

# Cautionary Notes on Asian Economic Integration<sup>1</sup>

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## Introduction

Economic integration and cooperation in Asia has traditionally been more market-driven and institution-lite. The Asian Financial Crisis (AFC) in 1997/98 and the Great Recession in 2008 changed that. As the number of Free Trade Agreement (FTA) in Asia increases, intraregional trade has intensified and it continues to grow. In the financial side, the cross-border holding of financial assets is still low but began to expand especially since 2008. In this short manuscript I will first evaluate Asia's integration in trade and financial sector before looking at the progress of regional cooperation. I will then provide my critical assessment on the concept of regional integration and cooperation.

## Trade Integration

Trade integration has progressed significantly in Asia driven mainly by market forces. The emergence of cross-border production networks and China's rise as a manufacturing and export base further strengthened the integration.<sup>2</sup> The proliferation of FTAs, especially after the AFC, also contributes to the process. But for long it has been the unilateral liberalization policies that have played a major role in Asia. Then came the Lehman collapse in 2008. This changed the world's economic landscape. The impact of a sharp fall in world trade during the crisis was particularly severe in export-oriented economies such as Japan, Korea, PRC, Malaysia, Singapore, and Thailand. Industrial countries including the US are important markets for their final goods exports; Asia's

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<sup>1</sup> Materials for discussions at the ADBI Annual Conference 2011, "Reform of the International Monetary System," December 2, 2011, Tokyo.

<sup>2</sup> The production network has also played an important role in forging the region's productivity.

intraregional trade was mainly in intermediate goods. Production network emerged strongly along with such a trade pattern.

With the declining role of the United States and the European Union's preoccupation with its own financial crisis and unification process, it would be ill-advised for Asia to continue relying on markets in these countries for their final goods exports. With the falling demand from the slow-growing industrial countries, intraregional trade in final goods is expected to increase. Recent data after 2007 confirm this (Table 1).

Table 1

Shares of East Asia trade partners (%) to individual country's total exports

	East Asia			US			eurozone			Other Emerging and Developing Economies			Rest of the World		
	2001	2007	2011M2	2001	2007	2011M2	2001	2007	2011M2	2001	2007	2011M2	2001	2007	2011M2
BRU	79.25	74.85	77.52	11.55	5.35	0.73	0.15	0.08	0.04	0.72	3.67	0.15	8.32	16.06	21.56
CAM	9.39	13.21	16.66	63.67	58.15	43.79	14.27	14.94	16.26	0.55	1.64	3.52	12.11	12.07	19.77
PRC	47.17	37.28	30.06	19.95	18.70	20.28	12.11	14.80	16.50	11.94	19.59	20.48	8.83	9.63	12.68
HKG	50.77	61.39	67.94	22.05	13.65	8.25	10.00	9.39	7.24	6.43	6.66	9.18	10.74	8.91	7.39
INO	54.89	58.93	58.74	13.19	9.71	9.30	10.55	9.38	8.75	10.51	14.43	15.49	10.87	7.55	7.71
JPN	37.17	44.11	50.45	28.56	19.13	14.53	11.91	10.44	8.35	8.63	13.09	13.48	13.72	13.23	13.19
KOR	42.68	46.52	47.67	19.88	11.80	9.99	10.38	10.33	6.83	16.58	22.04	25.02	10.48	9.30	10.50
LAO	42.52	62.13	76.88	0.96	1.42	1.36	25.76	7.98	4.35	0.88	1.00	0.45	29.87	27.47	16.96
MAL	52.99	53.67	61.19	19.27	15.09	8.98	10.30	9.83	7.88	7.59	12.28	12.31	9.85	9.13	9.64
MYA	47.07	65.30	67.68	17.18	0.00	0.00	11.09	5.21	2.98	16.36	24.56	26.38	8.30	4.94	2.97
PHI	47.21	58.66	65.39	25.40	16.30	13.21	14.56	14.92	8.68	2.08	3.30	4.52	10.75	6.81	8.20
SIN	53.00	60.77	61.02	14.96	8.75	5.89	10.95	7.36	6.93	9.36	11.57	15.93	11.73	11.56	10.22
TAP	52.54	52.33	52.23	17.06	12.09	9.33	9.93	7.72	7.33	11.22	19.87	22.84	9.26	7.99	8.27
THA	47.76	51.73	54.38	19.68	12.33	9.89	11.62	9.70	7.31	8.54	14.20	16.17	12.41	12.05	12.25
VIE	49.36	41.76	38.30	6.89	20.37	19.70	15.50	13.75	16.36	7.31	6.02	9.59	20.93	18.10	16.04
EAST ASIA	45.97	46.94	46.43	21.67	15.73	14.08	11.26	11.34	10.82	9.81	15.59	17.28	11.30	10.40	11.39

Source: processed by ARIC-ADB

Notice the opposite trend of the relative share of Asian trade with other Asian countries and other emerging market economies (increasing) viz the Asian trade with the US and EU (declining). In these kind of circumstances, freer trade among Asian countries (and other emerging market economies) is a reasonable solution that will simultaneously lower the global imbalances. It is therefore important for the region to dismantle any

barriers to intraregional trade. Here, the proliferation of FTAs among Asian countries is helpful.<sup>3</sup>

No less important is the stability of intraregional exchange rates. Evidence has shown that stable intraregional rates can help foster intraregional trade.<sup>4</sup> But external forces can bring more volatility. The second round of quantitative easing (QE2) by the US Federal Reserve aimed at preventing a possible deflationary spiral at a time of fiscal policy paralysis, is adding more pressures for capital to flow out from the US. Even before QE2 the interest rates in the US and other industrial countries were already low, triggering a wave of capital outflows where a substantial amount of them flowed into emerging Asia with its high returns, robust growth, stable macroeconomic conditions, and strong currencies. This brings me to the topic of financial integration.

### **Financial Integration**

The extent of financial integration in Asia remains limited (even more so when countries in South Asia is included). Asian economies have closer financial linkages with developed countries rather than among themselves, although intraregional financial flows began to increase after the Great Recession in 2008.

Based on the intraregional correlation matrix for stock and bonds, it is revealed that from the pre to post AFC the intraregional correlation of most ASEAN countries' stock market increased except for Indonesia. The correlation is relatively high during the post AFC especially between the Philippines and Vietnam, between Indonesia and Singapore, and between Malaysia and Singapore (there is also a strong correlation with India). In the case of ASEAN-China, the highest correlation is with Vietnam, although it is also not insignificant with Singapore and Indonesia. After 2008 the region's stock market correlation increases, as most extra regional market became less attractive and

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<sup>3</sup> Although some agreements that cover all Asia are still elusive, and in some cases the pace of implementation remains questionable.

<sup>4</sup> After Lehman's collapse, interregional rates started to become more volatile and intraregional trade fell. It is also important to note that greater intraregional exchange rate stability can also help reduce policy tension. It is, however, to the region's advantage if flexibility of their currencies against non-regional currencies is maintained. The flexibility is important for managing external shocks and further capital flows.

some even went into difficulty. In the case of bonds market, the intraregional correlation is weaker.

Another indicator often used to proxy financial integration is the correlation of real interest rates. Here too shows that Asia is hardly integrated. The correlation coefficients are either small or negative. One of the sources of negative correlation is the fact that in some small countries (e.g., Myanmar, Lao PDR) the real interest rates have been negative given the relatively high inflation rate. By 2009, however, the real interest rates in all countries (except Myanmar due to lack of data) turned positive, although the monetary policy integration in the region continues to be low.

Some analysts may evaluate the regional financial integration from different perspectives, i.e., looking at the cross-border holding of financial assets. Using this indicator, equity investment among Asian countries (including India) increased from 10.6 to 23.8 percent from 2001 to 2009 (Tables 2 and 3). US investors invested about 22.1 percent of its equity investment in Asia, while EU-15 invested around 11 percent in 2009.

Among investors in Asia, those in Indonesia, Singapore, Malaysia and Korea are the most regional-bias in equity investment, although with the exception of Singapore the cross-border investment has been concentrated in only few countries; i.e., Indonesia-India, Malaysia-Singapore-Hong Kong, China, and Korea-China-Hong Kong, China. A significant increase of investment by regional investors has taken place in India, jumping from less than half a billion to almost US\$27 billion. Singaporean investors have been particularly attracted to the Indian market, although Indonesian investors began to follow suit.

In terms of debt investment, the increase of cross-border asset holding from 2001 to 2009 was much smaller, from 4.2 to 5.6 percent, of which short-term debt account for a larger share than the long-term ones. The lack of regional bias is clearest in the case of Japanese investors, who invested only 1 percent of their total debt portfolio investment

in Asia, while Korean investors about 5 percent, down from 21 percent in 2001 (see Tables 4 and 5). By 2009, investors from Thailand are the most regional bias with respect to debt investment. Their exposure in Asia is roughly 78 percent, mostly in Korea. Malaysia is ranked the second (36 percent). Meanwhile, US and EU15 investors' investment in Asian debt market is small, less than their equity investment (the majority of this is in Japan).<sup>5</sup>

Table 2

Asia Cross Border Equity Securities Investments (in million USD)

Investment from:											end-2001		
Investment in:	Hong Kong, China	India	Indonesia	Japan	Korea, Republic of	Malaysia	Philippines	Singapore	Thailand	Total Asia	United States	EU 15	Total value of investment
China, P.R.	5,449	---	---	789	15	8	---	1,035	4	7,301	2,370	3,083	13,236
Hong Kong, China	---	---	11	4,848	100	47	---	3,125	6	8,138	30,154	34,368	79,869
India	---	---	---	31	---	1	---	218	---	250	6,897	5,492	13,376
Indonesia	---	---	---	50	13	44	---	307	15	428	1,526	1,164	3,590
Japan	2,145	---	2	---	101	7	---	1,536	1	3,793	170,714	125,796	332,338
Korea, Republic of	1,311	---	---	381	---	8	---	1,034	---	2,735	29,537	15,408	51,869
Malaysia	604	---	---	339	124	---	---	5,295	---	6,361	2,578	3,168	12,882
Philippines	60	---	---	213	3	61	---	420	1	758	1,344	579	3,447
Singapore	1,403	---	2	924	1	461	2	---	8	2,801	21,376	9,223	36,185
Taipei, China	1,486	---	---	394	---	6	---	987	1	2,875	19,607	13,609	39,023
Thailand	488	---	---	290	20	15	1	1,520	---	2,334	1,916	3,088	7,791
Vietnam	---	---	---	1	6	10	---	25	3	46	---	13	85
<b>Total Asia (A)</b>	<b>12,946</b>	<b>---</b>	<b>16</b>	<b>8,260</b>	<b>385</b>	<b>668</b>	<b>4</b>	<b>15,503</b>	<b>39</b>	<b>37,819</b>	<b>288,019</b>	<b>214,988</b>	<b>593,753</b>
<b>Total value of investment (B)</b>	<b>94,815</b>	<b>---</b>	<b>17</b>	<b>227,351</b>	<b>1,300</b>	<b>1,332</b>	<b>111</b>	<b>31,319</b>	<b>82</b>	<b>356,126</b>	<b>1,612,667</b>	<b>2,447,492</b>	<b>5,196,439</b>
<b>Ratio of A to B</b>	<b>13.7</b>	<b>---</b>	<b>95.3</b>	<b>3.6</b>	<b>29.6</b>	<b>50.1</b>	<b>3.2</b>	<b>49.5</b>	<b>47.6</b>	<b>10.6</b>	<b>17.9</b>	<b>8.8</b>	<b>11.4</b>
United States	11,458	---	---	123,511	454	68	92	6,034	14	---	---	590,374	1,026,731
EU 15	28,827	---	1	69,924	163	55	14	5,271	8	---	843,404	1,383,516	2,637,863

Source: Author's calculation based on data from IMF, Coordinated Portfolio Investments Survey

Notes: The data are derived from the creditor side for both assets and liabilities

--- Indicates a zero value or a value less than US\$ 500,000

.... Indicates an unavailable datum

(p) Indicates preliminary data

(e) Indicates that a non-zero datum was not disclosed for reasons of confidentiality

<sup>5</sup> Broken down into short-term and long-term debt, most cross border debt within the region is short-term, where Thailand's investment in Korea continues to dominate. Over the years (2001-2009) this short-term debt market has jumped from US\$9.5 million to US\$29 million. Even investors in EU-15 started to enter the Asian short-term debt market, although in general the non-Asian investors still hold more longer-term debt in Asia. Singaporean investors who are attracted to the Indian market also opted more for long-term debt.

Table

## Asia Cross Border Equity Securities Investments (in million USD)

Investment from:											end-2009		
Investment in:	Hong Kong, China	India	Indonesia	Japan	Korea, Republic of	Malaysia	Philippines	Singapore	Thailand	Total Asia	United States	EU 15	Total value of investment
China, P.R.	134,279	29	--	12,600	12,559	240	(c)	15,788	58	175,554	101,616	75,181	382,138
Hong Kong, China	--	79	9	15,055	6,791	2,246	--	12,888	121	37,190	91,391	85,363	238,279
India	971	--	759	4,432	3,372	53	(c)	16,921	--	26,509	62,045	47,891	279,587
Indonesia	192	6	--	663	245	482	(c)	2,908	19	4,515	15,467	12,362	44,738
Japan	5,763	--	1	--	2,574	110	--	15,210	12	23,669	370,860	245,310	730,572
Korea, Republic of	1,841	31	--	4,508	--	540	--	5,585	1	13,486	87,915	72,679	191,990
Malaysia	889	1	2	587	208	--	--	5,898	8	7,592	12,133	10,348	37,446
Philippines	213	--	--	163	72	16	--	604	2	1,069	6,110	3,301	11,592
Singapore	3,983	14	7	6,081	663	2,251	(c)	--	244	13,225	45,424	30,735	103,316
Taipei, China	3,553	19	--	2,900	469	778	(c)	3,375	--	11,094	76,631	54,521	150,112
Thailand	621	5	39	1,054	181	230	2	3,026	--	5,157	12,962	14,324	43,923
Vietnam	43	--	--	22	522	685	--	235	11	1,517	176	481	2,563
<b>Total Asia (A)</b>	<b>152,348</b>	<b>184</b>	<b>817</b>	<b>48,045</b>	<b>27,857</b>	<b>7,630</b>	<b>2</b>	<b>83,418</b>	<b>476</b>	<b>320,577</b>	<b>882,720</b>	<b>652,497</b>	<b>2,216,256</b>
<b>Total value of investment (B)</b>	<b>498,880</b>	<b>1,327</b>	<b>952</b>	<b>594,069</b>	<b>76,889</b>	<b>20,150</b>	<b>26</b>	<b>153,639</b>	<b>3,323</b>	<b>1,349,156</b>	<b>3,995,298</b>	<b>5,923,127</b>	<b>13,683,551</b>
<b>Ratio of A to B</b>	<b>30.5</b>	<b>13.9</b>	<b>95.9</b>	<b>8.1</b>	<b>36.0</b>	<b>37.9</b>	<b>6.4</b>	<b>54.3</b>	<b>14.3</b>	<b>23.8</b>	<b>22.1</b>	<b>11.0</b>	<b>16.2</b>
United States	18,501	291	12	230,339	19,738	4,965	10	24,252	483	298,591	--	1,057,552	2,037,013
EU 15	80,776	739	17	154,399	15,039	2,191	12	19,822	1,264	274,258	1,525,034	3,162,361	5,861,078

Source: Author's calculation based on data from IMF, Coordinated Portfolio Investments Survey

Notes: The data are derived from the creditor side for both assets and liabilities

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Table 4

## Asia Cross Border Debt Securities Investments (in million USD)

Investment from:											end-2001		
Investment in:	Hong Kong, China	India	Indonesia	Japan	Korea, Republic of	Malaysia	Philippines	Singapore	Thailand	Total Asia	United States	EU 15	Total value of investment
China, P.R.	2,967	--	--	880	142	--	--	412	--	4,401	634	1,412	7,029
Hong Kong, China	--	--	96	1,268	306	28	25	1,622	119	3,464	1,893	9,717	16,809
India	--	--	--	166	66	6	--	266	--	504	301	834	2,009
Indonesia	--	--	--	108	63	8	3	560	--	741	315	422	1,957
Japan	7,103	--	1	--	75	15	5	9,014	--	16,213	27,125	75,170	209,707
Korea, Republic of	3,789	--	--	5,454	--	3	7	2,182	--	11,433	4,938	7,360	24,920
Malaysia	1,817	--	2	2,200	329	--	9	1,591	--	5,947	1,680	1,733	9,705
Philippines	1,179	--	--	1,347	106	41	--	761	--	3,435	2,671	1,926	9,304
Singapore	1,282	--	38	1,209	151	10	59	--	98	2,847	1,442	8,151	14,508
Taipei, China	609	--	--	82	8	15	13	340	--	1,066	253	677	2,074
Thailand	659	--	--	748	159	21	--	841	--	2,429	782	765	4,217
Vietnam	--	--	--	30	15	--	--	--	--	45	21	37	106
<b>Total Asia (A)</b>	<b>19,405</b>	<b>--</b>	<b>137</b>	<b>13,432</b>	<b>1,419</b>	<b>147</b>	<b>121</b>	<b>17,588</b>	<b>217</b>	<b>52,526</b>	<b>42,055</b>	<b>108,205</b>	<b>302,348</b>
<b>Total value of investment (B)</b>	<b>110,385</b>	<b>--</b>	<b>701</b>	<b>1,062,403</b>	<b>6,735</b>	<b>947</b>	<b>2,024</b>	<b>73,923</b>	<b>743</b>	<b>1,258,460</b>	<b>690,936</b>	<b>3,555,740</b>	<b>7,515,934</b>
<b>Ratio of A to B</b>	<b>17.5</b>	<b>--</b>	<b>19.5</b>	<b>1.3</b>	<b>21.1</b>	<b>15.5</b>	<b>6.0</b>	<b>23.8</b>	<b>29.2</b>	<b>4.2</b>	<b>6.1</b>	<b>3.0</b>	<b>4.0</b>
United States	27,795	--	249	366,689	3,309	140	1,752	11,977	278	412,190	--	628,935	2,074,148
EU 15	22,685	--	214	427,855	1,017	490	61	28,436	198	480,936	360,185	2,218,666	3,670,376

Source: Author's calculation based on data from IMF, Coordinated Portfolio Investments Survey

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Table 5

## Asia Cross Border Debt Securities Investments (in million USD)

Investment from:											end-2009		
Investment in:	Hong Kong, China	India	Indonesia	Japan	Korea, Republic of	Malaysia	Philippines	Singapore	Thailand	Total Asia	United States	EU 15	Total value of investment
China, P.R.	16,956	--	--	521	150	--	--	1,537	--	19,165	687	4,906	26,591
Hong Kong, China	--	--	140	1,401	385	100	76	3,724	184	6,009	1,495	3,185	12,819
India	5,563	--	87	739	81	104	--	6,281	34	12,889	3,450	11,888	35,613
Indonesia	325	--	--	1,792	166	69	--	6,950	10	9,312	7,274	8,520	26,822
Japan	12,221	--	151	--	212	--	106	7,709	90	20,489	34,271	197,105	466,436
Korea, Republic of	15,582	--	10	8,484	--	1,296	183	17,835	15,120	58,509	16,911	33,817	117,039
Malaysia	4,232	--	5	2,509	130	--	56	5,481	201	12,615	6,784	11,788	32,198
Philippines	703	--	6	1,477	56	196	--	1,481	29	3,948	3,216	5,973	17,609
Singapore	3,909	--	436	3,987	102	636	--	--	86	9,155	6,680	9,259	29,526
Taiwan Province of China	1,424	--	--	11	--	1	--	1,721	--	3,156	227	2,715	6,243
Thailand	443	--	--	717	74	104	18	1,317	--	2,674	1,260	1,690	6,133
Vietnam	279	--	--	33	2	2	--	210	1	527	243	847	1,663
<b>Total Asia (A)</b>	<b>61,637</b>	<b>--</b>	<b>834</b>	<b>21,671</b>	<b>1,358</b>	<b>2,507</b>	<b>439</b>	<b>54,247</b>	<b>15,756</b>	<b>158,448</b>	<b>82,498</b>	<b>291,673</b>	<b>778,694</b>
<b>Total value of investment (B)</b>	<b>311,901</b>	<b>39</b>	<b>3,844</b>	<b>2,251,825</b>	<b>25,483</b>	<b>6,904</b>	<b>4,969</b>	<b>193,386</b>	<b>20,087</b>	<b>2,818,437</b>	<b>1,957,569</b>	<b>12,602,537</b>	<b>23,478,876</b>
<b>Ratio of Asia to Total</b>	<b>19.8</b>	<b>--</b>	<b>21.7</b>	<b>1.0</b>	<b>5.3</b>	<b>36.3</b>	<b>8.8</b>	<b>28.1</b>	<b>78.4</b>	<b>5.6</b>	<b>4.2</b>	<b>2.3</b>	<b>3.3</b>
United States	73,896	--	458	689,007	13,027	1,046	2,305	41,378	1,516	822,633	--	1,852,424	5,270,884
EU 15	95,499	16	1,203	829,481	5,374	870	461	66,878	1,285	1,001,067	936,102	8,763,623	13,094,479

Source: Author's calculation based on data from IMF, Coordinated Portfolio Investments Survey

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Why is there a lack of regional bias? What are the most critical criteria that regional investors use in their investment decision? As far as non-Asian investors are concerned, the decision to invest in the Asian debt market has been influenced more by the "pull" factors especially returns and repayment capacity, followed by financial and trade openness, rather than the "push" factors (e.g., diversification). For the Asian investors, we have conducted a survey in 6 Asian countries, the results of which are similar, that is, the primary reason why Asian investors invest outside home country's bond market is to improve overall returns. Lowering portfolio risks is in far second - almost tying with the motivation for diversification (Table 6).<sup>6</sup>

<sup>6</sup> 12 out of 23 respondents have robust decisions; 4 are sensitive to legal factors; 6 are sensitive to trading barriers, and 2 are sensitive to governance. Fund managers of treasury assets of the 4 largest banks (in terms of bank assets) in the Philippines argued that they will invest outside the country if it would decrease risk exposure of the portfolio. Second largest fund manager of TRUST assets in PH will invest outside to diversify portfolio because of mandate. Also important to note, to most investors economic/political stability is a more important than the state of financial market. Under investment factors, liquidity is regarded as the top priority, a similar conclusion as in Garcia-Herrero, Wooldridge and

Table 6. Results of the AHP-Based Field Survey

Priorities with respect to:	
Economic/Political Stability	0.638
Financial Market	0.362
Priorities with respect to:	
Liquidity	0.340
Risk-Return Profile	0.242
Investment Opportunity	0.181
Asset Correlation	0.119
Market Size	0.118
Priorities with respect to:	
Trading Barriers	0.341
Openness	0.297
Legal	0.218
Governance	0.144
Overall Inconsistency	0.115
Return	0.438
Risk	0.284
Diversification	0.279

## Regional Cooperation

Coincidentally or not, Asia's stronger integration in trade than in finance has been in line with the fact that regional cooperation in trade is ahead and having a longer history than cooperation in finance. Quite numerous things have been proposed, tried, and implemented in regional trade cooperation. What the region may now need to shift to is the "second generation" of cooperation that focuses on behind-the-border barriers (institutional or regulatory deficiencies, protection to sensitive sectors etc). This is more difficult than the "first generation" cooperation (dealing with tariff-related issues) because it is more sensitive to domestic political affairs. It is important to note, however, that we have to be more careful in contrasting the Westphalian idea of government

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Yang (2009). The risk-return profile for portfolios is second, availability of investment opportunities is third, asset correlation is fourth, and only after those factors investors consider market size to be a factor to consider. Among structural issues, trading barriers are the primary considerations in deciding whether to pursue a regional investment or not, openness (capital controls) is second, legal/regulatory environment (tax treatment for foreign investors) is third, and governance is the last.



defining sovereignty, as strongly held by most Asian countries in many regional agreements, with the 'celebrated' concept of regional cooperation. I will discuss further this issue in the next section.

It is the regional cooperation in financial sector that is lack behind, yet increasingly more important in Asia given what happens in the current global economic sphere. Let me begin with the background. Disappointed with the IMF-driven policy during the AFC in 1997, a number of countries initiated regional cooperation to deal with future crisis. The early proposal to set up an Asian Monetary Fund (AMF) was shelved because of the rejection of the United States and the IMF who argued that it would be an unnecessary duplication since the IMF can continue functioning as a lender of last resort through its Supplementary Reserve Facility (SRF) and Contingent Credit Line (CCL). The counter-argument, however, pointed to the fact that the severity of Asian crisis required fast and large amount of disbursement of liquidity support that put serious constraints on the IMF to act in a timely manner with sufficient financial resources.<sup>7</sup>

The episode, however, did not stop governments in the region from pursuing its efforts to strengthen the cooperation. In May 2000, they declared the Chiang Mai Initiative (CMI) that effectively expanded the swap arrangements among ASEAN countries to include Japan, PRC and Korea (hence the term ASEAN+3).<sup>8</sup> Intended to focus on closer cooperation and concrete regional financial arrangement, the proposal stipulated the importance of regional surveillance and monitoring, particularly of capital flows, and the need to complete a network of Bilateral Swap Arrangements (BSA) that would provide liquidity support for member countries when needed. Although the name Asian Monetary Fund was no longer used in order to avoid a further conflict, all the above components are essentially similar to what constitutes the IMF's standard tasks. Following intense discussions, Finance Ministers and Central Bank Governors of

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<sup>7</sup> A case in point was the far too small supplementary support from the IMF to Thailand and Indonesia during the 1997 crisis. The disbursement of financial support was also not timely, because it was done in several tranches. See Azis, I.J (2009), *Crisis, Complexity and Conflict*, Emerald-London

<sup>8</sup> The Association of Southeast Asian Nations (ASEAN) was founded on Aug. 8, 1967. It is geo-political and economic organization of 10 countries located in Southeast Asia. The latest important effort by ASEAN that will affect the economic integration among member countries is to establish the ASEAN Economic Community (AEC), intended to integrate member countries' economies by 2015.

ASEAN+3 and the Monetary Authority of Hong Kong, China declared that the expanded CMI, which is called the Chiang Mai Initiative Multilateralization (CMIM), became effective in March 2010. For crisis prevention, they stressed the importance of enhancing market confidence by raising the committed amount within the CMIM framework (currently \$ 120 billion), and to collaborate with the IMF particularly on the surveillance work.<sup>9</sup> As the new crisis prevention mechanism will apply only for member countries with strong policy track records, questions were raised how to deal with those countries that would not be qualified for it. The difference of designs between the IMF's traditional Stand-By Arrangements (SBA) and the Flexible Credit Line (FCL) was also highlighted, where the latter may help overcome the IMF stigma which remains widespread throughout the region.

On April 2010, ASEAN+3 finance ministers agreed to establish an independent regional surveillance unit, ASEAN+3 Macroeconomic Research Office (AMRO) to monitor macroeconomic and financial conditions, to detect emerging vulnerabilities, and to support the CMIM decision-making. Not meant to replace the IMF, this Singapore-based office can and will play a crucial role for the future of CMIM, as long as it is credible, competent, and independent. The effectiveness of CMIM also depends on whether the AMRO can perform the regional surveillance work effectively.

Another important development in regional cooperation is the establishment of Asian Bond Market Initiative (ABMI). Through this Initiative the ASEAN+3 officials intend to develop and integrate the region's bond markets where the underlying objective is to promote the utilization of the region's savings for investment within the region and the resilience of the economies to external shocks. The ABMI has contributed to the remarkable growth and development of the region's bond markets since its inception in 2003 and is expected to further contribute to their integration. There are currently discussions about expanding the Initiative beyond bond markets to include stock

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<sup>9</sup> Under the current arrangements, a country can draw up to 20% of its quota for up to six months without being subjected to IMF conditionality. Some argued that this may discourage member countries to use the facility, and therefore it is now under review.

markets, essentially scaling up ABMI to ACMI (Asian Capital Market Initiative), despite concerns over a possible duplication of the efforts.

Within the context of ABMI, Credit Guarantee and Investment Facility (CGIF) was set up in May 2010 as a trust fund of ADB with an initial capital of US\$700 million (the ADB contributes \$130 million as paid in capital). The main function of the CGIF is to provide credit enhancement to allow the region's marginal issuers to issue local currency bonds and larger issuers to issue across national border by overcoming the sovereign credit ceiling. In the future, the CGIF could develop further as an investment facility. CGIF is expected to be operational in early 2012

Recently, ASEAN+3 finance ministers have endorsed to study three possible areas for future cooperation; i) infrastructure financing, ii) disaster risk insurance, and iii) using local currencies for the regional trade settlement. Infrastructure financing was discussed in the ASEAN+3 working group meeting on 14 September this year (a seminar on the issue is planned to be held in November), while Japan's Ministry of Finance (JMOF) will organize discussions on disaster risk insurance in October. The issue of regional trade settlement is planned to be held in Korea also this year. One of the sticking issues on infrastructure is about financing; either to increase the resources for multilateral financial institutions to provide significantly larger lending for infrastructure, or to establish a new mechanism to channel resources for infrastructure development.

Next is cooperation in macroeconomic affairs. With spillovers from national policies (e.g., capital controls of various forms to respond to increased capital flows and current global economic problems) and the growing interdependence among region's economies, the next step for regional cooperation could possibly be in macroeconomic policy. Given the potential spillover effects and externalities of any unilateral policy, Asia can benefit from a stronger mechanism of macroeconomic monitoring, information sharing, and even in policy cooperation. One of the emerging issues that increasingly needs coordination and cooperation is on maintaining exchange rate stability, particularly the stability of intraregional exchange rate to support the intra-Asian trade.

This will also be consistent with the rebalancing efforts as stressed by the G20. The modality of cooperation, however, remains to be explored.

Following the collapse of Lehman, capital inflows into Asia surged, exerting strong pressure on exchange rates to appreciate. The resulting dollar depreciation and Asian currencies' appreciation led many countries to respond by either imposing capital controls or conducting exchange rate intervention. This makes efforts to maintain stability of intraregional exchange rates more difficult, but at the same time it opens up the possibility of policy coordination. Indeed, some countries in ASEAN+3 have initiated a series of discussions and policy dialogues on this issue.<sup>10</sup> The phenomenon of a sudden stop (as happened in 1997) is another source of concern.

But the difficulty in finding an acceptable modality of cooperation due to the diversity of exchange regimes and associated political sensitivity may have put off any formal arrangement from emerging. A classic case of the prisoner's dilemma thus prevails. Indeed, since the nature of cooperation in Asia has been traditionally institution-lite, and individual countries always tend to put a huge weight on the value of national sovereignty, cooperation began only informally through dialogues and discussions among policy makers, allowing mutual understanding about the potential spillover effects of national policies. Only after greater trust among member countries is established, a deeper form of cooperation can be pursued. There is a whole spectrum of options to select, ranging from a basket system that can be designed to avoid the "N-1" problem, to Bretton Woods-like systems where countries directly peg their currencies to each other and let them float jointly against other currencies, say, the US dollar. The latter is similar to what happened in Europe before a common currency was adopted and managed by a supranational body, the ECB. The rates against a regional basket (e.g., the Asian Monetary Unit, AMU) as a reference zone can also be considered, where certain deviations from it will trigger some policy measures.

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<sup>10</sup> Because the PRC's trade balance with most ASEAN countries is in deficit, a scenario of simultaneous exchange rate adjustment through cooperation will also make the realignment of the Chinese Yuan easier. It may be more effective than pressuring a country to adopt a particular exchange system.

Asia is likely to shy away from a strong form of cooperation or other forms that require strong institutions such as monetary union or common currency. The current sovereign debt crisis in Europe made the benefit of having such arrangements more doubtful. Asia also does not have a good track record of institution-heavy economic cooperation.<sup>11</sup> An alternative approach maybe to assess policies that have been taken by governments throughout the region before offering alternative cooperative policies. Building on the region's recent experience of capital controls to deal with massive inflows of capital and realizing the political sensitivity of the issue, member countries can then gradually move to more formal exchange rate cooperation.

### **Critical Assessment**

I want to end this manuscript with my critical assessment on the concept of regional integration. Is deeper integration desirable? I would argue that it's not always. We often heard an assertion about the benefits of integration especially when a new agenda of regional cooperation to strengthen integration is being promoted, e.g., risk sharing, locked-in domestic reform, positive spillover, ease of market penetration, division of labor, etc.<sup>12</sup> What is missing in the analysis is the systematic evaluation of the risks that often arise. Examples abound showing the contagion and rapid transmission of financial crisis in one country to another, especially when they are all integrated due to either geographical proximity or regional arrangement.

Take the case of regional financial arrangement that can lead to further financial integration. As I have shown elsewhere, the benefits and opportunities of closer and formal regional financial cooperation with a single currency (basket) system in Asia is large, and it can lead to stronger regional integration. However, when the costs and the risks are taken into account, including those that are intangible, such an arrangement becomes unfavorable.<sup>13</sup> Even after running some sensitivity tests the results remain

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<sup>11</sup> Even during the Great Depression of 2008, the CMI facility was not used.

<sup>12</sup> In some cases, cooperation and integration are promoted for political reasons and trust building. Even if that is the case, the resulting political windfall can lead to significant economic benefits.

<sup>13</sup> See Iwan J. Azis, "Articulating the Benefits and Costs of Regional Financial Arrangement in East Asia," in Simorangkir (ed) *Global Imbalances and Their Impact on Emerging Market Economies: Issues and Challenges*, Bank Indonesia, Jakarta, 2004; and Iwan J. Azis "A Regional Cooperation To Support

robust. Clearly, neglecting the risks and costs of regional cooperation could have led to wrong conclusions and misguided policy recommendations

Another caution is with regards to the ultimate goal of regional cooperation and integration. Like any policy and strategy, the goal has to be welfare improvement, especially for the largest segment of society. To evaluate whether or not a regional trade agreement is beneficial, measures related to the volume and composition of trade maybe used as the indicators. This, however, should only be a part of the story. The extent to which changes in those indicators result in the improvement or deterioration of a number of socio-economic indicators ought to be gauged as well. True, the latter may not be the direct focus of the trade arrangement agenda, but from the overall development goal perspectives, missing this part of the story may make the policy and strategy unsustainable. Worse, it may pose a serious risk of misguided policy.

My other critical assessment is on the notion that individual countries would be better off to cooperate in order to foster regional integration. That is, collective regional policies are superior than unilateral policies. I have no serious problem with the logic, but to derive from it that unilateral policies will not have any benefit for the region is misleading. Or, to say that unless individual countries cooperate something bad will happen, that is farfetched. My suspicion is that, we often think of an integrated regional economy like global economy, implying a regional or global commons. By participating in a regional cooperation or agreeing on some regional agenda we think we will provide benefits to the whole region. Even leaving aside the risks of integration as discussed earlier, this is the wrong way to think. Countries commit to a regional agenda because it provides opportunity and allows them to allocate their own resources more efficiently. If they fail to see so, and decide not to participate, no disastrous outcome for the region

will emerge (this is very different than the regional or global commons case as in climate change affair). On the other hand, if unilateral policies improve a country's economic performance, it is not difficult to imagine the positive spillover impact of it on the region's economy. In the case of trade and financial integration, if countries adopt policies that are good for themselves instead of signing up for regional cooperation, they will have more robust and stable economic growth, which by itself is advantageous for the whole region.

Even in today's more globalized world, nation states remain dominant, where democratic deliberation is still largely organized around it. Each country has the right to protect its own regulatory arrangements and institutions. In view of regional integration and cooperation, it is important to provide national or domestic policy space in order to maintain the integrity of domestic institutions.<sup>14</sup> Filled in with the right measures, the policy space can contribute positively to the regional economy. The key principle here is, make clear and transparent that the unilateral policy and the national deliberation are taken based on facts and evidence, e.g., for welfare improvements. The agenda of regional cooperation can then focus on the rules and monitoring that will ensure more effective implementation and that the negative spillover is minimized (act as a safeguard). This approach of regional cooperation may also improve the quality of the national deliberation, making it more effective to achieve the ultimate goal of welfare improvement.

The case of cross border holding of financial assets comes to mind. As discussed earlier, the size of such cross-border flows in Asia is relatively small. In the case of fixed income assets, even after the regional initiative (ABMI) has been implemented, the size remains small. But the market in individual countries grew significantly, providing the necessary alternatives of investment and ways to raise long term fund. More importantly, this can avoid the potential maturity mismatch. Since the growing market is in local currency, this will also avoid the currency mismatch (double mismatch played a

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<sup>14</sup> A similar principle applied to the concept of globalization is proposed by Dani Rodrik in his article "The Globalization Paradox," *Making It*, August 24, 2011.

central role in the 1997 AFC). It was domestic national policy that spurred this development. While a strong fixed income market in individual countries is welfare-improving, it also spells favorably to regional bond market and the regional economy.

This issue of associating regional integration with regional/global commons is a less-explored frontier. I suggest that if policy makers really want to be more realistic about the concept of development, governance and integration, and to focus more on the welfare improvement as the ultimate goal, which they should, this type of evaluation has to be conducted.

### **Concluding Remarks**

In the Asian context, regional cooperation and integration have been more market-driven than institution-driven. Signs began to emerge, however, that this may change in the post 1997 Asian Financial Crisis and 2008 Great Recession. True, that the rising intraregional trade and increased integration may have occurred irrespective of the 1997 and 2008 event, but judging from the rate of acceleration those two events acts almost like a structural break. The timing is more than just serendipity.

The fact that trade integration is stronger than financial integration, is already expected. By extension, the rapid growth of intraregional trade after 2008 will lead to greater financial integration, is also expected. But the question is, how much integration we want to have. If market dictates that the current level can go further higher, which I believe that is the case for Asia at this stage especially for the financial integration, policies can and should facilitate such a trend, e.g., trade facilitation, standardization, payment settlement, etc. But if even with these policies and various regional initiatives the integration remains limited, I would argue let's be it. There is nothing wrong with it. Like anything else, regional integration can provide benefits but it can also be costly and risky.

At the end of the day, regional cooperation should be directed towards deepening and broadening the benefits of human development, narrowing the development gap



between and within countries, and advancing common interests in a global-rule setting. More often than not, these can be done more effectively and realistically through domestic national policies. Absent of regional cooperation and integration does neither reduce the intrinsic benefits of such policies for the individual countries nor cause disaster for the regional economy (unlike in the concept of regional/global commons). Such benefits can even make the whole region better off. Risk sharing being a clear reward of increased integration is a sound and valid concept. But that is an ideal situation. A growing number of evidence including in Asia has shown that the degree of risk sharing given an idiosyncratic shock in a more integrated regional economy has neither improved nor high. The impact of regional integration must be predicated not on an ideal world but on the world as it is.