbondsonline.adb.org; IMF 2007b Available: http//www.imf.org: BIS 2008. Available: http//www.bis.org; World Bank 2008b, and World Federation of Exchanges 2007. Available: http://www.world-exchanges.org/ (all accessed May 2008).

insurance market regulator in 1999, and a pension market regulator in 2004. The National Stock Exchange was likewise created in the mid-1990s. By one measure—the number of transactions—this is now the world's third largest exchange. Derivatives trading on the National Stock Exchange started in 2000, and the Indian market is now the tenth largest in the world for futures contracts on single stocks and indexes.

While the market for government bonds has grown steadily, largely due to the need to finance the fiscal deficit, both the government and corporate bond markets have been stymied by regulation and remain small compared to both the bank and equities markets (Figure B4.1). Only in 2005 did the bond market become an electronic order market.

Since the mid-1990s, India's financial system has been gradually deregulated and opened up to international financial markets. It is now more efficient and robust. Bank and financial intermediation, however, remain relatively low, and most banks remain largely controlled by public sector institutions.

Deepening financial intermediation in India requires better regulation and greater transparency, as well as stronger institutions and legal frameworks. Ongoing reforms seek to improve the regulatory framework, strengthen payments and settlement systems, and bolster integration with global financial markets (Government of India, Planning Commission [2008]).

4.3 Regional financial integration: evidence and obstacles

How has Asian financial integration evolved over the past decade? Are the prices of financial assets across Asia converging? Is the share of Asian assets in investors' portfolios increasing?

In economic terms, integration implies price convergence. Fully integrated financial markets imply that traders can perform transactions freely anywhere within an area. In a financially integrated region, therefore, prices for similar financial assets—i.e., those with similar expected risk-adjusted returns—should converge. Arbitrage will tend to erode price differentials that may have arisen due to market power, different regulations, and imperfect flows of information. Financial integration therefore implies greater co-movement of prices in the region and is typically accompanied by an increase in the share of financial assets traded within the region and that held by regional participants.

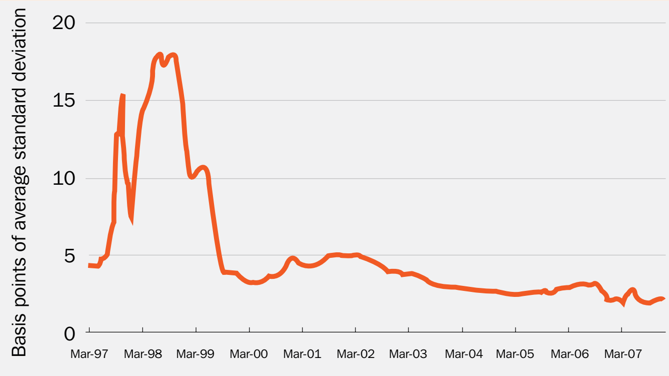
Greater regional integration also affects macroeconomic variables. In a financially integrated region, an economy's investment and savings can increasingly diverge, as it is free to borrow and lend with other economies in the region. Fluctuations in national consumption may thus become less dependent on changes in national output—the consumption-smoothing effect. National and regional consumption may also become increasingly correlated.

Price convergence

Interest rates in Asian economies have increasingly converged over the past decade (Kim and Lee 2008). Figures 4.7 and 4.8 illustrate how cross-country money market rate and bond yield differentials have fallen dramatically since the crisis. The standard deviation of the cross-country variation of overnight money market rate differentials from US rates dropped considerably after 1999, as Figure 4.7 shows. Until 2007, though, it was still generally above the comparable figure for the EU prior to the euro's introduction. The standard deviation of the absolute average cross-market long-term government bond yield spread over benchmark US Treasury bonds, shown in Figure 4.8, has been falling since 1999, although it remained substantial until 2005. Since March 2007, it has fallen to a new low, with an average standard deviation of about 2 basis points.

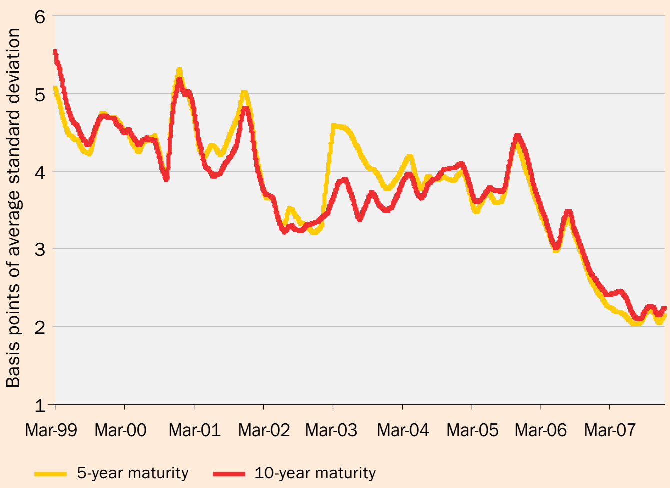
While the dispersion of interest rates in the region has declined over the past decade, it has remained substantial until very recently

Figure 4.7. Declining interbank rate differentials
(Standard deviation of cross-market overnight interbank rate differentials)



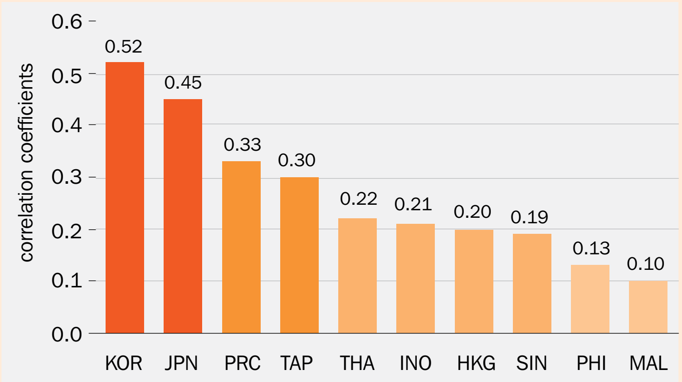
Notes: Average standard deviation (61-day) of government bond yield spreads of 10 Asian currencies (for which data are available) over the dollar. The currencies are the yuan, Hong Kong dollar, rupiah, yen, won, ringgit, peso, Singapore dollar, New Taiwan dollar, and baht.
Source: Data from Bloomberg 2007. Available: http://www.bloomberg.com (accessed December 2007).

Figure 4.8. Converging bond yields
(standard deviation of cross-market bond-yield spread differentials)



Notes: Average standard deviation (61-day) of government bond yield spreads of 10 Asian currencies (for which data are available) over the dollar. The currencies are the yuan, Hong Kong dollar, rupiah, yen, won, ringgit, peso, Singapore dollar, New Taiwan dollar, and baht.
Source: Data from Bloomberg 2007. Available: http://www.bloomberg.com (accessed December 2007).

Figure 4.9. Correlation of stock price indexes in Integrating Asia
Absolute changes in the average of bilateral correlation coefficients precrisis (1990:Q2–1996:Q4); postcrisis (2000:Q1–2006:Q2)



HKG = Hong Kong, China; JPN=Japan; KOR=Republic of Korea; INO=Indonesia; MAL=Malaysia; PHI=Philippines; PRC=People's Republic of China; SIN=Singapore; TAP=Taipei,China; THA=Thailand; US=United States.
Source: Asian Development Bank staff elaborations based on Bloomberg data, Available: http://www.bloomberg.com.

(Poonpatibul, Tanboon, and Leelapornchai 2006). Indeed, tests of covered interest parity are rejected for several Asian countries, implying little change from the pre-crisis situation.[46] Covered interest parity requires that in an integrated financial market, the domestic interest rate equal the world interest rate plus the forward discount on domestic currency.[47]

In terms of co-movement, the bilateral correlations of equity-price indexes across markets have risen over the past decade, as shown in Figure 4.9 and documented in greater detail in Tables A4.4 and A4.5 in the Appendix to this chapter. This is not necessarily proof of greater regional financial integration; it may simply reflect growing links among most Asian bourses via the US or Europe. Nevertheless, Figure 4.9 shows that bilateral correlations among Asian bourses are generally higher in both the pre- and post-crisis periods than bilateral correlations with the US equity market: 80% of bilateral correlations

[46] For example, Garcia-Herrero and Wooldridge (2007). The covered interest parity was consistently rejected due to a non-zero constant term prior to the crisis.
[47] The covered interest parity is the most used interest parity measure because it involves the fewest onerous assumptions; when it does not hold, it suggests a lack of market integration. See, for example, Gochoco-Bautista (2005).

among Asian exchanges have increased between the two periods, and all such correlations are positive in the post-crisis period.

In contrast, the bilateral correlations of bond and money market rates do not suggest a high degree of co-movement. They are particularly low for local currency bond returns, especially compared with developed country correlations (these are 0.8 or higher for Germany, the United Kingdom, and the US, for example).

Quantity indicators

In quantitative terms, regional financial integration has been increasing. Table 4.1 details how cross-border portfolio holdings of assets and liabilities have evolved.[48] Excluding Japan, 15 Asian economies (Asia-15)[49] held more than a quarter of their total portfolio assets within the region in 2006, up from 15% in 2001. Their holdings of US assets, in contrast, declined from 19.6% of the total in 2001 to 14.5% in 2006. Thus, by portfolio asset holdings, the Asia-15 are now more integrated with each other than with the US. But if Japan is included, the picture markedly changes. As Japan holds very few Asian assets (2.2% of its total assets in 2006) and invests more in the US (34.0%), the share of assets held intraregionally by the Asia-15 plus Japan is a mere 9.7%, while the share held in the US is 28.4%. Even among the Asia-15, Asian holdings of US assets and US holdings of Asian assets have risen in absolute terms, and as a share of GDP (Table 4.2). This may imply that integration with the US has also increased.[50]

The geographical distribution of Asia's portfolio liabilities is similar to that of its assets. But most Asian economies (except Hong Kong, China; Japan; and Singapore) have a larger share of cross-border portfolio liabilities held within the region. Among the Asia-15, the share of total liabilities held within the region rose from 13.7% in 2001 to 19.3% in 2006. Including Japan, the figure was only 11.1% in 2006. The US remains the main source of international

[48] The figures are from the IMF's Coordinated Portfolio Investment Survey, which was first conducted in 1997, and has been repeated annually since 2001 (IMF 2007a). In each case, the bilateral positions of the source countries in 223 destination countries and territories are reported. Hence, although the PRC and Taipei,China do not report data on international asset holdings, their liabilities data are gathered from the bilateral position of the source countries. Total portfolio investments are divided between debt and equities.

[49] Brunei Darussalam; Cambodia; the PRC; Hong Kong, China; India; Indonesia; the Republic of Korea; the Lao People's Democratic Republic; Malaysia; Myanmar; the Philippines; Singapore; Taipei,China; Thailand; and Viet Nam.

[50] More detailed figures on the distribution of Asian economies' portfolio assets and liabilities are available in Kim and Lee (2008).

Table 4.1. Deepening financial integration: portfolio investment ($ billion)

Reporting economy	Assets invested in				Total assets	Liabilities received from				Total liabilities
	IA less Japan	Japan	IA	US		IA less Japan	Japan	IA	US	
2001										
IA less Japan	48.6	20.0	68.6	63.6	324.8	48.6	21.8	70.4	125.0	354.0
Share	15.0%	6.2%	21.1%	19.6%	100.0%	13.7%	6.1%	19.8%	35.3%	100.0%
Japan	21.75		21.8	490.2	1,289.8	20.0		20.0	197.8	542.3
Share	1.7%		1.7%	38.0%	100.0%	3.7%		3.7%	36.5%	100.0%
IA	70.4	20.0	90.4	553.8	1,614.6	68.6	21.8	90.4	322.8	896.3
Share	4.4%	1.2%	5.6%	34.3%	100.0%	7.7%	2.4%	10.1%	36.0%	100.0%
2006										
IA less Japan	238.4	28.2	266.6	136.8	941.9	238.4	50.8	289.1	467.4	1,233.4
Share	25.3%	3.0%	28.3%	14.5%	100.0%	19.3%	4.1%	23.4%	37.9%	100.0%
Japan	50.6		50.6	797.6	2,343.5	28.2		28.2	585.6	1,434.9
Share	2.2%		2.2%	34.2%	100.0%	2.0%		2.0%	40.8%	100.0%
IA	289.1	28.2	317.4	934.4	3,285.3	266.6	50.8	317.4	1,053.0	2,850.4
Share	8.8%	0.9%	9.7%	28.4%	100.0%	9.4%	1.8%	11.2%	36.9%	100.0%

IA = Integrating Asia, US = United States.
Note: Integrating Asia includes Brunei Darussalam; Cambodia; People's Republic of China; Hong Kong, China; India; Indonesia; Japan; Republic of Korea; Lao People's Democratic Republic; Malaysia; Myanmar; Philippines; Singapore; Taipei,China; Thailand; and Viet Nam.
Source: Asian Development Bank staff computations based on IMF 2007a. Coordinated Portfolio Investment Survey. Available: http://www.imf.org/external/np/sta/pi/cpis/htm.

portfolio investment in the region, consistently accounting for some 36–37% of the total in 2001–2006 among Asia-15 plus Japan.

In short, Table 4.1 shows that while Asian financial integration has been rising, it remains limited. The region is more integrated with global financial markets, especially when Japan is included.

As a share of GDP, two economies—Hong Kong, China and Singapore—have relatively large cross-border portfolio asset and liability holdings. Among the Asia-15, international portfolio asset holdings invested in the region average 4.5% of GDP, as do liabilities held within the region. Including Japan, the shares decline to 2.9% of GDP and 2.7%, respectively (see Table 4.2).

Table 4.2. Portfolio investment in Integrating Asia (as percent of GDP)

Reporting economy	Assets invested in: IA less Japan	Japan	IA	US	Total Assets	Liabilities received from: IA Less Japan	Japan	IA	US	Total Liabilities
2001										
IA less Japan	1.7	0.7	2.4	2.3	11.7	1.7	0.8	2.5	4.5	12.1
Japan	0.5	–	–	12.0	31.5	0.5	–	–	4.8	13.2
IA	1.0	–	1.3	8.0	23.5	1.0	–	1.3	4.7	12.8
2006										
IA less Japan	4.5	0.6	5.1	2.7	18.6	4.5	0.9	5.6	9.2	24.4
Japan	1.1	–	–	18.3	53.7	0.6	–	–	13.4	32.9
IA	2.9	–	3.3	9.9	34.9	2.7	–	3.3	11.2	28.3

– = no data, GDP = gross domestic product, IA = Integrating Asia, US = United States.
Notes:
IA includes Brunei Darussalam; Cambodia; People's Republic of China; Hong Kong, China; India; Indonesia; Japan; Republic of Korea; Lao Peoples' Democratic Republic; Malaysia; Myanmar; Philippines; Singapore; Taipei,China; Thailand, and Viet Nam.
Source: Asian Development Bank staff elaborations from IMF 2007a. Coordinated Portfolio Investment Survey. Available: http://www.imf.org/external/np/st/pi/cpis.htm.

Consumption correlations

Economic theory suggests that in a financially integrated region, consumption growth in an individual economy could be more closely linked to regional consumption growth than to national income growth. As regional economies can readily borrow from each other, domestic consumption patterns need not be dictated by current income, while investment needs not be capped by current savings.

Recent evidence, however, shows that consumption growth in Asian economies is still closely linked to current national income growth—as it is in most economies around the world (Poonpatpibul, Tanboon, and Leelapornchai 2006). Domestic savings and investment remain highly correlated. The correlation between national and regional consumption remains low, although it has increased somewhat.[51] Where it occurs, consumption risk sharing largely happens through the major global financial centers (Jeon, Oh, and Yang [2005]; and Kim, Lee, and Shin [2007]). This is to be expected, because the output of individual economies within the region is highly correlated, which would not facilitate consumption smoothing regionally.

[51] This was observed by Takagi and Hirose (2004) and corroborated by Kim and Lee (2008).

Obstacles to Asian financial integration

Asia's legacy of underdeveloped national financial markets and institutions is perhaps the biggest impediment to greater regional financial integration and intermediation. While some economies have more developed financial sectors than others, and all have made huge progress over the past decade, the traditional dependence on bank financing and the legacy of financial repression have stunted the growth of equity and bond markets in many economies. Likewise, while regulatory frameworks vary across the region and are generally much improved, many countries suffer from an inadequate legal framework, weak regulation, low accounting and auditing standards, poor transparency, weak corporate governance, and weak investor protection (Lee 2008).

Considerable barriers to financial flows still exist in many Asian economies. Inadequate deregulation and the limited openness of national financial markets impede their development. It hinders the issuance of local currency bonds, limits investment in foreign bonds by domestic investors, and prevents foreign borrowers from issuing bonds denominated in different currencies in Asian markets. Restrictions on capital account transactions and barriers to the entry of foreign financial institutions also impede financial integration.

Chinn and Ito (2007) calculated the openness to capital of various East Asian economies using principal component analysis of four variables—capital controls, multiple exchange rates, current account controls, and export proceed give-backs—before and after the crisis. They found little progress in opening up to international capital flows, at least until 2005. Where it has occurred—notably in Singapore and Hong Kong, China—capital account liberalization has stimulated greater cross-border financial flows and financial integration.

But even when capital account opening is slow and patchy, allowing in foreign financial institutions boosts competition as well as financial development and integration. Foreign ownership of banks has increased since the 1990s; commercial banking has received the largest share of foreign investment (Parreñas 2007). In two important capital market services—primary market underwriting and secondary market operations—European and American banks have established a near-monopoly position, which is not necessarily desirable (Park and Bae 2002). Chelleg-Steeley and Steeley (1999) likewise posit that the abolition of exchange controls would promote the integration of regional equity markets, as it has in Europe.

To sum up, while there is little evidence of increasing regional financial integration, cross-border bank claims have increased, money market rate differentials are converging, and stock market indices are increasingly moving together (Kawai 2008b, Kim and Lee 2008).

As Asian economies continue to grow and their financial markets become more integrated, Asia's financial centers can play an increasingly important role as both regional and global financial centers (Box 4.2).

4.4. Building integrated regional financial markets

Important initiatives to bolster regional financial cooperation have been launched since the crisis. Yet Asian policy makers agree that more can—and should—be done to help the region prevent, or at least withstand, a future financial shock. ASEAN and ASEAN+3 are major umbrellas for financial cooperation in the region, while central bank groups, such as EMEAP, are also important, and private sector bodies increasingly cooperate, too. As Table 4.3 summarizes, regional cooperation typically involves information exchange and policy dialogue, as well as convening working groups to examine specific issues.

Regional structures for short-term liquidity provision have also been developed, namely the ASEAN Swap Arrangements (ASAs) and the CMI under ASEAN+3, which includes several bilateral swap agreements betwen central banks from the PRC, Japan, and the Republic of Korea, with those from major ASEAN countries (see Table 5.5, Chapter 5). The ABMI under ASEAN+3 seeks to strengthen the supply side of bond market development, while Asian bond funds under EMEAP (with Asia Cooperation Dialogue promoting political support for the initiative) seek to strengthen the demand side. Many regional arrangements also undertake training, research, and other capacity-building programs.[52] Duplication and overlap exist; regional cooperation might be more efficiently and coherently handled through a more consolidated process under a regional institution.

ASEAN hosts four major initiatives to strengthen financial cooperation: (1) the ASA (created in 1997); (2) the finance ministers'

[52] Information was drawn from materials and documents available on the websites of the regional groups (www.aseansec.org, www.apec.org, www.acddialogue.com, www.seacen.org, www.emeap.org), and ADB's Asia Regional Integration Center website (www.aric.adb.org).

Box 4.2. Asia's financial centers

The centers. Asian economies host eight of the world's 50 most important financial centers (City of London Corporation 2007). Two centers—Hong Kong, China and Singapore—rank third and fourth respectively, albeit far behind first-place London and second-place New York. Tokyo is tenth, while Beijing, Mumbai, Osaka, Seoul, and Shanghai are among the lower ranks of the top 50. A further 18 Asian cities can be considered national financial centers, and two (Macau, China and Labuan) are offshore ones (Figure B4.2).[1]

Financial centers are locations where financial intermediation plays a crucial role in the economy. They tend to host a stock exchange, the headquarters or relevant offices of a central bank and other public and private financial institutions, as well as an established supervisory authority.[2] As financial regulation still differs widely among Asian economies, each country has at least one national financial center that plays an important function in raising, distributing, and reallocating funds locally.

To become a regional financial center, national centers need to develop the necessary economic infrastructure, attract a larger number of regionally focused banks and financial companies in general—including those specializing in legal and consulting matters—host a respected supervisory authority, be governed by a predictable regulatory environment, and eventually expand the size of the market and the range of products offered. Maintaining the country's capital account open is also an important factor to allow national centers to develop into regional or global financial centers.

Since the 1990s, Hong Kong, China; Singapore; and Tokyo have served as global financial centers, as they offer a full range of financial services with deep, liquid, and diversified markets; host all major international banks; and offer regulatory and supervisory frameworks that preserve the reliability and predictability of contracts and the overall integrity of the financial system.[3]

As regional financial cooperation and integration proceeds, with domestic regulations gradually harmonized and entry barriers lowered, competition among Asia's financial centers will intensify. Some national centers will take on a regional role; others will shrink.

Centers such as Mumbai and Shanghai may become global centers—but this will require radical reforms, not least fully open capital accounts. It will also require removing internal barriers separating different segments of financial markets, eliminating regulations and practices that discriminate against foreign banks and other financial companies, introducing tax incentives (exemptions) for offshore funds, deregulating to allow a broader range of products to be traded in financial markets, and relaxing rules governing the establishment of markets for professional investors.

It will also require greater innovation, and a forward-looking approach by local authorities. Important factors include a sound regulatory and supervisory framework; a well-developed economic infrastructure (especially telecoms and transport); a reliable payment system, a well-trained, professional, and available workforce; a high quality of life; and an open, politically, and legally stable economy. As competition intensifies, different centers may specialize in subsectors where they develop a comparative advantage.

[1] Basic data are from City of London Corporation 2007 and ADB (Office of Regional Economic Integration) staff assessments. The 18 national centers are Bandar Sri Begawan, Bangalore, Bangkok, Fukuoka, Hanoi, Hiroshima, Ho Chi Minh City, Jakarta, Kuala Lumpur, Manila, Nagoya, Niigata, Phnom Penh, Shenzhen, Surabaya, Taipei, Vientiane, and Yangon.

[2] Standard economic indicators to assess the importance of financial centers include the contribution of financial services to GDP, the number of financial institutions, and the contribution of financial services to total employment.

[3] In addition to national, regional, and global financial centers, Asia hosts two "offshore" financial centers: Macau, China and Labuan. These are small centers that aim to offer a limited and specialized range of financial services with low regulation and considerable fiscal advantages, especially to nonresidents.

Figure B4.2. Asia's financial centers

Source: Asian Development Bank.

Table 4.3. Emerging monetary and financial cooperation

		Finance ministry-led cooperation				Central bank-led cooperation			Others	
	Forum	**APEC**	**ASEAN**	**ASEAN+3**	**ASEM**	**EMEAP**	**SEACEN**	**SEANZA**	**ACD**	**EAS**
	Year established	1989	1967	1999	1996	1991	1966	1956	2002	2005
	Number of members	21	10	13	45	11	16	20	28	16
Function	Policy dialogue/information exchange	√	√	√	√	√	√	√	√	√
	Surveillance/peer review		√	√		√				
	Regional financing arrangements		√	√		√				
	Regional capital-market development	√	√	√		√				
	Capacity building	√	√	√	√	√	√	√		
	Research	√	√	√	√	√	√			√

ACD = Asian Cooperation Dialogue; APEC = Asia-Pacific Economic Cooperation (includes Australia, Canada, Chile, Mexico, New Zealand, Papua New Guinea, Peru, Russian Federation, and United States; ASEAN = Association of Southeast Asian Nations (includes Brunei Darussalam, Cambodia, Lao People's Democratic Republic, Indonesia, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam); ASEAN+3 = ASEAN countries plus People's Republic of China, Japan, and Republic of Korea; ASEM = Asia-Europe Meeting (includes Mongolia, Pakistan, and 27 European Union member countries); EAS = East Asian Summit (includes ASEAN+3 countries plus Australia, India, and New Zealand); EMEAP = Executives' Meetings of East Asia-Pacific Central Banks (includes the People's Republic of China; Hong Kong, China; Indonesia; Japan; the Republic of Korea; Malaysia; the Philippines; Singapore; and Thailand); SEACEN = South East Asian Central Banks (includes Fiji Islands, Mongolia, Nepal, Papua New Guinea, and Sri Lanka); SEANZA = South East Asia New Zealand and Australia (includes Australia, Bangladesh, Iran, Mongolia, Macao, Nepal, New Zealand, Pakistan, Papua New Guinea, and Sri Lanka).
Notes:
ACD Working Group on Financial Cooperation meets once a year. ACD proposed Finance Ministers Meeting in 2006 was postponed.
EAS held its first informal senior EAS finance officials' dialogue in September 2007 in Jakarta, Indonesia.
Source: Based on Yap, 2007, Table 3.2, p.30, with modifications.

process (established in 1997); (3) the surveillance process (started in 1998); and (4) a road map for financial and monetary integration based on the four pillars of capital market development, capital account liberalization, financial services liberalization, and currency cooperation.

In terms of encouraging capital market development, recent initiatives include increasing information sharing, trading ties, and clearing mechanisms among ASEAN bond markets; institutionalizing private sector consultation; and launching the ASEAN exchange traded fund, based on the FTSE-ASEAN 40 index[32] on the Singapore Exchange in September 2006. This fund aims to promote greater

[53] FTSE is an independent company owned by the Financial Times and the London Stock Exchange.

transparency and pave the way for an electronic trading platform and a regional clearing and settlements system by 2015. An ASEAN bond portal is also set to be established to serve as a centralized platform for information on ASEAN bond markets. The ASEAN Capital Markets Forum spearheads efforts to harmonize standards, rules, and regulations, including those on disclosure and a set of "IOSCO plus" standards on cross-border offers. Harmonization is aimed at developing an interlinked ASEAN securities marketplace by 2010. A task force is also considering how to establish a new infrastructure financing mechanism called the ASEAN Infrastructure Fund.

In terms of capital account liberalization, the road map is up for review to ensure its consistency with the 2015 deadline for establishing an ASEAN Economic Community. Under the blueprint for an ASEAN Economic Community, the liberalization of financial services and capital flows will proceed at different speeds according to member countries' readiness, national policy objectives, and levels of economic and financial development.

The ASEAN+3 finance ministers' meeting, launched in 2000, has established three major initiatives: (1) the CMI (to be discussed at greater length in Chapter 5); (2) the economic review and policy dialogue; and (3) the ABMI (Box 4.3). It has also launched the Economic and Financial Monitoring Working Group and the Research Group.

Central banks in the region also cooperate through South East Asia, New Zealand, and Australia (SEANZA), founded in 1956; South East Asian Central Banks (SEACEN), set up in 1966; and EMEAP, established in 1991. Cooperation involves dialogue, information exchange, and research and training programs. Although a network of US dollar repurchase agreements existed among EMEAP central banks during the crisis, they were not activated. EMEAP has also played a key role in developing Asian bond markets. Other regional groups that undertake financial cooperation initiatives include the APEC, Asia-Europe Meeting (ASEM), and EAS. APEC and ASEM both conduct finance ministers' meetings.

Asia's financial market actors also meet in many private sector and semiofficial regulatory bodies. For securities markets, there is the Asia-Pacific Regional Committee of IOSCO—but most information sharing among securities market regulators occurs on the basis of bilateral memorandums of understanding. Nine Asian economies are, or are committed to becoming, signatories to IOSCO's multilateral memorandum of understanding, the first global information-sharing

Box 4.3. Building Asian bond markets

ASEAN+3's Asian Bond Markets Initiative (ABMI) and Asian Bond Fund (ABF) of the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP) both aim to develop regional bond markets.

Asian Bond Markets Initiative

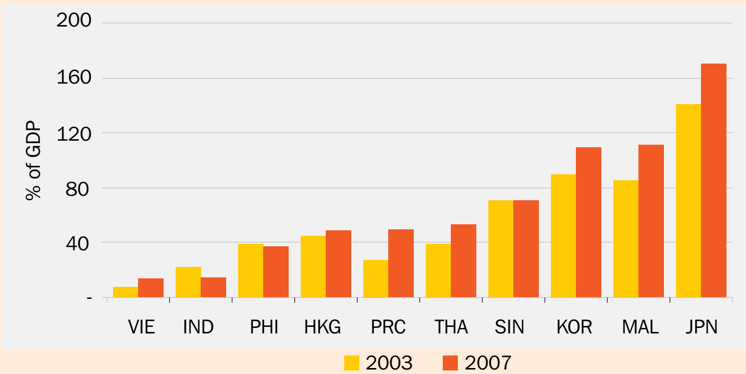
The ABMI has helped widen the variety of local currency issues and improve market infrastructure nationally and regionally. Working groups conduct studies that build consensus among policy makers and address priorities such as the creation of new securitized debt instruments, the establishment of regional credit guarantee and investment mechanisms, the feasibility of a regional foreign exchange settlement and clearance system, and the strengthening of regional rating agencies.

The ABMI has encouraged issuance by international financial institutions, such as the Asian Development Bank (ADB) and the International Finance Corporation, as well as by multinational corporations. This has increased the supply of high-quality local currency bonds in domestic markets and raised the bar for subsequent issuers, particularly in terms of disclosure and documentation. It has also led to the design and implementation of a $10 billion Asian currency note program by ADB, the first multicurrency bond platform to link domestic debt markets in the region. Under the scheme, ADB has issued Asian currency bonds under a unified framework with a common set of documents governed by English law, setting the groundwork for regional issuers. The evolution of local currency denomnated bond markets in selected Asian countries from 2003 to 2007 is shown in Figure B4.3.

Asian Bond Fund

The ABF promotes the development of national and regional bond markets by directly creating bond funds. The first, ABF1, was launched in 2003 and pooled $1 billion in international reserves from the 11 EMEAP central banks. ABF1 invested these in dollar-denominated sovereign and quasi-sovereign bonds issued by eight economies—the PRC; Hong Kong, China; Indonesia; the Republic

Figure B4.3. Growing local-currency denominated bond markets
Share of total issuances in GDP, 2003 and 2007



GDP = gross domestic product; HKG=Kong Kong, China; IND=India; JPN=Japan; KOR=Republic of Korea; MAL=Malaysia; PHI=Philippines; PRC=People's Republic of China; SIN=Singapore; THA=Thailand; and VIE=Viet Nam.
Note: Total issuances refers to corporate issuances plus government issuances.
Source: AsianBondsOnline. 2008. Available: http://asianbondsonline.adb.org/regional/regional.php (accessed April 2008).

of Korea; Malaysia; the Philippines; Singapore; and Thailand.

The second, ABF2, initially comprising $2 billion of pooled central bank reserves, was introduced in December 2004. Half was allocated to the Pan-Asian Bond Index Fund, which purchased local currency sovereign and quasi-sovereign bonds from the same eight EMEAP economies; the other half went to the Fund of Bond Funds, a parent fund divided between eight single-market subfunds. Unlike its predecessor, ABF2 was designed to be listed in individual markets and opened up to private investors.

The ABF framework has made local currency bonds more attractive to investors and helped develop deeper and more liquid national bond markets. It has also encouraged regulatory and tax reforms—for instance, prompting some national governments to offer withholding tax exemptions on investment income to nonresident investors (in Malaysia and Thailand, for instance) and others to loosen capital controls (in the PRC and Malaysia, for example).

The introduction of transparent, credible, and representative ABF indexes is a big step forward; these can also serve as benchmarks for other fixed income or derivative products. The use of passively managed funds has provided a low-cost and convenient to invest in Asian bonds. Most of the ABF2 funds have already been listed or have become open-ended funds, with the total size rising to around $3 billion by mid-2006.

Improving bond markets in Asia

The ABMI and the ABF both spur governments to fast-track bond market reforms. ABMI working groups have addressed specific barriers to bond-market development, nationally and regionally. By supporting international best practices and exercising peer review, these groups are instrumental in establishing infrastructure benchmarks, while neighboring economies' reforms encourage a redoubling of national efforts (Eichengreen 2006).

The "learning-by-doing" element of the ABF program has given policy makers and regulators a deeper understanding of the practical impact of market impediments, such as capital controls, withholding taxes, regulatory hurdles, and weak infrastructure (Ma 2007). This gives them a greater incentive to address such problems, making the program extremely fruitful despite the relatively small amounts involved (a few billion in a $1.5 trillion regional bond market).

The ABMI's further success depends on ensuring working groups' efforts are followed through and a clear path for future reforms is struck. The ABF needs to do more to handle remaining market impediments. These concerns are being addressed. The ABMI, for instance, has almost completed a road map for the future.

The two programs have so far been mainly successful and have made a big contribution to the larger effort to integrate the region's financial markets (for instance, via the harmonization of laws, taxes, structure, and regulations). The ABF, in particular, may have inspired similar initiatives by other multilaterals (such as a forthcoming World Bank emerging market local currency bond fund).

arrangement among security regulators. Other groups include the East Asian Stock Exchanges Conference, which seeks to facilitate information exchange, and the Asian and Oceanian Stock Exchanges Federation, which fosters dialogue and research and has developed proposals on cross-border trading; market links; demutualization; corporate governance; information management; the harmonization and coordination of listing, trading, and clearing; and market surveillance. Progress on the ASEAN initiative to develop an interlinked ASEAN securities market by 2010 will be an indication of how these problems can be solved. Despite the potential difficulties, there has been some practical progress toward links among some regional exchanges.[54]

Independent securities industry organizations also cooperate, through the Asian Securities Forum and the Asian Securities Analysts Federation, for instance. Five major Asian securities houses from four Asian economies formed the first pan-Asian online stock exchange network, the Asian Stock Exchange Network, in April 2000. Deposit insurance corporations and credit rating agencies have also formed regional bodies. The derivatives industry, still relatively underdeveloped in the region and heavily concentrated in Singapore, established the Asian Pacific Association of Derivatives in 2004 to promote research and increase knowledge of the use of derivative securities and markets.

4.5. An agenda for deeper regional financial cooperation

Further progress on regional financial integration will need to address fundamental causes—weaknesses in national financial systems, differences in national financial regulations, and the complexity of market opening and capital-market liberalization. There is a growing consensus that much can—and should—be done about these issues on a regional level, both to improve the efficiency of markets and to forestall financial shocks.

[54] These include a strategic alliance between the Singapore and Tokyo stock exchanges in October 2001, a co-trading link between the Australian and Singapore exchanges in December 2001, and a memorandum of intent of cross-border securities trading signed by the Tokyo and Korea exchanges in August 2005. The Tokyo and Korea exchanges signed a memorandum of understanding on the Market Alliance Project on 7 July 2006, and the Tokyo Stock Exchange spent about $304 million to buy a 4.99% stake in the Singapore Exchange Ltd. in June 2007.

Strengthening national financial systems

The weaknesses in national financial systems are perhaps the biggest impediment to deeper integration. They include insufficient market opening and capital account liberalization; the limited and varying degrees of improvements in transparency, financial regulation, financial supervision, and corporate governance; inadequacies in risk management in financial firms and markets; and the heterogeneity of supervisory, accounting, and auditing rules and regulatory frameworks across countries.

Clearly, some Asian economies are more advanced than others, and their particular strengths and weaknesses vary. Each domestic financial system requires specific reforms. This study, however, given its regional focus does not provide a detailed analysis of each country's priorities. Therefore, the following suggestions are necessarily general and do not apply to all economies in the region. For instance, while Asian economies should generally continue to liberalize their capital accounts and promote cross-border financial service flows, prudence is needed. Efficient financial systems require competition and economies of scale—which ultimately entails exposing national financial markets and firms to international competition. In many Asian economies this has already been accomplished; in others, the benefits of integration still have to be balanced against the risks of liberalization. For the latter economies, progress needs to be measured and prudent. Steady liberalization is essential, but it needs to be accompanied by the development of institutions that can ensure markets' continued stability.

At a national level, reforms to strengthen the banking sector and improve its regulation and supervision are vital. So too are the adoption of international prudential norms and standards, and measures to promote the development of financial markets. Capital markets, especially local currency bond markets, should be bolstered to create the liquidity and innovative financial products needed to attract a wider and more diversified investors' base.

At a regional level, the priorities are strengthening regional dialogue and financial market surveillance; promoting internationally accepted standards and codes of practice and the mutual recognition of minimum standards; fostering the growth of regional bond markets; and building market infrastructure such as regional clearing houses, payment and settlement systems, credit rating agencies, research and training facilities, and data bases.

Developing a meaningful regional surveillance mechanism is crucial. Data on domestic financial sector reform is patchy and inconsistent, in part because participation in processes such as the IMF Financial Sector Assessment Program and the World's Bank's Reports on the Observance of Standards and Codes is low. If countries remain reluctant to participate in these initiatives and similar processes created by the IMF, building a strengthened regional surveillance mechanism could provide much needed benchmarks. Enhancing regional cooperation in information sharing, monitoring, and surveillance—which can complement global forums—would bolster regional financial stability.

Developing regional institutions

Developing new regional institutions can help. Given the need to enhance coordination both within and across domestic financial systems, and also to help face the current turmoil in global financial markets, establishing a new, high-level Asian Financial Stability Dialogue on financial sector issues is a particular priority. This could operate in parallel with the ASEAN+3's economic review and policy dialogue which addresses macroeconomic cooperation. An "Asian Financial Stability Dialogue" would bring together all responsible authorities—including finance ministries, central banks, and other financial supervisors and regulators—to address financial market vulnerabilities, regulations, and efforts at integration, as well as engage in dialogue with the private sector.

Its immediate task would be to consider appropriate responses to the global financial situation. In the longer term, it could promote discussion of challenges arising, for instance, from financial conglomeration and internationalization, and seek to develop codes for best practices in investment and service agreements. Greater private sector involvement is also needed to improve communication and coherence, notably in crisis management coordination and developing protocols to share information. Government-level groups may not be able to capture the complex nature of financial regulation in a rapidly changing world and across varying systems.

Other priorities

Promoting consistent standards and mutual recognition is also an important priority. Most Asian economies still need to improve prudential norms, regulation and supervision, and standards for governance and transparency. Harmonized standards would facilitate the regulation of financial activities across jurisdictions and would lower information and transactions costs for investors. Given that harmonization poses great challenges for Asia's diverse economies—it is complicated, time-consuming, costly, and may be politically impossible for now—the region's policy makers should take a two-pronged approach: develop guidelines for best practices (an ultimate basis for harmonization) and set minimum standards that can be recognized, initially at least among subsets of economies. Even this is imperfect, of course, since it leaves investors vulnerable to gaps in the region's least-stringent regulatory regimes (Coleman 2001).[55]

Another priority is strengthening financial markets, especially local currency bond markets and their infrastructure. Deeper and more innovative financial markets could be promoted by expanding catalytic official initiatives such as the ABMI and ABF. These have raised disclosure and documentation standards and attracted new international issuers and investors to regional markets. The ABMI's working groups are considering broad improvements, including the development of securitized debt instruments, regional credit guarantees, settlement and clearance systems, and rating agencies. Because many Asian financial markets individually lack the resources to build adequate transactions infrastructure—for credit enhancements, payments and settlements, and information exchange—coordination among them is essential to achieve critical economies of scale. While international financial institutions have undertaken some initiatives, regional efforts could do more to improve the quality, comparability, and consistency of local financial market data and information sharing. Developing public databases and websites, such as ADB's Asia Regional Integration Center and AsianBondsOnline websites, helps keep various institutions and regional organizations up to speed on relevant issues.

More broadly, the need for regional financial cooperation—and the CMI in particular—stems from an unwillingness to rely solely on multilateral institutions in a prospective future crisis. Henning (2002) argues that governments in the region are likely to overcome intraregional conflicts over deeper cooperation

[55] Another possibility is self-regulation. By obtaining insurance for individual transactions, banks and brokerage companies may be able to create a transnational market for financial services that does not rely on regulatory arbitration. Financial services firms would be responsible for obtaining private insurance for their services; participating governments would then allow these firms to do business internationally. How a standard acceptable to governments might be created is unclear, however, and may run into similar problems to the full harmonization and mutual recognition approaches.

if shocks come from outside the region and the multilateral response remains inadequate. Without an appropriate multilateral framework, regional coordination and cooperation may be a viable second-best solution. These could also be viewed as providing regional public goods and reconfiguring the policy space, because regional coordination and harmonization can increase the effectiveness of national policies (UNCTAD 2007c).

Asian economies face the daunting, but essential, task of building world-class financial sectors. The agenda is largely national, but the region as a whole is a key stakeholder. Regional financial cooperation can provide a forum for dialogue and information sharing, a framework for drafting mutually acceptable standards, and peer pressure to accelerate the adoption of difficult policies. It can foster the development of broader and deeper regional markets—and thus ultimately enhance the productivity of the region's massive savings. Developing new regional institutions could also strengthen market efficiency and effectiveness.

In addition to markets and governments, regional development banks can also play an important role in helping to channel resources to foster regional economic and financial development. ADB, in particular, is active in providing funds for regional infrastructure development along with offering knowledge products, expertise, and policy advice.

Chapter 4: appendix

Table A4.1. Evolution of financial assets of Integrating Asia

a. Bank claims, equities, and bond markets in $ billion

$ billion	Bank Claims		Equities Market		Bond Market		Total Financial Assets	
	1996	2006	1996	2006	1996	2006	1996	2006
China, People's Republic of	800	3,699	119	1,146	62	1,185	981	6,030
Hong Kong, China	242	255	449	1,715	36	66	727	2,036
India	176	591	123	774	81	326	379	1,691
Indonesia	122	155	91	139	7	88	220	381
Japan	11,355	9,527	3,011	4,614	4,531	8,488	18,897	22,629
Korea, Republic of	606	976	139	834	283	1,010	1,028	2,821
Malaysia	143	194	306	236	73	147	522	576
Philippines	61	54	81	68	28	45	170	166
Singapore	74	99	153	384	25	87	252	570
Taipei,China	447	595	274	595	100	201	821	1,391
Thailand	252	223	96	140	18	112	366	475
Integrating Asia	**14,278**	**16,368**	**4,841**	**10,645**	**5,243**	**11,753**	**24,362**	**38,766**
United States	6,032	13,017	8,452	19,569	22,621	11,229	37,104	43,814
European Union (15)	9,877	20,200	4,314	13,177	12,183	7,490	26,374	40,866

b. Bank claims, equities, and bond markets as percent of GDP

Percent of GDP	Bank Claims		Equities Market		Bond Market		Total Financial Assets	
	1996	2006	1996	2006	1996	2006	1996	2006
China, People's Republic of	94	139	14	43	7	44	115	226
Hong Kong, China	153	134	283	903	23	35	458	1073
India	46	65	32	85	21	36	99	187
Indonesia	53	42	40	38	3	24	96	105
Japan	246	220	65	106	98	196	409	521
Korea, Republic of	109	110	25	94	51	114	184	318
Malaysia	142	130	304	158	73	99	518	387
Philippines	74	46	97	58	34	38	204	142
Singapore	80	75	166	291	27	66	272	431
Taipei,China	155	167	95	167	35	57	284	391
Thailand	139	108	53	68	10	54	202	230
Integrating Asia	**189**	**159**	**64**	**103**	**69**	**114**	**323**	**376**
United States	77	99	108	148	144	171	329	418
European Union (15)	110	148	48	97	84	89	242	334

IA = Integrating Asia.
Note: European Union includes its first 15 members.
Sources: AsianBondsOnline. 2008. Available: http://asianbondsonline.adb.org/regional/regional.php (accessed March 2008); IMF various years. International Financial Statistics. Available: http://www.imf.org (accessed March 2008); BIS 2008. Available: http://www.bis.org (accessed March 2008); and World Bank 2008. World Development Indicators 2008. Available: www.worldbank.org/data (accessed March 2008).

Table A4.2. Size of markets for institutional investors, 2006

Economy	$ billion			Percent of GDP		
	Pension funds	Mutual funds	Life insurance	Pension funds	Mutual funds	Life insurance
China, People's Republic of	34.8	131.9	44.3	1.3	4.9	1.7
Hong Kong, China	49.5	713.0	15.3	26.1	375.6	8.1
India	20.7	58.2	37.2	2.3	6.4	4.1
Indonesia	7.3	5.7	2.9	2.0	1.6	0.8
Japan	1,439.2	578.9	378.5	33.2	13.3	8.7
Korea, Republic of	191.3	12.9	58.8	21.5	1.5	6.6
Malaysia	66.6	21.3	5.0	44.7	14.3	3.3
Philippines	0.4	1.2	0.9	0.3	1.0	0.8
Singapore	81.1	18.9	7.1	61.3	14.3	5.4
Taipei,China	170.3	65.0	41.3	47.9	18.3	11.6
Thailand	10.3	29.0	3.5	5.0	14.1	1.7
Integrating Asia	**2,071.3**	**1,636.1**	**594.8**	**20.1**	**15.9**	**5.8**

GDP = gross domestic product.
Source: Economist Intelligence Unit. 2008. Country Finance Reports 2006 and 2008. Available: http://www.eiu.com (accessed March 2008).

Table A4.3. Thrust of financial sector reforms in Integrating Asia since the 1997/98 financial crisis
Developments in regulations, supervision, disclosure, and challenges to further reforms

PEOPLE'S REPUBLIC OF CHINA

Regulations

- By mid-2005, financial restructuring of three of the four major commercial banks was completed through capital injection and sales of nonperforming loans.
- Foreign financial institutions were permitted to provide services in foreign currency without restrictions since WTO accession to the World Trade Organization (WTO) in 2001.
- Lowered restrictions to foreign exchange transactions and cross-border capital inflows
- In August 2005, the People's Bank of China announced that banks satisfying certain requirements will be permitted to conclude foreign exchange forward and swap transactions in the interbank market.

Challenges to further reforms

- The government to reform the equity market by easing restrictions on the sale of government-owned shares in listed companies and allowing the pricing of initial public offerings to be more market determined.
- Also, the newly revised Securities Law has streamlined and reduced financial requirements for stock exchange listing (making it easier for firms with less capital to list), strengthening disclosure requirements for firms.
- Established a special working group in February 2004 to improve regulatory practices including access of non-government enterprises, relaxing approval limits on issuance, and easing interest rate controls, although there is still a cap on the interest rate that can be paid on corporate bonds.
- Significant progress achieved in developing the short-end of the bond market by opening the short-term corporate bill market, which has become very active as a number of the People's Republic of China's largest corporations have tapped this segment of the market.
- Establishment of the interbank market for asset-backed securities with maturities of 1–10 years has also been announced.
- New Securities Act for the bond market has removed some of the legal impediments that had kept the market from expanding, although the current "merit" based bond issuance system, requiring government selection of each bond issue, remains a hurdle.

INDIA

Regulations

- State Bank of India (SBI) reduced financially repressive policies through
  – lowering reserve requirements,
  – liberalizing and deregulating interest rates,
  – streamlining rules on the allocation of credit to certain sectors.
- SBI also
  – enhanced competition by easing entry rules for private and foreign investors,
  – allowed expansion of ownership base through private equity infusions,
  – strengthened bankruptcy and bank corporate governance laws, and
  – developed markets for government securities.

continued

Table A4.3. continued.

Supervision

- Introduced risk-based capital standards and international standards for income recognition, asset classification and provisioning for non-performing loans and regular performing loans.
- Strengthened payment and settlement systems.

Disclosure

- Strengthened apparatus for on-site inspections and off-site surveillance and external audits.
- Extent and quality of information required for banks to disclose broadened and improved.

Challenges to further reforms

- State-owned banks still dominate banking sector; privatization remains work in progress.
- Guidelines for further consolidation currently being formulated by the Reserve Bank of India.
- Risk-based prudential measures (Basel II) have just been introduced, leading to increased demands on regulatory capacity.
- Regional rural banks continue to be undercapitalized.
- Access to credit (financial inclusion) of the broader population remains a concern.

INDONESIA

Regulations

Strengthening of regulations regarding

- loan classification and provisioning,
  - legal lending limits,
  - net open positions,
  - liquidity monitoring,
  - capital adequacy,
  - bank management and ownership, and
  - risk management practices

Supervision

- Implemented risk-based supervision.
- Improved information systems and technology in banks.

Disclosure

- Pursued consolidation through mergers.
- Pursued privatization of state-owned banks.

Challenges to further reforms

- Scope remains for strengthening state-owned banks.
- Resolution of controversy in setting up the Financial Services Authority.
- With respect to Basel II, there is uncertain capability of enforcing risk weights for holdings of government securities.

MALAYSIA

Regulations

- Bank Negara Malaysia (BNM)
  - enhanced safety and soundness through expanded and more frequent disclosure;
  - reduced limits on exposure to a single customer;
  - introduced market risk-based capital adequacy rules and accreditation requirements in credit risk management;

– Introduced measures to improve competition and efficiency including benchmarking, mergers of finance companies into commercial bank groups, and the creation of an investment banking industry; and
– Introduced measures to enhance consumer protection.

Supervision

- Reforms focused on enhancing supervisor capacity, including supervisory techniques such as: regular stress testing, risk-based consolidated supervision, more rigorous on-site examination.

Disclosure

- To enhance market discipline, BNM undertook an educational program for consumers and introduced the Financial Mediation Bureau for consumer protection and redress

Challenges to further reforms

- Inability of domestic banks to integrate information on exposures to borrowers and related parties and on collateral pledged for risk mitigation purposes.
- BNM is preparing for a more effective supervisory process by developing an enhanced methodology to assess internal models and advanced risk management systems.

PHILIPPINES

Regulations

- Focused on corporate governance reforms (board oversight of compliance and internal risk management systems), ownership limitations, operational limitations on many aspects of banking operations, including on open foreign exchange positions.
- Introduced Basel I capital adequacy ratio for credit risk (in 2001) and market risk (in 2002).
- Rationalized regulations to promote mergers and consolidation, microfinance, role of external auditors, and new accounting and disclosure standards.

Supervision

- Introduced consolidated supervision of bank groups and shifted to risk-based approach to supervision, introducing a risk assessment system to supplement the risk-based examination approach and a new rating system for branches of foreign banks.

Disclosure

- Bangko Sentral ng Pilipinas (BSP) made mandatory disclosure of information such as capital adequacy ratios, credit concentration, quality of loans, adequacy of loss provisions, and related party transactions in quarterly published statements and annual reports.
- BSP also introduced safeguards to ensure independence of auditors. Also recognized credit rating agencies for bank supervision purposes and accredited five rating agencies (two national and three international).

Challenges to further reforms

- No central credit information bureau yet, but BSP supports legislation establishing such a bureau.

SINGAPORE

Regulations

- Reforms foster competition and strengthen bank governance
- Liberalized access to the domestic banking sector, required banks to focus on core activities to limit risk of contagion from nonfinancial business to the bank, issued rules on corporate governance.

continued

Table A4.3. continued.

- Embarked on review to enhance the management of concentration risk to a single counterparty.
- Reduced the minimum capital adequacy ratio to give banks incentives to better manage their risks.
- Minimum liquidity requirements were made forward-looking, taking into account supervisory reviews of banks' liquidity policies and practices.
- Rules and regulations made more transparent and policy changes become subject to public consultation

Supervision

- Focused on risk-based supervision of financial institutions and examination of banks' internal controls and risk management systems
- Authorities harmonized risk assessment frameworks applied to all classes of institutions (banks, insurance companies, capital market intermediaries, trust companies and payment systems), aiming to enhance ability to assess large, complex financial groups.
- Authorities also enhanced macro-financial surveillance capabilities.

Disclosure

- Banks raised their disclosure standards in line with industry developments and international best practice. In their annual reports, banks disclose information on corporate governance practices, financial performance, risk exposure, risk management practices and risk-taking philosophy.

Challenges to further reforms

- Monetary Authority of Singapore (MAS) considers management of supervisory resources for Basel II implementation a major challenge. MAS has therefore embarked on several initiatives to raise the awareness of management and staff within MAS and embarked on a major training program of its staff.

THAILAND

Regulations

- Issued new rules and procedures for loan classification and provisioning; accrual of interest; collateral valuation; debt restructuring; loan portfolio review; related lending; capital adequacy; capital requirements for market risk; eligible capital; management of interest and currency risk, including interest rate risk in the banking book; and limits on net open forex positions (for single and aggregate currency positions).
- Bank of Thailand (BOT) issued rules on auditing and disclosure, conforming with Thai Accounting Standards.
- BOT required banks to disclose uniform financial statements, items that have material effects on their financial conditions, and payments to directors and senior management.

Supervision

– Management encouraged reorganization of the Supervision Group at BOT to support new risk-based supervision approach

– BOT also strengthened capacity for off-site supervisory risk assessments at both macro and micro levels.

– BOT also supported the creation of a Bank Examiner School to increase competency and commission examiners, particularly those involved in risk-focused examinations and a financial institutions data base to support all supervisory activity.

Disclosure

- BOT strengthened regulations and guidelines on accounting and disclosure, requiring more frequent audits of financial statements.

- BOT also issued guidelines on the scope of audit work for internal and external auditors.
- BOT required banks to appoint audit committees with the majority of members being independent directors

VIET NAM

Regulations

- State Bank of Vietnam (SBV) drafted new regulations on bank capital adequacy, liquidity ratios, and lending and investment limits, which have restricted the scope for new bank lending for the purchase of stocks after the stock market boomed.
- A cap on securities-related credit was introduced.
- State-owned commercial banks are currently being privatized.
- SBV allowed foreign banks to apply for full banking licenses.
- SBV drafted easier entry rules for foreign banks.
- Minimum capital requirements increased to promote consolidation and mergers.
- SBV recently raised reserve requirements in an effort to quell inflationary pressures.

Supervision

- SBV is currently pursuing governance reforms in banking system to minimize conflicts of interest, separating audit and risk control functions from management and strengthening rights of minority shareholders in banks.

Disclosure

- Various implementing regulations of the securities law were issued by SBV to strengthen supervision of stock-market related activities. These related to disclosure requirements, stiffer penalties for violations, and requirements for improved corporate governance, including with respect to the organizational structure for securities companies and fund management companies.
- The Securities Commission (SSC) tightened enforcement of regulations on market transparency and asked listed companies to improve their provision of accurate and timely information to the public.

Challenges to further reforms

- SBV has a regional structure with over 60 branches, each functioning relatively independently and controlled by the local government. This high level of fragmentation limits its efficiency.
- SBV's co-ownership of the state-owned commercial banks creates a conflict of interest that may diminish the independence of its supervisory oversight
- Although SBV has introduced some requirements on capital, collateralization, asset quality, and provisioning by type of financial institution, banks are not required to publicly disclose details of their performance against these standards, so transparency is an issue; similarly, SBV is very reluctant to publish sector data
- Legal infrastructure is still weak by global standards; bankruptcy law is not implemented.
- Supervision at SBV and SSC is hampered by an absence of an effective reporting, monitoring, and statistical database system.

Source: Asian Development Bank staff.

Table A4.4. Correlation of stock price indexes in Integrating Asia

	PRC	HKG	INO	KOR	MAL	PHI	SIN	TAP	THA	JPN	US
Precrisis 1990:Q2–1996:Q4											
PRC	1.00	0.24	0.06	-0.47	0.00	0.02	-0.26	-0.09	-0.33	-0.49	0.14
HKG	0.24	1.00	0.59	-0.06	0.69	0.53	0.62	0.18	0.48	-0.15	0.57
INO	0.06	0.59	1.00	-0.06	0.68	0.51	0.59	0.15	0.67	-0.10	0.58
KOR	-0.47	-0.06	-0.06	1.00	0.04	0.07	0.15	0.39	0.10	0.33	-0.22
MAL	0.00	0.69	0.68	0.04	1.00	0.70	0.74	0.36	0.72	0.18	0.48
PHI	0.02	0.53	0.51	0.07	0.70	1.00	0.78	0.63	0.65	0.17	0.49
SIN	-0.26	0.62	0.59	0.15	0.74	0.78	1.00	0.44	0.74	0.27	0.58
TAP	-0.09	0.18	0.15	0.39	0.36	0.63	0.44	1.00	0.16	0.34	0.33
THA	-0.33	0.48	0.67	0.10	0.72	0.65	0.74	0.16	1.00	-0.03	0.35
JPN	-0.49	-0.15	-0.10	0.33	0.18	0.17	0.27	0.34	-0.03	1.00	-0.03
Average	**-0.15**	**0.35**	**0.34**	**0.06**	**0.46**	**0.45**	**0.45**	**0.28**	**0.35**	**0.06**	**0.25**
Post-crisis 2000:Q1–2007:Q2											
PRC	1.00	0.25	0.13	0.03	0.34	0.22	0.26	0.15	0.02	0.23	0.28
HKG	0.25	1.00	0.43	0.55	0.56	0.53	0.75	0.69	0.49	0.63	0.66
INO	0.13	0.43	1.00	0.61	0.67	0.69	0.72	0.46	0.76	0.50	0.45
KOR	0.03	0.55	0.61	1.00	0.52	0.66	0.68	0.78	0.70	0.60	0.55
MAL	0.34	0.56	0.67	0.52	1.00	0.53	0.69	0.64	0.61	0.46	0.36
PHI	0.22	0.53	0.69	0.66	0.53	1.00	0.83	0.62	0.68	0.47	0.67
SIN	0.26	0.75	0.72	0.68	0.69	0.83	1.00	0.65	0.65	0.57	0.70
TAP	0.15	0.69	0.46	0.78	0.64	0.62	0.65	1.00	0.69	0.57	0.56
THA	0.02	0.49	0.76	0.70	0.61	0.68	0.65	0.69	1.00	0.54	0.49
JPN	0.23	0.63	0.50	0.60	0.46	0.47	0.57	0.57	0.54	1.00	0.53
Average	**0.18**	**0.54**	**0.55**	**0.57**	**0.56**	**0.58**	**0.64**	**0.58**	**0.57**	**0.51**	**0.47**

Table A4.5. Change in coefficient of stock price correlation pre- and post-crisis

	PRC	HKG	INO	KOR	MAL	PHI	SIN	TAP	THA	JPN	US
PRC											0.15
HKG	0.00										0.09
INO	0.08	-0.16									-0.13
KOR	0.50	0.62	0.67								0.77
MAL	0.34	-0.12	-0.01	0.48							-0.13
PHI	0.21	-0.01	0.18	0.58	-0.16						0.18
SIN	0.52	0.13	0.12	0.53	-0.05	0.05					0.12
TAP	0.24	0.51	0.31	0.40	0.28	-0.01	0.21				0.24
THA	0.35	0.02	0.08	0.60	-0.11	0.03	-0.09	0.54			0.13
JPN	0.73	0.78	0.60	0.27	0.28	0.30	0.30	0.23	0.57		0.56
Average	**0.33**	**0.20**	**0.21**	**0.52**	**0.10**	**0.13**	**0.19**	**0.30**	**0.22**	**0.45**	**0.22**

HKG = Hong Kong, China; INO=Indonesia; JPN=Japan; KOR=Republic of Korea; MAL=Malaysia; PHI=Philippines; PRC=People's Republic of China; SIN=Singapore; TAP=Taipei,China; THA=Thailand; US=United States.
Source: Asian Development Bank staff elaborations based on data from Bloomberg. 2008. Available: http://www.bloomberg.com (accessed March 2008).

Chapter 5

Managing Macroeconomic Interdependence

Chapter 5

Managing macroeconomic interdependence

Asia is growing together, with tighter trade, investment, and financial links both driving and reflecting this increasing macroeconomic interdependence (as detailed in chapters 3 and 4). Each economy's macroeconomic variables—such as economic growth, inflation, and exchange rates—are increasingly affected by the shocks that neighboring economies experience and the policies they adopt. This bolsters the need to improve information sharing, to strengthen mutual surveillance, and to coordinate macroeconomic policies, such as monetary, fiscal, and exchange rate policies. New regional forums for policy dialogue have already emerged. The foundations for mutual financial support are also in place—the CMI, in particular, has led to the creation of a network of bilateral swap arrangements to help cope with future financial crises. But are existing arrangements adequate? Or do the region's policy makers need to cooperate more closely to improve economic performance and enhance stability—and if so, how?

Macroeconomic interdependence is the degree to which individual economies interact with each other. This can be measured in all sorts of ways, but among the most important is the intensity with which macroeconomic variables—output and prices in particular—affect each other across national borders. Output and price correlations need not be positive, but normally, where economies share similar industries and face common shocks, they can be expected to move more closely with each other. Vertical integration through intrafirm trade and FDI also ought to increase the synchronization of output movements. Common shocks may come on the demand side, e.g., if Asian economies all produce electronics and global demand for electronics picks up, all will tend to expand. They may also occur on the supply side if the prices of crude oil and raw materials rise substantially, Asian economies will tend to slow. Such shocks may originate outside a region, as with the two global shocks just described, or they may be specific to a region or an individual country within it. For example, a stock market collapse in one country may cause investors in neighboring economies to sell off shares, or a consumption boom in one country may suck in imports from its regional trading partners, also boosting their economies.

But the nature and degree of interdependence also hinge on the broad policy environment. For example, a price shock is more likely to spread from one economy to another if both operate with a fixed exchange rate. Likewise, a financial shock in one economy will have a greater impact on another's capital markets if both economies permit greater capital mobility between their markets. And as macroeconomic interdependence grows, policy coordination becomes increasingly beneficial. Policy makers can no longer pursue optimal policy without taking into account neighboring economies' actions.

Policies and interdependence reinforce each other in other ways. For example, a region that trades a lot with itself would gain from policies to foster integrated financial markets in which agents can better manage geographic risks. It would also gain from insulating real exchange rates (relative prices adjusted for nominal exchange rates) from erratic temporary fluctuations, making them a more efficient signal for resource allocation. Asia must now seriously consider this interplay of interdependence and collective policy response. It needs to manage its growing exposure to external shocks better—both to reduce the economic volatility and risks that they generate and to create an environment in which regional links can continue to deepen.

The rest of this chapter is organized as follows. Section 5.1 considers how economic links and macroeconomic interdependence in Asia have developed. Section 5.2 reviews recent monetary, fiscal, and exchange rate policies, and examines the stability of real exchange rates in recent years. Section 5.3 discusses Asia's challenges in maintaining growth and stability, while Section 5.4 proposes regional solutions—including policies and institutions—that would help address the challenges of an interdependent region. Section 5.5 concludes. The Appendix contains detailed explanations and documentation of the technical evidence presented in the text.

5.1. Deepening macroeconomic interdependence

There is no single, perfect measure of macroeconomic interdependence, but output and price links are among the most frequently used. This section will first look at these two measures and then discuss how global and regional shocks are transmitted through the region, another measure of interdependence. Interdependence is not a question with a yes or no answer; it is a matter of degree. Thus, interdependence can only be assessed against a yardstick. In this section, Asia's regional macroeconomic interdependence is benchmarked against the precurrency crisis period, as well as against its interdependence with other regions, in particular the EU and US. Evidence will be reviewed, recognizing that different data sets, methodologies, and sample periods have yielded radically different results, underscoring the need to be cautious and tentative in conclusions.

Output links

One might expect greater interdependence to lead to similar movements in real variables such as trade, output, and employment. But this is not necessarily so. If interdependence leads economies in a region to become increasingly specialized, their business cycles may become driven by different shocks and determinants and may therefore become more dissimilar (Frankel and Rose 1998). Interdependence need not imply greater co-movements in macroeconomic variables.

Yet there are at least two good reasons to believe that interdependence is creating a co-movement of macroeconomic variables in Asia. First, as Asian economies develop tighter trade, investment, and financial links, their markets are becoming increasingly important drivers of regional economic activity. Second, because most trade within Asia consists of intra-industry trade in parts and components, it propagates common, industry-specific shocks across the region.[56] Third, because Europe and the US remain the main export markets for Asia's final goods—accounting for nearly half of total exports—external demand shocks to Asian economies tend to be similar.[57] Many recent studies suggest that the synchronization of

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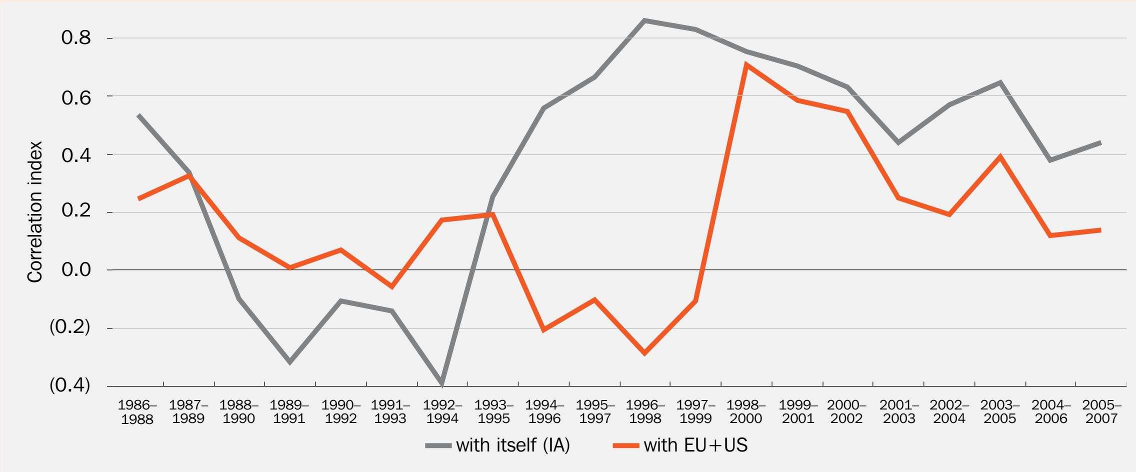
[56] More than 70% of intra-Asian trade is said to consist of intermediate goods used in production (ADB 2007a).

[57] Rana (2007) shows that intra-industry trade is an important factor explaining the positive output correlations in Asia.

Figure 5.1. Output correlation of Integrating Asia
Reactions by type of shock per month pre- and post-crisis



EU = European Union, IA = I ntegrating Asia, US = United States.
Notes:
Sample period: 1986:Q1–2007:Q3 12 quarter moving average. Other details of the correlation analysis are in Methodological Notes 5.1 in the Appendix to this chapter.
Source: Asian Development Bank staff computations. Data from Oxford Economics 2008. Forecasting and Analysis. Available: http://www.oef.com/OE_FA_IntMac.asp; and Bureau of Economic Analysis 2008. National Income Accounts. Available: http://www.bea.gov/national/index.htm (accessed February 2008).

Asian business cycles has greatly increased (McKinnon and Schnabl 2002, Kawai and Motonishi 2005, ADB 2007a). Some simple measures of output co-movements, based on quarterly GDP data, are presented in Figure 5.1 (technical details and more results are presented in Methodological Note 5.1 and Figure A5.1 in the appendix to this chapter).

Figure 5.1 shows that, when using 3-year moving averages, the correlation of quarterly GDPs among integrating Asian economies has greatly increased in recent years.[58] The sharp rise in the correlation in the late 1990s was largely due to the crisis, but, after a brief dip, the correlation has remained strong. The average correlation coefficient of quarterly GDP has risen from a mere 0.07 before the crisis to 0.54 after it.

Asian economies appear to be increasingly interdependent—with each other, and with the rest of the world. A closer look (as reported

[58] Integrating Asia in this exercise include Japan; the PRC; Hong Kong, China; Indonesia; the Republic of Korea; Malaysia; the Philippines; Singapore; Taipei,China; and Thailand.

in Figure A5.1 in this chapter's appendix) suggests that the increase reflects stronger ties with the US, despite the fact that the share of the US market in Integrating Asia's exports declined from 35% in 1986 to 18% in 2006. The increase may also reflect the nature of much of Asia's intraregional trade, which is driven by the vertical integration of production chains, with the US remaining the main destination for final goods.

Empirical studies differ on the extent to which Asian business cycles have become more autonomous. Some find that business cycles have become more synchronized globally as a result of strengthening trade and financial links, and that cyclical swings in global economic conditions—particularly in the US economy—still exert significant influence on Asia.[59] The International Monetary Fund (IMF) notes that the nature of global interdependence differs significantly according to the type of shock (IMF 2007b). If, for instance, a US recession is caused by a global shock, the rest of the world is also likely to suffer. In other cases, economic developments in the rest of the world are becoming more independent of those in the US. The same study also finds that regional factors are increasingly important relative to global ones in determining macroeconomic outcomes.[60]

Price links

Foremost among the drivers of regional integration during the last decade has been intraregional trade (Urata 2007b). Coupled with this, lower trade barriers are stitching together national markets for goods and services. This has promoted greater arbitrage in tradable goods prices; it should also have strengthened the links through which price shocks are transmitted from one economy to another.

Evidence indicates that price links in Asia are stronger than before the crisis. Looking at the correlation of quarterly detrended consumer prices of one economy with another's, adjusted for nominal exchange rate changes, the average for 12 Asian economies and for all pairs increased from 0.10 in 1988–1996 to 0.39 in 1999–2007. (Methodological Note 5.2 and Table A5.1 in the appendix to this chapter supply technical details and bilateral correlations.) Stronger price links indicates either that individual Asian economies face price shocks that are more similar than they had been previously, or that

[59] See, for a survey, ADB (2007a) and IMF (2007b).

[60] The difficulty of disentangling these conflicting influences may explain why some studies have yet to find evidence of the growing independence of Asian business cycles from the US cycle (Rana [2007]; Kawai [2007b]; and Dees and Vansteenkiste [2007]).

price shocks in one part of the region are being transmitted to others with greater force.

But this increased correlation is only indicative, because correlation can be spurious—Asian economies could be responding to similar exogenous shocks, rather than to shocks transmitted from one Asian economy to another. In practice, many factors affect consumer prices, not just external price shocks. Some of the large correlations observed for India, the country believed to be among the least integrated in the region, may well be spurious. And some of the small correlations observed for Singapore, the country believed to be among the most integrated, may appear puzzling. But the correlation of two detrended price series need not reflect the trade integration of their economies, because greater price arbitrage should result in a smaller deviation between price levels, and not necessarily lead to a higher correlation of shocks to the price level. What is remarkable, though, is the consistently large correlations observed for the PRC and Japan, the region's two largest economies. The average correlation for the post-crisis period was 0.46 for Japan (compared with -0.07 before) and 0.53 for the PRC (0.33 previously). The correlation may mean that price shocks originating in the two economies are now significantly influencing price developments in their regional trading partners. Coupled with the overall increase in consumer price correlations for the region, this is further evidence of growing macroeconomic interdependence in Asia.

Transmission of shocks

Another aspect of interdependence is how a shock is transmitted from one economy to another. This might entail a supply shock—such as a policy reform or technological improvement that boosts supply or an oil price rise or natural disaster that dents it—or a demand shock—such as an increase in government spending or a fall in investor confidence that slows domestic capital formation. Such shocks could originate either within or outside the region. Whatever the shock, the issue for Asia is how it might impact output in individual economies.

Vector autoregression (VAR) is a standard statistical procedure for investigating how shocks are transmitted from one entity to another. Using VAR, a shock that originates within the region (a regional shock), a shock that originates in the rest of the world (a global shock), or Japan (a "Japan shock")—which is considered separately because Japan accounted for a large share (as much as 60% in 1990) of total regional output—have been considered. How regional output responded to these shocks before and after the crisis was then analyzed.[61]

The VAR analysis indicates that before the crisis, almost 90% of the variance of Asia's GDP (outside Japan) was explained by a regional shock, but that this fell to 60% after the crisis (Methodological Note 5.3 and Figure A5.2 in the appendix to this chapter provide details). The determination of Asia's GDP became more autonomous, as the share of the long-run output variance explainable by a global shock declined (from 50% to 40%). Before the crisis, output responded significantly only to a regional shock (Figure 5.2). If anything, the response to a global or Japan shock was negative. Since the crisis, though, regional output has become significantly responsive to all shocks, and the response to a global shock, as well as a Japan shock, became positive.

Kim and Lee (2008) provide further evidence that Asia's global and regional macroeconomic interdependence may be growing using a panel VAR framework for a slightly different set of countries.[62] Their model repeated the analysis for each of the Asian economies, with the region in each case comprising the rest of Asia. They find that, for the precrisis period of 1990–1996, a global shock had no impact on domestic output, while a regional shock had a negative effect. In the post-crisis period of 2000–2007, however, both global and regional shocks had a significantly positive impact on domestic output.

Thus several strands of evidence suggest that regional interdependence has increased in terms both of output and price correlations and of the long-run variance of output explainable by shocks originating within the region. But, somewhat surprisingly, the region's dependence on the global economy appears not to have diminished. Output correlations with the world have increased, a greater portion of the current output variance is explained by a global shock, and Asia's output has become more responsive to a global shock. In other words, through its deeper integration with international markets, Asia appears to have become more exposed to shocks within the region, while remaining sensitive to those from outside it.

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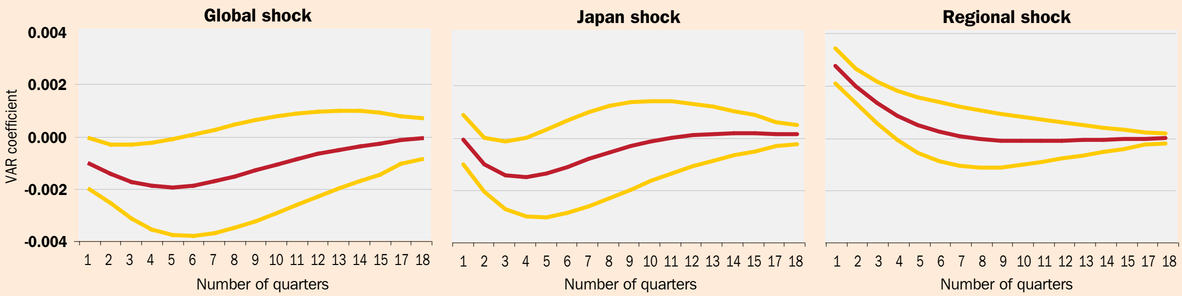
[61] Here, Asia includes the PRC; Hong Kong, China; India; Indonesia; Japan; the Republic of Korea; Malaysia; the Philippines; Singapore; Taipei,China; and Thailand. The rest of the world comprises the United Kingdom; the US; and six European economies: Belgium, France, Germany, Italy, the Netherlands, and Spain. The precrisis period refers to Q1:1988–Q4:1996; the post-crisis period covers Q1:1999–Q4:2006.

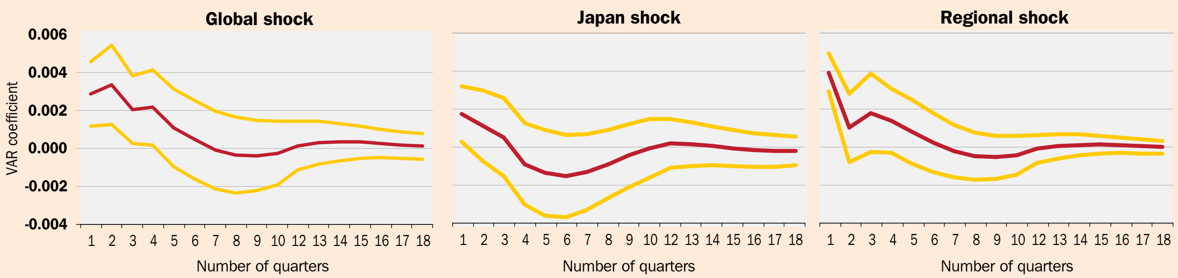
[62] For Asia, Kim and Lee (2008) excluded India from the sample. The rest of the world comprises the Group of 7 countries, except for Japan.

Figure 5.2. Global and regional shocks have greater impact on Asian economies
Reactions by type of shock per month pre- and post-crisis

a. Precrisis



b. Post-crisis



VAR = Vector autoregression.
Note: The upper and lower lines indicate confidence intervals (two standard deviations).
Sources: Calculations by Shinji Takagi. Data from the IMF various years. International Financial Statistics. Available: http://www.imfstatistics.org (accessed October 2007); and CBRC 2007. Financial Statistics Monthly. Available: http//www.cbc.gov.tw (accessed October 2007).

There has been a heated debate on whether Asia is decoupling from the global business cycle and the US's in particular (see ADB [2007a]). Proponents say that, with recent growth and integration, the importance of regional demand as a driver of Asia's economic growth has increased. Opponents argue that, with the commitment to openness and the importance of the EU and US markets as destinations for final goods exports, Asia's economic links with the rest of the world have intensified. The debate misses the possibility that both are true. National determinants—the third possible driver—could have diminished relative to regional and global forces in the face of greater openness.

5.2. Macroeconomic policies

The evidence of growing macroeconomic interdependence may lead to the expectation that macroeconomic policies have also converged. Is such a convergence borne out by evidence? This section will show that, except when the region's economies reacted in a broadly similar fashion to the large common shock of the currency crisis in the late 1990s, macroeconomic policies in the region have been far from convergent. Real exchange rates, though, have been relatively stable, given the—until recently—benign external environment of price and exchange rate stability. Yet, the section concludes that, if left unchanged, the divergence of policies may undermine real exchange rate stability, and hence the macroeconomic stability of an increasingly integrated region.

GDP growth

The growth performance of the region's economies reflects, in part, the wide diversity in economic conditions. Figure 5.3 shows average GDP growth rates for Integrating Asia for the two most recent 4-year periods: 2000–2003 and 2004–2007. The region's economies grew by an average of 3.5% a year in 2000–2003 and 5.5% in 2004–2007, with considerable differences across countries.[63] Differences in growth rates have led to big changes in some economies' shares of aggregate regional output. For instance, while Japan's share has fallen from about 60% in 2000 to 50% in 2007, the PRC's has risen from 15% to almost 25% during the same period. As developing Asian economies are generally growing faster than more advanced ones, living standards, if not growth rates, are converging.

Monetary policy

Along with the lack of monetary policy coordination across the region, inflation tends to vary widely (Figure 5.4). From 2000 to 2003, inflation remained subdued throughout the region, averaging 2.7% across Integrating Asia, as most economies had excess capacity following the crisis. Monetary policy was mostly directed at supporting weak domestic demand, especially given the need for fiscal consolidation in many countries. In this respect, economies' monetary policy stance—or interest rate cycle—was reasonably synchronized.

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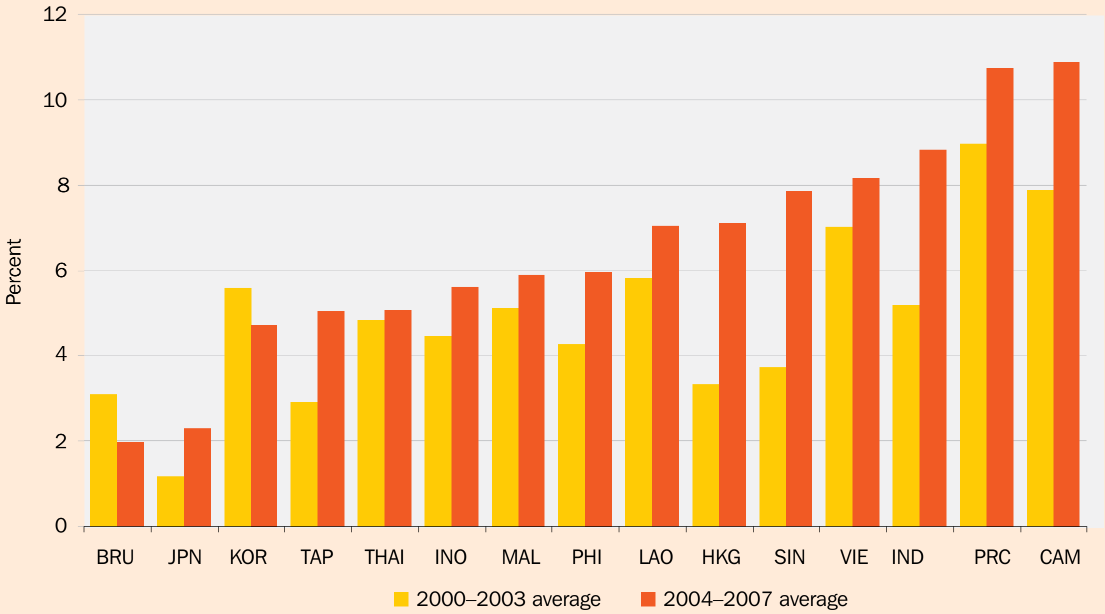
[63] The inclusion of Japan, by far the largest Asian economy, with an average GDP growth rate of 1.2% in 2000–2003 and 2.3% in 2004–2007, lowers the regional average. Excluding Japan, the growth rates are 6.5% and 8.3%, respectively.

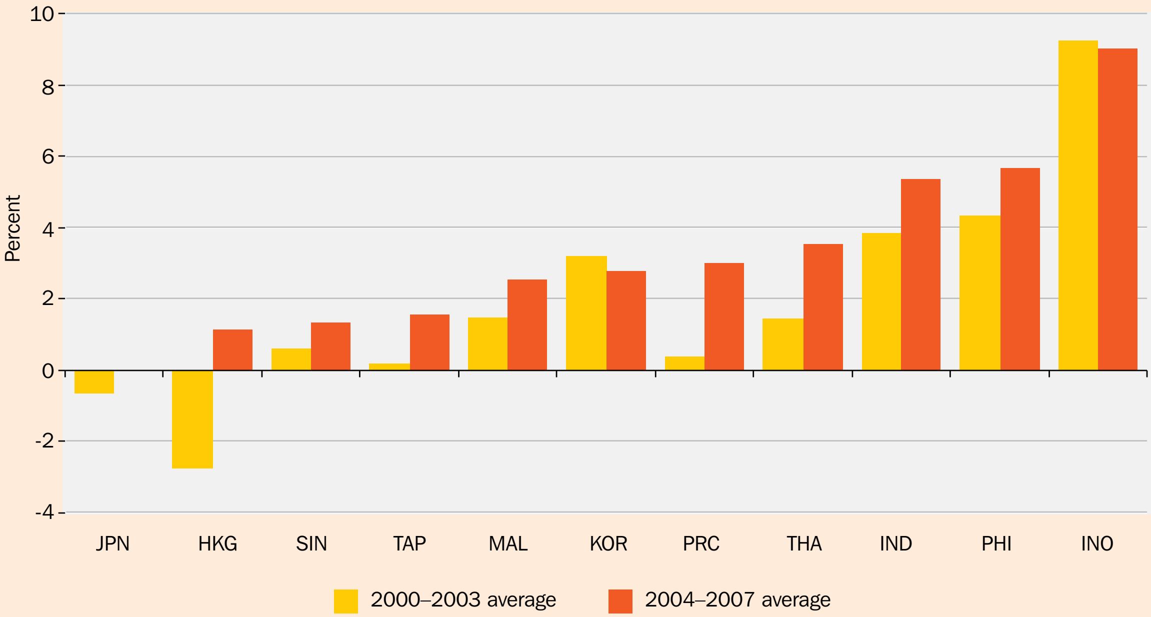
Figure 5.3. Variations in Asia's growth rates
GDP 4-year averages, 2000–2007



BRU = Brunei Darussalam; CAM = Cambodia; GDP = gross domestic product; HKG = Hong Kong, China; IND = India; INO = Indonesia; JPN = Japan; KOR = Republic of Korea; LAO = Lao People's Democratic Republic; MAL = Malaysia; PHI = Philippines; PRC = People's Republic of China; SIN = Singapore; TAP = Taipei,China; THA = Thailand; VIE = Viet Nam.
Notes:
GDP growth rates for 2000 are based on 1993 prices; growth rates from 2001 on are based on 2000 prices.
Growth rates from 1999 to 2000 are based on 1987 prices; growth rates from 2001 on are based on 2000 prices.
For fiscal year April–March. No data available for 2006 and 2007.
Figures for 2004–2006 are not linked to the GDP figures 2003 backwards due to National Statistics Office revisions for sectoral estimates.
Actual 2007 figures for Japan, Republic of Korea, Indonesia, Philippines, and Singapore; ADB forecasts for the other economies.
Excludes Brunei Darussalam and Myanmar for all years as weights are unavailable.
Sources: Data from the ADB 2007a. Key *Economic Indicators*. Available: http://www.adb.org (accessed May 2008).

Conditions began to change in 2004, with the strengthening of economic activity and a rise in commodity prices. The monetary authorities of several economies—such as the PRC; India; Indonesia; Malaysia; Taipei,China; and Thailand—responded to inflationary pressure by tightening policy somewhat. Inflation became a concern in the PRC, India, and Indonesia. Following the US Federal Reserve's lead in mid-2004 but with some lags, a few countries, such as Indonesia and Thailand, raised interest rates substantially. Others, such as the Republic of Korea, did so more modestly, but all remained careful not to undermine weak domestic demand. Monetary policy has since

Figure 5.4. Variations in Asia's inflation
(2000–2007)

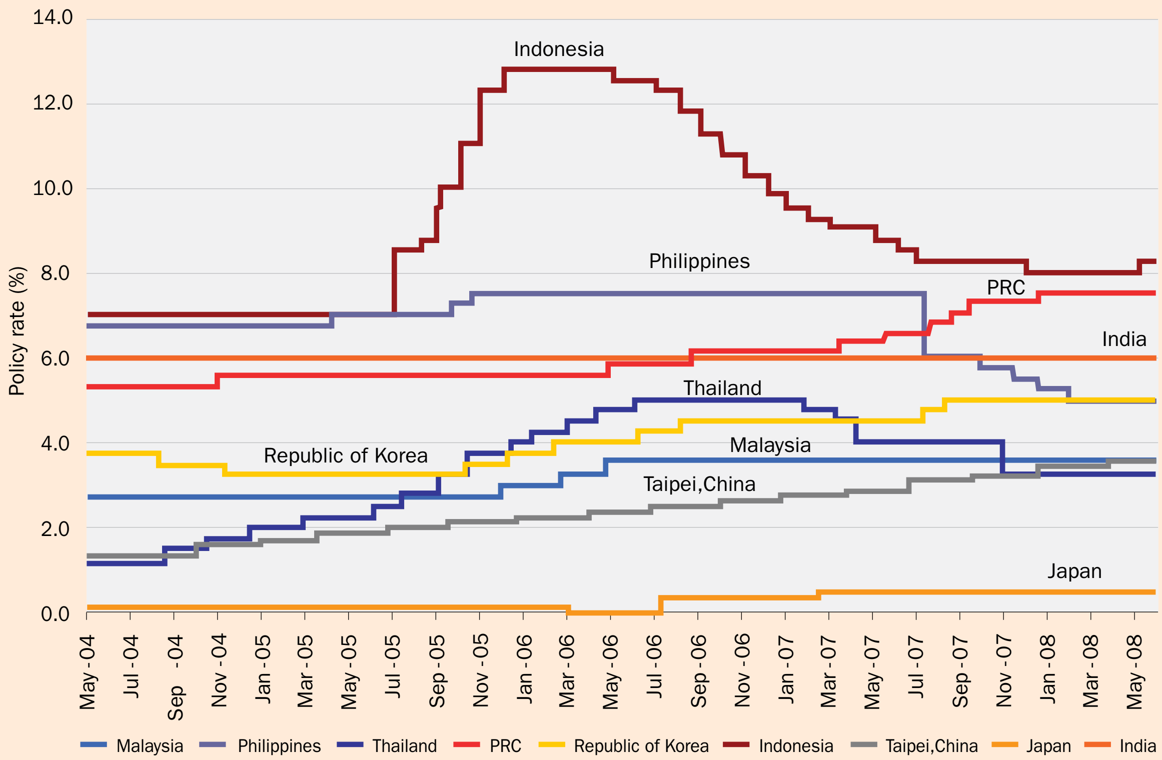


HKG = Hong Kong, China; IND = India; INO = Indonesia; JPN = Japan; KOR = Republic of Korea; MAL = Malaysia; PHI=Philippines; PRC = People's Republic of China; SIN=Singapore; TAP=Taipei,China; THA=Thailand.
Sources: Data from the ADB 2007c. *Key Indicators* 2007. Available: http://www.adb.org (accessed May 2008); IMF various years. *International Financial Statistics* Online and IMF 2008. *World Economic Outlook* database. Available: http://www.imf.org; and national sources (accessed May 2008).

diverged more, not least since the US began cutting interest rates in the second half of 2007 in response to the unfolding "credit crunch." But while some Asian economies were cutting rates in response to falling inflation pressures and weak domestic demand, others began to tighten monetary conditions (Figure 5.5).

Although monetary policy remained loose until recently, inflation generally declined across the region to an average 2.6% of in 2007. This reflected—in part—a benign environment, and was also due to an improvement in macroeconomic institutions. The Republic of Korea, the Philippines, and Thailand adopted a formal inflation-targeting framework. In other countries, such as Malaysia and Singapore, authorities acted prudently within a macroeconomic policy framework that gives paramount weight to price stability. Although both inflation and interest rates vary across the region, their variance has tended to decline over time (Figure 5.6).

Figure 5.5. Policy rates in selected integrating Asian economies



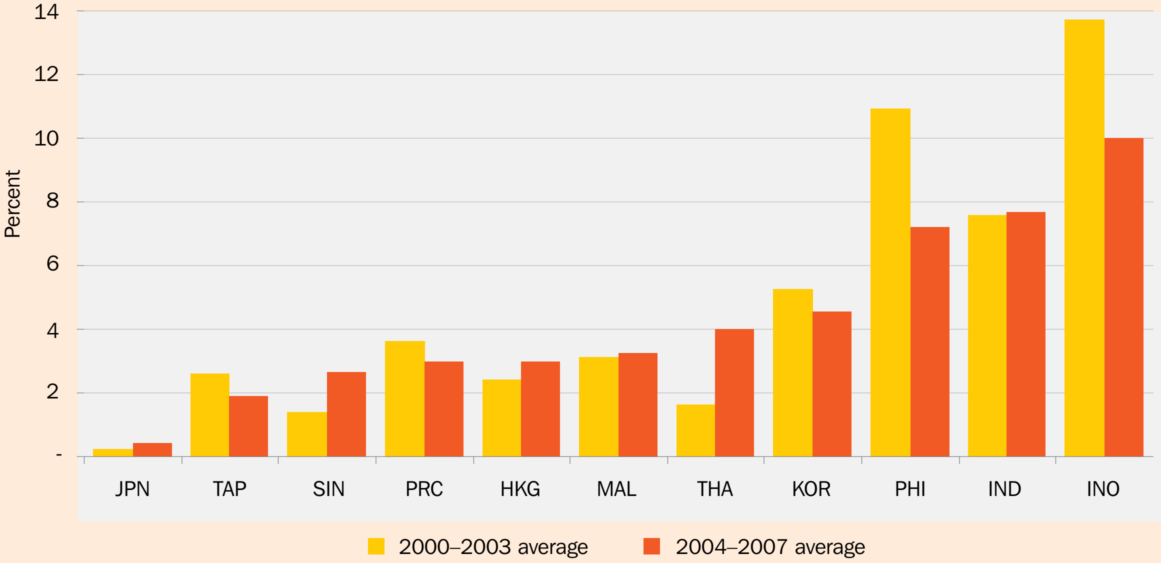
GDP = gross domestic product, PRC = People's Republic of China.
Notes:
Policy rates are as follows: Base rate (Hong Kong, China); Bank of Indonesia rate (Indonesia); reverse repo rate (India); overnight call rate (Japan); overnight call rate (Republic of Korea); overnight policy rate (Malaysia); reverse repurchase rate (Philippines); official discount rate (Taipei,China); and 1-year lending rate (PRC). Bank of Thailand switched its benchmark from 14-day to 1-day reverse repurchase rate on 17 January 2007.
Sources: Data from various sources and Bloomberg 2008. Available: http//www.bloomberg.com/ (accessed June 2008).

Fiscal policy

Asian economies' fiscal policy stance has also differed somewhat, albeit much less so than the stances on monetary policy. More important for the region's macroeconomic stability is governments' varying room for fiscal maneuver, because this frames how different economies can respond to future shocks that affect the region.

In the aftermath of the crisis, fiscal positions in Asia deteriorated sharply, and public debt soared. Since then, the region's authorities have made restoring fiscal discipline a priority. Even when growth weakened at the turn of the century, governments eased fiscal policy

Figure 5.6. Variations in Asia's interest rates
Three-month interest rates, 4-year averages, 2000–2007



HKG = Hong Kong, China; IND = India; INO = Indonesia; JPN = Japan; KOR = Republic of Korea; MAL = Malaysia; PHI = Philippines; PRC = People's Republic of China; SIN = Singapore; TAP = Taipei,China; THA = Thailand.
Note: 2001 and 2002 data are not available for Thailand.
Source: Bloomberg 2008. Available: http//www.bloomberg.com/ (accessed May 2008).

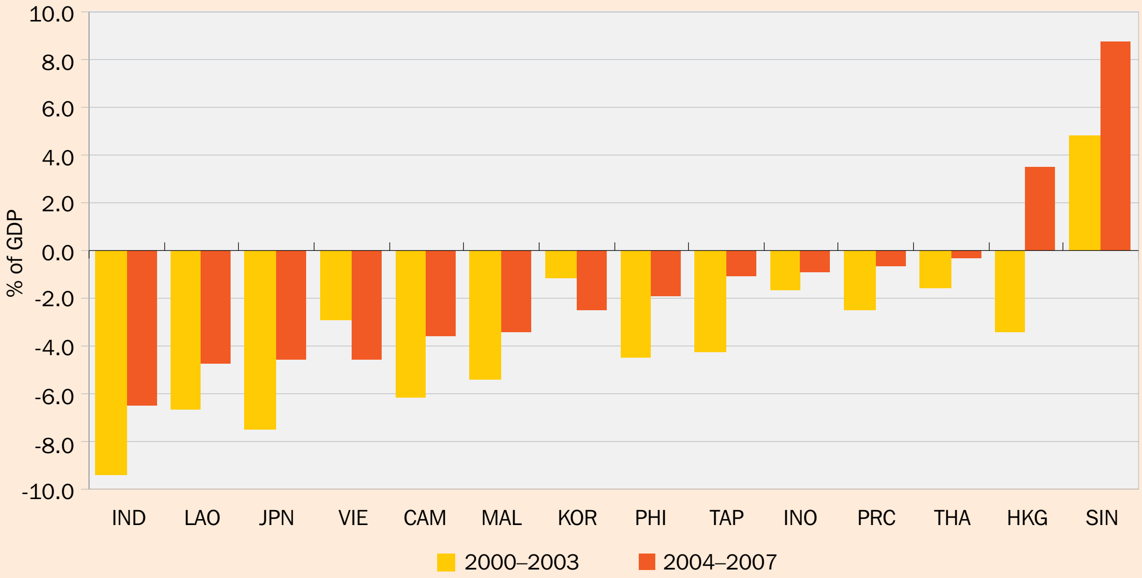
only modestly. Fiscal deficits deteriorated in 2001 across Asia—except, notably, in the PRC, Malaysia, and Thailand—but quickly improved in several countries in 2002. When economic activity strengthened, almost all economies began to tighten policy, though large deficits remained in some.

For the most part, fiscal policy has remained conservative in 2000–2007. Indonesia, the Republic of Korea, Malaysia, and Thailand in particular have steadily pursued fiscal consolidation. Public debt levels in the region as a whole have fallen to their lowest since 2000. But authorities are aware that these efforts are not sufficient in view of the prospective costs of aging populations. Fiscal consolidation has been less successful in India, Japan, and the Philippines, where public debt has reached critically high levels (Figure 5.7a).

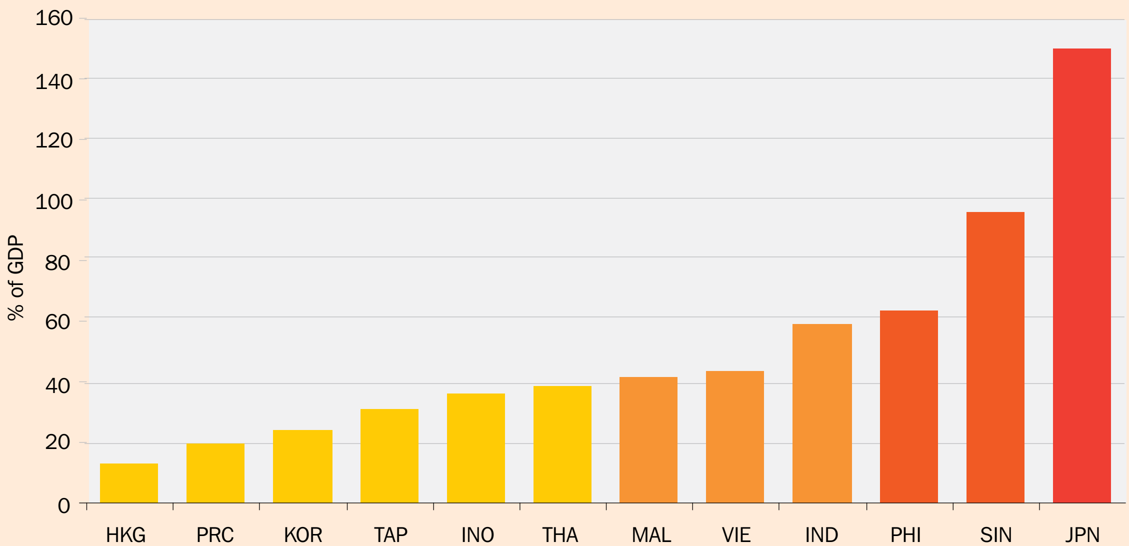
Although fiscal policy across the region is broadly neutral, actual fiscal positions vary widely (Figure 5.7b). Despite the urgent need to reduce their debts, India and Japan continue to run deficits of about 6% of GDP. Singapore, in contrast, had a surplus of as much as 12% of

Figure 5.7. Variations in Asia's fiscal indicators

a. Central government fiscal balance 4-year averages, 2000–2007



b. Gross public sector debt, 2007



Sources: Data from ADB various years. *Asian Development Outlook*. Available: http://www.adb.org (accessed April 2008); and IMF 2008. *World Economic Outlook*. Available: http://www.imf.org (accessed April).

GDP in 2007. The differences in fiscal positions and public debt levels imply that some countries have greater scope to use fiscal policy to support demand, which implies that divergent responses to adverse external shocks across countries are likely.

Exchange rate policy

Asia has a wide range of exchange rate systems. Before the crisis, most economies in the region officially operated a managed float for their currencies; in practice, they tightly controlled their movements against the US dollar. Under this de facto dollar peg, Asian currencies fluctuated sharply against the Japanese yen, the most important regional currency, whenever the yen fluctuated against the dollar. Takagi (1999) shows that the yen figured prominently in Asian economies' exchange rate policies only when the yen depreciated sharply against the US dollar, reflecting the desire of some authorities not to lose price competitiveness against Japan in third markets.

When the crisis caused the dollar pegs to collapse, affected economies temporarily adopted more flexible exchange rate regimes. But as calm returned in the second half of 1998, many began to revert to informal dollar pegs, albeit somewhat more flexible ones. Malaysia even restored a formal dollar peg in September 1998, while Hong Kong, China continued to peg its currency to the US dollar through a currency board. Officially, the PRC had a managed float; in practice, it pegged its currency to the US dollar. Japan was almost alone in having a floating currency, although in practice it too intervened to limit any appreciation against the dollar, particularly in 2003–2004.

Since the crisis, the diversity of exchange rate regimes in Asia has increased, and while most countries have adopted more flexible policies, they have done so at different times and to varying degrees. Officially, most Asian economies have maintained a managed float throughout the past 10 years. The notable exceptions are Indonesia and the Republic of Korea, both of which explicitly switched to a free float. But in practice, several managed floaters have moved toward greater flexibility. This may be due in part to the PRC's announcement on 21 July 2005 that it was revaluing the yuan by 2% against the US dollar and henceforth setting the yuan's value with reference to a basket of currencies. On the same day, Malaysian authorities also shifted to a managed float for the ringgit.

Although exchange rate regimes in Asia continue to vary, with Hong Kong, China and Viet Nam still committed to a US dollar peg, the PRC's decision may have given some countries greater scope for flexibility. Table 5.1 provides one measure of it. The figures indicate the average monthly percentage change of each currency against the US dollar; a positive sign implies depreciation, while a negative sign signals appreciation. The figure in brackets provides a measure of the variability of monthly exchange rate changes. Overall, most Asian currencies have shown more flexibility against the US dollar in recent years than in the period before the crisis.

Table 5.1. Monthly dollar exchange rate movements

Currency	1995/96	2001/02	2003/04	2005/06
Chinese yuan	-0.07	0.00	-0.00	0.00
	(0.01)	*(0.00)*	*(0.00)*	*(0.00)*
Hong Kong dollar	-0.00	0.00	-0.00	0.00
	(0.00)	*(0.00)*	*(0.00)*	*(0.00)*
Indian rupee	0.56	0.11	-0.41	0.06
	(3.61)	*(0.22)*	*(1.98)*	*(2.49)*
Indonesian rupiah	0.33	-0.30	0.16	-0.12
	(0.13)	*(37.55)*	*(4.81)*	*(5.20)*
Japanese yen	0.63	0.18	-0.59	0.55
	(14.25)	*(8.81)*	*(6.64)*	*(2.76)*
Korean won	0.28	-0.27	-0.57	-0.45
	(1.10)	*(5.16)*	*(5.46)*	*(2.35)*
Malaysian ringgit	-0.05	0.00	0.00	-0.31
	(0.86)	*(0.00)*	*(0.00)*	*(0.64)*
New Taiwan dollar	0.19	0.19	-0.36	0.11
	(1.65)	*(1.49)*	*(1.20)*	*(1.97)*
Philippine peso	0.31	0.25	0.24	-0.57
	(1.07)	*(3.41)*	*(0.93)*	*(2.05)*
Singapore dollar	-0.18	0.01	-0.25	-0.26
	(0.58)	*(2.40)*	*(1.22)*	*(1.18)*
Thai baht	0.09	-0.01	-0.42	-0.33
	(0.22)	*(2.63)*	*(1.81)*	*(3.02)*
Vietnamese dong	0.04	0.25	0.10	0.07
	(0.03)	*(0.08)*	*(0.03)*	*(0.02)*

Notes:
Values are in averaged logarithmic difference form, multiplied by 100.
Values in parentheses are variances multiplied by 10,000 for ease of presentation.
Exchange rate values are end of period data.
Sources: Data from IMF various years. International Financial Statistics. Available: http://www.imf.org (accessed December 2007); and CBRC 2007. Financial Statistics Monthly. Available: http://www.cbc.gov.tw/EngHome/default.asp (accessed December 2007).

At one extreme, the Hong Kong dollar has zeroes in both columns: its exchange rate against the US dollar has remained fixed throughout. The Japanese yen, on the other hand, displays both significant appreciations and depreciations, with significant variance. The PRC has shifted from a basically fixed exchange rate against the US dollar to an appreciating one since 2005, with (very limited) variability around that trend. As expected, compared to the precrisis period, as well as to the benchmark of the dollar-yen rate, the Indonesian rupiah, the Korean won, and the Thai baht have become more flexible; the Singapore dollar may also have become somewhat more flexible. The pace of yuan appreciation, which has so far been very gradual, appears to be slowly picking up, although the change is too recent to be reflected in the table.

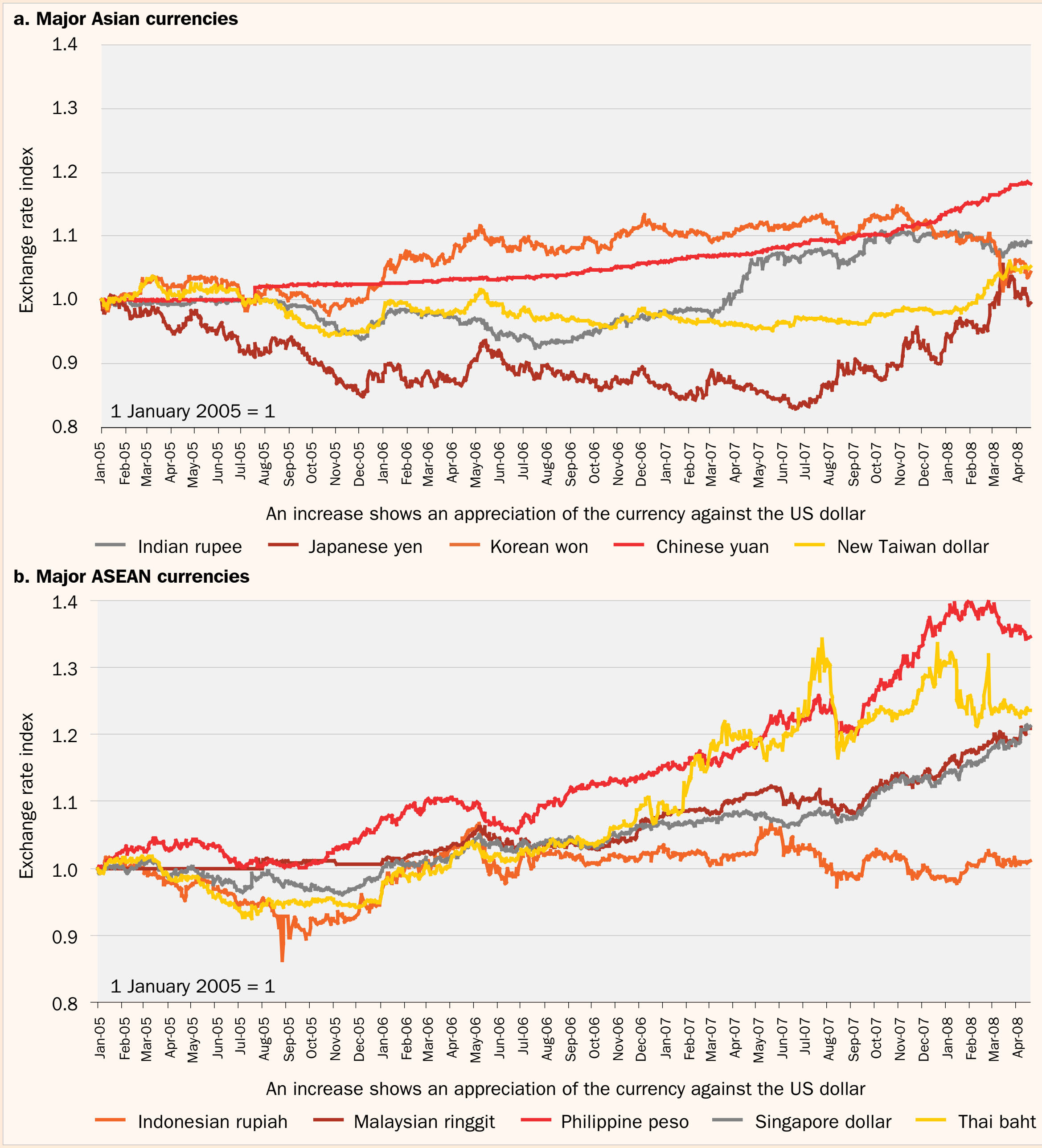
Figure 5.8 charts how Asian currencies moved against the US dollar from January 2005 through the end of April 2008. The Philippine peso has markedly appreciated, as has the Thai baht, albeit in an increasingly volatile fashion. The Malaysian ringgit, Singapore dollar, and PRC yuan all appreciated by approximately 20% against the US dollar. Until summer 2007, the Japanese yen was—alone among major Asian currencies—depreciating against the US dollar, but since then it has picked up. By the end of April 2008, the yen was roughly back where it was in January 2005.

Real exchange rate stability

Real exchange rates—nominal exchange rates adjusted for differences in inflation—guide the allocation of resources across economies. Efficiency requires that they respond to changes in economic fundamentals (such as relative resource endowments, productivity growth, and technical progress), which generally change slowly over time, but that they not jump around erratically for other reasons, such as currency speculation. Given reasonable price stability, the short-run stability of nominal exchange rates is thus critical to the macroeconomic stability of an interdependent region.

Asia has been fortunate to experience two favorable macroeconomic trends in recent years. Inflation has declined across the region, and lower average inflation in effect implies a greater convergence of inflation rates. Meanwhile, the relative weakness of the yen against the US dollar in an environment of greater exchange rate flexibility has meant that some Asian currencies have moved more closely with the yen in recent years than before. These two developments have contributed to greater real exchange rate stability

Figure 5.8. Trend of Asian currencies against the US dollar



ASEAN = Association of Southeast Asian Nations; US = United States.
Note: An increase shows an appreciation of the currency against the US dollar.
Source: Asian Development Bank staff elaborations based on Bloomberg data. 2008. Available: http://www.bloomberg.com (accessed April 2008).

among the region's economies, despite the lack of any formal policy coordination.

Applying the Frankel-Wei methodology to monthly exchange rate data helps to identify changes in the pattern of Asian exchange rate movements (Frankel and Shang 1994). The exchange rate of a particular currency is regressed against those of major currencies, all expressed in terms of some common currency. The estimated coefficients can then be interpreted as the major currencies' weights in determining the exchange rate of the chosen currency. For example, a large weight of the yen, when the methodology is applied to the ringgit, means that the two currencies move closely together against a common currency. Table 5.2 shows that the weight of the Japanese yen rose among the flexible currencies, from 0.06 in the precrisis period on average to 0.20 in the post-crisis period. The weight of the US dollar has significantly declined, although it continues to be larger than that of the yen. An explanation of the Frankel-Wei approach and regression estimates are included in the Methodological Note A5.4 and in Table A5.2 in the appendix to this chapter.

The recent pattern of price and nominal exchange rate changes across the region has led to a substantial fall in the variability of prices and exchange rates. For example, the variances of percentage deviations from the average of US dollar exchange rate and consumer price changes peaked at the time of the currency crisis, but diminished

Table 5.2. Weights of major currencies in Asian exchange rates

	January 1988–December 1996		January 2000–December 2006	
Anchor currency	**Simple average for 11 currencies**	**Simple average for 7 flexible currencies**	**Simple average for 11 currencies**	**Simple average for 7 flexible currencies**
US dollar	0.88	0.90	0.78	0.67
German mark/euro	0.08	0.00	0.07	0.10
Japanese yen	0.07	0.06	0.13	0.20

Notes:
11 currencies = Chinese yuan, Hong Kong dollar, Indian rupee, Indonesian rupiah, Korean won, Malaysian ringgit, Philippine peso, Singapore dollar, New Taiwan dollar, Thai baht, Vietnamese dong.
7 flexible currencies = Indian rupee, Indonesian rupiah, Korean won, Philippine peso, New Taiwan dollar, Thai baht, Vietnamese dong.
Sources: Estimates by Shinji Takagi. Data from IMF various years. International Financial Statistics. Available: http://www.imf.statistics.org/ (accessed October 2007); and CBRC 2007. Financial Statistics Monthly. Available: http://www.cbc.gov.tw (accessed October 2007).

Table 5.3. Declining variance of real exchange rate movements in Asia

Variable \ Period	1989–1991	1992–1994	1995–1997	1998–2000	2001–2003	2004–2006
Nominal exchange rates	65.9	86.8	33.2	432.8	24.3	16.4
CPI inflation	17.0	17.7	11.0	71.8	11.3	8.8
Real exchange rates	62.0	45.4	37.2	234.0	32.1	22.8

CPI = consumer price index.
Notes:
Economies included in this analysis are the People's Republic of China; Hong Kong, China; India; Indonesia; Japan; Republic of Korea; Malaysia; Philippines; Singapore; Taipei,China; and Thailand.
Figures are the variances of annual percentage deviations from the simple average, multiplied by 10,000 for ease of presentation. Percentage deviations are approximated by first logarithmic differences.
Sources: Estimates by Shinji Takagi based on IMF various years. International Financial Statistics. Available: http://www.imfstatistics.org/ (accessed October 2007c); and ADB 2007c. *Key Economic Indicators*. Available: http://www.adb.org (accessed October 2007).

sharply afterwards (Table 5.3). Real exchange rates in the region varied less in 2004–2006 than in any other comparable period over the past 17 years. This increased real exchange rate stability was not, however, the product of a deliberate policy decision. There is nothing in the policy regime to ensure that real exchange rate stability will be sustained. Indeed, this pattern may already have changed since the dollar's fall against the yen that began in the summer of 2007.

5.3. Challenges to maintaining growth and stability

Most Asian economies have performed well in recent years; some spectacularly so. With some exceptions, growth rates have been strong, inflation contained, fiscal positions sound, currencies stable. Above all, a crisis has been avoided. All of this has been achieved with scarcely any macroeconomic policy coordination within the region. Thus, the reason that Asian policy makers need to collaborate may not be immediately obvious.

Yet the stability of recent years is deceptive. It has been achieved against the backdrop of a remarkably benign global environment—one that may already have ended since the credit crunch that began in the summer of 2007. A potential US slowdown—or even a recession—requires Asia to reorient demand from exports outside the region to consumption and investment within it. But even if these adjustments are not forced by short-term macroeconomic developments, they will be necessary in the longer run in order to resolve the major global imbalances that have emerged in recent years.

The falling US dollar is also putting a strain on the region's currency arrangements, leaving governments that have accumulated vast US dollar reserves with an unpalatable choice: either inflation or a revaluation that would erode the value of those US dollar assets. The risk of a financial crisis is real—indeed, history shows that most economies occasionally experience crises. Amid such uncertainty, and more generally because of the region's growing interdependence, Asian policy makers increasingly need to cooperate. This section examines three big challenges to the region's growth and stability; Section 5.4 will propose regional solutions.

Toward growth based on domestic demand

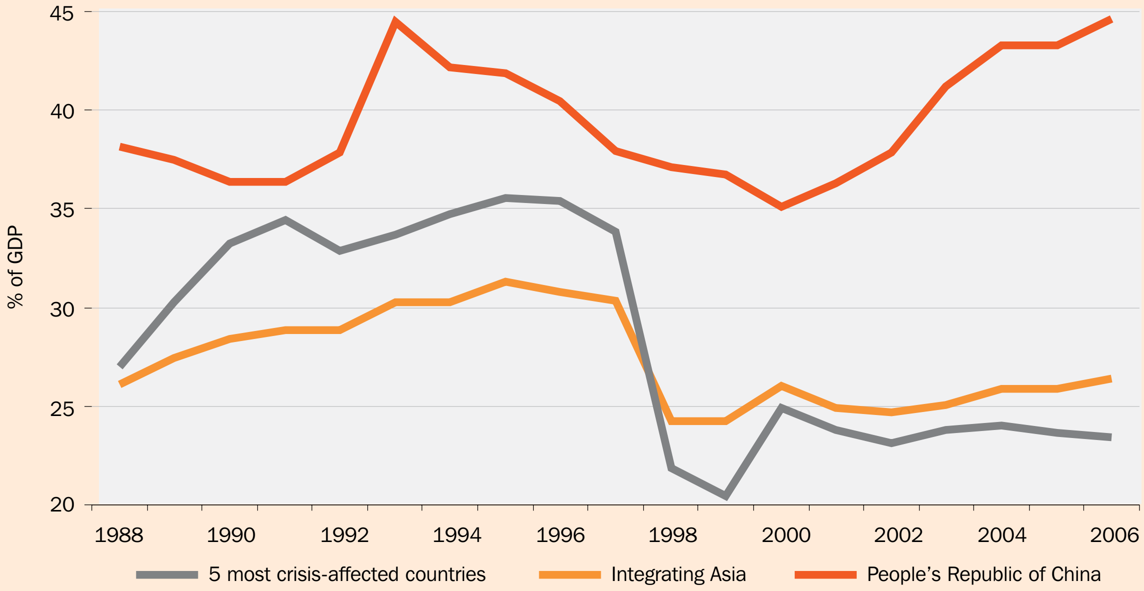
If Asia's economy is to "decouple" from that of the US, regional demand must fill the gap left by lower exports to the US. One way to do this is through higher levels of investment in several economies where growth has not returned to precrisis levels, most likely because of weak investment (Figure 5.9). Hong Kong, China; the Republic of Korea; Malaysia; and Singapore have seen investment decline considerably, by an average of 10% of GDP.[64] Although investment has picked up recently in Thailand, it is still low (20–30% of GDP) compared with the 40% or more recorded before the crisis. While precrisis investment levels may not have been sustainable, the size of the subsequent fall is worrying.[65]

A significant part of the fall in investment rates is due to a drop in private investment. Except in the Philippines, domestic savings have remained high, real interest rates are low by historical standards, and banks' balance sheets have been greatly strengthened. A lack of credit, then, cannot wholly explain the poor investment performance. Overcapacity and implementation constraints (Indonesia), poor infrastructure (Indonesia and the Philippines), and a shortage of skilled labor (Malaysia and Thailand) may have held back private investment somewhat. In Indonesia and the Philippines, investors' perception that governance and regulatory frameworks are unfavorable may be the dominant factor. In Thailand, political uncertainty may be an additional one. This big fall in investment has serious implications for future growth.

[64] In contrast, investment has remained high in lower income countries, including the PRC, India, and Viet Nam.

[65] See Lee and McKibbin (2007) for an assessment of domestic investment decline and its consequences for global current account imbalances in the post-crisis period.

Figure 5.9. Widening gaps in gross capital formation
Selected Asian economies, percent of GDP, 1988–2006



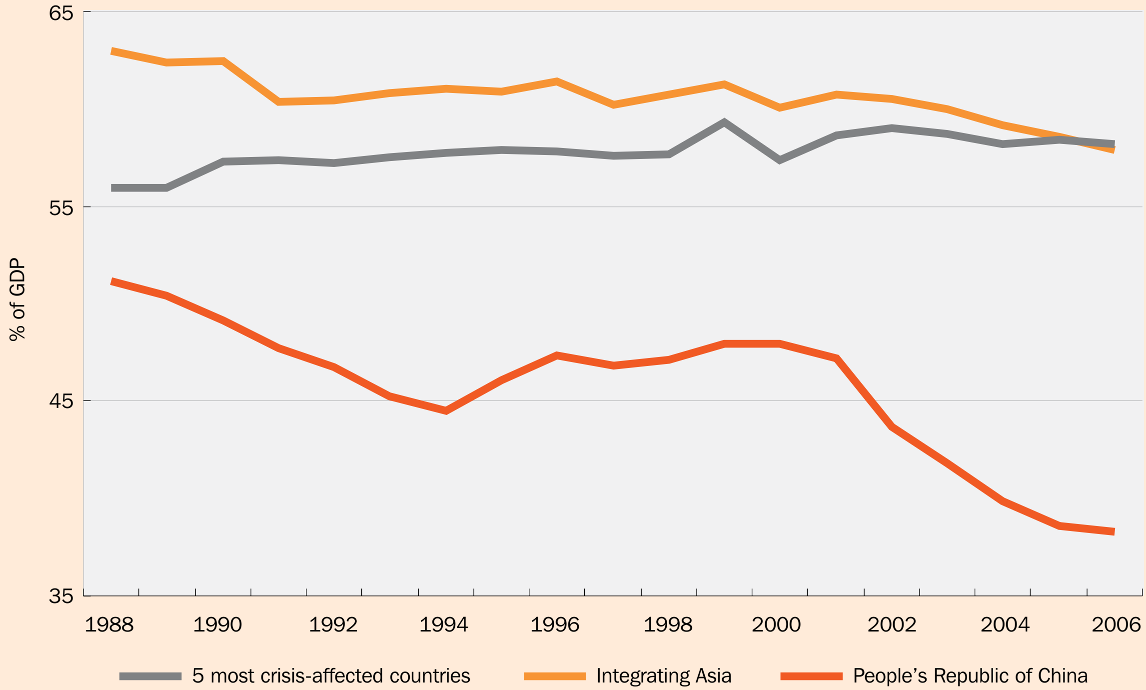
GDP = gross domestic product.
Notes: The five most crisis-affected countries are Indonesia, the Republic of Korea, Malaysia, Philippines, and Thailand.
Sources: Data from World Bank 2008. World Development Indicators. Available: http://www.worldbank.org (accessed April 2008).

In the PRC, the share of personal consumption has been extremely low in recent years (Figure 5.10).[66] It has slumped from an already low 48% of GDP in 2000 to a mere 38% in 2006. A number of reasons have been suggested, including the rapid growth in per capita incomes (given some ratchet effect) and the need for precautionary savings to make up for an insufficient social safety net. With overcapacity in some sectors and the potential for declining asset quality, some rebalancing of domestic demand from investment toward private consumption is needed to make economic growth more sustainable. The PRC authorities have already stated that they are pursuing such a policy. There is considerable scope for increasing public spending on pensions, education, welfare, and health care, which amount to a mere 3% of GDP (Lardy 2007). More balanced tax and dividend policies could enable the government to tap a larger share of the

[66] In contrast, India has historically maintained a high consumption-to-GDP ratio, although the ratio has been on a declining trend; indeed, it is one of the few Asian countries where economic growth has been largely driven by domestic demand.

Figure 5.10. Widening gaps in consumption

Selected Asian economies, percent of GDP, 1988–2006



GDP = gross domestic product.

Notes: The five most crisis-affected countries are Indonesia, Republic of Korea, Malaysia, Philippines, and Thailand.

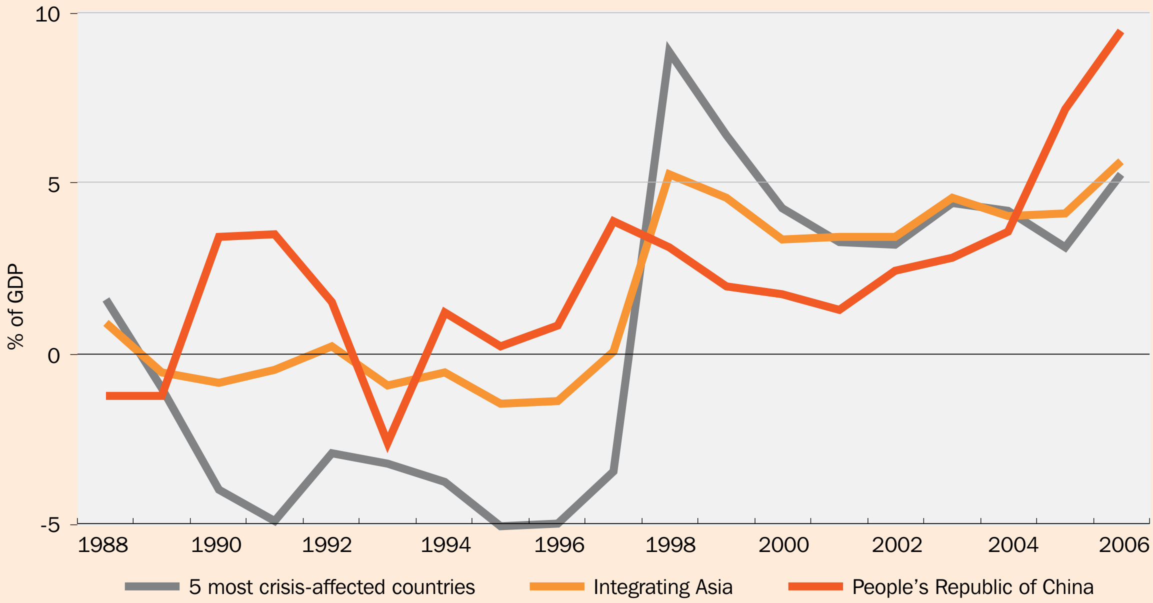
Sources: Data from World Bank. 2008. World Development Indicators. Available: http://www.worldbank.org (accessed April 2008).

exceptional profits of the commercial sector (both private and state-owned). These resources, in turn, could be used to address the high cost of education and health care and the inadequacy of the social safety net and pension systems.

Asia's rapid growth and increased interdependence are opening new opportunities for the region to focus its economic growth on its own markets. Yet high savings and weaker domestic demand have led to large and persistent current account surpluses in several key Asian economies (Figure 5.11). In Indonesia; the Republic of Korea; Malaysia; the Philippines; Taipei,China; and Thailand, the average current account balance swung from a deficit of 2–4% of GDP in 1994–1996 to a surplus of 4–6% in 2003–2006. Japan has a hefty surplus of 5% of GDP, too. The PRC and Hong Kong, China now have surpluses of around 10% of GDP, while Singapore's approaches 30%.

Figure 5.11. Rising current account surpluses

Selected Asian economies, percent of GDP 1988–2006.



GDP = gross domestic product.

Notes: The five most crisis-affected countries are Indonesia, Republic of Korea, Malaysia, Philippines, and Thailand.

Sources: Data from World Bank. 2008. World Development Indicators. Available: http://www.worldbank.org (accessed April 2008).

Asia has thus played a big part in the global imbalances of recent years. Six Asian economies—the PRC; Japan; Singapore; Hong Kong, China; Malaysia; and Taipei,China—had current account surpluses that equaled some 60% of the US current account deficit of $810 billion in 2006. Such imbalances are not sustainable. For one thing, they have created substantial political frictions and an upsurge in protectionist pressures. Since Asia's rapid growth depends on global supply chains for final goods that are principally sold in the US and Europe, it has a big stake in limiting protectionism. More fundamentally, if the size of global imbalances is at least in part a result of Asia's export-led growth strategy, Asia's weight in the world economy will eventually be such—indeed, already arguably is such—that it cannot depend on demand outside the region to propel its growth. A region that already accounts for 22% of the world economy and which is likely to make up a quarter of it in 2020 cannot rely on the other three quarters as much as it does now.

It is therefore in Asia's interest to shift the primary engine of growth from demand outside the region to demand within it—and policies to encourage further economic regional integration are thus crucial. Policies to promote domestic investment and consumption are part of this. Asia has vast savings; it is a large net exporter of capital. By building a stronger and more efficient capital market, some of the capital exported to the US and elsewhere could be redirected to Asia's own large investment needs in physical and social infrastructure.

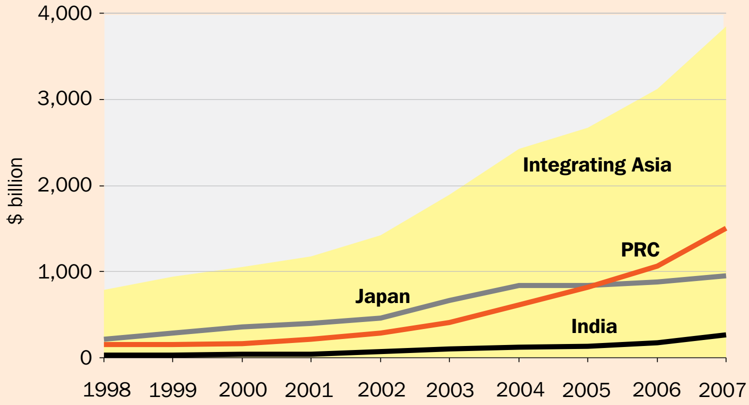
Will real exchange rate stability continue?

The expected unwinding of the global imbalances will likely require substantial adjustments in real exchange rates in coming years. To safeguard regional integration, Asia's policy makers will have to manage the potential disruption that comes from large exchange rate realignments. Asia's economies have recorded steady growth in recent years in a rather benign environment supported by nominal exchange rate and price stability, but both of these are already at risk.

Currency stability may be disturbed if the yen continues to strengthen rapidly against the US dollar, as it has done since summer 2007. While some appreciation of the yen may be desirable in the medium term in order to help unwind the global imbalances, a US dollar collapse would disrupt the region's stability. Asian policy makers would have to choose between allowing their currencies to fall against the yen in line with the US dollar and revaluing or increasing the flexibility of their exchange rate regimes so as to permit an appreciation against the US dollar.

The latter would reduce currency instability within Asia and help reorient economies away from exports to the US, but to ensure that this does not result in lower growth, regional demand must take up the slack. Appreciation against the US dollar would inevitably erode the value of the region's vast dollar reserves and other dollar investments. These have swollen in recent years in line with expanding current account surpluses that have far exceeded net capital outflows. This reflects monetary authorities' determination to insure themselves against the possibility of a currency crisis as well as their desire to maintain export competitiveness by moderating the pace of nominal appreciation through large currency intervention. The combined reserves of Integrating Asian economies have risen from $788 billion at the end of 1998 to close to $4 trillion at the end of 2007, with the PRC's soaring from $150 billion to almost $1.5 trillion, nearly two fifths of the current total (Figure 5.12). These reserves, which have

Figure 5.12. Rising foreign exchange reserves
Integrating Asia, 1998–2007 (excluding gold)



PRC = People's Republic of China.
Notes: Data include the most recent month available. For Brunei Darussalam, the most recent data are for December 2006.
Sources: Data from IMF various years. International Financial Statistics. Available: http://www.imfstatistics.org; and CBRC. 2008. Available: www.ceicdata.com (accessed April 2008).

not been fully sterilized, are already creating inflationary pressure in some economies, notably the PRC. A decision not to allow currencies to appreciate at a measured pace risks a far worse outcome, if it leads to a collapse of the dollar that has a greater impact on the value of reserves.

Disturbances to real exchange rates could also come from other sources, not least because of the region's divergent macroeconomic prospects and the conflicting demands on macroeconomic policies in the region. While it is important to allow real exchange rates to adjust to changes in fundamentals, mitigating large, abrupt changes in real exchange rates will be equally important for an interdependent region.

The desire to manage more efficiently the huge reserves accumulated in recent years has led several Asian governments to set up, or consider setting up, sovereign wealth funds. Box 5.1 discusses the implications of sovereign wealth funds for the Asian and world economies.

Box. 5.1 Global and regional implications of Asia's new sovereign wealth funds

Many of the sovereign wealth funds (SWFs) that have recently been set up in Asia are modeled on successful precedents such as Singapore's Temasek Holdings and the Government of Singapore Investment Corporation. Examples of new Asian sovereign funds include the China Investment Corporation, established in September 2007, and the Korea Investment Corporation in July 2005.

SWFs provide an institutional model for active reserve management. Unlike central banks or national treasuries, their primary goal can be defined to maximize investment returns. If managed on an independent, transparent, and commercial basis, SWFs could make a deep, steady pool of savings available for investments in the region and worldwide.

Reallocating a share of foreign exchange reserves to a SWF could yield a substantial fiscal dividend. Park (2008), based on the methodology of Summers (2007), estimates that the People's Republic of China's 2006 fiscal dividend could be as large as $43 billion, or 1.63% of gross domestic product. This is not one-off income, but a recurrent stream of investment income. The fiscal dividend could help governments tackle their huge long-term development challenges. Yet such gains are neither automatic nor guaranteed. Creating another Temasek or Government of Singapore Investment Corporation requires time and effort to build up the institutional capacity needed for successful high-risk, high-return investment strategies. Prudence suggests that the new Asian funds should start with less risky asset classes and build up their investment-management capacity before contemplating riskier asset classes and investment strategies.

SWFs' investment activities affect the interests of both investing and host countries. As such, a global dialogue in which both are fully and fairly represented would be mutually beneficial. This is being coordinated via the International Monetary Fund (IMF), which is finalizing a set of best practices for SWFs focused on the identification of investment objectives and risk management practices. The IMF is also involved in policy and institutional discussions as well as on operational issues, such as the publication of data on the sources and uses of SWFs. A draft of new guidelines for SWFs is expected to be endorsed during the IMF Annual Meetings in October 2008.

Asian governments should discuss the role of SWFs within the region. The controversy over Temasek's purchase of Thailand's Shin Corporation is a useful reminder of the potential benefits of regional dialogue. This could help to defuse the threat of financial protectionism and promote financial openness, which ultimately benefits all Asian economies.

5.4. Regional cooperation: why and how

Asia's continued growth and stability rest, first and foremost, on each of the region's economies pursuing sound policies for their own sake—which is precisely how many have grown so fast in recent decades. But while compromising national welfare simply for the sake of a common regional policy would be foolish, cooperation is often more beneficial than going it alone. As trade and financial links within the region grow, each economy's fate increasingly depends on what happens to their neighbors. A shock—including a policy decision—that originates in one Asian country can quickly and forcefully affect others. To the extent that Asia's integration is a vital factor in luring fragmented production to the region, currency dislocations could prove highly disruptive. Insofar as Asia's economies are increasingly synchronized, they may sometimes gain from formulating a common response. In principle, there could also be gains to formulating different responses to common shocks insofar as different countries are affected differently by the same shock.

Broadly, three types of regional macroeconomic policy cooperation are conceivable: information sharing, regime setting, and policy coordination.[67] The most rudimentary, information sharing, involves a mechanism for dialogue (and possibly surveillance) that seeks to improve each government's understanding of the economic performance, macroeconomic and structural issues, policy objectives, and policy choices faced by its peers. This can enhance the region's economic welfare by enabling each country's policy makers to use more accurate information in their own decisions.

Regime setting involves agreeing on common rules of the game, within which individual countries can pursue independent policies that suit their own economic interests. This type of policy cooperation includes regional agreements on payments settlement, financing arrangements, rules for exchange rate management, and frameworks for action in a crisis.

Policy coordination can take various forms, of varying intensities. A weaker form might involve acting in concert to avoid unexpected spillovers. This was attempted through the Group of 7 (G-7) in the

[67] Much of the argument in this section comes from Kawai and Takagi (2005). See also Kenen (1994) and Hamada and Kawai (1997).

1970s and 1980s, when the task of fiscal expansion or currency appreciation was assigned to a group of countries. In its most ambitious form, the economies' policy makers would act as if the region were a single economy in order to maximize a weighted sum of their economic welfare. The successful launch of a common currency in Europe, the euro, is a good example of this, although arguably it goes even further, because some national sovereignty is surrendered to a supranational agency.

Macroeconomic policy cooperation in Asia is mostly at the first stage of information sharing. But while the bilateral swap agreements to provide additional short-term liquidity in a crisis represent a fledgling attempt at regime setting, any deeper form of cooperation, let alone coordinated joint policy action, appear unrealistic for the foreseeable future. Policy outcomes differ widely, and policy stances are likely to evolve differently, while authorities' values and objectives also vary.

Yet Asia cannot rely entirely on a global framework to help address the challenges associated with increasing regional spillovers. Some formal policy dialogue and cooperative framework is needed, if only to mitigate the political tensions that may arise from increasing macroeconomic interdependence—and, because institution building takes time, it must begin now. So the main task for the region is to strengthen existing mechanisms of information sharing, policy dialogue, and mutual surveillance, and to identify areas in which agreeing on common policy regimes could yield mutual gains.

One important area for policy dialogue and cooperation is the stabilization of real exchange rates, which are the key channel through which macroeconomic disturbances are transmitted from one economy to another. Although the expected divergence of growth rates in Asian economies will require substantial and ongoing adjustments in real exchange rates, cooperation to avoid abrupt changes is vital for macroeconomic stability.

Cooperation is also needed to build a regional architecture to secure financial stability. The crisis highlighted that the global framework for managing and resolving financial crises provided too little help, too late. It also showed that contagion has a geographic dimension, because neighboring economies tend to share similar characteristics, are more closely connected with each other than with other economies, and are perceived as similar by outside investors. There is thus a case for establishing a regional crisis management mechanism, to complement, not substitute for, the global framework centered on the IMF.

A regional framework would also be a useful forum to discuss global and regional issues. With nearly 200 sovereign states in the world, it is virtually impossible to discuss the details of any issue in a global setting, let alone to agree on solutions. Economies that are closely interdependent share many common features and can discuss them more readily. They can also arrive at common positions in global negotiations that maximize their leverage, and, to the extent that their position is constructive, improve the state of the world. Asia must remain open and become more engaged in discussions of global issues. A regional framework would provide a means of more effectively projecting common concerns globally.

Consultation and mutual surveillance

Asia's policy makers already have many forums for dialogue (Table 5.4), but most are not as effective as they could be. While face-to-face contact is desirable, dialogue ought to be more formally structured with a view to producing better tangible policy outcomes through closer monitoring of economic conditions and peer pressure.

As discussed in Chapter 4, Section 4.4, perhaps one of the most developed channels so far is the ASEAN surveillance process, established in 1998. It seeks to strengthen policy dialogue and policy making capacity in the monetary, fiscal, and financial fields. It involves ASEAN finance ministers meeting twice a year and the ASEAN Surveillance Coordinating Unit preparing a report that analyzes the latest economic and financial conditions in the region and elsewhere. This is considered and finalized by ASEAN finance and central bank deputies before being discussed by ASEAN finance ministers during their peer review session.

The ASEAN+3 economic review and policy dialogue process also includes the PRC, Japan, and the Republic of Korea. Following the meeting of heads of state or government in December 1997, ASEAN+3 finance ministers met for the first time in April 1999. Since the ERPD was formally established in May 2000, ministers have met annually to exchange information and discuss policy issues. The process aims to strengthen policy dialogue and coordination, as well as collaboration on financial, monetary, and fiscal issues of common interest. Steps have been taken to cooperate in monitoring short-term capital flows

Table 5.4. Emerging structures of the regional policy dialogue
Regional and transregional forums in Integrating Asia

Economy	Finance ministers and/or central banks					Central banks			Total
	ASEAN	ASEAN+3	EAS	APEC	ASEM	SEANZA[a]	SEACEN[a]	EMEAP	
Brunei Darussalam	✓	✓	✓	✓	✓		✓		6
Cambodia	✓	✓	✓		✓		✓		5
China, People's Rep. of		✓	✓	✓	✓	✓		✓	6
Hong Kong, China				✓				✓	2
India			✓		✓	✓			3
Indonesia	✓	✓	✓	✓	✓	✓	✓	✓	8
Japan		✓	✓	✓	✓	✓		✓	6
Korea, Republic of		✓	✓	✓	✓	✓	✓	✓	7
Lao PDR	✓	✓	✓		✓				4
Malaysia	✓	✓	✓	✓	✓	✓	✓	✓	8
Myanmar	✓	✓	✓		✓		✓		5
Philippines	✓	✓	✓	✓	✓	✓	✓	✓	8
Singapore	✓	✓	✓	✓	✓	✓	✓	✓	8
Taipei,China				✓		✓	✓		3
Thailand	✓	✓	✓	✓	✓	✓	✓	✓	8
Viet Nam	✓	✓	✓	✓	✓		✓		6
Integrating Asia	**10**	**13**	**14**	**12**	**14**	**20**	**11**	**9**	
Others			2	9	29	10	5	2	
Total	**10**	**13**	**16**	**21**	**43**	**20**	**16**	**11**	

ASEAN = Association of Southeast Asian Nations; EAS = East Asia Summit (ASEAN plus Australia and New Zealand); APEC = Asia-Pacific Economic Cooperation (includes Australia, Canada, Chile, Mexico, New Zealand, Papua New Guinea, Peru, Russian Federation, and United States); ASEM = Asia-Europe Meeting (includes Mongolia, Pakistan, and the 27 European Union member countries); Lao PDR = Lao People's Democratic Republic; SEANZA = Southeast Asia, New Zealand, and Australia (includes Australia; Bangladesh; Iran; Macao, China; Mongolia; Nepal; New Zealand; Pakistan; Papua New Guinea, and Sri Lanka); SEACEN = South East Asian Central Banks (includes Fiji Islands, Nepal, Mongolia, Papua New Guinea, and Sri Lanka); and EMEAP = Executives' Meetings of East Asia-Pacific Central Banks.

[a] SEANZA and SEACEN are primarily training institutions.
Source: Asian Development Bank staff elaboration from Kawai 2007c.

and in developing a regional early warning system to assess financial vulnerabilities.[68]

Among the groups for the region's central bankers, EMEAP has the broadest geographical coverage.[69] EMEAP was organized in 1991 with the leadership of the Bank of Japan and the Reserve Bank of Australia, and promotes enhanced regional surveillance, the exchange of information and views, and financial market development. EMEAP's activities include annual meetings of central bank governors; twice-yearly meetings of deputy governors; and three working groups on bank supervision, financial markets, and payments and settlement systems.

The effectiveness of these and other processes has been limited by their multiplicity, the lack—except in the case of the ASEAN surveillance process—of a permanent secretariat to provide consistency and logistics to the process, and a lack of agreement on analytical tools for monitoring economic developments.[70] All these weaknesses need to be addressed.

First, a formal, central structure to coordinate macroeconomic policy and surveillance initiatives in the region should be established. Existing mechanisms should be subsumed within a single overarching framework, so that they could be coordinated to work toward achieving common regional objectives. The logical step would be to formalize the ASEAN+3 finance ministers' process, and establish an "Asian Secretariat for Economic Cooperation" with qualified, permanent regional staff. This institution would most logically operate under the oversight of ASEAN+3 finance ministers and in coordination with the region's central banks, but the functions it administers could have varying memberships, including economies that are not beyond ASEAN+3 members.[71] The secretariat could provide logistical support as well as substantive inputs based on surveillance of economic developments. Responsibility for organizational matters in ASEAN+3

[68] From 1997 to 2002, Asia had another region-wide dialogue and surveillance mechanism, under the so-called Manila Framework Group. This mechanism provided a forum for surveillance and dialogue among participating finance ministries and central banks, with support from the IMF, World Bank, ADB, and the Bank for International Settlements. The Manila Framework Group involved deputy finance ministers and deputy central bank governors.

[69] The other important regional central bank forums are known as South East Asia, New Zealand, and Australia (SEANZA) and South East Asian Central Banks (SEACEN), discussed in Chapter 4, Sector 4.4. In addition, the central banks of ASEAN members have met for policy dialogue as the ASEAN Central Bank Forum since late 1997.

[70] In 2006, the ASEAN+3 set up a group of experts and an economic technical working group to find ways to strengthen regional surveillance and to develop an early warning system.

[71] Membership could eventually be expanded to include other economies, such as Australia; Hong Kong, China; India; Mongolia; New Zealand; and Taipei,China.

(and EMEAP) is currently rotated among the participants. The choice of topics therefore tends to reflect the preferences of the particular country holding the chair, and the process lacks the consistency, continuity, and institutional memory needed to be effective.

Second, to make the new Asian Secretariat for Economic Cooperation effective in its surveillance role, member governments should develop and agree on the analytical tools to monitor economic developments. These should comprise a set of appropriate objective indicators as well as standards of good conduct. Developing an objective indicator of exchange rate alignment among the region's currencies is vital. Following the precedent of the European Monetary Cooperation Fund first and the European Monetary System (EMS) later, a basket of regional currencies could be developed for the purpose of improving regional surveillance (see further discussion under exchange rate cooperation, to follow). With the agreed analytical tools, a dialogue and consultation mechanism could develop into a mutual surveillance mechanism.

Regional financing facility

The most compelling way to progress to the regime setting phase is to push forward with efforts to create a regional financing facility. Pooling the region's enormous foreign exchange reserves and agreeing to rules under which they could be used would create a regional institution for crisis management and related purposes. This could be done by multilateralizing the bilateral swap arrangements under the CMI.

The CMI (agreed to in May 2000) was designed to strengthen the longstanding ASEAN swap arrangement (ASA)[72] and introduce bilateral swap arrangements (BSAs) for the ASEAN+3 members. In November 2000, the ASA was enlarged to $1 billion and included as part of the CMI. The total bilateral swap size reached $84 billion, with 16 bilateral swap arrangements as of January 2008 (Table 5.5), and the ASA has been expanded to $2 billion.

Signatories also agreed on the basic framework of bilateral support. For example, countries can borrow international liquidity

[72] The ASEAN swap arrangement (ASA) was established in August 1977, when the original five ASEAN members created a $100 million facility, which was doubled in 1978, to provide immediate, short-term financing to any member facing a temporary liquidity shortage. The ASA was activated by Indonesia in 1979, Malaysia in 1980, Thailand in 1980, and the Philippines in 1981 (Henning 2002). In March 2000, ASEAN finance ministers, recognizing the need to enhance the facility to respond more effectively to future crises, agreed to expand the ASA to all new ASEAN members.

Table 5.5. Swap arrangements under the Chiang Mai Initiative
$ billions as of January 2008

From \ To	PRC	Japan	Rep. of Korea	Indonesia	Malaysia	Philippines	Singapore	Thailand	Total
PRC		3.0	4.0	4.0	1.5	2.0		2.0	16.5
Japan	3.0		13.0	6.0	1.0	6.0	3.0	6.0	38.0
Korea, Rep. of	4.0	8.0		2.0	1.5	2.0		1.0	18.0
Indonesia			2.0					18.5	2.0
Malaysia			1.5						1.5
Philippines		0.5	1.5						2.0
Singapore		1.0							1.0
Thailand		3.0	1.0						4.0
Subtotal	**7.0**	**15.5**	**23.0**	**12.0**	**4.0**	**10.0**	**3.0**	**9.0**	**84.0**
ASEAN Swap Arrangements									2.0
Total	**7.0**	**15.5**	**23.0**	**12.0**	**4.0**	**10.0**	**3.0**	**9.0**	**86.0**

ASEAN = Association of Southeast Asian Nations, PRC = People's Republic of China.
Source: Asian Development Bank staff elaborations based on data from Japan's Ministry of Finance website. Available: http://www.mof.go.jp/english/index.htm (accessed May 2008).

collateralized by domestic currencies with government guarantees, rather than offering US Treasury bonds as collateral. BSAs are for a period of 90 days, renewable up to seven times, at an interest rate equivalent to the London interbank offered rate (LIBOR) plus 150 basis points for the first drawing and first renewal. Thereafter, the premium goes up by 50 basis points every two renewals, up to a maximum of 300 basis points. Members requesting liquidity support could immediately obtain short-term financial assistance for the first 10% of the BSA facility, but could draw on the remaining 90% only under an IMF adjustment program.

The CMI has been repeatedly strengthened since its launch. Major recent developments include

- the integration and enhancement of the economic review and policy dialogue into the CMI framework (May 2005);
- an increase in the ceiling for CMI swap activation without an IMF program in place, from 10% of the total to 20% (May 2005);
- the adoption of a collective decision-making procedure for CMI activation, as a step toward multilateralizing the CMI (May 2006);

- an agreement in principle on a self-managed reserve pooling arrangement governed by a single contractual agreement as the appropriate form of CMI multilateralization (May 2007); and
- the total size of the pooled resources to be at least $80 billion, 20% from ASEAN and 80% from the "+3" countries (May 2008).

ASEAN+3 finance ministers and central bank deputies are studying key elements of CMI multilateralization, including surveillance, reserve eligibility, borrowing quota, and the activation mechanism.

While the CMI's efficacy in a crisis is unproven, many Asian economies continue to accumulate massive external reserves. Multilateralizing the CMI would enable them to pool their reserves, cutting down on this costly and wasteful duplication. Making the activation of a substantial part of swaps conditional on IMF programs was essential in the early stages of the CMI, but, as the facility becomes larger, multilateral, and more fully institutionalized, the direct link with IMF financing could be phased out. This would make the facility more effective, because it would enable a more rapid commitment of funds in times of crisis, and would give the region a greater incentive to monitor and influence national policies.

The multilateralized CMI should be supported by a permanent secretariat created for surveillance. This should be a guardian of the pooled resources and, in a crisis, should negotiate a program of economic policies with a country seeking financial support. The multilateralized CMI's administrative expenses could be financed by the interest earned on the pooled reserves and from lending operations, if any. The CMI could thus complement the IMF's surveillance and crisis management efforts in Asia.

Exchange rate cooperation

Exchange rate cooperation could begin with a regime setting exercise in which the region's economies agree on broad rules for conducting policy, including intervention and reserve management. This may naturally evolve into a deeper form of cooperation. The region will increasingly benefit from concerted action to deal with spillovers from exchange rate movements.

Because exchange rates are one of the key links among interdependent economies, one country's exchange rate decisions can harm another. For example, if the Japanese yen began to appreciate substantially against the US dollar and the Republic of Korea sought to prevent the won's value from rising against the US dollar, this would harm Japan's international price competitiveness in the short term but fuel inflation in the Republic of Korea over the medium term. It would be preferable if the Republic of Korea allowed the won to appreciate too—and this would be less costly in the short term if other countries that compete with the Republic of Korea in the US and other third markets allowed their currencies to appreciate concurrently.

Another case involves joint action to deal with the macroeconomic consequences of large capital inflows. Without collective action, a country that receives capital flows might be reluctant to allow its currency to appreciate for fear that it might lose price competitiveness against its neighbors. In a bid to forestall this, Thailand in December 2006 responded to a surge of capital inflows by imposing capital controls, damaging regional financial integration. Other economies, though, have recently allowed their currencies to appreciate unilaterally.

Countries could instead choose to jointly revalue their currencies.[73] But if—as is often the case—some economies receive greater capital inflows than others and are affected differently by them, exchange rates within the region would still need to adjust.

Even so, regional collective action could expand the menu of options available to countries in dealing with large capital inflows and upward currency pressure. Because international investors from both within and outside East Asia are channeling liquidity to its emerging economies and thereby placing upward pressure on the value of many regional currencies, this is an option worth pursuing.

For collective currency appreciation to be a viable option, there must be a mechanism of close policy dialogue and cooperation designed to ensure intraregional exchange rate stability. The current policy dialogue processes among the region's finance ministers (such as ASEAN+3) and central bank governors (such as EMEAP) need to be significantly enhanced to foster such policy coordination. Such an arrangement could ultimately lead to the formation of an East Asian monetary zone, along the lines seen in Europe after the collapse of the Bretton Woods system in the early 1970s.

Because growth within the region varies widely, arrangements must be flexible enough to allow real exchange rates to adjust. But, in the cases described above, concerted action is needed. More

[73] Kawai (2008b) estimates that a 20% collective appreciation of all East Asian currencies would entail an appreciation of only 9% in effective terms even if all the countries outside the region maintained the nominal value of their currencies against the US dollar.

broadly, cooperation to maintain reasonable exchange rate stability will become increasingly important for the macroeconomic stability of the region. Such stability would bolster intraregional trade and help reorient demand toward consumption within the region. Whatever form such cooperation takes, it requires analytical tools to monitor exchange rate developments in the region, and a strengthening of existing policy-dialogue and surveillance mechanisms, including agreement on the scope and conditions for collective action.

To give some sense of the form such exchange rate cooperation might take, some economists have suggested, following the proposal by Williamson (1999) of a "basket, band, and crawl" regime,[74] that East Asian economies stabilize their exchange rates against a common basket of currencies. Opinion differs as to the composition of such a basket, especially whether the US dollar and euro should be included. The benefit of including major global currencies is that, by pegging to such a basket, East Asian economies could stabilize not only their exchange rates against each other but also their effective exchange rates (see Williamson [2005] and Kawai [2008a]). Alternative ideas for stabilizing both bilateral and effective exchange rates within the region include, for example, a dollar peg advocated by McKinnon and Schnabl (2003).

A basket consisting only of the region's currencies—alternatively called an "Asian currency unit," "regional currency unit," "Asian monetary unit," or "regional monetary unit" by different groups—has its own merits. As with the EMS's European Currency Unit, a similarly constructed regional basket could serve as a stabilizing device as well as an indicator of the degree of joint movement of East Asian currencies—for example, in the context of the eventual unwinding of global payments imbalances or surges of capital inflows to East Asia—as well as of the degree of divergence of each component currency from the regional average. When the PRC moves to a more flexible exchange rate regime, the basket could provide more meaningful information and allow the regional surveillance process to become more intensive (Kawai 2008a).

Some people see a greater role for such a regional currency unit. For example, Eichengreen (2006) argues that, if the basket is used as a parallel currency and its use is promoted, it could become a catalyst for monetary integration in the region—this would be a way of allowing economics, rather than politics, to drive the decision to

[74] This refers to a basket peg, with a band of fluctuation, whose central rate can be adjusted at a predetermined pace.

move to a common currency (see also Chai and Yoon [2007]) for a similar idea). Technical difficulties remain regarding how to design such a basket and how to make it effective (Adams and Chow [2007]), and not every government currently appears to support the idea of a regional currency basket. The topic, however, is already on the agenda of ASEAN+3, and discussion is ongoing among technical experts. In the spirit of Asian pragmatism, the process could begin with the elements that are most acceptable and feasible under the circumstances.

Exchange rate cooperation does not have to involve every economy from the outset. It may be more compelling for the advanced ASEAN members—Indonesia, Malaysia, the Philippines, Singapore, and Thailand, whose business cycles are highly synchronized (in terms of industrial production, the average correlation was nearly 70% in 1999–2006). To jump-start the process, this subgroup of ASEAN countries could initiate exchange rate cooperation. They could then be joined by other countries as they find greater benefits from such joint action.[75]

5.5. Macroeconomic challenges ahead

Asia's impressive macroeconomic performance in recent years has occurred in a relatively benign environment characterized by nominal exchange rate and price stability within the region. This period would now appear to be over. With divergent prospects and conflicting demands on policy, significant exchange rate realignments are possible. With the accumulation of large international reserves, inflationary pressure is already mounting in some countries. How to manage these real exchange rate shocks has implications for the macroeconomic stability of an increasingly interdependent region.

The engine of growth urgently needs to shift from demand outside the region to demand at home and within the region. Asia's increasing economic weight in the world places a natural limit to the strategy of relying on external demand to propel its growth. Asia has plenty of room to increase investment and consumption, not only to grow, but also to improve its infrastructure and quality of life.

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[75] Based on a weighted average of various measures (such as purchasing power parity (PPP), interest rate parity, trade intensity, and interest rate correlations), cluster analysis by Takagi and Hirose (2004) also shows that Malaysia, the Philippines, Thailand, and (in some specifications) Singapore form a highly integrated group of countries.

Asia cannot rely on a global framework to mitigate the tensions that may arise from policy spillovers. Asia will need to develop its own institutions to deal with the consequences of increased interdependence. Institution building for regional policy cooperation could begin with a framework of information sharing, which could then evolve into a deeper form. The second step is to establish a regional financing facility by multilateralizing the CMI. The third step is to develop a framework of exchange rate cooperation. All of this could be done step by step, starting with a subset of ASEAN countries, which could then be expanded to others as they see benefits from greater policy cooperation.

ASEAN has articulated a vision for 2020 involving the creation of an ASEAN economic community. Its road map for integration envisages that the aim will be achieved through capital market development and liberalization, financial services liberalization, and currency cooperation. While ASEAN countries (or a subset of members at similar stages of development) may lead the way, the rest of the region could eventually join the process to maximize the benefits from regional cooperation.

A deeper form of macroeconomic cooperation, including monetary policy coordination and a cooperative exchange rate arrangement, could come later. Although economic conditions are still divergent, business cycles in the region are becoming more synchronized, minimizing the costs to individual economies of a coordinated monetary policy. Moreover, the benefits of coordination will rise as exchange rate volatility becomes increasingly incompatible with an integrated region. Although few people see that a cooperative EMS-type of exchange rate arrangement is feasible over the next two decades, appreciation of the benefits of such an arrangement—and even a common currency—could increase over time, as the economies of the region continue to integrate and become more interdependent. This would require years of working together, institution building, common values, and shared policy objectives.

The steps outlined in this chapter do not necessitate setting an ultimate endpoint for cooperation, but will rather provide experience and insight into the feasibility of further monetary integration. For now, the priorities are to strengthen regional macroeconomic monitoring; better coordinate macroeconomic and exchange rate policies; pool reserves; start to develop effective regional economic institutions by multilateralizing the CMI; and develop institutional capacity to support macroeconomic cooperation, notably through the proposed establishment of an ASEAN Secretariat.

Chapter 5: appendix

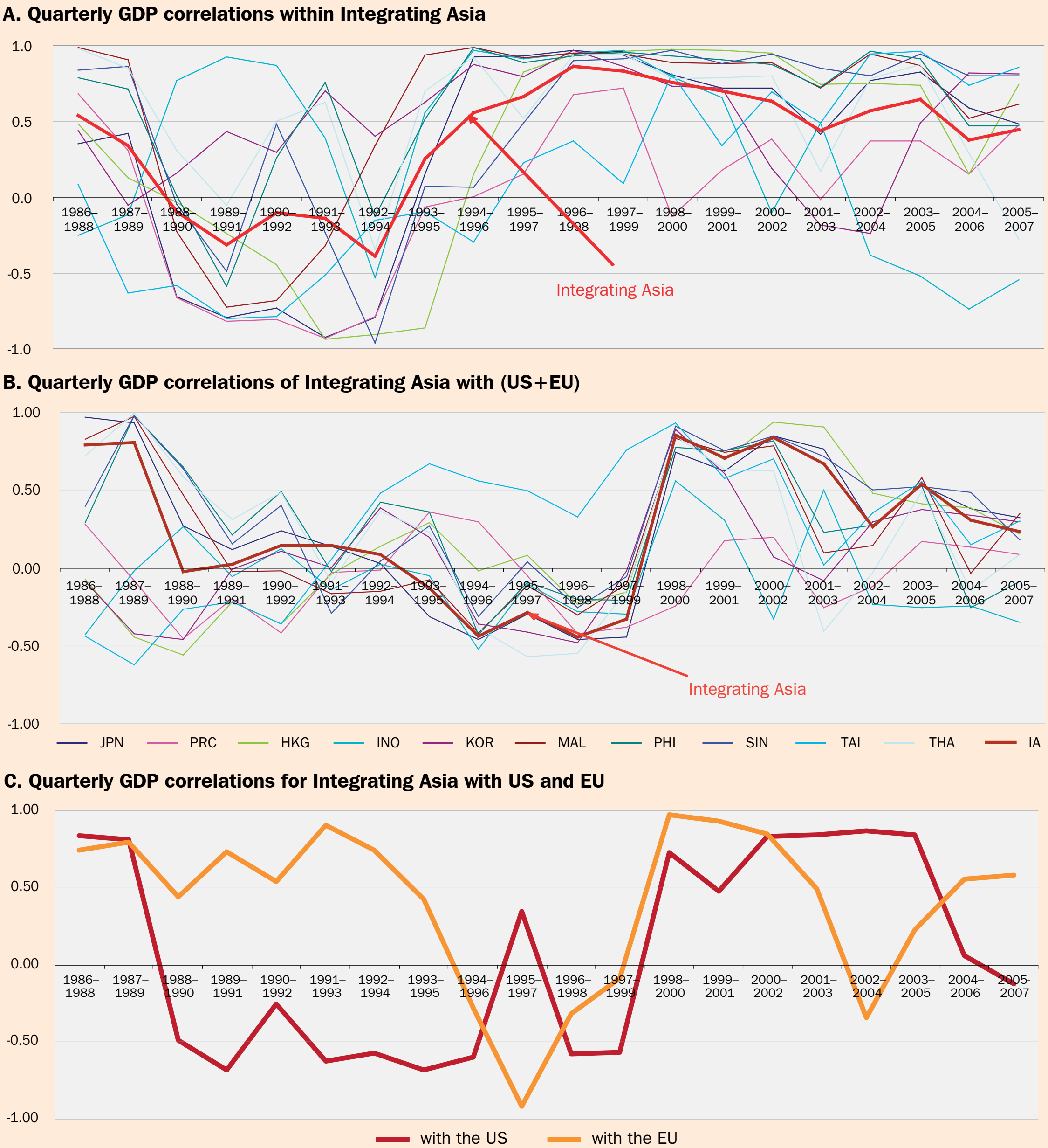
Methodological note 5.1. Correlation of quarterly gross domestic product

The analysis of output correlations uses quarterly gross domestic product (GDP) data for the following sets of countries: (1) for Integrating Asia—the People's Republic of China (PRC); Hong Kong, China; Indonesia; Japan; the Republic of Korea; Malaysia; the Philippines; Singapore; Taipei,China; and Thailand; and (2) for the rest of the world—the United States (US) and the eurozone of the European Union (EU). The sample period covers Q1:1986–Q3:2007. Data come from Oxford Economics (2008); for the US, data are from the Bureau of Economic Analysis (2008). For 2007 only, national sources are used.

Correlations are computed bilaterally for Integrating Asia as well as between it and the rest of the world. As indicated in figures A5.1–3, different combinations of regional and nonregional entities are attempted. Correlations are based on year-on-year growth of quarterly GDP at current prices; where aggregation is necessary, GDPs in US dollars are used as the weights. To eliminate the cyclical components of GDP, the fixed length Baxter-King filter is used (12 quarters, low: 6.0; high: 32.0). The so-called band-pass filter is designed to eliminate long-term trends (of more than 32 quarters) and high frequency fluctuations (of less than six quarters) while retaining only the cyclical components of a series.

Correlations reported in Figure A5.1 (as well as in Figure 5.1) are all 12-quarter moving averages.

Figure A5.1. Correlation of quarterly GDP of Integrating Asia



EU = European Union, US = United States.

Notes: Integrating Asia = Japan; People's Republic of China; Hong Kong, China; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; Taipei,China; Thailand.

Sources: Data from Oxford Economics 2008. Forecasting and Analysis. Available: http://www.oef.com/OE_FA_Int_Mac.asp (accessed February 2008); Bureau of Economic Analysis. 2008. National Income Accounts. Available : http://www.bea.gov/national/index.htm (accessed February 2008).

Methodological note 5.2. Correlation of quarterly exchange-rate-adjusted consumer prices

Data for the tables on the exchange-rate-adjusted consumer prices come from the International Financial Statistics (IMF various years); for Taipei,China only, the data are from (CBRC 2007). Consumer price indexes are seasonally adjusted and detrended by the Hodrick-Prescott filter.

Table A5.1. Correlation of quarterly exchange rate-adjusted consumer prices

a. Precrisis 1988–1995

Economy	PRC	HKG	IND	INO	JPN	KOR	MAL	PHI	SIN	TAP	THA
HKG	0.19										
India	0.64	0.48									
Indonesia	0.13	-0.64	0.11								
Japan	0.36	-0.67	0.09	0.73							
Korea, Rep. of	0.75	0.01	0.66	0.32	0.54						
Malaysia	0.3	0.15	0.66	0.19	0.11	0.26					
Philippines	-0.27	0.69	-0.11	-0.64	-0.76	-0.46	-0.26				
Singapore	0.19	0.26	0.16	-0.15	0.02	0.4	-0.05	0.03			
Taipei,China	-0.06	0.53	0.15	-0.59	-0.51	-0.01	-0.1	0.4	0.11		
Thailand	0.57	0.18	0.26	0.18	0.22	0.34	-0.11	0.22	-0.07	-0.05	
Viet Nam	0.79	0.51	0.31	-0.35	-0.88	-0.44	-0.64	0.53	-0.63	0.27	0.86

b. Post-crisis 1999–2007

Economy	PRC	HKG	IND	INO	JPN	KOR	MAL	PHI	SIN	TAP	THA
HKG	0.75										
India	0.52	0.63									
Indonesia	0.71	0.59	0.76								
Japan	0.63	0.62	0.65	0.45							
Korea, Rep. of	0.23	0.17	-0.31	-0.2	0.01						
Malaysia	0.68	0.68	0.78	0.81	0.63	-0.43					
Philippines	0.61	0.79	0.19	0.16	0.39	0.34	0.3				
Singapore	-0.09	0.12	-0.33	-0.34	-0.01	0.14	-0.14	0.45			
Taipei,China	0.37	0.45	0.1	0.1	0.28	-0.11	0.42	0.53	0.46		
Thailand	0.69	0.82	0.67	0.66	0.64	-0.17	0.86	0.57	0.18	0.66	
Viet Nam	0.72	0.8	0.54	0.58	0.74	0.17	0.59	0.47	-0.14	0.49	0.72

HKG = Hong Kong, China; PRC = People's Republic of China.
Note: Data include first quarter of 1999 to fourth quarter of 2007, except for Viet Nam, which ends on the second quarter of 2006.
Sources: Data from IMF various years. International Financial Statistics. Available: http://www.imfstatistics.org (accessed 2008); and CBRC 2008. Financial Statistics Monthly. Available: http://www.cbc.gov.tw (accessed April 2008).

Methodological note 5.3.
Vector autoregression analysis

To examine the nature of macroeconomic interdependence in Asia, a vector autoregression (VAR) model has been estimated for an Asian economy, consisting of three equations representing global, Japanese, and regional outputs. Consider the following moving average representation:

$$(1)\quad Xt = \Sigma\phi_{1j}\, u_{t\text{-}j} + \Sigma\phi_{2j}\, v_{t\text{-}j} + \Sigma\phi_{3j}\, w_{t\text{-}j}$$
$$(2)\quad Yt = \Sigma\lambda_{1j}\, u_{t\text{-}j} + \Sigma\lambda_{2j}\, v_{t\text{-}j} + \Sigma\lambda_{3j}\, w_{t\text{-}j}$$
$$(3)\quad Zt = \Sigma\eta_{1j}\, u_{t\text{-}j} + \Sigma\eta_{2j}\, v_{t\text{-}j} + \Sigma\eta_{3j}\, w_{t\text{-}j}$$

where X_t is real gross domestic product (GDP) in the United States (US) and Europe (henceforth referred to as "global"); Y_t, real GDP in Japan; and Z_t, real GDP in the rest of Asia (referred to as "regional"), all expressed as indexes in order to remove the influence of nominal exchange rate changes; and u is a shock to global GDP (a global shock), v is a shock to Japanese GDP (a Japan shock), and w is a shock to regional GDP (a regional shock). Knowing how regional GDP (Z) responds to the past global and Japan shocks is particularly interesting, before and after the currency crisis of 1997/98.

The extremely simplified setup of equations (1–3) is dictated by the small number of observations, especially when the data are divided into the pre- and post-crisis periods. Even with this setup, data limitations have restricted the coverage of countries and the choice of sample period. The estimation of a VAR system is often sensitive to the choice of particular strategy (e.g., detrending method, order of inversion, and lag length). For this exercise, the popular Hodrick-Prescott filter is used to detrend the data. In addition, it is assumed that global GDP affects both Japanese and regional GDPs, Japanese GDP affects only regional GDP, and regional GDP affects neither. The Akaike information criterion is used to determine lag length.

Sample

The sample countries include (1) for Asia—the PRC; Hong Kong, China; India; Indonesia; Japan; the Republic of Korea; Malaysia; the Philippines; Singapore; Taipei,China; and Thailand; and (2) for the rest of the world—Belgium, France, Germany, Italy, the Netherlands, Spain, the US, and the United Kingdom. Global and regional GDPs are the weighted averages of the individual country GDPs in each region, with 2000 US dollar GDPs used as the weights. The precrisis period refers to Q1:1988–Q4:1996; the post-crisis period covers Q1:1999–Q4:2006. The underlying data are from Oxford Economics, Quarterly Model, February 2007, as supplied to the Asian Development Bank's Economics and Research Department.

Analysis of shocks

VAR is a standard statistical procedure to investigate how shocks are transmitted from one entity to another. Using this statistical procedure, a shock that originates within the region (a regional shock) and a shock that originates in the rest of the world (a global shock) are considered, and two measures of the responsiveness of regional output to these shocks are computed. The first measure is how much of the total variance of regional output is explained by the variance of respective shocks. The second measure is the response of regional output to a 1 standard deviation shock to global and regional output. In order to quantify the evidence of growing macroeconomic interdependence, these measures are compared before and after the crisis.

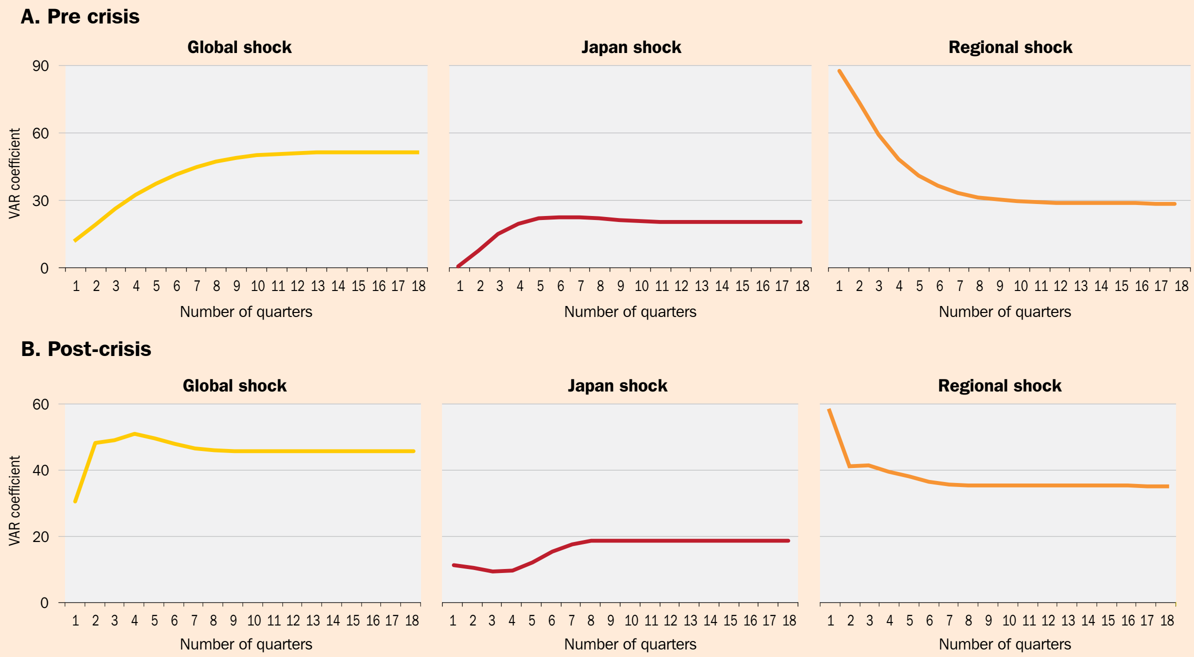
Results

Two sets of charts (Figure A5.2 and Figure 5.2, in the main text) describe the results of estimating a VAR model that consists of global GDP, Japanese GDP, and regional GDP. After estimating several alternative VAR specifications, the best results were obtained when Japanese GDP (which accounted for about 60% of the region's GDP in 2000) was separated from regional GDP.[76] The results became less robust when PRC output was also separated out of regional output. With the PRC separated, the impact of a Chinese shock on regional output became larger after the crisis, but the impact is much smaller than the impact of a regional, Japan, or global shock. This may reflect the possibility that, though the impact of PRC growth on the rest of the region has risen, part of PRC demand is a conduit for global demand (as parts and components are supplied to the PRC for final exports to the rest of the world) and the PRC competes with neighboring economies in the medium- to low-tech industries (Haltmaier et al. 2007).

Figure A5.2 indicates the variance of regional GDP that can be explained by a global shock, a Japan shock, and a regional shock. Before the crisis, almost 90% of the variance of Asia's GDP (outside

[76] Japan's share subsequently declined to less than 50%.

Figure A5.2. Variance decomposition of Asian GDP (in percent of total)



VAR = Vector autoregression.
Sources: Calculated by Shinji Takagi. Data from IMF various years. International Financial Statistics. Available: http://www.imfstatistics.org (accessed October 2007); and CBRC. 2007. Financial Statistics Monthly. Available: www.cbc.gov.tw (accessed October 2007).

Japan) was explained by a regional shock, with only 10% explained by a global shock, although the regional shock's impact began to decline over time to 30%, while the global impact increased to 50%. The percentage of the variance explainable by a Japan shock was nil in the current period, though it rose to 20% over time. Following the crisis, the percentage of the variance explainable by a regional shock fell to 60% (while those attributable to global and Japan shocks rose to 30% and 10%, respectively, from 10% and 0%), though the long-run decline is smaller (to 40%).

The other set of charts (Figure 5.2, main text) shows the responses of Asia's GDP to a 1 standard deviation shock to global, Japan, and regional GDP. Before the crisis, regional GDP responded significantly only to a regional shock (in each graph, the red dotted lines indicate a confidence interval). If anything, the response to a global or Japan shock was negative. Following the crisis, however, regional output became significantly responsive to all shocks, and the response to a global shock as well as a Japan shock became positive. Coupled with the results of the foregoing variance decomposition, the overall VAR results seem to indicate evidence of greater macroeconomic interdependence for the 11 Asian economies, both with Japan and with the rest of the world during the post-crisis period.

Methodological note 5.4. Frankel-Wei weights for individual currencies

The Frankel-Wei methodology (Frankel and Shang 1994) is applied to estimate the following regression equation:

$$\Delta\log e^0_t = \alpha_0 + \alpha_1 \Delta\log e^1_t + \alpha_2 \Delta\log e^2_t + \alpha_3 \Delta\log e^3_t + \varepsilon_t$$

where e^0 is the exchange rate of an Asian (home) currency, e^1 the exchange rate of the United States (US) dollar, e^2 the exchange rate of the euro (or previously the Deutsche mark), and e^3 the exchange rate of the Japanese yen, all against the United Kingdom (UK) pound (chosen as the numeraire because it is the only widely traded third currency that is presumably not highly correlated with the euro or the Deutsche mark); α_0, α_1, α_2, and α_3 are coefficients to be estimated; Δ is a random error; is a first difference operator; and *t* is a time subscript. The underlying data are from IMF (2007b); and for Taipei,China only, CRBC (2007).

Table A5.2. Frankel-Wei regression estimates for selected Asian currencies

Currency	January 1988-December 1996			January 2000-December 2006		
	US dollar (α_1)	Deutsche mark (α_2)	Japanese yen (α_3)	US dollar (α_1)	Euro (α_2)	Japanese yen (α_3)
Chinese remninbi	1.05***	-0.04	0.04	1.01***	0.02	-0.01
	(0.00)	(0.88)	(0.85)	(0.00)	(0.27)	(0.60)
Hong Kong dollar	1.00***	0.01	-0.01	0.99***	0.01	-0.00
	(0.00)	(-0.14)	(0.23)	(0.00)	(0.24)	(0.87)
Indian rupee	0.96***	0.08	0.12	0.85***	-0.01	0.10**
	(0.00)	-0.6	(0.30)	(0.00)	(0.81)	(0.03)
Indonesian rupiah	0.97***	0.01	0.01	0.70**	0.28	0.25
	(0.00)	(-0.3)	(0.18)	(0.02)	(0.36)	(0.30)
Korean won	0.96***	-0.03	0.09***	0.51***	-0.15	0.45***
	(0.00)	-0.48	(0.01)	(0.00)	(0.18)	(0.00)
Malaysian ringgit	0.84***	0.09	0.07	1.01***	0.01	-0.00
	(0.00)	(0.16)	(0.13)	(0.00)	(0.29)	(0.70)
Philippine peso	1.04***	-0.19*	-0.06	0.86***	0.19*	0.04
	(0.00)	-0.1	(0.47)	(0.00)	(0.09)	(0.65)
Singapore dollar	0.71***	0.10***	0.13***	0.63***	0.16***	0.22***
	(0.00)	(0.01)	(0.00)	(0.00)	(0.01)	(0.00)
New Taiwan dollar	0.87***	0.00	0.10*	0.74***	0.05	0.15***
	(0.00)	(0.96)	(0.07)	(0.00)	(0.44)	(0.00)
Thai baht	0.82***	0.05***	0.11***	0.62***	0.18*	0.19**
	(0.00)	(0.00)	(0.00)	(0.00)	(0.09)	(0.02)
Vietnamese dong	0.46	0.78	0.22	1.00***	0.00	0.01
	(0.56)	(0.52)	(0.80)	(0.00)	(0.99)	(0.48)

Estimates' significance level:
*** significant at α=0.01; ** significant at α=0.05; and * significant at α=0.10
Notes: Values refer to coefficients of the regression estimates; those in parentheses are the p-values.
Sources: Frankel and Shang 1994. Data from IMF various years. International Financial Statistics. Available: http://www.imfstatistics.org (accessed March); and CBRC 2008. Financial Statistics Monthly. Available: http://www.cbc.gov.tw (accessed March).

The estimated coefficients (based on monthly data), along with their p-values, for 11 Asian currencies for 1988–1996 and 2000–2006 are in Table A5.2.

Although the US dollar remains the most important currency, its weight declines for most currencies. The vector autoregression (VAR) analysis of Chow (2006) confirms the smaller impact of the US dollar on the exchange rates of major regional currencies, including the Indonesian rupiah, the Korean won, the Philippine peso, and the Thai baht, during the post-crisis period. In contrast, the weight of the Japanese yen becomes significant in the post-crisis period for the Indian rupee, the Korean won, the Singapore dollar, the Thai baht, and the New Taiwan dollar; it increases by five times for the Korean won and almost doubles for the Singapore dollar and the Thai baht. These results are corroborated by Ogawa and Yoshimi (2007) who, on the basis of daily data, came to a similar conclusion, especially for the Thai baht and the Singapore dollar.[1]

[1] Ogawa and Yoshimi (2007) further show that the weight of the yen was statistically significant for the Malaysian ringgit (0.11) and for the Myanmar kyat (0.07) during the year 2006. The yen's weight for the Korean won, however, becomes numerically quite small in daily data, suggesting that the exchange rate is managed with reference to the US dollar, the intervention currency, on a daily basis. Fukuda (2002), also based on daily data, shows that the weight of the yen was very high for the Malaysian ringgit (0.90), the Thai baht (0.75), and the Singapore dollar (0.65) during the immediate post-crisis period prior to the pegging of the ringgit to the US dollar, indicating the incentives of these countries to maintain exchange rate stability against each other's currency.

Chapter 6

Making Growth Inclusive and Sustainable

Chapter 6

Making growth inclusive and sustainable

The goal of economic development is to improve social well-being in the broadest sense: to enable people to enjoy rich and fulfilling lives. Economic growth that benefits a broad cross-section of the population is essential. And if the benefits of regional integration are to be shared by everyone—including the poor and the socially disadvantaged—a wide range of social issues also needs to be addressed. Public policies need to focus on inclusive growth so as to create opportunities for everyone, in particular the poorest; provide a safety net for those who fall on hard times; and achieve other social and environmental objectives.

As discussed in previous chapters, Asia's increasing integration creates a new platform to bolster economic growth, with the poorest countries in the region typically having most to gain. This boosts social welfare directly and provides the means for extra spending on essential public services, such as health and education. Poverty has fallen in all integrating Asian economies and income inequality across most of them has decreased, as the PRC, India, Viet Nam, and others catch up with the more prosperous economies in the region. Continued regional dynamism combined with appropriate social policies could make a huge contribution to reducing poverty and other social problems. Regional cooperation could also support individual economies in implementing policies that make growth more inclusive.

But economic integration can also be associated with negative side effects, such as the greater dislocation of exposed sectors and negative impacts on the poor. For sure, the devastating social repercussions of the 1997/98 crisis cannot be blamed on regional integration per se—a combination of factors, not least premature financial liberalization combined with inadequate social protection systems, is responsible.[77] Inevitably, though, some people benefit more from change than others—and some may lose out initially. Coastal regions tend to grow faster than more remote parts; urban areas that combine industrial factories and dense markets tend to pull ahead of rural areas; people with skills that are in demand prosper most; those who are best able to adapt to the rapid pace of change, notably the young, tend to fare better; and so on. Inequality within many Asian countries has increased—as, indeed, it has in many non-Asian countries.[78]

A rapidly modernizing economy therefore needs effective social policies to make growth broadly acceptable and to complement traditional mechanisms—based on extended families and small communities—for caring for those left behind. It also needs to address other important issues, such as threats to health, safety, and the environment.

These areas are of interest not only because they have large welfare implications, but also because they are amenable to regional—as well as national and global—action. Each requires a complex mix of national and regional policies, including extensive knowledge and experience sharing. Successful collaboration on these issues would improve equity and boost efficiency by making the most of everyone's potential, and thus help to generate broad support for the policies required for economic growth.

Section 6.1 examines achievements and challenges and their implications for regional cooperation. Section 6.2 looks at how to widen opportunities to participate in regional growth. Section 6.3 considers how to provide regional public goods in areas such as health and safety, environmental protection, infrastructure, labor migration, and knowledge exchange. Section 6.4 concludes with a social and environmental agenda for the region.

6.1. Achievements and challenges

Given the complexity of Asia's social problems, efforts to tackle poverty and inclusion need to rest on systematic information on which groups are left behind and why. Much progress has been

[77] Poverty incidence increased in Indonesia from 15% in 1997 to 33% by the end of 1998 (Suryadi, Sumarto, and Pritchett [2003]); in the Republic of Korea from 3.0% in the last quarter of 1997 to 7.5% in the third quarter of 1988; and in Malaysia from 6.7% in 1997 to 7.6% in 1998 (Knowles, Pernia, and Racelis 1999).

[78] Chaudhuri and Ravallion (2007) argue that post-reform growth in both the PRC and India has not been pro-poor.

made in recent years—especially in the context of the Millennium Development Goals (MDGs)—toward understanding the scope and causes of poverty, in both its income and non-income dimensions. This work needs to continue, especially in pinpointing the factors that lead to exclusion—such as geography, skills, age, gender, and race—and the policies that can offset them.

Poverty

Asia has made remarkable progress in reducing poverty (Table 6.1), but large challenges remain. The good news is that Asia looks set to meet the MDG of halving extreme poverty by 2015. Whereas, more than one fourth of Viet Nam's population lived on less than $1 a day in early 1990s, by 2004 less than a tenth did. In the PRC, the proportion has fallen from 28% in 1993 to 11% in 2004. In Indonesia, which was particularly badly hit by the crisis, the extreme poverty rate more than halved between 1993 and 2002. That, despite the crisis, poverty

Table 6.1. Gains in the battle against poverty

Economy	Poverty index					
	$1-a-day		$2-a-day		Survey year	
	Initial	Final	Initial	Final	Initial	Final
PRC	28.3	10.8	64. 5	37.8	1993	2004
Cambodia	25.5	18.5	76.5	61.6	1993	2004
India	41.8	35.1	85.1	79.6	1993	2004
Indonesia	17.4	7.7	64.2	52. 9	1993	2002
Lao PDR	47.8	28.8	89.9	74.4	1992	2002
Malaysia	0.0	0.0	19.2	9.8	1993	2004
Philippines	18.1	13.2	52.7	43.6	1994	2003
Thailand	6.0	0.0	37.5	25.8	1992	2002
Viet Nam	27.3	8.4	73.5	43.2	1993	2004

PRC = People's Republic of China; Lao PDR = Lao People's Democratic Republic.
Note: Poverty index = percentage of population below the poverty line.
Source: Data from ADB 2007c.

has fallen everywhere in the region is a huge achievement—and the boom years since 2003 will doubtless have made another big dent in it.

Yet progress has been much slower in some countries, especially on non-income measures. Extreme poverty fell by less than a third in the Philippines between 1994 and 2003, and by only a sixth in India between 1993 and 2004. Across Asia, the fall in those living on less than $2 a day has been less impressive: in no country has it halved in the decade or so surveyed in Table 6.1; in many, it has not fallen much. People who earn a little over $1 a day clearly risk slipping back under the bar during hard times. Meanwhile, nearly 2 billion people in the region are without basic sanitation, and over 650 million are without clean water (ESCAP-ADB-UNDP 2007). Nearly 100 million children under five are underweight; 4 million die each year before reaching the age of five. Nearly 30 million children of primary school age do not attend classes. Nine million Asians have tuberculosis; 6 million are infected with human immunodeficiency virus (HIV).

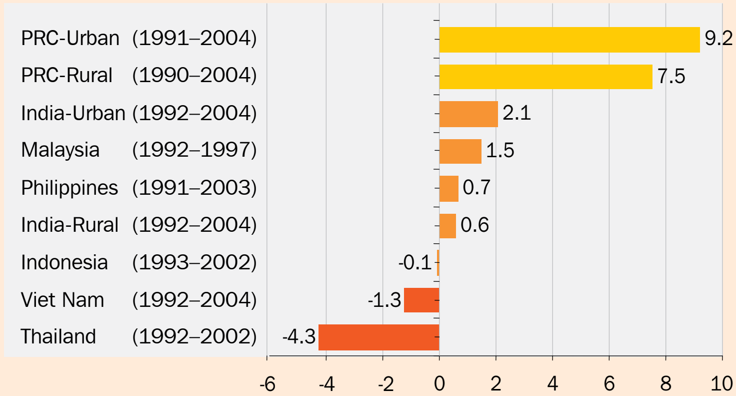
While primary-school enrolment is becoming nearly universal across the region, some countries have vastly lower infant mortality, maternal mortality, and malnutrition rates than others. Within countries, huge disparities persist too. The rich fare much better than the poor; urban dwellers do better than rural ones, notably in access to sanitation and clean water; women, those of a lower caste, minorities, and indigenous people also do worse then most (ADB 2007c). Over 250,000 mothers die in childbirth each year. Women's participation in nonagricultural employment is low and their representation in government or parliament remains minimal.

Inequality

The persistence of inequality is socially unacceptable, and may undermine support for regional integration. While the pattern of development in Asia is highly uneven—Hong Kong, China is among the richest territories in the world; Viet Nam among the poorest—this is not self-evidently problematic: 40 years ago, all of Asia (except Japan) was poor, and is now considerably richer. And since the poorer economies in the region, notably the PRC, India, and Viet Nam, are also among the fastest growing, the gap is closing.

More worrying, perhaps, is that inequality within many Asian countries is high and rising. Measured by the Gini coefficient, inequality has fallen in Thailand and Viet Nam, but has risen considerably in

Figure 6.1. Rising income inequality
Trend of the Gini index in selected countries



PRC = People's Republic of China.
Note: The Gini index is a measure of the inequality of income or wealth distribution. Bars are total change in per capita income while numbers in brackets are average change per year.
Source: World Bank various years. World Development Indicators. Available: http://worldbank.org/data (accessed December 2007).

the PRC and India (Figure 6.1).[79] Spending by the richest fifth of the population is rising much faster than that of the poorest fifth (Figure 6.2). Even so, this does not involve "the poor getting poorer and the rich getting richer", rather the "rich getting richer faster than the poor" (ADB 2007c). The region's overall development model is working, but the gains need to be shared more equally.

Several studies suggest that high inequality can limit the impact of economic growth—and thus that of regional integration—on poverty reduction.[80] It may also hinder growth itself, since the potential of the less fortunate is wasted. It may spur demands for growth-sapping redistributive policies. And it may undermine the institutions that foster growth by making them more vulnerable to elite capture (ADB 2007c). Cross-country data suggests that inequality has a negative impact on growth, particularly in low-income countries.[81]

The causes of growing inequality vary, but one, generally, is that the rich are better equipped to exploit the opportunities offered by

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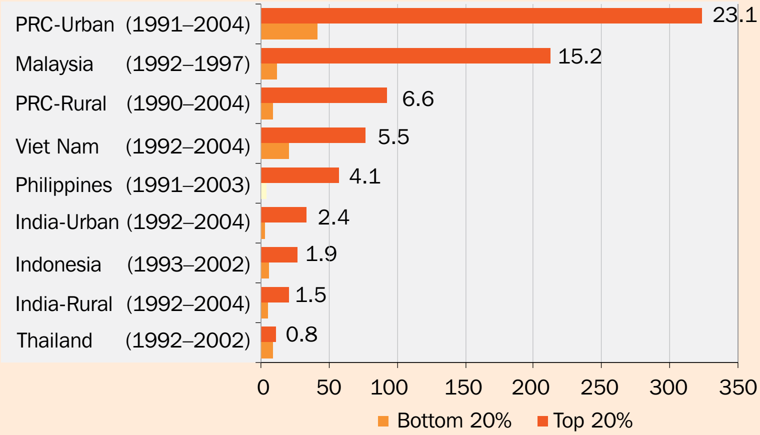
[79] Gill and Kharas (2007) show that inequalities within countries are more significant than those between them; such disparities—for instance, across income classes, between rural and urban areas, and across regions—persist or are rising.

[80] See for instance Ravallion (2004), ADB (2004b and 2007c).

[81] For instance Barro (2000 and 2008). The earlier results show a positive relationship for high-income countries, but with new data this is no longer significant.

Figure 6.2. Rising expenditure inequality
Increases in per capita expenditures of the richest 20% of the population and the poorest 20%



PRC = People's Republic of China.
Notes: Data labels refer to rate of change of mean income (%).
Horizontal axis refers to change in mean income (1993 purchasing power parity $).
Source: World Bank various years. World Development Indicators. Available: http://worldbank.org/data (accessed December 2007).

economic change. Urban dwellers tend to be better off than rural inhabitants, but within urban areas inequality has also widened. Some groups are systematically excluded from economic opportunities—especially women, people of lower caste, minorities and indigenous people. Tackling discrimination is critical: in the case of gender, for example, successful regional initiatives have ranged from gender-sensitive poverty-alleviation programs to improving access to finance and property. People also fall behind through bad luck—by working in a declining sector or becoming unable to work, for instance.

Unemployment and underemployment

Asia's official unemployment rates are not high by global standards. But despite Asia's spectacular growth, unemployment is higher in most countries in the region than it was before the crisis (Table 6.2). Studies also show that employment growth is less responsive to output growth than previously (Felipe and Hasan 2006, Kapsos 2006). Because the poor's main asset is generally their labor, fewer new jobs tends to imply less poverty reduction.

Underemployment, while difficult to define and harder still to measure consistently, is an even bigger issue. In 2005, some 500

Table 6.2. Formal unemployment is low but rising

Economy	Unemployed Rate (%)		Unemployed Number (in millions)		Survey Year	
	Initial	Latest	Initial	Latest	Initial	Latest
Cambodia	1.0	1.8	0.1	0.1	1996	2001
PRC	3.0	4.1	20.9	32.1	1996	2006
Hong Kong, China	2.8	4.8	0.1	0.2	1996	2006
India	2.6	3.1	7.8	11.9	1994	2005
Indonesia	4.9	10.4	4.4	11.1	1996	2006
Korea, Republic of	2.0	3.5	0.4	0.8	1996	2006
Lao PDR	3.6	5.1	0.1	0.1	1996	2003
Malaysia	2.5	3.3	0.2	0.4	1996	2006
Philippines	8.6	7.9	2.6	2.8	1996	2006
Singapore	2.0	3.4	0.0	0.1	1996	2006
Taipei,China	2.6	3.9	0.2	0.4	1996	2006
Thailand	1.5	1.5	0.5	0.5	1996	2006
Viet Nam	5.9	5.6	2.1	2.4	1996	2004

PRC=People's Republic of China, Lao PDR=Lao People's Democratic Republic.
Source: ADB 2008c. Statistical Database System. Available: http://sdbs.asiandevbank.org:8030/sdbs/index.jsp (accessed April 2008).

million—about 29%—of Asia's 1.7 billion workers were reckoned to be either unemployed or underemployed. The segmentation of labor markets between urban and rural areas, as well as between the formal and informal sectors, also constrains growth and perpetuates inequalities. It hampers the adjustment to changes in global demand and crimps the emergence of new sectors.[82] Historical institutional rigidities, such as remaining restrictions on internal migration due to the PRC's *hukou* system of permanent registration, are partly to blame (Tao 2006).[83] Excessive labor-market regulations that have been introduced in several countries to provide social protection—such as minimum wages set above the market-clearing wage and restrictions on hiring and firing employees—often gum up the labor market. Because they mainly relate to workers in the organized sector,

[82] Cunat and Melitz (2007) even show how countries with flexible labor markets are able to specialize in sectors with higher volatility implying enhanced ability for diversification.
[83] Whalley and Zhang (2007) provide numerical simulation evidence showing how the removal of migration barriers would reduce inequality in the PRC.

they leave workers in the large unorganized sector unprotected. The use of "inappropriate" capital-intensive techniques may also reduce labor use.[84]

Partly as a result of rigidities in the formal and organized labor market, employment in the informal sector is large and rising. In India, informal work accounted for 80.5% of nonagricultural employment in 1993/94 and 83.2% in 1999/2000. In Indonesia, informal-sector employment rose from 63% of the total in 1997 to 71% in 2003. Although hard numbers are not available, the informal sector in transition economies such as the PRC and Viet Nam is also expected to grow as state-owned enterprises retrench and restrictions on migration from rural to urban areas are eased. The growth of the informal sector is worrying because it tends to provide low-productivity, low-wage work outside the purview of labor laws and social-protection systems, and often detached from the rest of the national—and regional—economy.

Another issue is that the new jobs created in Asia are disproportionately for skilled workers. Outsourcing, foreign direct investment, skills-biased technical change, competition from imports, and quality upgrading to meet the demands of exporting on global markets have all boosted the demand for skilled workers.[85] While this is generally a good thing, because it tends to boost productivity and average incomes, it is problematic if the low-skilled poor are unable to obtain the skills required to acquire the new jobs. Since the education system has not been able to keep up with the economy's needs, skill shortages have become widespread in Asia, particularly in high-growth economies. India, for instance, faces a severe shortage of technical skills, particularly in the information technology sector.

Environmental issues

Environmental concerns in Asia are increasing, particularly because economic growth in much of the region remains fuelled by carbon-intensive production. As Asia continues to grow, so will its demand for energy. The challenge is to achieve an orderly and affordable

[84] ADB (2007c) cites several causes, such as (1) many production processes involve fixed techniques which are often capital-intensive as they are imported from developed countries where labor is scarce; (2) distortions in developing-country capital markets fail to reflect capital scarcity due to subsidies encouraging use of capital-intensive techniques; and (3) given low labor productivity in many developing countries, it may be efficient to use capital-intensive techniques despite low nominal wages.

[85] See Goldberg and Pavcnik (2007) for a detailed discussion.

transition toward growth that involves lower carbon emissions and the sustainable management of natural resources. Asia's growth is also leading to rapid and often unplanned urbanization and motorization, which add to the region's environmental woes. Many of Asia's major urban centers have unacceptably poor indoor and outdoor air quality. As Figure 6.3 shows, dangerous air pollutants remain at unacceptably high levels in many Asian cities.

The region's water bodies—including its major water supplies—are also under stress. The discharge of untreated waste and pollutants from households, farms, industries and municipalities also contributes to the spread of waterborne diseases and is a major public health issue.[86]

The region's environmental problems are increasingly caused by factors that cut across national borders. For example, the Asian brown cloud, a haze that covers most of South and Southeast Asia, is caused by pollutants released by the burning of fossil fuels and rural biomass across the region. Haze caused by forest fires is common in Southeast Asia. Problems such as desertification and dust storms, which plague Northeast Asia, cut across national boundaries. Water and natural resources that are shared by several countries are often a source of friction.

Climate change is likely to exacerbate these environmental problems and cause new ones. Sudden shifts in regional weather patterns, such as monsoons and El Niño, may also raise the risk of natural disasters, while rising temperatures will spread the range of vectorborne diseases such as malaria and dengue fever (ADB 2007c). Climate change will affect the poor most. Those living in coastal areas are threatened by rising sea levels and more frequent tropical storms, with poor peasants in drought- and flood-prone areas most at risk. Adaptation measures need to address their needs first.

The region's worsening environment is doing increasing damage to Asia's economy and people's health. Air pollution alone is estimated to cause nearly 2 million premature deaths a year. Many more suffer health problems which affect their productivity. Water pollution and lack of sanitation also are extremely harmful. Agriculture is severely affected by air and water pollution; the cost to the PRC in lost agricultural produce in 2004 was estimated at $12 billion. Climate

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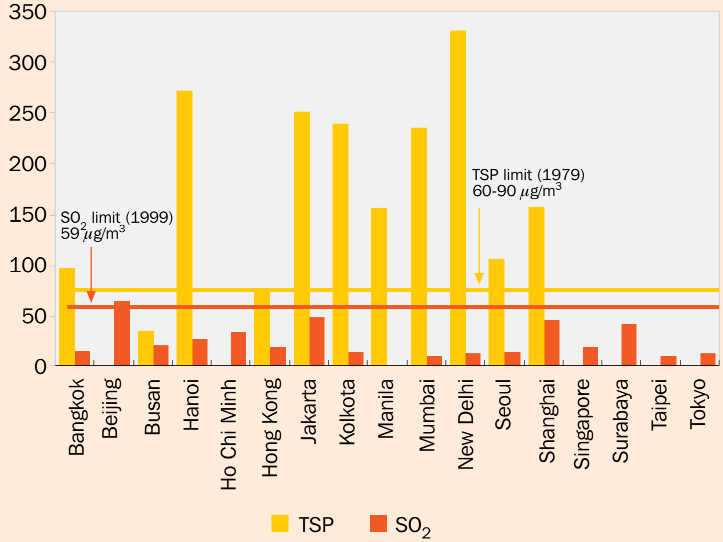
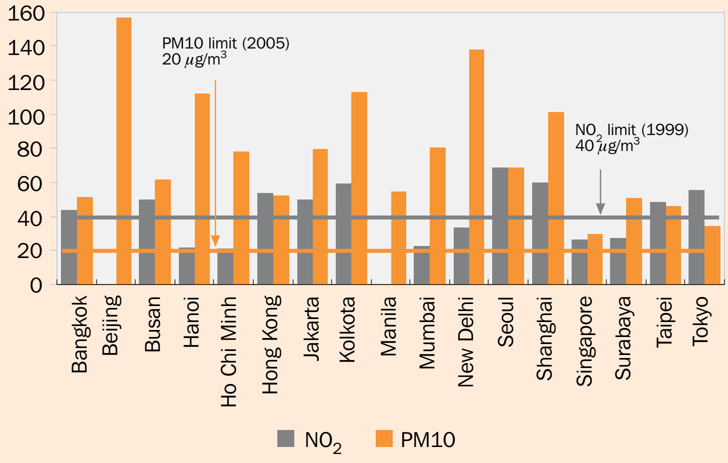
86 WHO (2004) estimates that 1.8 million people die every year from diarrheal diseases (including cholera), 90% of whom are children under five and mostly in developing countries. About 88% of diarrheal disease is attributed to unsafe water supplies and inadequate sanitation and hygiene.

Figure 6.3. Average annual air quality levels of Asian cities
(2000–2004 average)

a. Total suspended particulates and sulfure dioxide



b. Nitrogen dioxide and particulate matter of 10 microns or less



$\mu g/m^3$ = micrograms per cubic meter, NO_2 = nitrogen dioxide, PM10 = particulate matter of 10 microns or less, SO_2 = sulfure dioxide, TSP = total suspended particulates.
Note: Limits to pollutants pertinent to specific years are set by the World Health Organization.
Source: Data from Clean Air Initiative Asia. 2006. Available: http://www.cleanairnet.org/caiasia/.

change is forecast to crimp crop yields by 2.5–10% in parts of Asia by 2020 compared to 1990 levels (Zhang 2007).

6.2. Widening participation in regional growth

If Asia is to make the most of the benefits of regional integration, it needs to widen access to opportunities to participate productively in the economy. This requires labor-market reform, expanding education and skills, measures to promote more inclusive growth, more spending on infrastructure, and stronger social protection systems. Many of the necessary measures are national; some would benefit from regional cooperation.

Labor market reforms

The battle against poverty and exclusion begins with creating high-productivity jobs. But whether people have access to these jobs depends on how well labor markets function, and how effectively the places where they live are connected to dynamic regional and global markets. Policies that favor capital at the expense of labor, such as artificially low interest rates and fiscal incentives, are highly detrimental. Rigid labor laws that cause entrepreneurs to invest in machinery rather than commit themselves to a permanently larger workforce are also harmful. Governments need to provide workers with adequate social protection, including help with retraining and redeployment from units facing closure. The key challenge is to reform regulations that make labor costly and risky.

The vast informal sector needs particular help in improving its productivity and integrating with the wider—including the regional—economy.[87] In part, this requires measures to make business registration easier and cheaper. De Soto (2000) has famously argued that property-rights systems in developing countries require reform to enable the informal sector to tap formal sources of financing, since untitled assets cannot be used as collateral for loans. Improved access to technology and training would also boost the productivity of workers in the informal sector. Making the formal labor market more flexible and reducing the burden of labor market regulations would also reduce the incentive to operate informally.

87 See, for instance, Blunch, Canagaraja, and Raju (2001), and Maloney (2004).

Even with sound policies, however, new formal-sector jobs often favor skilled workers, due to skill-biased technical change and the quality requirements of export markets. This is beneficial for the economy as a whole—it boosts productivity and average incomes—but it does not help people who lack, and are unable to acquire, the requisite skills.

Education and skills

Developing the skills needed by Asia's growing economies is therefore essential. The initial priority is broadening access to good quality basic education as well as vocational and skills training. While universal basic education across Asia is achievable within the next decade, vocational and skills training is still not of sufficient quality in many countries.

Investing in trainability—the capacity to learn how to use new technologies—is especially important. This requires a good basic education, over which vocational and skills-enhancing training and tertiary-level education can be instilled. Some economies—such as the Republic of Korea and Taipei,China—have set an example by planning ahead and investing in education ahead of demand. Others, such as Thailand, have changed course after it become clear that severe skills shortages were hampering their growth potential. More is not necessarily better, however. Developing human capital in areas without potential and in ways unmatched to needs can cause problems. In the Philippines, for example, graduates with secondary and higher education suffer the highest unemployment rates (Orbeta 2002).

Sectoral strategies for inclusive growth

Another important approach is to target sectors, geographical areas, and social groups that are falling behind, so that they too can share in the region's development (World Bank 2007a).

Appropriate policies in agriculture—the mainstay of Asia's poor—are particularly important. Unfortunately, these are often misguided. Subsidizing staple food crops, for instance, discourages diversification into higher value crops and the adoption of productive planting and marketing strategies (World Bank 2007a). Aid for trade could make an important contribution: in the Greater Mekong Subregion (GMS), for example, innovative programs promote cross-border agricultural trade and investment, supported by public-private partnerships in agricultural science and technology (ADB 2007d).

Soaring food prices and recent shortages have highlighted many issues that beset the agriculture sector, including the restrictions—

artificial and structural—on trade. Fears about food supplies are leading food-surplus countries to withhold exports to deficit ones, exacerbating the problems. Food-price rises disproportionately affect poor—particularly urban poor—consumers, who spend a large share of their income on food. While food shortages have many causes, governments' ill-advised responses highlight the need for regional

Box 6.1. Tackling the food crisis

For decades, real food prices had been declining. In recent years, however, they have not merely recovered: by the end of 2007 they were roughly double the 2002 level. Since then, food prices have skyrocketed, stoking fears of a food crisis. The World Bank's food price index climbed 57% in the first quarter of 2008. The price of rice has increased dramatically: Thai rice, for example, fetched a monthly average record $930 per metric ton in May 2008 from $380 in January. Soaring food prices have contributed to sharp increases in inflation in Asia, while also threatening macroeconomic stability by increasing the fiscal cost of food subsidies and widening current account deficits in food importing countries.

The impact of rising global food prices on the region is particularly acute as about 1 billion Asians spend at least 60% of their income on food. As measured by its share of the consumer price index, food is typically the largest single component of Asian household budgets—and its weight is especially great in the region's poorer economies. (Figure B6.1).

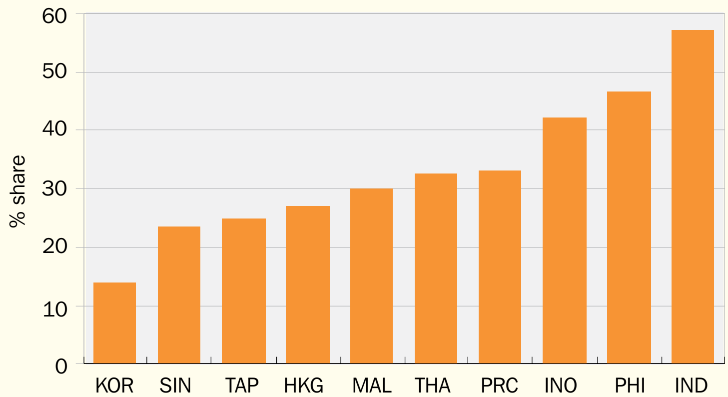
As a net food exporter with fairly large grain stocks, the People's Republic of China is in a relatively strong position. But, for net food importers, such as the Philippines, soaring food prices are more worrying. They reduce the real incomes of the poor, forcing them to spend less on vital health care, education, and clothing and causing the poorest to go hungry. While the urban poor are generally worst-hit, net food buyers in rural areas are also suffering.[1] Millions of poor people risk falling below the poverty line, while those already below it face hunger and malnutrition. Much of the remarkable poverty reduction that Asia has achieved in the past decade risks being undone.

While cyclical factors—such as flooding in South Asia, plant-hopper infestation in Viet Nam, and Australia's drought—partly explain soaring world food prices, the causes are mostly structural. Falling global food stocks show that production has not kept up with consumption. For example, in the first quarter of 2008, world rice and wheat stocks were more than 40% below their 2000 levels. A growing population, together with rising incomes in emerging economies—notably, Asia—which has contributed to a change in diets toward grain-intensive meat and dairy products, are increasing consumption. At the same time, food production has been diverted toward biofuels; the rising cost of energy-intensive inputs, such as fertilizers; as well as continuing soil degradation, increasing water scarcity, and underinvestment in new high-yield and pest-resistant crops have curbed the growth of agricultural productivity.

Governments have exacerbated the problem through the long-standing protectionism that blights global agricultural trade and through their ill-conceived responses to the food cooperation to address food issues. Rice, Asia's staple, is a particular priority. Box 6.1 discusses the recent increase in food prices and the consequences on poverty reduction in Asia.

Rural areas, where 70% of Asia's poor live, continue to lag behind. In many countries, such as Indonesia, Malaysia, and Thailand, poverty in rural areas is much higher than in urban ones. Greater efforts are

Figure B6.1. Food weights in the consumer price index
Selected Asian economies, 2008



HKG = Hong Kong, China; IND = India; INO = Indonesia; KOR = Republic of Korea; MAL = Malaysia; PHI = Philippines; PRC = People's Republic of China; SIN = Singapore; TAP = Taipei,China; THA = Thailand.
Sources: National statistics offices; Asian Development Bank resident missions.

crisis, such as export bans, taxes, and price controls. Such "beggar-thy-neighbor" policies deter farmers from expanding production and may suppress domestic food trade. Conversely, by liberalizing agricultural trade Asian governments could help moderate food prices, reduce uncertainty, and increase food security. Substantial investment should also be made throughout Asia to improve agricultural infrastructure and technology, increase productivity, enhance institutional capacities, improve governance, and provide educational facilities. And by facilitating information exchange, increasing policy dialogue, and spreading best practices, regional cooperation could also help find a lasting solution to the food crisis.

needed to help rural areas participate in the trade and growth that regional integration fosters. Investment-climate surveys show that many factors prevent rural nonfarm enterprises from expanding. The factors include (1) limited access to financial services; (2) poor infrastructure, notably power, transport, and communications; (3) limited information about market opportunities; (4) a lack of education and training; and (5) limited access to new technologies, including information and communication technology. It is important to identify which constraints bind most where, and to design public policies and efficient institutions to overcome them.

While economic growth enables households to spend more on education and health and provides governments with the means to invest more in public services, it is not sufficient to achieve the MDGs.[88] Public provision of basic services therefore needs to be improved, by increasing budgets and making existing programs more effective. While evidence of the overall effectiveness of public spending is mixed, studies consistently show that it significantly benefits the poor.[89] This suggests that the delivery and targeting of public services need to be improved.[90]

There is increasing evidence of the importance of good governance and participation to development in general and the welfare of the poor in particular. Decentralizing government functions to local authorities can give the poor more voice and improve the delivery of basic services (Shah and Chaudry 2004). This has occurred during the last two decades—swiftly in some countries, such as Indonesia; more slowly in others, such as the Philippines and Viet Nam. The effectiveness of delivery depends crucially on local authorities' capacity to deliver public services and the proper design of programs and institutions governing their implementation. Measures to equalize disparities across regions are needed, however. Preventing local elites from capturing local governments by local elites is also important, notably by closely involving communities in public programs. Involving the private sector and civil society is another

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[88] ADB (2004b): *Key Indicators* estimates that while the income-poverty elasticity for countries in the Asia-Pacific region is nearly 2, nonincome poverty elasticity is around or below 1.

[89] For example Gupta, Verhoeven, and Tiongson 2002; Bidani and Ravallion 1997.

[90] Studies have identified inefficiencies such as "inefficient composition of public spending" (Al-Samarrai 2006) or "spending on the 'wrong' goods and the 'wrong' people" (Devarajan and Reinikka 2004). Leakages and corruption are also well documented (Bhushan, Keller, and Schwartz 2002) and must be prevented.

effective way of enhancing service delivery in health, education, and water (Ahmad et al. 2005).

Tackling discrimination and other forms of exclusion is also vital. In the case of gender, initiatives include gender-sensitive poverty-alleviation programs; improving access to productive assets and resources, education and health services, and property ownership; and increasing representation in society's decision-making bodies. In the Philippines, for example, a budget for gender-oriented programs is mandatory at all levels of government. Mechanisms have also been established to oversee and monitor their implementation. The caste system prevalent in much of South Asia is another major source of discrimination. It causes significant inequity in the acquisition of capital assets, employment, education, health, and other human-development outcomes. Special policies are needed to counteract these social exclusions. India, for example, has enacted laws against discrimination, reserved places for members of particular castes in state services and political bodies, and promoted economic empowerment though specific plans and the allocation of targeted funds through financial institutions. India has also established an administrative machinery to oversee the implementation of these programs.[91]

Infrastructure development

Strategic investments in infrastructure—in transport, communications, and energy—can also connect low-income regions with Asia's dynamic core. Growth in remote areas can save substantial social, financial, and relocation costs; it benefits people who move as well as also those who are unable to do so.

Infrastructure projects play an important role in poverty reduction by increasing aggregate demand and employment and alleviating bottlenecks that constrain growth.[92] By increasing the availability of goods and reducing transport costs, transport projects lower the prices of essential commodities and inputs for farmers, and thus help reduce poverty. They also increase the poor's mobility, enabling them to find higher-paying work. And they encourage the production of higher value cash crops by enhancing access to markets. Improved transport infrastructure also improves access to education, health, and other social services.

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[91] Thorat (2007) provides a detailed discussion of the Indian experience.

[92] Several studies have discussed the nexus between infrastructure and poverty. See for example, ADB-JBIC-World Bank 2005. and Chatterjee et al. 2004.

Energy projects fuel economic activity. They allow small-scale rural entrepreneurs to process agricultural products, work longer hours, and hence earn more. They help disseminate information on crops and farming methods via radio and television. They increase study time in the evening for children. Investments in rural infrastructure raise agricultural growth and employment, provide increased incomes to the rural poor, and help reduce income poverty.

Cross-border infrastructure projects also help improve connectivity and open up opportunities for higher growth (Box 6.2),

Box 6.2. Transport corridors in the Greater Mekong Subregion

Developing an integrated transport network that enables goods and people to move quickly and cheaply within the subregion is a strategic priority for the Greater Mekong Subregion (GMS) Economic Cooperation Program.[1] With the support of multilateral funding organizations and aid agencies, GMS countries are working together to build and upgrade their road, rail, and port links. This will reduce production costs, stimulate economic activity, enhance development, and thus alleviate poverty.

Since its inception in 1992, cooperation in the GMS has made substantial progress in developing physical connectivity. Infrastructure projects worth nearly $10 billion have been completed or are being implemented, including upgrading the Phnom Penh-Ho Chi Minh City highway and the East-West Economic Corridor that runs from Mawlamyine in Myanmar to Da Nang in Viet Nam.

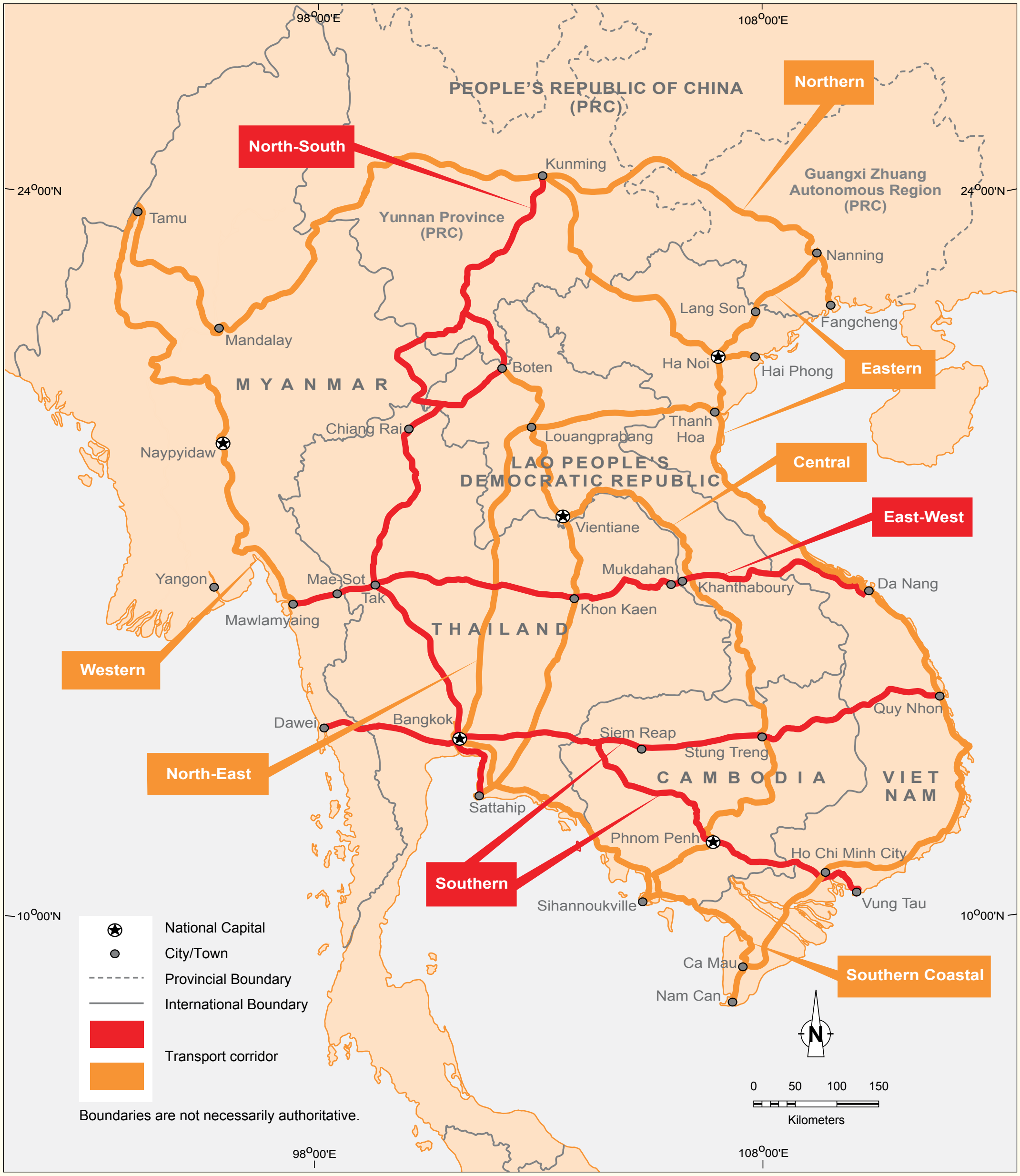
Regulations, procedures, and standards also need to be harmonized. The costs and benefits of infrastructure development are unevenly distributed; this calls for the coordinated design, planning, and implementation of infrastructure projects. Cooperation on regional infrastructure projects would be a powerful instrument for growth and poverty reduction.

As of April 2008, more than 150 new investment projects related to the transport corridors have been proposed. These include 31 high priority projects with an estimated cost of $2.4 billion, including 20 road, 2 railway, 4 airport, and 5 water transport projects. Nine transport corridors have been identified to connect the north, central and south areas of the GMS into a single loop (Figure B6.2).

The development of the transport network will enable Yunnan Province of the People's Republic of China and northern Lao People's Democratic Republic to gain access to international seaports in Thailand and Viet Nam; provide a continuous land route between the South China Sea and the Andaman Sea; offer access to seaports in northeast Thailand and the central regions of the Lao People's Democratic Republic; accelerate the westward flow of goods, eventually to India; and ease the movement of goods and people, especially tourists, in the region.

[1] The Greater Mekong Subregion includes Cambodia, the People's Republic of China, the Lao People's Democratic Republic, Myanmar, Thailand, and Viet Nam.

Figure B6.2. Greater Mekong Subregion transport network



Source: Asian Development Bank.

but complementary policies are needed to ensure that infrastructure projects reduce poverty. Projects in poor areas should be prioritized and market mechanisms that translate improvements in infrastructure into tariff reductions used (Chatterjee et al. 2004). In the GMS, infrastructure improvements have been shown to improve trade (Fujimura and Edmunds 2006) and reduced poverty (Menon and Warr 2006).

Social protection and demographic ageing

Even with the best efforts to ensure that as many people as possible share in the region's growth, some will be left behind or require additional help. Effective social protection systems are therefore essential. While these have greatly improved since the crisis, they remain inadequate in most of Asia. Ortiz (2001) attributed this to a combination of factors: limited coverage, insufficient funds, inadequate or inappropriate instruments, legal restrictions on access, administrative bottlenecks, and/or problems with compliance. A more recent assessment conveys a similar picture (Van der Auwera 2006).

A comprehensive assessment in 2003 of direct social protection programs in ADB developing member countries concluded that while most had programs covering almost all the facets of social protection, these had "low effectiveness." ADB has helped develop a social protection index to monitor progress in implementing measures in the five areas identified in the 2001 social protection strategy: labor markets, social insurance, social assistance, community protection schemes, and child protection.[93] As Table 6.3 shows, coverage is patchy and targeting often poor, but expenditures are already quite considerable in some countries. ADB is supporting the expansion of the project from the initial 6 countries to a further 23.

The social protection index provides a means of comparing the overall level of social protection provision across countries and over time on a consistent basis. It is thus a useful tool for diagnosing policy weaknesses, setting priorities, and learning from other countries' strengths. Through information sharing, spreading best practices, and peer pressure, regional cooperation could help improve social protection across the region.

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93 The four dimensions of the index are cost (the share of GDP spent on social protection), coverage (the proportion of the relevant population that benefits from social protection), poverty targeting (the proportion of the poor that receive social benefits), and social impact (value of social benefits relative to the poverty line). The social protection index uses the maximum value as the standardizing value and applies equal weights to each of the dimensions of the index.

The priorities are how to increase the coverage, affordability, and targeting of social protection programs. Effective schemes need not be unaffordable—the United Nations' World Economic and Social Survey calculates that the cost of providing a pension of $1 a day to everyone over 60 in 66 developing countries (including those covered by this study) is less than 1% of GDP a year (UN 2007b).

Even low-income countries need to provide public assistance to the extremely poor. But to remain affordable, such schemes must be targeted at the neediest. Targeted nutrition programs, such as those for children and lactating mothers in poor households, are particularly effective. In the Philippines, a food-for-school program has helped fight hunger. Embedding such targeted nutrition programs in community-driven development programs increases their effectiveness (World Bank 2004).

Conditional cash transfers targeted to pay for social services are another important instrument. These have had considerable success in Latin America, where they have reduced overheads and corruption. They provide money to the poor on condition that children remain in school and mothers visit health clinics and have their children immunized. So far, the use of such programs in Asia has been limited, but Indonesia recently replaced an unsustainably expensive general fuel subsidy with a conditional cash transfer program for poor families.

It is also important that when an economic shock strikes, spending on social protection schemes and essential services is maintained. Except in Malaysia, education and health budgets were severely cut in countries affected by the crisis in 1997/98, just when the need was greatest (Knowles, Pernia, and Racelis 1999). Countercyclical support to sustain social spending in hard times could be provided by regional and international development banks.

Because formal-sector jobs with formal social insurance are rare in most of Asia and security in formal-sector jobs is eroding too, social protection for the informal sector is desperately needed. Innovative ways of enhancing access to formal-sector services are also required. ADB (2003) recommends micro- and area-based schemes involving measures such as micro-insurance, agricultural insurance, and social funds. Micro-insurance schemes are voluntary contribution schemes that generate small savings and provide small-scale cash flows to address community risks. Their coverage needs to be expanded, particularly in rural areas. Challenges include a lack of re-insurance, a shortage of reliable data on which to base premiums, and the

Table 6.3. Key social protection indicators for selected Asian countries, 2006

Countries	Social-protection costs	Coverage of social protection: indicators					
		Unemployed/ underemployed	Elderly	Sick	Social assistance	Micro-credit	Disabled
Cambodia[a]	1.4 (0.8)	5.0 (5.0)	8.0 (8.0)	7.0 (7.0)	16.0 (16.0)	41 (-)	9.0 (9.0)
PRC	4.6	31.0	26.0	29.0	100.0	10.0	28.0
India	4.0	14.0	23.0	10.0	100.0	16.0	23.0
Indonesia	1.9	1.6	16.0	42.0	7.5	0.9	2.0
Lao PDR	1.3	19.0	7.0	3.0	18.0	57.0	10.0
Malaysia	4.0	21.0	59.0	24.0	64.0	0.0	61.0
Philippines	2.2	7.0	16.0	70.0	5.0	32.0	24.0
Viet Nam	3.5	1.7	34.0	23.0	7.5	2.2	35.0

Lao PDR = Lao People's Democratic Republic, PR C= People's Republic of China.
[a]Numbers in parentheses are Asian Development Bank estimates without the microfinance programs.

Social protection component	Indicator
Social protection costs	Total social protection expenditure as percent of gross domestic product
Coverage of social protection	Beneficiaries as % of total unemployed/underemployed
Elderly	Elderly receiving assistance as percent of population aged 60+ years
Sick	% of population with health insurance or in receipt of subsidies
Social assistance	Population receiving some social assistance/welfare as % of poor population
Microcredit	Population receiving microcredit as % of poor population

Source: Adapted from Baulch, Wood, and Weber 2006.

high costs of dealing with many small transactions (which could potentially be overcome using mobile phones). Targeted agricultural insurance can help small-scale farmers more than subsidies do. Social funds that channel public resources to meet pressing social needs can deliver quick, visible, efficient, and accountable results in poor communities.

While human development and social protection systems are primarily national concerns, regional cooperation can also play a part, notably in sharing best practices and encouraging the portability of social protection benefits across countries through regional agreements. Exchanges of expertise ought to be promoted, as should sharing lessons on methods, institutions, and technologies; the provision of technical expertise; and capacity building.

While demographic ageing is not yet a major issue for most of Asia—only 6.4% of the region's population is aged 65 or above—it

Children with special needs	Overall coverage indicator	Poverty targeting	Impact on expenditures
45.0 (45.0)	17.0 (11.0)	44.0 (30.0)	4.3 (2.7)
100.0	43.0	69.0	44.0
100.0	35.0	100.0	34.0
17.0	34.6	73.0	11.0
44.0	19.5	40.0	6.6
99.0	36.0	56.0	19.0
5.0	33.0	30.0	4.8
14.0	21.7	51.0	11.6

Social protection component	Indicator
Disabled	Disabled beneficiaries as % of disabled population
Children with special needs	Children with special needs receiving assistance as % of poor children aged 5–14 years
Overall coverage indicator	Weighted average of coverage subcomponents
Poverty targeting	% of poor population who receive some assistance
Impact on expenditures	Social protection expenditure per poor person as % of annual per capita poverty line income/expenditure

will eventually become so. By 2030, five economies—the PRC; Hong Kong, China; the Republic of Korea, Singapore, and Hong Kong, China, and Thailand—will join Japan in having a much higher proportion of elderly people (Table 6.4). They, and others that will face similar problems later, need to start developing appropriate institutions for supporting a larger elderly population now (ADB 2002b). These include efficient and secure pension systems, a well-run financial institutions and health care systems that can provide quality care to the elderly. The current reliance on personal and family support for the aged may not be sustainable: in future there will be fewer children to support the elderly; young people are increasingly leaving home to seek work elsewhere; more women are working; and new ideas about marriage, family, and individualism are emerging.

A recent review of pension programs in the region summarized the common problems as affordability, poor returns on financial

Table 6.4. Ageing population in Integrating Asia

Economy	Population 65 and over as a percentage of total population			Population 65 and over as a percentage of population 15–64		
	2005	2015	2030	2005	2015	2030
Brunei Darussalam	3.2	4.2	8.9	4.8	6.0	12.7
Cambodia	3.1	4.0	5.8	5.3	6.2	8.7
China, People's Rep. of	7.7	9.6	16.2	10.8	13.4	24.4
Hong Kong, China	12.0	14.5	25.8	16.4	19.8	40.9
India	5.0	5.8	8.8	8.0	8.8	12.9
Indonesia	5.5	6.6	10.7	8.3	9.6	15.5
Japan	19.7	26.2	30.6	29.8	42.6	52.3
Korea, Republic of	9.4	13.3	23.4	13.1	18.2	36.2
Lao People's Dem. Rep.	3.5	3.4	5.6	6.2	5.3	8.4
Malaysia	4.4	5.8	10.4	6.8	8.7	15.4
Myanmar	5.6	6.3	10.9	8.3	8.9	15.8
Philippines	3.8	4.7	7.5	6.4	7.5	11.2
Singapore	8.5	13.5	27.4	11.8	18.2	45.9
Thailand	7.8	10.2	17.4	11.1	14.5	26.6
Viet Nam	5.6	5.8	10.9	8.6	8.4	15.8
Integrating Asia	**6.8**	**8.3**	**12.9**	**10.3**	**12.1**	**19.2**
Asia	6.4	7.6	11.7	9.7	11.2	17.4
European Union	15.9	17.4	22.6	23.3	25.8	35.9
North America	12.3	14.3	19.8	18.4	21.6	31.7
World	**7.3**	**8.3**	**11.7**	**11.4**	**12.6**	**18.0**

Note: "Asia" refers to the United Nations definition.
Source: UN Population Division. 2008. World Population Prospects. Available: http://www.un.org/esa/population/unpop.htm (accessed May 2008).

assets, inadequate service levels, and inefficient administration. Several options for dealing with ageing have been proposed.[94] The options include later retirement, especially in countries where public support remains underdeveloped; basing wages more closely on performance, rather than seniority (as is popular in Japan and the Republic of Korea); and greater job flexibility. Simulations show that a greater reliance on self-support eventually results in higher per capita outlays on social protection than publicly funded pensions.

Health insurance increases in importance with ageing. Coverage is mainly restricted to formal-sector employees in most countries in

94 See for example Mason, Lee, and Lee (2007)

the region, but promising starts at extending coverage to the poor are being made. The Yeshavani scheme in the Indian state of Karnataka state already has over 2 million members of cooperative societies, mostly small-scale or marginal farmers and rural workers. The success of health insurance schemes for the poor depends on the capacity to provide quality health care services; good cost recovery; and a nodal agency, such as public agency or a civil-society organization, with a strong social focus. Other innovative ways to improve private support for the elderly have emerged. One is to formalize family support for the elderly through legislation. Singapore's Maintenance of Parents Act of 1994 gives courts the right to compel children with sufficient means to provide for parents who cannot support themselves. In India the assets of the elderly are converted into annuities that support their maintenance needs.[95]

6.3. Delivering regional public goods

Regional cooperation is essential for the delivery of regional public goods[96] that benefit all countries collectively but cannot be produced by countries acting alone. Areas where regional efforts could produce high payoffs include cross-border health and safety issues, labor migration, environmental issues, and education and knowledge exchanges.

Health and safety

Due to its high population densities and the limited health services in some countries, Asia is unusually vulnerable to epidemics. Regional integration and the more frequent movement of people and goods increase its vulnerability. HIV, severe acute respiratory syndrome (SARS) and avian influenza (H5N1) highlight how rapidly local health problems can become regional ones. These threats—and potential future ones—are risks not only to people who are directly affected, but to society at large, as they can have devastating economic and social consequences.

95 The program in India is a reverse mortgage where the lender (a bank) pays the borrower a sum every month. The borrower does not pay and the loan is settled on the death of the borrower.

96 Public goods are characterized by non-excludability (i.e., nonpayers cannot be excluded from their use) and nonrivalry (i.e., use by some does not reduce the supply for others).

Better information and cooperation could have reduced the hysteria about SARS. During the brief outbreak in the second quarter of 2003, 8,422 cases were reported, with an 11% fatality rate. Yet the World Health Organization (WHO) estimates that the economic cost to Asian countries was $20 billion, mainly from lost tourism revenues and lower consumer spending. SARS highlighted the inadequacy of public investment in health in developing Asian countries and the need for more regional burden sharing on such common threats. It also showed the importance of global monitoring and coordination in containing such epidemics (Lee and McKibbin 2004).

In contrast, the avian flu outbreak showed how regional cooperation can contain a health menace effectively. WHO has recorded 322 human cases of avian influenza with 195 fatalities from 2003 to August 2007. Early assessments find that the macroeconomic impact of avian flu has been minor, but that farmers with little access to social safety nets were worst affected.

Halting and reducing the incidence of HIV/AIDS[97] is one of the MDGs, yet the disease is actually spreading.[98] As well as killing people, HIV/AIDS can devastate the economy and society. It often strikes down people in the prime of their working lives, incapacitating or killing a family's primary bread winner. There is no cure, and treatment is expensive. HIV is often transmitted across borders by tourists, visiting businesspeople, and migrant workers, as well as through high-risk groups such as drug users and sex workers. Regional cooperation is urgently needed, yet current activities are characterized as lacking in resources, effective prevention initiatives, sufficient support and care for those infected and affected by HIV/AIDS, institutional and human-resource capacity at all levels and in all sectors, and strong and effective coordination.

Regional cooperation on health issues is a priority. The threat of a pandemic is real. Proposals include (1) strengthening the collection and dissemination of timely information about health threats, both for surveillance and in order to prepare vaccines, treatments, and containment mechanisms; (2) establishing the capacity to produce influenza vaccines; (3) supporting national capacity building, particularly surveillance and diagnostic capacity in poorer countries; (4) declaring HIV/AIDS a regional emergency; (5) developing a pro-poor compact for prevention and treatment; (6) creating an Asia-

97 Human immunodeficiency virus/acquired immunodeficiency syndrome.

98 About 8.2 million people were living with HIV in Asia at the end of 2004, up from 7.2 million in 2002.

Pacific intergovernmental collaboration mechanism to fight HIV/AIDS; and (7) taking concerted action on other diseases covering standards, health promotion, early-warning systems, and communications (ESCAP-ADB-UNDP 2007).

National governments need to give a higher priority to public health. Expenditure on health is generally low; spending on public health particularly so. The overcrowded conditions and failing health services in urban centers are a notable threat, while the lack of transparency and sharing of information during disease outbreaks is a big obstacle to managing them effectively.

Asia, and the poor in particular, are also threatened by natural disasters (Ortiz 2001), as the devastating tsunami of 2004, the cyclone that hit Myanmar in 2008, and the Sichuan earthquake have highlighted. Regional cooperation could help to make the response to disasters faster, more effective, and less costly. It should include regional early-warning systems where appropriate; disaster-management and recovery plans; and arrangements for information-sharing, transport, and communications. Financial innovations—such as regional catastrophe bond and flood insurance markets—could improve the management of such risks (Lin, de Guzman, and Cuevas 2007).

Labor migration

Encouraging labor mobility is broadly beneficial. This is true for migration within countries as well as among them. Among the 200 million or so international migrants, the top three countries of origin are in Asia: the PRC, with 35 million; India, with 20 million; and the Philippines, with 8 million (Global Commission on International Migration 2005).[99] International migration is expected to continue rising, driven by huge wage disparities among countries, ageing populations and low birth rates in advanced countries, and rising education levels in developing countries. This can bring huge benefits—to migrants, to the countries to which they contribute their labor, as well as to their countries of origin, to which they transfer money and skills.

Globally, migrants' remittances through formal channels are reckoned to have topped $300 billion a year in 2007 (Ratha and Xu 2008), while twice that much may be sent informally. Remittances are the single largest resource transfer to developing countries, exceeding

[99] These values include all migrants and differ from Table 6.5 which refer only to those who are registered in a census abroad.

the $100 billion that governments of rich countries give in overseas aid and the $200 billion or so that developing countries receive in FDI. Developing countries in Asia are estimated to receive $112 billion a year in remittances—India tops the list with $27 billion, followed by the PRC with $26 billion and the Philippines with $17 billion (Table 6.5). Official remittances to the Philippines amounted to nearly 12% of GDP in 2007.

Studies show that remittances boost households' expenditure on education and housing, as well as their investment in household enterprises (Adams 2005, Yang 2006, Lu and Tremain 2007). Estimates using cross-country data for a set of 71 developing countries show that a 10% increase in the share of international migrants in a country's

Table 6.5. International migrants by origin and inflows of remittances

Economy	Migrants (thousands)		Remittance Inflows ($ millions)		Remittance Inflows % of GDP (2007)*
	2000	2005	2000	2007 (est.)	
Brunei Darussalam	18	13	–	–	–
Cambodia	312	349	121	322	3.74
China, People's Republic of	5,820	7,258	6,244	25,703	0.79
Hong Kong, China	714	716	136	297	0.14
India	9,059	9,987	12,890	27,000	2.46
Indonesia	1,833	1,737	1,190	6,000	1.39
Japan	884	940	1,374	1,578	0.04
Korea, Republic of	1,492	1,609	735	985	0.10
Lao PDR	352	413	1	1	0.02
Malaysia	785	1,459	981	1,700	0.91
Myanmar	315	427	104	125	0.92
Philippines	3,400	3,631	6,212	17,000	11.79
Singapore	279	230	–	–	–
Thailand	857	758	1,697	1,707	0.69
Viet Nam	2,007	2,225	–	5,000	7.14
Integrating Asia	**28,127**	**31,753**	**31,685**	**87,418**	**0.78**
World	**175,708**	**190,590**	**131,500**	**317,700**	**0.58**

– = no data available, est. = estimate, Lao PDR = Lao People's Democratic Republic, PRC = People's Republic of China.
*Figures are calculated using the International Monetary Fund's published gross domestic product data and estimates of remittance inflows for 2007.
Sources: Ratha and Xu. 2008. Available: www.worldbank.org/prospects/migrationandremittances; DRC. 2000. Global Migrant Origin Database for 2000 version 4. Updated 27 March 2007. Available: http://www.migrationdrc.org/research/typesofmigration/global_migrant_origin_database.html; and IMF. 2008. World Economic Outlook. Available: http://www.imf.org/external pubs/ft/weo/2008/update/01/pdf/0108.pdf. (accessed June 2008).

population tends to lead to a 2.1% decline in the share of people living on less than $1 dollar a day, while a 10% increase in official remittances leads to a 3.5% decline in extreme poverty (Adams and Page 2005). Pritchett (2007) estimates that if rich countries allowed their labor force to swell by 3% by easing restrictions on labor mobility, poor countries would gain some $305 billion a year. Those gains would exceed the combined benefits of rich countries' lowering their trade barriers, granting debt relief, and giving overseas aid. Easing labor migration restrictions would also do more to help poor countries meet the MDGs than all the other measures combined.

Unfortunately, migrant workers are vulnerable to exploitation and abuse, and there is a pressing need for cooperation to ensure that they are better protected. Irregular migrants, who tend to be poor and low-skilled, are particularly at risk. Even when they migrate legally, women are especially vulnerable; illegal trafficking in women is another major issue.

Several international conventions—notably, those of the International Labor Organization (ILO)—and regional declarations, such as ASEAN's declaration on the protection and promotion of the rights of migrant workers, seek to promote the welfare and uphold the human dignity of migrant workers. But unless these conventions are enshrined in domestic law and are then enforced, their impact is necessarily limited. Bilateral arrangements also exist, but these are generally both too slow and too limited in scope, dealing only with legal migrants and not covering access to services in host countries.

Concerted regional action and peer pressure could help rally support for countries to adopt these international conventions. Documenting and sharing best practices on the protection of migrant workers among sending and receiving countries is another fruitful area for regional cooperation. Ensuring the portability of social protection measures across national boundaries would also be helpful.

Regional agreements could help ease labor market surpluses and shortages in integrating economies by helping to match workers to jobs. In particular, younger, poorer countries could export health care workers to older, richer societies. A well-managed regional system could help quell fears about job losses in receiving countries and a brain drain in sending ones. Such a system ought to cover low-skilled workers as well as skilled ones, not just because they are in great demand in older, richer economies, but also because allowing them to migrate temporarily is particularly useful in reducing poverty.

The management of migration flows, remittances, and social protection systems for migrant workers should also be improved.

Since migration and remittances are mostly handled by the private sector, governments' main role is in enacting regulation and enforcing rules. Innovative financial instruments for small savers and assistance in identifying investment opportunities would help make the most of remittances.

Reviewing social protection legislation in countries with many migrants, designing better systems, and highlighting best practices is also important. Providing social protection to families left behind also needs to be considered, as does the reintegration of returning migrant workers. Finally, cooperation to curb trafficking in women and other illegal forced migration is essential. Eventually, migration could lead to a more integrated regional labor market.

Environmental issues

The severity of Asia's environmental challenges calls for urgent national and regional action. At a national level, governments need to set and enforce tougher emission standards on polluting companies, align domestic energy prices with international prices by removing subsidies on fossil fuel use, increase energy efficiency, encourage the use of clean energy, integrate environmental policies with economic and sectoral ones, and engage the private sector to achieve environmental goals.

Many solutions to Asia's environmental problems can also be found through regional cooperation (ADB 2006c). Countries and subregional organizations need to harmonize environmental standards, regulations, and laws. They should act together to reduce air pollution, land degradation, and global climate change. Particular attention needs to be paid to the poor who are generally worst hit and least able to adapt.

There is considerable scope for cooperation in curbing cross-border air pollution. ASEAN countries have taken a lead in seeking to reduce haze and improve air quality in cities through agreements to prevent land and forest fires, and to control emissions.[100] Other affected countries ought to join such efforts, and similar agreements are needed to deal with the Asian brown cloud and dust and sand storms.

National efforts alone cannot mitigate and combat the effects of climate change. Poorer countries cannot single-handedly cope with the increased frequency and intensity of natural disasters such as

[100] The ASEAN Agreement on Transboundary Haze Pollution and ASEAN Framework for Environmentally Sustainable Cities are examples.

tropical storms. Regional cooperation is needed for developing early-warning systems and bolstering disaster relief. Fiscal constraints inevitably hamper public efforts at disaster management. Market instruments such as catastrophe bonds and flood insurance may need therefore to be explored. Regional cooperation is also needed to help poorer countries take stock of the impact of climate change on the vulnerable, and develop alternative livelihoods for those likely to be affected. Regional efforts could also contribute to reducing greenhouse gas emissions through the transfer of technology and good practices as well as by supporting the adoption of clean technologies.

Regional bodies such as regional UN institutions and multilateral agencies could play an important role in promoting cooperation on environmental issues and providing much-needed technical advice and financial support.

Regional cooperation could also be instrumental in helping preserve Asia's natural resources. Subregional initiatives provide a good model for other countries in the region (Box 6.3).

Education and knowledge exchange

Education and cultural exchanges enrich the lives of participants and can foster a sense of regional community. Europe's Erasmus program is a good model.[101] The program involves more than 2,000 higher educational institutions (some 90% of the total) in 31 countries, and includes student and teacher exchanges, the joint development of study programs, networking among departments and faculties, and a credit transfer system. Since the program started in 1987, about 1.5 million students have benefited from it.

The ASEAN University Network, established in 1995, has a similar aim. The network involves 20 leading universities. Its activities also include quality assurance in education and a youth cultural forum. The network also has joint programs with the PRC, India, Republic of Korea, and Japan. So far, the network has benefited only a few hundred students and teachers—it ought to be greatly expanded.

[101] Further information on the Erasmus program is available at http://ec.europa.eu/education/programmes/llp/erasmus/erasmus_en.html.

Box 6.3. BIMP-EAGA: a model of subregional environmental cooperation

The Brunei Darussalam-Indonesia-Malaysia-Philippines East ASEAN Growth Area (BIMP-EAGA) was established in March 1994 to address the social and economic development of the poorer and more remote territories of the four participating countries. It hosts some of the world's richest repositories of land and marine life and a plan has been developed to protect the environment and its unique biodiversity. Priorities include conserving the equatorial rainforests of the Heart of Borneo and the Sulu-Sulawesi marine eco-region.

Borneo's biodiversity

The forests of the Heart of Borneo are among the most biologically diverse habitats on earth. Many indigenous peoples depend on the forest for a variety of resources, including edible and medicinal plants, fish, meat, construction materials, and water, yet it is threatened by land conversion, illegal logging, poor forest management, and forest fires.

Many of Borneo's rivers flow into the Sulu-Sulawesi Sea. This contains nearly two-thirds of the world's reef building corals, over 1,200 species of reef fish, and complex systems of habitats: estuaries, lagoons, sea grasses, sand cays, fringing and barrier reefs, atolls, submerged volcanoes, seamounts, and deep interisland passages and oceanic channels. It is also one of the most important spawning grounds for fish and other marine life in the Asia-Pacific region. Fisheries productivity is high. With average annual harvests reaching nearly $1 billion, this has provided food and security for millions of coastal peoples. Yet the Sulu-Sulawesi region is now threatened by reef destruction, over-fishing, and unsustainable fishing practices.

Initiatives for cooperation

The four BIMP-EAGA governments recognize that environmental protection and managing the long-term sustainability of these important natural resources requires effective subregional, multisector cooperation. With the Asian Development Bank (ADB) as their regional development adviser and through the BIMP-EAGA Business Council, they are collaborating on scientific research to create detailed profiles of these eco-regions, assess the policies and institutions needed to manage natural resources sustainability, and formulate a long-term environmental protection program.

The Sulu-Sulawesi marine ecoregion was the focus of BIMP-EAGA's first major environmental cooperation program, which initially focused on developing national conservation plans. Several conservation projects have since been started, and an intergovernmental body, the Tri-national Committee, has been established to take ownership and leadership of such projects.

In February 2007, Brunei Darussalam, Indonesia, and Malaysia signed a declaration of support in Bali for the Heart of Borneo project. Forest management plans are being prepared and completed in 2008. The national plans will form the basis of the cooperative framework for managing shared forest resources.

6.4. A social and environmental agenda

Asian regionalism cannot fulfill its immense potential unless it also addresses disparities within countries and among them. Left to market forces, Asian regional integration will bypass many people and support for it will be eroded. Governments increasingly recognize this; their vision of shared regional prosperity requires corrective action.

Regional cooperation is not only useful for addressing critical social and environmental issues directly; it could also help make a strong case for action—as the MDGs have done globally—and help mobilize national, regional, and global support. Deeper networks among policy makers, research institutions, and nongovernment organizations could improve the design and implementation of policy. By acting together, the region could ensure that the impact of social and environmental policies on the competitiveness of particular industries and subregions is recognized and, if necessary, addressed through complementary policies.

The priorities are as follows.

- **First, connecting the poor to the thriving regional economy**. Policies will vary across countries, but they should aim to eliminate regulatory, social, and geographical barriers in labor markets; prioritize development strategies with a strong impact on reducing poverty; invest in education and training to make workers more productive; and build infrastructure to connect disadvantaged regions with economic centers.

  Aid for trade (Box 6.4), a recent WTO initiative, can be helpful for addressing the policy, capacity, and supply-side constraints that prevent poorer countries from benefiting from new trade opportunities, is particularly important.[102]
- **Second, developing cost-effective social protection systems**. With family and community mechanisms of social protection declining, low-income and middle-income countries also need

[102] The WTO website defines aid for trade as "aid that finances trade-related technical assistance, trade-related infrastructure and aid to develop productive capacity." See Prowse (2005) for a full discussion of importance of looking at aid for trade as an integral component of a country's overall development strategy utilizing the integrated framework mechanism (UNCTAD 2005) and Stiglitz and Charlton (2006) for a discussion of the paucity of compensation as the basis for aid for trade. Available: http://www.wto.org/english/tratop_e/devel_e/a4t_e/aid4trade_e.htm).

Box 6.4. Aid for trade

Aid for trade is a multidonor initiative launched by the World Trade Organization (WTO) in December 2005 that aims to promote the economic development of the world's least-developed countries by stimulating the trade component of projects financed by regional and global financial institutions. Aid for Trade seeks to channel financing for trade-related technical assistance and infrastructure, as well as aid to develop new productive capacity. Such capacity building is expected to help the countries reap the full economic and social potential of international trade.

Aid for trade projects are meant to (1) build the infrastructure needed to transport goods and establish new, viable, and competitive exports; (2) promote exports and finance trade; (3) fund training for customs officials as well as trade negotiators; and (4) help in implementing the required market-oriented reforms and building the social safety nets needed for people to adapt to economic change. As of March 2008, contributions of about $15 billion had been pledged to kickstart programs worldwide through 2010.

Implications for Asia

Integrating Asia's successful experience of outward-oriented development can be replicated in Asia-Pacific's least-developed countries, which together are home to 7% of the world population but account for a mere 0.8% of global output and trade.[1] Aid for trade projects are expected to help reduce the gap between advanced and less advanced subregions of Asia—the so-called "two faces of Asia."

Ingredients for successful aid for trade programs

The Asian Development Bank's experience in trade-related development programs shows that successful technical assistance needs to encompass (1) the development of trade-related transport and communication infrastructure; (2) the enhancement of productive capacity and inclusion in production chains and supply networks; (3) the implementation of market-oriented reforms, development of social safety nets, and retraining of workers to ease industrial transition; (4) the development of export-promotion and trade-finance facilities; and (5) trade-related capacity building, notably enhanced training for customs officials and government officials to negotiate and implement trade agreements.

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[1] Afghanistan, Armenia, Azerbaijan, Bangladesh, Bhutan, Cook Islands, Fiji Islands, Georgia, Kazakhstan, Kiribati, Kyrgyz Republic, Maldives, Marshall Islands, Federated States of Micronesia, Mongolia, Nauru, Nepal, Pakistan, Republic of Palau, Papua New Guinea, Samoa, Solomon Islands, Sri Lanka, Tajikistan, Timor-Leste, Tonga, Turkmenistan, Tuvalu, Uzbekistan, and Vanuatu.

adequate social protection systems. Recent experiments are expanding the range of cost-effective solutions, in part with innovations that exploit technology and microfinance strategies.

- **Third, facilitating and managing labor migration**. National and international migration can improve the lives of migrants, their families, and the citizens of host economies. Cross-border labor migration should be encouraged, both to harness complementarities in labor markets and to make regional integration more inclusive. The challenge is to permit migration to grow within socially acceptable levels and to ensure that migrants have basic rights and protections, and are treated with dignity.
- **Fourth, protecting regional health and safety**. Densely populated and closely integrated Asia needs world-class systems to monitor; prevent; and, if necessary, contain epidemics. Providing the "public goods" of disease prevention and controlling outbreaks is a top regional priority.
- **Fifth, making development sustainable**. Asia's rapid development is posing an increasing strain on the environment. Cooperation is required to set environmental standards, design interventions, and monitor results. Regional cooperation could be useful in mobilizing Asian and non-Asian resources and technologies. It is essential for addressing cross-border issues.

Sharing such regional goals will help to build a genuine Asian community. By understanding each others' successes and failures, people and countries will develop stronger foundations for cooperation. A common, inclusive vision will also help to mobilize popular support, an essential requirement for realizing the promise of Asian regionalism.

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Komunidad ng Asyano
CỘNG ĐỒNG CHÂU Á
HỘI NHẬP KHU VỰC
Regional Integration
การรวมตัวทางภูมิภาค
Masyarakat Asia
Pag-uugnayang Panrehiyon
Asian Community
Integrasi Regional
ประชาคมเอเชีย
地域一体化
区域一体化
지역통합
아시아공동체

Chapter 7

Creating an architecture for cooperation

The case for greater regional cooperation in Asia is broad, deep and compelling, as previous chapters make clear. During the last decade, valuable new initiatives and institutions have been launched as awareness of the need for Asian regionalism has grown. Yet marshaling collective efforts across this vast, diverse region is a huge challenge. The examples of the EU and, to a lesser extent, of NAFTA, highlight some of the possible developments—and challenges—of regional cooperation. But Asia is not Europe or North America. Its economics, politics, and history are different. In some respects—particularly trade and investment in regional production networks—Asia's economies are today more closely intertwined than Europe's were in the early stages of European regionalism in the 1950s and 1960s. In other areas—such as financial markets—Asian economies remain much more integrated globally than within themselves.

As market-led regional economic integration deepens—especially in East Asia—greater policy cooperation is needed, notably in trade, finance, and macroeconomic management, as well as in social and environmental issues. Domestic regulatory and institutional reforms—such as pro-competitive deregulation, improvements in financial standards, enhancement of governance, and stronger social safety nets—are essential for accomplishing these objectives. More effective national institutions and closer regional intergovernmental cooperation complement each other.

Integrating Asia's growing importance in the global economy also demands more ambitious and coherent regional cooperation. To play an appropriately greater role in addressing global economic issues, the region must increasingly act together—not only out of self-interest, but also to help maintain global economic prosperity. Asia has a huge stake in bolstering global economic stability and promoting open international markets. By pooling its strengths, it could have significant influences on global economic institutions, such as the WTO or the IMF, to Asia's benefit and the world's.

But while interdependence is strengthening in Asia and economic cooperation intensifies, the region's great diversity and complex politics argue for flexibility and pragmatism in the scope, speed, sequencing, and style of economic cooperation. The architecture of Integrating Asia's regional cooperation is multitrack and multispeed, follows a bottom-up approach, and has so far developed only few, lean regional institutions. While this flexibility is often seen as a weakness—not least because European regionalism is mistakenly taken as the benchmark—it is in fact both a necessary and a desirable feature of the Asian model.

Asia's distinctive approach to cooperation allows any group of countries, economies, subregions, or territories to join the integration process and share in its benefits, regardless of its level of development. As partnerships strengthen, they can lead to deeper and wider collaboration. Asia's emerging open, gradual, and flexible regionalism ensures that Asia's economic integration remains market-friendly and responsive to the region's diverse economic, political, social, and cultural realities.

This chapter is structured as follows. Section 7.1 defines Asia's objectives for cooperation and section 7.2 analyzes its distinctive model of regionalism. Section 7.3 sets out the nature and role of emerging regional and transregional organizations and how they interact. Section 7.4 concludes with suggestions on how the architecture of regional cooperation could—and should—evolve. East Asia's experience in regional integration and intergovernmental cooperation, which is uniquely adapted to the needs of developing countries, can provide important lessons to many countries in other parts of Asia and the Pacific, Latin America, and Africa.

7.1. Regional goals and global interests

While market forces are mainly responsible for Asia's integration, this study has shown that economic, social, and environmental spillovers are increasing and, without purposeful cooperation, could undermine the benefits of integration. To sustain economic integration and to maximize gains from it, the region will need to work together in all three levels of policy making: regional, national, and global.

First, at the regional level, cooperation is needed on setting regional policies in trade, investment, and finance to deepen Asia's growing and wide-ranging economic links. To build such a framework, Asia has relied mainly on unilateral or global trade liberalization strategies in the past and its economies today are substantially—and in some cases dramatically—more open than they were a decade ago. Yet significant barriers remain in some economies and sectors, and reducing the most entrenched barriers becomes difficult on a unilateral basis. Regional cooperation will be needed for deepening and extending the liberalization process; it will be necessary for streamlining the proliferation of bilateral negotiations and consolidating them into a single regional agreement; and it can provide a complementary multilateral framework for liberalization to support global integration), as discussed in Chapter 3.

Regional cooperation is especially important for achieving further integration in financial markets, where market-based processes have not worked as well. This study has shown that deeper financial integration will require strengthening the financial systems of individual economies. An important priority will be to institutionalize a dialogue among the principal architects of domestic financial markets, with the objective of strengthening supervision and surveillance; coordinating regulatory frameworks; and creating minimum, common standards—efforts that could be tackled through high-level cooperation, as proposed in Chapter 4. Future economic pressures are also likely to develop around the region's exchange rate system, macroeconomic policies, and mechanisms for channeling savings into investments. In all these areas, stronger regional institutions will be required to keep pace with the growing scale and complexity of the Asian economy.

Second, on national policies, cooperation is needed to create a coherent and efficient regional environment for doing business. As a result of successful past liberalizations, the principal constraints on the region's integration are no longer barriers to international transactions (border measures), but have increasingly become regulatory and institutional factors that result in discriminatory outcomes within economies (behind the border measures). Addressing these more complex barriers is a key challenge for a new generation of policy reforms, aimed at making regulations and standards more transparent and consistent across economies (Drysdale 2007). Studies by Dee (2007) demonstrate that the benefits of broad reforms can be substantial—even exceeding the benefits of some types of trade liberalization. Regional cooperation is essential for achieving such harmonization—it can provide models of best practice; it can support policy choices that would be difficult to make in any one economy; and it can coordinate national decisions to build consistent regional frameworks.

Finally, on the global level, cooperation is needed on initiatives that help the region secure a major constructive role in global economic decision making. Asia's ongoing economic transformation is so rapid and extensive that it generates large impacts and a need for adjustment around the world. The management of these adjustments will ultimately require global cooperation—it cannot be resolved only within the region's individual economies, or even within the region as a whole. Asia's economies can best address this challenge by working together—that is, by undertaking adjustments within the region as well as encouraging complementary adjustments by countries outside it. Although Asia's major economies already play a prominent role in global economic affairs—and are committed to global integration—their influence can be amplified through regional cooperation. To be sure, it will be important to prevent the misperception that the goal of regional cooperation works against the global interest. Accordingly, the region needs to sustain—and, whenever possible, demonstrate—its continuing support for open global markets.

All of these objectives require that Asia achieve greater cohesion in its economic dealings within itself and with global institutions. While new initiatives in ASEAN and ASEAN+3 in the aftermath of the crisis gave Asia a sense of common purpose, these institutions have not yet acquired high policy impact. This is due to their early stage of development as well as the tendency for countries to act bilaterally (Soesastro 2007a). Platforms for generating and testing regional policy initiatives are just beginning to emerge. This is important: cementing the region's economic ties will ultimately require confident political cooperation as well as economic logic. Asia's economic progress will depend on the region's ability to continue to reduce political tensions both among its economies and with the rest of the world. Effective mechanisms of consultation and cooperation will be essential for achieving these goals.

7.2. Regionalism with Asian characteristics

Europe is generally seen as the benchmark for modern regionalism. From the Pan-European Movement of 1923 to the six signatories of the Treaty of Rome in 1957 through to today's 27-member EU and 15-member eurozone, European integration and cooperation has a long history of close interactions. It is the outcome of intensive political debate and compromise aimed to increase economic growth and prosperity through the systematic development of integrated trade, investment, fiscal, financial, and monetary arrangements. The European model has shown that, in a wide realm of areas, national sovereignty can be successfully ceded to regional institutions, with clear benefits to member countries.

But while Europe's experience provides some lessons for Asia's integration and cooperation, Asia is not Europe and circumstances have changed dramatically since 1957, when the European project began (Eichengreen 2007). Several differences stand out.

- Because economic integration intensified later in Asia than in Europe, it has emerged in the context of greater global interdependence. Asian economies are closely integrated with countries both inside and outside Asia and retain a critical stake in their global relationships.
- Financial cooperation in Asia is especially recent, with the first significant initiatives following the 1997/98 crisis. By that time, many Asian economies had well-developed ties with global financial markets. In contrast, capital markets in many European economies developed in parallel with regional cooperation.
- European regionalism began with a small group of economies at similar stages of development, and only gradually expanded to include more diverse ones. By contrast, Asia's market-led integration already connects a much more diverse set of economies.
- At critical stages in European regionalism, prominent national leaders—often in partnership with each other—played an important role in fostering cooperation. In Asia, cooperation has most often been stimulated by economic forces.
- While cooperation in Asia has focused primarily on economics, European integration has also involved political and social issues, with media and civil society playing a significant role.

European experience may provide helpful insights for Asia in these areas.

Thus, Asia's emerging regionalism reflects very different realities than Europe's. It needs to span considerably greater economic, political, and cultural diversity, and it needs to develop in the context of a far more globalized economy. Some of the economic issues addressed by Asia are similar to those that Europe faced, and Asia can derive valuable lessons from the European experience. Nevertheless, the scope, speed, sequencing, and style of Asian regionalism will naturally differ. In particular, as Box 7.1 explains, Europe's often

Box 7.1. Europe and Asia: contrasting approaches to regionalism

Europe's often supranational, rules-based structure does not sit comfortably with Asia's history, circumstances, and varying stages of development. Whereas building a united Europe is among the European Union's priorities, there is no appetite in Asia for creating a united Asia. While the Second World War delegitimized nationalism in Europe, in Asia it led to decolonization and the birth of new Asian nations. National autonomy is highly prized; nonintervention in others' sovereign affairs has been the rule.

Community method

Could Asia's limited tolerance for ceding national prerogatives stymie Asian regionalism? It would certainly be very difficult for Asia to adopt what in Europe is called the community method, the pooling of national sovereignty in certain areas within supranational regional entities. Conceivably, the Association of Southeast Asian Nations (ASEAN), the region's most established cooperative institution, and perhaps others might eventually accept specific rules-based requirements in certain economic areas. But since even ASEAN currently adopts a flexible approach depending on the development status of its members, a strict community method is not the way ahead for Asia at least for now.

Open coordination

But Asia, while maintaining its flexible approach, still needs some form of institutional development and there are alternative routes forward. The common institutions needed for integrated markets could, for instance, be established through incentive-compatible agreements on regulatory standards, which would allow for flexible participation of regional members. This open method of coordination—which involves an intergovernmental approach to regulation, guidelines, benchmarking, and peer pressure to achieve policy convergence—is also used in Europe and seems much more appropriate for Asia, given its diversity and economic circumstances. As countries interact more deeply—by creating wider free trade agreements, administering pooled regional reserves multilaterally, and developing regional credit rating agencies or harmonizing bond issuances—the momentum for standardization of the regulatory environment and even harmonizing regulations is likely to grow in Asia.

supranational approach, is inappropriate for Asia at least in the near future. Asian regionalism needs to be evaluated not by how closely it follows the European model, but by how appropriate and effective it is for Asia (and the world).

The Asian model

Asia's approach to regionalism is pragmatic and flexible. It is based on the principle of "variable geometry," which indicates a willingness do adapt the structure of cooperation to the priorities of different groups of members. Asian regionalism is thus multitrack and multispeed. It is based on a bottom-up approach that supports markets and subregional cooperation as the building blocks of an eventual broader, deeper, and more unified regional architecture.

Such a flexible and pragmatic approach is dictated by Asia's economic and political realities. As detailed in earlier chapters, some economies are much more open and economically advanced than others. Some have a long tradition of political stability; others have only just emerged from conflict. Some are more committed to regional cooperation than others—indeed, some have political regimes that strictly limit cross-border contact. The region's flexibility and pragmatism has many underappreciated advantages. It fosters experimentation with new approaches and healthy competition among them. It avoids costly and restrictive bureaucracy. It respects countries' differing needs and sensitivities. And it allows the region to remain open to newcomers and to the rest of the world. Regional cooperation is not an end in itself—and in many cases a flexible, pragmatic approach can deliver better results than a rigid, one-size-fits-all framework.

But following a model based only on flexibility and pragmatism has limitations. Governments may be reluctant to make commitments to regional institutions that do not generate early tangible results. They will also be more likely to negotiate bilaterally if they feel that regional cooperation is difficult—even if the benefits from regional initiatives are potentially greater. As a result, important regional objectives are less likely to be realized. Stronger mechanisms of cooperation are increasingly needed to manage Asia's expanding challenges and opportunities.

Asian cooperative arrangements

The scope of Asian cooperative arrangements is wide ranging. They stretch from subregional groups, such as the GMS, that focus on cross-border projects for infrastructure development, trade facilitation, and other focused initiatives, to transregional bodies, such as APEC and the Asia-Europe Meeting (ASEM). While their coverage varies, they tend to focus on trade, finance, macroeconomic policy, the environment, and energy. None involves supranational authorities; elements requiring formal or informal policy action remain extremely limited. While macroeconomic issues and policies are extensively discussed, there has so far been no formal cooperation in this domain.

The speed of integration varies across subregions and policy areas. Regionalism has advanced most in East Asia, but much less so in South or Central Asia, or across the Pacific islands. Within East Asia, integration is more advanced in trade and investment than in financial or monetary affairs. Integration is proceeding particularly fast in ASEAN ((Box 7.2), and more slowly outside East Asia. In South and Central Asia, for example, countries are only starting to focus on improving cross-border connectivity and stimulating trade integration.

The sequencing of integration also varies. While cooperation in Europe has scarcely been linear—it has been marked by long pauses followed by bursts of activity in many areas simultaneously—it broadly focused on trade integration first and monetary and financial integration later. But whereas many European economies maintained capital controls until the late 1980s—that is, for the first three decades of what has now become the EU—a majority of Asian economies already have relatively open capital accounts. Thus, Asian financial integration is occurring almost in tandem with—albeit more slowly than—trade integration.

Asia's regionalism is distinctive in other ways as well. The region's policy making style is pragmatic and cautious. Cooperation is aimed at making markets work better and is usually defined by specific initiatives and objectives. Intergovernmental dialogue at all levels has greatly increased, but formal regional institutions remain relatively underdeveloped. Yet there is wide recognition that the need for more effective institutions is growing—ASEAN, for example, has committed to increasing the capacity of its Secretariat along with implementing its new blueprint for establishing an ASEAN Economic Community.

Box 7.2. ASEAN: the hub for Asian integration?

The Association of Southeast Asian Nations (ASEAN) is well-placed to be the regional hub for closer economic cooperation within East Asia and beyond. It carries weight, but is not overwhelming—together, ASEAN's 10 member economies had, in 2007, a population of 576 million and a combined gross domestic product of almost $1.3 trillion, while their merchandise trade was worth about $1.8 trillion and they attracted more than $50 billion in inflows from foreign direct investment (FDI).

ASEAN is a reliable and equal Southeast Asian partner that is linked to many larger, more powerful economies and groups. Its economies helped anchor the launch of the Asia-Pacific Economic Cooperation (APEC), Asia-Europe Meeting (ASEM), and (later) ASEAN+3, and it is the coordinating point for the East Asian Summit (EAS). Cooperation within ASEAN is particularly advanced, and given its long experience in regional consultation and addressing common issues and concerns, ASEAN is a natural vehicle for consolidating regional cooperation in Asia—for instance, the creation of an Asia-wide free trade agreement (FTA).

Major developments

When it was founded with the Bangkok Declaration in 1967, ASEAN had five members—Indonesia, Malaysia, the Philippines, Singapore, and Thailand—whose goals were primarily political. ASEAN has since broadened its membership and widened its ambition by admitting five (generally poorer) new members—Brunei Darussalam, Cambodia, the Lao People's Democratic Republic, Myanmar, and Viet Nam. Instead of politics, ASEAN now focuses on economic and social objectives.

In 1992, members established the ASEAN Free Trade Area (AFTA), with a pledge to liberalize manufacturing trade within 15 years. AFTA's scope has since been widened and the pace of liberalization accelerated, albeit with some derogations for Cambodia, the Lao People's Democratic Republic, Myanmar, and Viet Nam. ASEAN has also made progress in cooperation on FDI—through one-stop investment centers; the ASEAN Investment Area; and trade facilitation, especially in customs cooperation.

In 2002, ASEAN heads of government agreed to create an ASEAN Economic Community by 2020. In early 2007 they advanced the deadline to 2015, and later that year signed the ASEAN Charter, while adopting a blueprint detailing steps for creating a single regional market and production base, as well as a region that is highly competitive, of equitable economic development, and fully integrated into the global economy.

In short, Asia's regional policy agenda is too broad and too complex to be handled by any single institution, especially given its vast economies and diverse interests. Asia's emerging regionalism is thus appropriately based on a flexible and pragmatic, multitrack, multispeed architecture that emphasizes the gradual intensification of cooperation: engagement in limited areas first, followed by the deepening and widening of the scope of cooperation. ASEAN, the most

A model for cooperation

ASEAN's experience provides an indication of how regional cooperation in Asia might deepen. While ASEAN has evolved greatly since its inception, its development has been gradual and pragmatic. While promoting regional links, it has avoided establishing a protectionist bloc. Conversely: its external barriers have declined (arguably, in part, due to the region's integration efforts). New members have joined despite wide political differences. ASEAN runs a relatively small but effective Secretariat, which is due to expand to manage the implementation of the ASEAN Economic Community.

ASEAN generally proceeds by unanimity. But it has also introduced an "ASEAN-minus-x" formula, whereby "x" countries (albeit always a small minority) could temporarily opt-out from complying with certain decisions or agreements that are particularly difficult or require a longer adjustment process. The initiative for ASEAN integration seeks to enhance growth with equity in the organization, accelerating the integration of the newer, poorer members.

The signing of the ASEAN Charter in Singapore in November 2007 is an important milestone. This shifts ASEAN's institutional framework from its traditional consensus-based approach toward a more rules-based one. Yet it remains sufficiently pragmatic, acknowledging that national economic development and national priorities vary, particularly between the original five ASEAN members and the newer, less-developed economies that joined in the past decade.

The Charter gives ASEAN a formal legal personality, establishes greater institutional accountability and a system for compliance, and commits ASEAN to an important role in the future of Asia-Pacific and East Asia integration. It calls for a people-oriented ASEAN, the establishment of an ASEAN human-rights body, and gives an enhanced role to the ASEAN Secretary-General and Secretariat. The Charter also provides a way to promote ASEAN to all of the region's people, and to build the concept of "ownership" across ASEAN borders.

While the future of Asian regionalism is highly fluid, ASEAN is likely to be central to it, and the progress ASEAN has already made provides some indication of how broader efforts might proceed.

established regional organization, is likely to form the hub of closer cooperation and it provides an insight into how Asian regionalism might develop more broadly. ASEAN can also serve to spin regional initiatives to wider groups, such as ASEAN+3 or EAS, and to favor the development of new regional institutions as Asian leaders find them appropriate to the regional integration process.

7.3. Emerging architecture of regional cooperation

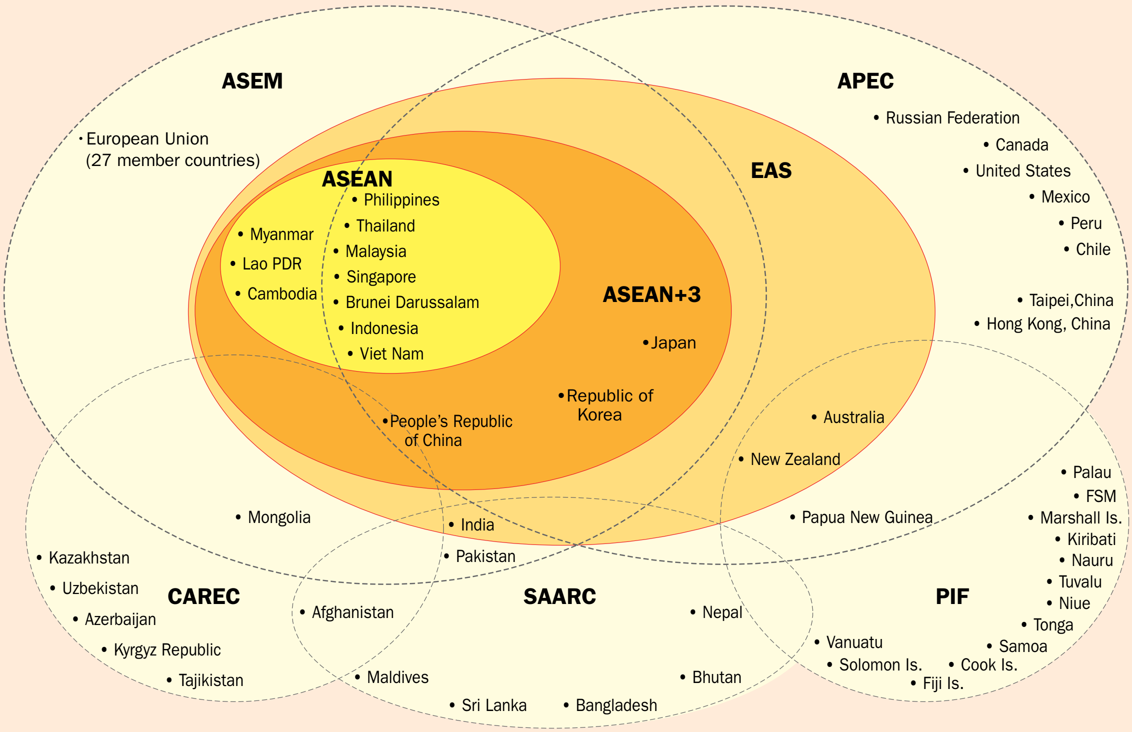
Asia's architecture of regional cooperation is broad, varied, and overlapping. Its principal forums involving Asian and non-Asian members are set out in Figure 7.1. They range widely in scope, from subregional institutions to ones that span continents. This diversity is consistent with and necessary for achieving the region's multiple policy objectives. For example, developing infrastructure to connect nearby communities through transport and energy links requires close subregional cooperation while ensuring that markets around the world remain open to each other requires dialogue in transregional and global institutions. The challenge is to maintain groups that are both effective and flexible while ensuring the coherence of their policy directions. While some institutional consolidation may be needed, overlap and competition among groups is not necessarily bad: it opens up options for addressing problems and encourages competing forums to become more effective (Drysdale 2007).

Moreover, an expanding network of forums, groups, and informal contacts brings the region's officials and business leaders together frequently. The overlapping memberships of the various core groups strengthen cooperation and spread ideas among them. As Figure 7.1 clearly indicates, ASEAN is central to this architecture, followed by ASEAN+3. But, as importantly, the people who meet and shape the dialogue in these forums also interact with policy makers in other, wider groups. These interactions among senior officials, trade ministers, finance ministers, central bank governors, and a wide range of other policy makers—who now meet through various groups almost monthly—is forging greater mutual understanding and stronger foundations for regional cooperative initiatives. And multiple forums provide a framework—if not yet explicit mechanisms—for achieving consistency among the region's many initiatives and varied partnerships.

Regional organizations for economic cooperation

The major groups involving Asian members are ASEAN, ASEAN+3, EAS, APEC, and ASEM (Table A7.1 in the appendix to this chapter provides a detailed list). ASEAN is furthest along the path toward integration, having established the ASEAN Free Trade Area (AFTA) and the ASEAN Investment Area, supported by economic partnership and cooperation agreements between ASEAN and each key non-

Figure 7.1. Economic architecture: regional and transregional forums



APEC = Asia-Pacific Economic Cooperation; ASEAN+3 = ASEAN plus three countries, as shown; ASEAN = Association of Southeast Asian Nations; ASEM = Asia-Europe Meeting; EAS = East Asia Summit; CAREC = Central Asia Regional Economic Cooperation; FSM = Federated States of Micronesia; Lao PDR = Lao People's Democratic Republic; PIF = Pacific Islands Forum; PRC = People's Republic of China; SAARC = South Asian Association for Regional Cooperation.
Notes:
ASEM includes also the European Commission as a member.
For CAREC, the PRC's membership is focused on the Xinjiang Uygur Autonomous Region.
Source: Asian Development Bank.

ASEAN economy in Integrating Asia. Given its history, scope, and institutional development, ASEAN remains the core of broader regional arrangements. It is integral to all of them and has a denser network of cooperative institutions, including a formal commitment to building an ASEAN Economic Community. While the approaches of individual members differ—some are less committed to the disciplines of regional association than others—all want to secure a role for ASEAN in any regional architecture. ASEAN is distinguished by its outward orientation toward the rest of Asia and the global economy. The larger ASEAN economies are among the most open economies in East Asia and the world (Armstrong, Drysdale, and Kalirajan 2008).

ASEAN+3 is a powerful extension of ASEAN: it includes the region's most dynamic economy (the PRC), its most advanced (Japan), and its largest newly industrialized economy (the Republic of Korea). ASEAN+3 was formally established in 1999 following the Asian crisis—the first informal leaders' summit was held in December 1997—and has created a dense network of regular meetings covering several broad-ranging areas of cooperation. It has also established several initiatives (as detailed in previous chapters) to boost economic monitoring and promote policy dialogues, enhance bilateral—and soon to be multilateral—reserve pooling (the CMI), promote the development of local currency bond markets (the Asian Bond Markets Initiative), and conduct research projects on economic cooperation and integration. ASEAN+3 is also considering the establishment of an East Asia Free Trade Agreement.

The final report in 2002 of the East Asia Study Group, commissioned by ASEAN+3, supported the creation of an East Asia Summit (EAS), defining it as "a desirable long-term objective… [as] part of an evolutionary process that builds on the substantive comfort levels of the existing ASEAN+3 framework." The EAS, which was started in 2005, also includes Australia, India, and New Zealand—hence it is sometimes called ASEAN+6. The EAS has concentrated so far on wider issues that could be categorized as regional or global public goods, such as issuing a declaration on climate change, energy, and the environment, as well as on East Asian energy security. The EAS is also discussing a free-trade agreement called the Comprehensive Economic Partnership in East Asia.

Other bodies stretch beyond the region. APEC, established in 1989, initially focused on economic issues, but has recently broadened its agenda to include human security issues. It engages North America, the Latin American countries of the Pacific Rim, and the Russian Federation, giving them a stake in this growing area of the world (Drysdale and Terada 2007). ASEM—which includes the EU, ASEAN+3, India, Pakistan, and Mongolia—meets for informal discussions on a range of economic and social issues.

The Executive Meeting of East Asia-Pacific central banks (EMEAP), comprises 11 of the region's monetary authorities[103] and is another vehicle for regional policy dialogue and financial cooperation.

[103] The 11 EMEAP members are the Reserve Bank of Australia, People's Bank of China, Hong Kong Monetary Authority, Bank Indonesia, Bank of Japan, Bank of Korea, Bank Negara Malaysia, Reserve Bank of New Zealand, Bangko Sentral ng Pilipinas, Monetary Authority of Singapore, and Bank of Thailand.

EMEAP's main achievement has been the launch of the Asian Bond Funds, which provide a catalyst for private investors to consider investment in Asian issues, particularly domestic currency bonds. EMEAP sits alongside these other arrangements but is not yet an integral part of them.

Intensifying regional cooperation in East Asia might gradually expand to include South Asia, and ultimately the formation of an Asian economic community, as advocated by Indian Prime Minister Manmohan Singh (2005). The regional strategies proposed in this report have been designed specifically to make it possible for economies new to the integration process to join the region's cooperative institutions. But this will necessarily be a gradual process that will ultimately depend on each subregion's pace of development and commitment to the open, outward-oriented policy strategies and economic reforms that are well entrenched in East Asia.

7.4. Toward closer cooperation

Asian regionalism is continually evolving. It will need to intensify as the region becomes more interdependent and as its global importance grows. Asia's rapid economic rise—notably that of giants such as the PRC and India— is having a huge impact on the world economy (Drysdale 2006). This will require large adjustments not only within Asia but also in the rest of the world. Smoothing this adjustment is in everyone's interests—and will require careful negotiation within Asia as well as with Asia's global partners. Clearly, Asia has a significant stake in keeping global markets open—and by acting together it will have greater leverage in global economic forums. The PRC, in particular, will have to assume a more prominent role in global economic affairs—and while its remarkable openness and engagement with Europe and North America stand it in good stead, close, strategic cooperation with its Asian partners—notably Japan, but also ASEAN and others—would help it negotiate these adjustments more effectively. As Asia's economic importance rises, it will also need to manage external pressures for greater exchange rate flexibility and coordinate reforms of the region's financial systems that will both facilitate these adjustments and channel regional savings to more productive investments.

Asia's powerful countries and centers of economic activity have many common priorities, but also differing ones. At times, the differences are amplified by history and politics. Regional cooperation

Box 7.3. Lessons for South Asia, Central Asia, and the Pacific

Measured by a number of yardsticks, East Asia is already a quite deeply integrated regional economy. And East Asian experience with deepening integration is of interest to other regions, such as South Asia, Central Asia, and the South Pacific, which are also pursuing closer economic integration.

The South Asian Association for Regional Cooperation (SAARC)—composed of Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka and founded in 1985—has so far focused principally on cooperation in agriculture, rural development, and health. The Central Asia Regional Cooperation Program (CAREC) —established in 1997 and including Afghanistan, Azerbaijan, the People's Republic of China (focusing on Xinjiang Uygur Autonomous Region), Kazakhstan, Kyrgyz Republic, Mongolia, Tajikistan, and Uzbekistan—promotes shared infrastructure projects and the improvement of the policy environment in priority areas, such as transport, energy, and trade. The Pacific Islands Forum (PIF), which comprises 16 self-governing islands, has developed the Pacific Plan, which covers areas ranging from fisheries to air transport safety.

Lessons

What can South Asia, Central Asia, or the South Pacific learn from East Asia (Chandra and Kumar 2007). In ASEAN and East Asia generally, economic development is a common and dominant political goal. The lesson for other Asian regions is that the primacy of proceeding with joint economic goals need not be derailed by political differences. Rather, ongoing dialogue on regional economic cooperation can set a positive tone for discussing and even settling political disputes. It ensures an informal avenue for political contact always exists, as these issues can be broached on the sidelines of meetings on economic cooperation.

East Asia continues to pursue an "open regionalism" approach that stresses efficient competition in global markets and promotes the least discriminatory component with nonmember countries. But while the inward-looking "Fortress Asia" mindset has no appeal in East Asia, it remains strong in South Asia. The agreement on a South Asia Free Trade Area, for instance, involves large negative lists, tariff concessions on only a limited number of products, and restrictive rules of origin requirements, while excluding services and issues such as border charges, fees, and other nontariff barriers.

India's role

India could take on a greater role in fostering economic cooperation in South Asia. Given its growing economic strength, it could start by working within the SAARC framework toward open regionalism. India could also act as an important conduit for connecting South Asia to the rest of Asia, especially East Asia. And it could play an active role in integrating its northeastern region—which has lagged behind the rest of the country economically—with neighboring countries, following the model set by the Greater Mekong Subregion.

may also entail the loss of some national autonomy and the narrowing of policy options for pursuing purely national objectives. It is understandably difficult for large, successful, and independent economies to make such compromises and ultimately to pool some sovereignty through regional institutions.

Asia's trademark flexibility and pragmatism respond to this political challenge. Flexibility and pragmatism also enable newcomers to regional integration to develop relationships in line with their capabilities. Smaller developing economies that are not yet fully integrated into the region—in Central, South Asia, or the Pacific islands—often have the most to gain from internalizing the lessons of Asian dynamism. Joining regional and global production networks could dramatically raise their productivity, employment, and output levels. As the requirements and implications of integration are better understood, potential newcomers to integration can adopt vigorously outward-oriented policies to take advantage of existing cooperative structures and institutions.

Box 7.3 provides a closer look at the implications of the region's cooperative structure for economies that are not yet full-fledged members of Integrating Asia. The lessons outlined there have important implications for national policies to help accelerate integration, and for subregional policies that can build foundations for joining the region's wider cooperative mechanisms.

Against this background, cooperation is gradually deepening, as countries realize the benefits of concerted action and gain confidence in the processes of joint decision making. Different groups of countries are progressing at various speeds, as they develop frameworks to address subsets of policy interests. Suitable institutions for regional cooperation in Asia will reflect the complexity of relationships between countries, given the great diversity across the region and the differing roads to autonomy.

Elements of intensified cooperation

Ultimately, intensified cooperation will require stronger institutions and greater focus and coherence. The process of institutional development can be decomposed into several incremental stages, as suggested by de Brouwer, Ramayandi, and Turvey (2006):

- discussion of national, regional, and global economic issues and policy responses to a changing economic and strategic environment;
- informal or ad hoc cooperative action on national economic policies to ensure regional or global consistency;

- binding or contractual cooperative setting of national economic policies at the regional level; and
- unified economic policy making at a regional level to determine policy outcomes including at the national level.

The first stage describes transregional forums such as APEC and ASEM, whose activities are focused primarily on information sharing and discussion. APEC has committed to creating an open trade and investment regime in the Asia and Pacific region (the so-called "Bogor" goals), but it relies on voluntary, unilateral policy actions and operates on the basis of "non-binding commitments, open dialogue, and equal respect for the views of all participants" (APEC 2008). ASEM is also an informal, general platform for political, economic, and cultural exchange.

The second stage roughly applies to the ASEAN+3 group and the newer EAS. These forums seek to articulate national views in a coordinated manner and have adopted formal cooperative initiatives (such as the ABMI or CMI) or are studying new ones (such as the East Asia Free Trade Agreement or Comprehensive Economic Partnership in East Asia, for example).

The third stage is exemplified by ASEAN, which has formal agreements (including the ASEAN Free Trade Area), a commitment to establish regional communities focused on economic, security, and social and cultural issues, and now also a separate legal identity through its Charter.

The fourth stage of cooperation—supranational institutions—has no counterpart in Asia today. While some types of joint decision making could emerge, given the region's diversity, there is likely to be very limited interest in yielding sovereignty to supranational entities in the intermediate future.

Nevertheless, as Asia's cooperative challenges expand, more institutions will be needed at higher stages on this ladder. This could be accomplished by the gradual strengthening of existing institutions, or by the creation of new ones. In general, deeper cooperation will require the streamlining and deepening of existing mechanisms, as well as institutional innovation.

It will be useful to strengthen the functions and capacity of existing institutions of collaboration to increase the focus and accountability of the region's cooperative efforts. For example, as Chapters 3 suggests, there would be value in concentrating dispersed negotiations on trade policies into a common framework, and in making sure that the region's future trade agreements are compatible with each other and so can be more readily rationalized. More explicit and comprehensive templates and procedures may be adopted in current cooperative mechanisms, as suggested in Chapter 5 in the case of macroeconomic surveillance under the economic review and policy dialogue process. It could mean expanding the resources and staffing of institutions that are overburdened by expanding responsibilities.

It will also be desirable to create some new mechanisms and institutions that would deepen cooperation. For example, the Economic Research Institute for ASEAN and East Asia has recently been created to provide essential intellectual foundations for cooperation and the coordination of development policies in ASEAN and the East Asian region. An Asian Financial Stability Dialogue could be created to bring together the principal agencies involved in managing financial markets (Chapter 4). An Asian Secretariat for Economic Cooperation could also be introduced to provide adequate professional expertise for addressing macroeconomic and financial issues and developing effective response mechanisms to shocks and crises (Chapter 5).

Maintaining the multitrack structure

Although there are important benefits to be gained from strengthening Asia's institutions, there are also good reasons to make sure that they remain lean, carefully structured to achieve stated purposes, and limited in authority. In other words, even as the region's institutional structure deepens, intergovernmental consultation and national decision making will likely remain the central feature of Asian cooperation.

Because the structure of regional cooperation in Asia remains very fluid, proposing firm assignments of institutional functions is premature. Nevertheless, as the detailed arguments of this study suggest, new institutions such as an Asian Financial Stability Forum or an Asian Secretariat for Economic Cooperation may be useful to strengthen Asia's integration. The cooperation process may naturally build on the ASEAN+3 structure, which benefits from a well-established working mechanism. ASEAN+3 is organized around ASEAN—which has the most experience with cooperation and operates the most advanced regional institutions. ASEAN+3 includes Asia's three large economies (the PRC, Japan, and the Republic of Korea) as the plus 3 members.

But Asian cooperation should not end there. Wider processes can be developed and structures for wider participation supported by, for example, the EAS or other frameworks. Asian cooperation should involve strong complementary relationships with each other, due to unique histories and expertise for addressing different aspects of regional dialogue. This argues not only for maintaining multiple regional arrangements, but also for establishing close connections among them. Stronger cooperative mechanisms and greater coordination among them will be essential both for improving the effectiveness of regional initiatives and for maintaining their coherence.

The benefits of cooperation on multiple tracks could be substantial. In addition to ASEAN+3, which has proven quite effective in financial and macroeconomic policy dialogue, for example, ASEAN will be an especially useful proving ground for more advanced forms of regional cooperation. It will become an increasingly effective hub as it pursues deeper integration itself, following the recent adoption of the ASEAN Charter and the ASEAN Economic Community Blueprint (Kawai, 2007c). The GMS framework, on the other hand, could provide an ideal laboratory for sharply focused cooperative efforts in areas such as coordinated cross-border infrastructure development and initiatives for fighting poverty. The EAS, in turn, may prove to be an effective forum for addressing broad issues such as the environment, climate change, and energy security. And given their broad memberships, APEC and ASEM could be especially effective in addressing transregional cooperation. APEC and ASEM could also play useful roles in policy dialogue on domestic regulatory approaches and in ensuring that the region's expanding global role is effectively managed. These multiple tracks offer effective solutions to varied challenges; they also provide a natural way to extend the benefits of cooperation to economies in early stages of integration with the region.

In the final analysis, however, political considerations will shape the region's institutional development. But Asia's economics and politics are interdependent, even if they are not always aligned. Economic interests shape political positions, much as political will affects economic outcomes. Closer economic cooperation within Asia will provide a stronger framework for managing the economic adjustments within the region. Closer cooperation will make it easier to manage the region's complex, expanding interactions with the world economy. As long as the economic benefits of regional integration are substantial, political solutions remain possible.

The perception survey conducted for this study (see Box 1.1 in Chapter 1) confirms that the region's opinion leaders welcome regional engagement and are optimistic that political hurdles can be overcome (Capannelli 2008). Asia's approach emanates from—and neatly accommodates—its diversity. The approach allows countries to retain a great deal of independence and control over their internal affairs, yet fosters a sense of community—in essence, mutual trust and confidence—that is the foundation of lasting peace and stability. As emerging Asian regionalism develops and intensifies, its diversity will continue to be its strength.

Chapter 7: appendix

Table A7.1. Major economic cooperation groups in Asia and the Pacific

Name, Year established	Membership	
Asia Cooperation Dialogue (ACD) 2002	Bahrain, Bangladesh, Brunei Darussalam, Bhutan, Cambodia, People's Republic of China (PRC), India, Indonesia, Iran, Japan, Kazakhstan, Republic of Korea, Kuwait, Lao People's Democratic Republic (Lao PDR), Malaysia, Mongolia, Myanmar, Oman, Pakistan, Philippines, Qatar, Russian Federation, Saudi Arabia, Singapore, Sri Lanka, Tajikistan, Thailand, United Arab Emirates, Uzbekistan, and Viet Nam.	
Asia-Pacific Economic Cooperation (APEC) 1989	Australia; Brunei Darussalam; Canada; Chile; PRC; Hong Kong, China; Indonesia; Japan; Malaysia; Mexico; New Zealand; Papua New Guinea; Peru; Philippines; Republic of Korea; Russian Federation; Singapore; Taipei,China; Thailand; United States; and Viet Nam.	
Asia-Europe Meeting (ASEM) 1996	Members of the Association of Southeast Asian Nations (ASEAN), European Union, and European Commission plus PRC, India, Japan, Republic of Korea, Mongolia, and Pakistan.	
Association of Southeast Asian Nations (ASEAN) 1967	Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Thailand, Singapore, and Viet Nam.	
ASEAN Plus Three (ASEAN+3) 1997	ASEAN members plus PRC, Japan, and Republic of Korea.	
Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC) 1997	Bangladesh, Bhutan, India, Myanmar, Nepal, Sri Lanka, and Thailand.	

Areas of focus	Major initiatives
• Technology • Tourism • Trade and investment • Money and finance • Energy • Health and education • Politics • Agriculture	• Annual ministerial meetings • Projects in 19 areas involving cooperation between various members • Think tank (symposium and network) to support ACD projects
• Business facilitation • Economic and technical cooperation • Trade and investment liberalization	• Bogor goals of “free and open trade and investment” • APEC Business Travel Card • Best practices for regional trade agreements and free trade agreements • Declaration on Climate Change, Energy Security and Clean Development
• Cultural and intellectual issues • Financial and social reform • Political issues • Trade and investment barriers	• Asia-Europe Cooperation Framework • Asia-Europe Foundation • Trans-Eurasian Information Network
• Economic cooperation • Trade and investment • Regional security • Sociocultural exchange	• Treaty of Amity and Cooperation in Southeast Asia • ASEAN Free Trade Area • ASEAN Economic Community • ASEAN Security Community • ASEAN Social and Cultural Community
• Finance • Macroeconomics	• Economic Review and Policy Dialogue • Chiang Mai Initiative • Asian Bond Markets Initiative • Research Group
• Transport • Tourism • Trade and investment • Energy • Health • Agriculture	• Link South and Southeast Asia • Commitment to liberalize trade by 2012 (3 members) • Plan for free trade pact by 2017

Table A7.1. continued.

Name, Year established	Membership	
Brunei Darussalam-Indonesia-Malaysia-Philippines–East ASEAN Growth Area (BIMP-EAGA) 1994	Brunei Darussalam plus provinces of Indonesia, Malaysia, and Philippines.	
Central Asia Regional Economic Cooperation (CAREC) 1997	Afghanistan, Azerbaijan, PRC provinces, Kazakhstan, Kyrgyz Republic, Mongolia, Tajikistan, and Uzbekistan.	
East Asia Summit (EAS) 2005	ASEAN members, Australia, PRC, India, Japan, Republic of Korea, and New Zealand.	
Greater Mekong Subregion (GMS) 1992	Cambodia, two provinces of PRC, Lao PDR, Myanmar, Thailand, and Viet Nam.	
Indonesia-Malaysia-Thailand Growth Triangle (IMT-GT) 1993	Provinces in Indonesia, Malaysia, and Thailand.	
Pacific Islands Forum (PIF) 1971	Australia, Cook Islands, Federated States of Micronesia, Fiji Islands, Kiribati, Nauru, New Zealand, Niue, Palau, Papua New Guinea, Marshall Islands, Samoa, Solomon Islands, Tonga, Tuvalu, and Vanuatu.	
Shanghai Cooperation Organisation (SCO) 2001	PRC, Kazakhstan, Kyrgyz Republic, Russian Federation, Tajikistan, and Uzbekistan.	
South Asian Association for Regional Cooperation (SAARC) 1985	Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka.	

Areas of focus	Major initiatives
• Agro-industry • Environment • Tourism • Transportation	• Roadmap to Development (2006–2010) • Agreements on air transport, other transport, trade facilitation, and tourism
• Energy • Trade facilitation • Trade policy • Transport	• Comprehensive Action Plan (CAP 2006) • Transport and Trade Facilitation Strategy • CAREC Institute
• Economic community • Energy and environment • Trade and finance	• Declaration on Climate Change, Energy and the Environment • Declaration on East Asian Energy Security
• Agriculture • Environment • Human resource development • Tourism • Trade and investment • Transport, energy, telecommunications	• East-West Economic Corridor • Ten-Year Strategic Framework
• Agriculture and fisheries • Environment • Human resource development • Tourism • Trade and investment • Infrastructure	• IMT-GT Roadmap to promote trade and investments, agriculture, agro-industry, tourism, infrastructure, human resource development, mobility of labor, and natural resource management • Joint tourism promotion
• Energy • Information and communication technology • Transport	• Pacific Agreement on Closer Economic Relations • Pacific Aviation and Safety Office • Pacific Island Countries Trade Agreement
• Political issues • Culture and education • Energy and transport • Environment protection • Science and technology • Trade and economy	• Action plan on implementation of the program for multilateral trade and economic cooperation • Regional Antiterrorist Structure • SCO Business Council and Interbank Consortium
• Agriculture and rural development • Environment and forestry • Health and population • Human resource development • Science, technology, and meteorology • Transport • Women, youth, and children	• SAARC Development Fund • South Asian Free Trade Area

KOMUNITAS ASIA
Komunidad ng Asyano
CỘNG ĐỒNG CHÂU Á
HỘI NHẬP KHU VỰC
Regional Integration
การรวมตัวทางภูมิภาค
Masyarakat Asia
Serantau Integrasi
สะมาຄົມອາຊີ
Masyarakat Asia
Pag-uugnayang Panrehiyon
Asian Community
Integrasi Regional
Masyarakat Asia
Integrasi Regional
Asian Community
एशियाई समुदाय
Serantau Integrasi
Komunitas Asia
ประชาคมเอเชีย
Serantau Integrasi
ประชาคมเอเชีย
Integrasi Regional
Integrasi Regional
Serantau Integrasi
Integrasi Regional
Masyarakat Asia
Komunitas Asia
地域一体化
아시아 공동체

Chapter 8

The way forward

Asia's remarkable rise is reshaping the world economy—and especially relations among the region's economies. Outward-oriented development, once aimed primarily at export markets elsewhere, is now knitting Asia together. This has far-reaching implications—in the face of both adverse developments, such as the financial contagion of the 1997/98 crisis, and constructive ones, such as the rise of regional production networks and the growing role of Asian demand in smoothing global business cycles. Regional economic integration is proceeding rapidly, not only due to Asia's growing importance, but also because structural changes are helping to deepen the region's economic and social ties. This market-driven integration is also increasingly supported by cooperation among the region's governments.

Regional integration has not weakened Asia's global connections—rather, as this study details, Asia's trade with the rest of the world remains strong. For most Asian economies, macroeconomic interdependence has increased both within the region and with the world. The global reach of companies in the region continues to widen. Every other day, it seems, new products and services are joining established Asian brands to become household names across the world. Eye-catching Asian investments dominate the news in some of the world's wealthiest markets—and help to build infrastructure and accelerate development in some of its poorest. At the same time, Asia is welcoming an unprecedented wave of outside investment. As was noted at the outset, Asian is emerging as the center of the world economy, and is ever more strongly connected to it.

8.1. A new type of regionalism

As this study shows, Asian regionalism defies conventional expectations. In Asia, regional and global integration are not substitute—they complement each other. Asian economic integration is deliberately outward-looking—it enhances the productivity and competitiveness of the region as a whole, in a global context. Asia faces important challenges in preserving its dynamism, maintaining a favorable global environment for its growth, and making its development more inclusive and sustainable. Regional cooperation, this study argues, will help Asia address these challenges and build more stable and enduring foundations for growth. Overall, Asian regionalism will benefit both Asia and the world by helping to smoothen global business cycles, stimulating innovation and productivity, reducing poverty in the region and outside it, and complementing and supporting global economic institutions.

The form of Asian regionalism is also unique. It involves wide-ranging intergovernmental consultations, but relatively few formal institutions. Compared to Europe, Asia is "institution light." However, measuring the development of Asian regionalism by non-Asian standards—as even regional observers sometimes do—can be misleading. Cooperation in Asia is based on deepening relationships, predominantly driven by markets rather than political agreements. Concerted unilateral action, even if only some countries in the region agree to it, has been remarkably effective in opening markets and facilitating trade; investment; financial deepening; cross-border capital flows; and, increasingly, labor flows too. Asia's integration is market-friendly, multitrack and multispeed—and healthily pragmatic.

While national economic institutions and policies continue to play a key role in Asia's economic success, regional initiatives increasingly complement them. ASEAN, the post-crisis ASEAN+3 framework, and the relatively new EAS reflect the broad regional dimensions of this process. At the same time, several of these institutions—among which there is some healthy competition—are beginning to get stronger. For example, ASEAN has recently made a major commitment to accelerate its integration and strengthen its secretariat, as it builds an ASEAN Economic Community. Overall, the approach is step-by-step and bottom-up, rather than a comprehensive project guided by a pan-Asian vision, or grand plan, for integration.

Subregional cooperation—a logical starting point, given the region's diversity and wide gaps in economic development—is also increasing. Each subregion has different needs, so the scope and pace of such cooperation varies. Some subregional bodies focus on a few areas; others pursue a more comprehensive agenda. As subregional cooperation develops, bridges naturally form, leading eventually to wider and more comprehensive cooperation and integration across Asia.

8.2. An agenda for cooperation

An important aim of this study has been to set out criteria for judging when collective action is needed. Some issues identified in public dialogue—such as the regional sourcing of production inputs in a competitive market—do not require regional cooperation, except of course the removal of impediments to business operations and the free flow of goods and services. Even among problems that require government involvement, relatively few require regional—rather than national or global—policy action.

But given the rapid growth of Asian economic interdependence, opportunities for cooperation are rising, even when judged by the most rigorous economic standards. Some priorities for cooperation include:

- providing new regional public goods, such as mechanisms to head off epidemics; resources to address financial crises; and rules to enable countries to integrate financial, goods, and services markets;
- managing spillovers among economies resulting from closer macroeconomic relations, greater capital and labor flows, and environmental degradation;
- exercising Asia's influence in global economic forums to help sustain open and competitive global markets;
- liberalizing trade and investment beyond levels achievable through global negotiations; and
- adding value to national policy making, notably by sharing the best practices and highlighting priorities that may be opposed by domestic special interests—such as measures to enhance competition and regulatory oversight, reduce poverty and inequality, and control environmental externalities.

These criteria give rise to a substantial agenda for collective action (Table 8.1). Important findings emerge in each of the study's five principal areas of analysis—and these are reviewed in the following section.

Table 8.1. Enhancing Asian regionalism: An agenda for collective action

Themes	Building an Asian Economic Community: the way forward	
	Priorities	**Policy solutions**
Integrating production	• Enhance investment in and the productivity of regional economies • Strengthen comparative advantage derived from integrated regional production chains • Promote technological upgrading and development of a knowledge economy	• Support the global trading system • Pursue regional cooperation as widely and deeply as possible • Develop guidelines for best practices in subregional trade agreements • Enhance regional connectivity
Integrating financial markets	• Increase resilience against financial crises • Develop larger, deeper regional financial markets • Improve returns for investors and reduce capital costs to firms by strengthening the regional intermediation of savings	• Improve financial market surveillance and create an "Asian Financial Stability Dialogue" • Promote consistent standards and mutual recognition • Strengthen financial markets (especially including local currency bond markets) and their infrastructure • Liberalize capital accounts and cross-border financial services prudently
Managing macroeconomic interdependence	• Increase macroeconomic and exchange rate stability • Smoothen global economic adjustments, including reallocation of the region's external savings to regional demand • Increase investment and growth in slower-growing economies	• Make macroeconomic consultation and surveillance more effective by creating an Asian Secretariat for Economic Cooperation • Strengthen Asia's short-term financing facility (Chiang Mai Initiative) • Cooperate in exchange rate and macroeconomic policy management
Making growth inclusive and sustainable	• Reduce poverty and income disparities • Improve social safety nets and provide support for the aged • Fight epidemics and mitigate the impact of disasters • Address environmental issues	• Connect the poor to the thriving regional economy • Develop cost-effective social protection systems • Facilitate and manage labor migration • Protect regional health and safety • Make development sustainable

Source: Asian Development Bank.

Integrating production

Asia's economic growth and the new economics of production networks are the principal driving forces behind regional integration, and make coherent regional policies especially important. The spread of subregional and bilateral trade negotiations reflects widespread interest in regional cooperation, but such agreements are inevitably partial, and could even turn out to be counterproductive. This study argues that Asia has a vital stake in maintaining open markets that help to accommodate the global impact of its growth and that help to build truly integrated regional markets. Asia can achieve these goals with policies that:

- **Support the open global trading system**. Asia's continued success depends on an open, rules-based global system of trade and investment. The region should help lead the world in successfully concluding the Doha round and maintaining a framework strongly consistent with that of the WTO.
- **Pursue regional cooperation as widely and deeply as possible**. Asia's bilateral and subregional free trade agreements should be gradually absorbed into a deep, open, and region-wide trade and investment framework.
- **Provide guidelines for subregional trade policies and agreements**. Guidelines could help to ensure that subregional trade agreements recognize regional interests and prioritize sectors, such as agriculture, that have beneficial distributional effects.
- **Enhance regional connectivity**. The region needs world-class infrastructure—transport, communications, and energy systems—to connect its economies, and in particular to link its poorer economies and subregions to its economic centers.

Integrating financial markets

Asia has made impressive progress since the crisis in strengthening its national financial systems and building connections among them. Nevertheless, Asian financial markets remain relatively underdeveloped and are more closely linked to global markets than to each other. This study argues that effective regional financial cooperation could help Asia build larger, deeper, and more open financial markets. These goals can be achieved with policies that

- **Improve financial market surveillance**. A new, high-level "Asian Financial Stability Dialogue" is needed to bring together all authorities responsible for financial markets and regulation, to help support the development and stability of Asian financial markets.
- **Promote consistent standards and mutual recognition**. The region should identify best-practice policies to help countries improve prudential norms and financial supervision, as well

as minimum standards to facilitate mutual recognition, at least among subsets of economies.

- **Strengthen financial markets and infrastructure**. Official initiatives, such as the Asian Bond Markets Initiative and Asian Bond Fund, and a new regional infrastructure for credit enhancements, payments and settlements, and information exchange could promote deeper markets.
- **Liberalize capital accounts and cross-border financial-services flows prudently**. The integration of regional financial markets could be accelerated though measured and prudent liberalization of flows of capital and financial services.

Managing macroeconomic interdependence

The 1997/98 crisis highlighted the urgency of regional macroeconomic and financial cooperation. Since then, Asia's macroeconomic links have strengthened, although formal policy coordination has been limited. New mechanisms include currency swap agreements —the Chiang Mai Initiative (CMI)—and specialized forums for consultation on macroeconomic policy: ASEAN+3's economic review and policy dialogue (ERPD). At the same time, many Asian economies have been building large external reserves, and the region faces potentially large adjustments as the current global payments imbalances unwind. To meet these and other potential challenges, Asia's macroeconomic cooperation needs greater focus and a deeper institutional structure. These goals can be achieved with policies that:

- **Strengthen macroeconomic consultation and surveillance**. The region should consider establishing an "Asian Secretariat for Economic Cooperation" with qualified, permanent staff, to support the ERPD process, the CMI, and other mechanisms.
- **Enhance Asia's short-term financing facility**. The CMI would become more effective if its swaps were multilateral and its rules permitted more rapid activation. The Asian Secretariat could oversee CMI resources and manage the activation process.
- **Cooperate in exchange rate and macroeconomic policy management**. Cooperation could begin to intensify with understandings on the conduct of macroeconomic and exchange rate policy, and coordinated ad hoc actions in, for example, currency adjustments.

Making growth inclusive and sustainable

Economic policies that benefit a broad cross-section of the population need to be supplemented with policies that focus on opportunities for groups who fall behind. This study finds that poverty and exclusion can be reduced with labor market and infrastructure investment policies, with improved social safety nets, and with increased labor migration and better conditions for migrants. Concerted regional efforts are also needed to manage the negative side effects of development, including rising threats to health, safety, and the environment. These goals argue for initiatives that

- **Connect the poor to the thriving regional economy**. Relevant policies include eliminating regulatory, social, and geographical barriers in labor markets; promoting trade in sectors with a strong impact on poverty; and investing in infrastructure to link poor populations to economic centers.
- **Develop cost-effective social protection systems**. New technologies and policy instruments are making it increasingly affordable to provide cost-effective social insurance.
- **Facilitate and manage labor migration**. Labor migration can benefit both sending and receiving countries, and complementary policies can control its social side effects and ensure that migrants enjoy basic rights and are treated with dignity.
- **Protect regional health and safety**. Densely populated and closely integrated Asia needs world-class systems to monitor, prevent, and contain epidemics. Such regional "public goods" are critical for disease prevention and disaster management.
- **Make development sustainable**. Regional cooperation can help to mobilize Asian and non-Asian resources and technologies to limit environmental degradation and tackle cross-border environmental issues.

Creating an architecture for cooperation

The case for regional cooperation is compelling, but its agenda is complex and wide-ranging. Asia's distinctive architecture of cooperation is gradual, flexible, multitrack, and multispeed—and is well-suited to the region's diversity. Short of major new shocks, Asia's architecture is likely to evolve step-by-step, with an emphasis on practical results. This evolution can be supported by policies that

- **Maintain a multitrack, multispeed architecture**. The region's cooperative efforts are best served by mechanisms that enable any group of countries, economies, or territories to join the integration process, while providing options for building deeper partnerships.
- **Strengthen institutional support**. An Asian Secretariat for Economic Cooperation (as proposed in Chapter 5), and other institutions should be established, as necessary, to provide consistent and highly professional support for regional integration.
- **Sharpen the focus and coherence of regional and global forums**. Asia needs to project a coherent voice in global institutions as well as regionally, and its cooperative forums need to work together to help implement regional objectives.

8.3. The challenge of leadership

Gradual, bottom-up cooperation has economic and political advantages; it also has risks, including possible inconsistencies among initiatives and slower progress than might be possible with a top-down approach. Which forces will generate momentum and pressure for deep and ambitious integration? Three groups of actors could: political leaders, regional institutions, and civil society. Ideally, all would play active roles in the "public diplomacy" of regional cooperation.

Political leaders are at the center of regional cooperation: they set its goals and implement its decisions. At the highest levels of government, the importance of regional cooperation is well accepted—Asian leaders have repeatedly and eloquently confirmed their commitment to work together. But they will need effective mechanisms to translate this intent into pragmatic results. The regional economy and regional cooperation initiatives are vital to most Asian economies. It is in each government's interest to prioritize national policy work that supports regional collective action, to appoint talented officials to lead it, and to empower them to use regional platforms creatively and wisely.

Institutions of regional cooperation are a second vital source of ideas and energy. The people who lead regional forums and manage nascent regional institutions are particularly knowledgeable about the challenges and opportunities of regional cooperation. With time and resources, they can provide insight into what should be done and how best to do it. But Asia's relatively undeveloped regional institutions and cooperative mechanisms operate with very limited resources, often with staff members on short, temporary assignments from their governments. This makes it difficult to chart and pursue a well-defined, long-term strategy. Greater capabilities for planning and implementation could yield large benefits by helping to guide regional collaboration, as ASEAN has recently concluded. It has accordingly committed to strengthening the capacity of its Secretariat to oversee the implementation of the new ASEAN Blueprint.

Knowledge-generating institutions outside the official sphere can play an especially vital role. Ideas matter. Unlike governments, the region's think tanks and universities are ideally structured to conduct research and offer advice: they can focus on issues in depth, and over time. They are well-positioned to guide integration—provided they work closely with governments to ensure that their research addresses timely questions and receives high-level attention. The region greatly needs strong institutions and networks for policy analysis. It already has many (discussed in Box 8.1); they should be fully engaged in crafting the regional cooperation agenda. New institutions may also need to be established as gaps are identified

Last and most important, civil society needs to participate in and vigorously champion regional integration. Our survey suggests that opinion leaders throughout the region welcome international cooperation. All groups seem to share this perspective, including business executives; professionals in other fields; leaders of nongovernment organizations; experts in universities, laboratories, and research institutes; and political and economic analysts in the media. Their cross-border collaborations and friendships represent a key source of information and ideas on regional issues, and are vital to the future of regional cooperation. By fostering such contacts at all levels—through professional, academic, and cultural exchanges—countries can build powerful foundations for mutual understanding and cooperation.

Asian integration does not lack champions. Its energy comes from political leaders, business and other professionals, academic experts, and public intellectuals—representing many viewpoints and segments of society. The challenge for governments is to make space for the leadership of this broad coalition, to provide forums where its voice can be heard, and to make sure that its impact is felt in the pursuit of the integration agenda.

Box 8.1. Engaging the region's brain trust

Regional economic integration and cooperation is a knowledge-intensive process, requiring careful policy analysis. Asia has outstanding institutions to support this effort, including public, semi-public, and private organizations. To be sure, their contributions will need to be effectively focused, most likely by governments and intergovernmental forums. Large benefits can be reaped by drawing on these resources in the integration process, as regionalism requires the insights and support of Asia's economic and political leaders. Eventually, the work may need to be complemented by new organizations linked to specific regional policy institutions.

Research institutes

Most Asian countries have significant relevant capabilities in their major research institutes (some public, some private, some in between), of which at least one is typically focused on international economic issues. These institutes have begun to organize through regional networks—such as the Asian Policy Forum, the East Asian Bureau of Economic Research, and the Network of East Asian Think Tanks—in order to share ideas and research.

Universities

Asia is now home to many of the world's leading research universities. They too are joining regional networks, such as the Association of East Asian Research Universities and the ASEAN University Network. Their faculties and students represent exceptional assets for analyzing and debating regionalism. Programs that involve leading centers of learning can bring powerful intellectual resources to bear on the subject of regionalism, and can help mobilize future leaders for the long-term project of building a regional community.

Business and nongovernment organizations

Business organizations, such as the ASEAN Business Advisory Council (the business arm of ASEAN) and many other regional business groups and nongovernment organizations can provide connections with the companies and communities directly affected by regional initiatives. Their participation in shaping the regional agenda will help to ensure that policies reflect the priorities of civil society, and that regionalism is positively received by the people whom it is intended to serve.

International organizations

Several global organizations have significant resources committed to analyzing the region. These include the International Monetary Fund (IMF), the Organisation for Economic Cooperation and Development (OECD), the World Bank, the agencies of the United Nations, and regional institutions such as the Asian Development Bank (ADB) and the Economic and Social Commission for the Asia Pacific (ESCAP). ADB's new long-term strategic framework, for example, identifies regional integration as one of ADB's priority areas of research and lending. These institutions have substantial expertise for project-oriented efforts, but could also play a sustained professional role in supporting regional forums and institutions.

8.4. A partnership for shared prosperity

It is easier, in some ways, to envision an integrated Asia many decades from now than to describe the more pragmatic and limited goals that might be reached by 2020. In the longer run, Asia is likely to have a single market subject to common regulations, a common currency, and substantial freedom of movement for workers—in other words, an environment not so different from that of the EU today. Asia is well placed to reap enormous benefits from the great diversity of its economies and peoples; its deep cultural heritage; the vast scale of its financial, technical, and other resources; and its joint ability to manage economic, social, environmental, and other threats. It will offer unrivaled opportunities for innovation, entrepreneurship, and commerce. And it will help subdue the political rivalries that could otherwise threaten stability.

A long-term vision can provide inspiration and offer guidance on the direction of change. But to inform immediate policy, the vision must be translated into steps that can—and should—be achieved in the near and medium term. The vision that motivates these steps has to be pragmatic. It must consist of realistic initiatives that show early, step-by-step results. This report has identified important options. By pursuing some of these, by 2020 Asia could have

- an integrated market free of restrictions on regional flows of goods, services, and capital;
- deep and liquid financial markets open to cross-border financial flows and services, with high standards of oversight and strong protection for national and foreign investors;
- effective frameworks to coordinate macroeconomic and exchange rate policies, taking into account global challenges and differing national circumstances;
- collective efforts to address vital social issues, such as poverty, exclusion, income insecurity, migration, ageing, health, and environmental threats;
- a consistent voice to project the concerns of Asian economies in global policy forums and enhance responsible global governance; and
- vital institutions, adequately and highly professionally staffed, to provide first-rate analytical and logistical support for these efforts.

The goals are challenging but achievable. Some should receive earlier attention than others; cooperation to ensure financial stability and the smooth adjustment to global imbalances are especially urgent.

Each step toward regional integration will require innovation, leadership, and support from major economies. Asia is poised to take these steps: its economies are sound and enjoy good relations with each other and other global centers. Appropriately, it is becoming more confident about the potential of Asian regionalism to contribute to both Asian and global welfare. All of this favors the emergence of a strong, prosperous, outward-looking Asian economic community, regionally integrated yet connected with global markets, and with responsibility and influence to match its economic importance. In short, emerging Asian regionalism is a partnership that can ensure the region's continued, peaceful progress, and help power its shared prosperity and that of the global economy.

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