Report Summary

- of Studies on

Trade, Investment and Financial Integration in East Asia

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Daiwa Institute of Research

The study group working on "Trade, Investment and Financial Integration in East Asia" has examined the economic integration of East Asia. The focal points have been the important linkages among trade, financial and monetary integration in East Asia. Analyses have been made by four research institutes -- DIR (Daiwa Institute of Research, Japan), KIEP (Korea Institute for International Economic Policy, Korea), SMU (Singapore Management University, Singapore) and IPM (Universiti Putra Malaysia, Malaysia). Their studies are summarized below, separately for each institution.

1. Daiwa Institute of Research (DIR)

(1) Perspectives of the Economic Integration

Trade and Investment Integration

Trade and investment integration in East Asia has proceeded since 1980s. An accumulation of Foreign Direct Investment (FDI) inflows worked both as the driving force that intensified intra-regional trade in the East Asia as well as the engines of the economic growth. Multinational firms, in particular Japanese firms, have extended their presence throughout Asia by means of FDI, and played an important role in developing intra-regional production and procurement networks, and in facilitating vertical economic integration. The integration that is proceeding, and presents special challenges and opportunities, is a market-driven trade and investment integration.

The shares of intra-regional trade in East Asia still remain at a lower level, around 40 percent, than those of the EU or NAFTA. As such, there may be scope for further expansion of intra-regional trade under Free Trade Agreements (FTAs). Any plausible combinations of FTA in East Asia will bring about welfare gains to all the FTA members. However, the expansion of the membership in FTAs will raise the amounts of the gains in total, as well as the gain of each member.

Monetary Integration and A Basket Currency Regime

A Basket Currency regime has several benefits as one of the intermediate and optimal options for East Asia, including stabilizing trade competitiveness, capital flows and GDP. However, even after the financial crisis, some of the Asian currencies were de facto pegged to U.S. dollar, resulting in several competitive devaluations. Because of a coordination failure problem, monetary authorities in East Asia failed to introduce a common currency basket system, even though they may have been aware of the merits of the system. The five ASEAN countries and Korea will be candidates for a common currency area with a common Currency Basket as an anchor currency. A common Currency Basket is more appropriate as an anchor currency than the US Dollar in forming a common currency area in the region.

Sequencing and Policy Prerequisites of Economic Integration

It is reasonable to believe that economic integration begins with elimination of customs barriers and quotas. Trade integration increases economic interdependence of member countries in the region, which will attract their attention and stimulate their interest in taking common action to prevent and alleviate economic shocks. Regional trade arrangements will in turn stimulate intra-regional FDI. Trade openness is closely related to the degree of financial integration.

Trade liberalization is a prerequisite to capital account liberalization. If domestic factor markets and foreign trade are still heavily distorted when the capital account is liberalized, capital could flow into sectors heavily affected by distortions, further increasing inefficiencies in domestic production. Trade openness is found to be closely related to the degree of financial integration.

Even after the FTAs are established, economic agents will face currency exchange costs and exchange rate risks in international transactions. In such a situation, the movement toward bilateral and regional free trade agreements might gain momentum to form a common currency area in East Asia.

(2) Policy Recommendations

Establish Regional FTAs as Immediate Actions

Trade integration takes a critical part in broad regional coordination agenda. As an item for policy agenda, expansion of the membership will properly be the basic strategy. The goal for the region should be an ASEAN+10+3 FTA, and any subsets would be transition stages. In such an expansion process, the policy-makers should carefully design FTAs to be compatible with larger FTAs that may be expected in the future. And the FTA should cover services as well as goods.

In the EU, economic cooperation supplemented the integration process. A remarkable example is the European Monetary System (EMS). The stability of the EMS became essential for the

EU to move forward to monetary integration. As such, economic cooperation has been an instrument with which the EU governments acquired capability to handle the challenges arising from the diversity of the participating countries. Regional FTAs will provide the countries in East Asia with the opportunity to formalize such cooperation actions.

Promote Financial Market Integration

The countries in East Asia should promote financial market integration in order to allocate efficiently accumulated savings into profitable investment projects in East Asia. Liberalizing and opening of capital market are basic measures needed for this to take place. Important prerequisites are institutional strengthening of the domestic financial sectors, development of the required financial markets, and establishment of prudential regulations. In the light of the currency crisis, a multi-speed approach to undertake domestic reforms, together with incentive measures such as the Asian Bond Market Initiative, and the Asian Bond Funds concept, are recommendable. Regional financial infrastructures, which include a regional settlement and clearing system and regional harmonization of credit rating standards, should be established for fostering regional cross-border bond markets in East Asia.

Policy Cooperation and Coordination as Prerequisites for Monetary Cooperation

Regional economic integration in terms of trade, FDI, and financial transactions would make private sectors recognize that foreign exchange transaction costs and foreign exchange risks are significant obstacles to trade, FDI flows, and realization of financial transactions. The East Asia economy would move on monetary cooperation and, in turn, monetary integration. However, it is suggested that policy cooperation and coordination among East Asian countries, especially regarding monetary policy, are needed as prerequisites for monetary cooperation. Sovereign East Asian monetary authorities need to fully develop their own domestic monetary policy capability before engaging in policy cooperation of any sort. As East Asia deepens its economic integration, policymakers should fully develop weak-form macroeconomic policy cooperation before contemplating formal monetary coordination. Regional policy cooperation might take a flexible and multi-speed approach that is endogenous to underlying fundamentals and institutions.

Implement Regional Exchange Rate Coordination

As the initial step of currency coordination, the monetary authorities should have a common understanding about the interactions between their currencies. This understanding would be attained by conducting policy dialogue and macroeconomic surveillances among policy makers of the regional countries. Macroeconomic surveillance alone may not be so effective if it is conducted by policy makers as representatives of each of their regional countries. It may be desirable that a neutral intraregional institution, which is independent of the governments of regional countries, should prepare for the macroeconomic surveillance to help the governments deepen their common understanding. It is also recommended to promote macroeconomic policy cooperation prior to formal coordination. Especially for coordinated exchange rate policies among East Asian countries, it is recommended to introduce deviation measurements of each East Asian currency from a weighted average of East Asian currencies, which we will call as Asian Currency Unit (ACU).

The report provides an example of ACU (and ACU star) that show a good performance in terms of stability. They may serve as indicators for surveillance purposes.

Create a Common Currency Basket as a Common Currency Unit

While all the options have pros and cons, a recommendable option to implement stronger regional coordination is to have all the monetary authorities in the region agree on an arrangement to create a common currency unit that consists of a currency basket, named here the Asian Currency Unit (ACU). The monetary authorities may use the ACU as a convergence criterion according to the European case. In addition, the monetary authorities could use their home currencies' deviation from the ACU to measure convergence, and consider the results of such measurements when discussing their exchange rate policies. In addition, because the monetary authorities would have a commitment to the arrangement, the regional currency arrangement for bringing the intra-regional currencies to the ACU will help them to avoid coordination failure when selecting their exchange rate policies and, in turn, prevent competitive devaluations in the region.

The monetary authorities in East Asian countries should first link their own home currencies to the ACU before they start work to achieve the objective of regional monetary integration. This implies that there is a choice for the monetary authorities to realign the exchange rates of the home currency vis-à-vis the ACU or to stop linking their home currencies to the ACU. The existence of this choice might induce speculative attacks against weaker currencies. Such a possibility makes it recommendable for the monetary authorities to make a strong commitment to link their home currency to the ACU. The strongest commitment is to take deliberate steps in the direction of monetary integration. In making that commitment, the monetary authorities of the participating countries would abandon any option to leave it. Such a commitment would thus contribute significantly to the stability of the exchange rate system because private economic agents would build up their confidence in the coordinated exchange rate policy prevailing in East Asia.

2. Korea Institute for International Economic Policy (KIEP)

Benefits and Costs of Financial Market Integration

There exists a general consensus that financial market integration contributes to long-term economic growth. Financial market integration increases benefits for portfolio risk diversification and consumption smoothing across countries and over time through borrowing and lending. By pooling the idiosyncratic risks from production, consumption, the terms of trade and so on, more inputs will shift into those industries that have a higher return. Therefore, the general welfare of the country will be improved.

On the other hand, it is increasingly recognized that a high degree of financial openness may produce significant short-term cost. A debate has grown on the role of financial integration as a triggering mechanism in emerging market crises for the last decade, including the Asian crisis. The costs of financial integration include an inadequate domestic allocation of capital inflows, which may hamper the country's economic growth and exaggerate prevailed domestic distortions; the loss of macroeconomic stability; pro-cyclical movements in short-term capital flows; a higher degree of volatility of capital flows; and risks associated with foreign financial institutions' penetration.

Degree of Financial Integration in East Asia

There are in general three different approaches in the literature that may be used to test international financial integration: a volume-based approach, an asset price-based approach, and a risk sharing approach. The volume-based approach examines the degree of financial integration by using data on countries' portfolios of external assets and liabilities. One reasonable measure in judging the degree of financial integration in a country is the level of international asset cross-holdings. Another strand of literature looks directly into asset prices. Real business cycle theory extends the role of financial markets to business cycles. It says that consumption co-movements with integrating international financial markets should be higher than output co-movements.

We find that the degree of financial integration in East Asia has recently increased, but East Asia has shown more financial integration with global economies than with regional economies.

Our finding implies that regionality is weak and there is no strong pulling, or anchor, market that would match the U.S. market. Though global integration is not a force that competes with regional integration, there seems no strong sign that lessons from the crisis in 1997-1998 have been transformed into creation of an effective market mechanism in East Asia. The lack of success in policy coordination among East Asian countries seems to be a fact despite the efforts that had been made. However, rightfully, the agenda of regional market integration and deepening is alive and it needs to be directed so as to focus on creation of a market mechanism that will endogenously bring forward real interest rate differentials to be eventually removed at the regional level.

Another important implication from this part of the study is the importance of trade openness that is closely related to the degree of financial integration. This implies that considering economic cooperation in East Asia is a multi-facet process rather than single-track process. Financial development and economic growth in the region is another important factor that we should consider in the multilateral frameworks. Finally, we may conclude that the current status of the direction and structure of capital movement in East Asia has created a highly vulnerable and unstable financial environment in East Asia, raising the likelihood of a future crisis impeding the development of capital market in the region.

3. Singapore Management University (SMU)

The SMU research team examines dimensions of integration and cooperation in East Asia. The first part of the SMU report looks at recent trends and offers a set of policy prescriptions for sequencing economic integration. The second part explores regional exchange rate coordination and monetary union within the context of ongoing efforts to pursue regional integration.

How Should Policymakers Interpret Recent Trends in Trade, Investment and Finance?

Intra-ASEAN trade and investment shares have stalled since the mid-1990s. At the same time, trade with China has surged, both within East Asia and globally. The combination of these trends reflects the dual reality of a China-driven Asian trade model. The establishment of regional production chains by transnational corporations has given rise to growing intensity in vertical intra-industry trade among East Asian countries. Those countries well positioned to exploit China's growing consumer and service demand will benefit from an increasingly open and developed China. Those forced to compete with China on a cost-basis will find China's increased real integration with Asia quite challenging.

Financial market integration and cross-border commercial activity are just beginning and do not yet reflect convergence or sustained regional integration. The many controls and restrictions that remain in place at the domestic level have hampered the development of legal, accounting, supervisory, and regulatory mechanisms essential to regional financial stability. At the same time, capital controls are necessary at the domestic level until domestic institutional reforms are in place. Without such fundamental reform at the domestic level, any attempt at regional financial integration may be moot.

Given that full compliance with WTO is the ultimate goal of a fully integrated Asian trade agreement, how should policymakers approach various sub-regional trade agreements? First, a multi-speed approach to integration is the practical way forward. Countries whose capital and labor are less sector-specific and whose entrepreneurs are more adaptable will have lower adjustment costs and thus could integrate first. However, the design of an RTA for a regional subgroup should anticipate enlargement. Agreements should be formulated according to a standard WTO format. The "spaghettization" of trade agreements that might undermine regional commitment should be managed in a manner that liberalizes trade while maintaining a standardization and consistency with WTO principles.

Should Policymakers Proceed With Financial Integration Along With Trade and Investment Integration?

Given the proliferation of sub-regional Free Trade Agreements, should policymakers proceed with financial integration along with trade and investment integration? While trade and investment integration should be linked, financial integration including trade in financial services must be preceded by domestic financial sector reforms regardless of the progress of trade and investment integration. The recommendable sequence of action is to focus on domestic banking sector reforms and development of independent regulatory and supervisory frameworks first and then develop domestic financial markets. Domestic financial sectors must be developed first, for regional financial integration to be successful. Paralleling trade and investment integration, financial integration must adopt a multi-speed approach reflective of the economic and political diversity of ASEAN+3 members.

How Should be the Capital Account Liberalization and Monetary Cooperation Be Managed?

To minimize instability, sound and sustainable macroeconomic policies as well as a sound institutional framework are prerequisites to effective capital account liberalization. Capital controls should be lifted gradually and non-uniformly.

To better accommodate adjustments arising from regional economic integration and from the fluidity of regional economic dynamics, Asian monetary authorities should increase domestic exchange rate flexibility. To provide flexibility as pegs would bring about vulnerability to speculative attacks and create a need for crisis management in support of the pegs. A flexible BBC requires varying band-widths around a parity with weights that reflect both trade and capital flow considerations (ACU+).

When contemplating regional monetary cooperation, monetary authorities must broaden the scope of monetary policy beyond exchange rate management and consider monetary, fiscal, strategic, and industrial policy dimensions. Before contemplating formal monetary coordination, policymakers should fully support optimal domestic policies through weak-form macroeconomic policy cooperation, especially economic surveillance, policy transparency, and information sharing through research and training. To address the issue of exchange rate volatility, policymakers can coordinate on the creation of a trade and capital-flow (ex-short term capital flows) weighted ACU (ACU+). However, domestic currencies should still float versus the ACU+, allowing countries more flexibility and discretion on whether to stabilize exchange rates.

Monetary Cooperation in ASEAN+3

What cooperative and/or coordination mechanism(s) should ASEAN+3 promote for increased macroeconomic cooperation and exchange rate stabilization? In order to anchor domestic monetary policies and regional monetary cooperation to underlying fundamentals without sacrificing deeply-held concerns for excessive exchange rate volatility, we advocate that regional exchange rate objectives be rooted within a flexible CPI-inflation targeting regime framework. Regional coordination would be achieved through the establishment of a trade and capital-flow weighted Asian Currency Unit (ACU+) with weights that are adjusted over time.

Macroeconomic cooperation would be achieved through three complementary efforts, each of which benefits from increased regional surveillance. They are transparency, standardization among central banks, and information sharing. The formulation of both the ACU+ and the individual parities would require a cooperative effort. Along with inflation and output gap targets, optimal weights to place on the stabilization of inflation, output, and the exchange rate would have to be estimated, forecasted, and maintained. Deviations from optimal weights would reflect special economic and/or political considerations. Greater deviations would be allowed in those countries needing more flexibility to adjust and integrate, while smaller deviations would be permitted in countries whose trade, investment and financial integration are well-advanced.

Policy independence and sovereign flexibility would remain intact through domestic control over monetary and macroeconomic policy. Optimal inflation and output gap targets would be determined for each country, along with the appropriate trade and capital flow parity with the ACU+. Optimal weights for CPI inflation, the exchange rate, and output gap stabilization would be determined for each country. As countries implement structural reforms that reflect greater integration and economic efficiency, optimal weights and permitted deviations will be changed.

The Long-term Vision for ASEAN+3?

We envision an economic union for Asia in which there is a high degree of economic integration, supranational institutional development, and macroeconomic cooperation, but for which there is not necessarily, in early stages, extensive monetary coordination or a currency union. We expect that over the next two decades, trade and investment linkages will continue to broaden and deepen in scope. We expect that domestic financial reforms will be deep enough to allow for the liberalization of capital accounts and the integration of regional financial markets to an extent matching those of other major economic blocs.

We expect the development of supranational regional institutions that will promote regional integration and cooperation through harmonization and standardization, economic mediation and adjudication, economic surveillance, research and policy transparency, information sharing, and policy cooperation. We expect monetary policy cooperation to broaden beyond exchange rates to encompass the fundamental components of macroeconomic policy: monetary, fiscal, strategic, and industrial policy dimensions.

We expect monetary policy management to be differentiated from macroeconomic or exchange rate crisis management. We expect monetary policy cooperation to feature a cooperative NOEM research agenda, especially among ASEAN central banks. We expect that cooperation and integration will foster greater economic convergence, which will in turn promote increased calls for greater cooperation and coordination. We believe that our immediate vision for Asian economic union requires neither currency union nor explicit monetary coordination. Limited exchange rate cooperation within a sovereign monetary policy framework can provide a coordination mechanism that can address deeply-held concerns over the exchange rate without sacrificing sovereign policy discretion. We advocate coordination with the ACU+ within a flexible CPI-inflation framework.

We expect that within two decades, the successes of the ASEAN+3 economic union will enable policymakers to clearly determine whether currency union should be pursued as a regional goal. Experiences with weak-form cooperation and stronger form coordination should unambiguously support prospective monetary union. The decision to go forward will necessarily reflect a clear willingness to commit to a political and social contract of regionalism.

If monetary union is to be successful, the following prerequisites must be met:

- The pursuit of monetary union must be endogenous to the underlying economic structure and social-political fabric.
- Asian policymakers must recognize that monetary union is more than the adoption of a common currency; it is a political and social pact that will limit the scope of both fiscal policies and strategic commercial policies.
- Asia needs to develop a "cult of regionalism."
- Asia needs to develop the political and cultural will to commit to monetary union: from inception to implementation to institutional permanence.
- Experiences with weak-form cooperation and stronger form coordination must unambiguously support the prospective monetary union.
- If monetary union does become a credible and widely-accepted goal within Asia, then policymakers must begin to develop a set of regional institutions capable of handling the economic, political, and social dimensions of monetary union.

4. Universiti Putra Malaysia, Malaysia (UPM)

The UPM research team undertook econometric analyses on foreign capital and economic growth and the exchange rates in East Asia, and developed several policy recommendations.

Foreign Capital and Economic Growth

The econometric investigation of the research team confirmed that FDI is growth-enhancing and showed that its impact in felt both in the short- and long-run. FDI influences on economic growth are found to be much higher than domestic investment. FDI has the potential to yield higher growth through higher efficiency in physical and human capital. The empirical analysis detected a causal relationship that runs from FDI to growth. From the policy perspective, this suggests that it may be unwise to impose capital controls that may deter inflows of FDI.

Short-term capital inflow has adverse effect on the long-term as well as short-term growth prospects of the East Asian countries. This evidence raised important policy issues about the risk a nation exposes itself if it becomes overly dependent on short-term capital. The empirical result seems to suggest that the composition of foreign capital inflow does matter for economic growth. Also, our results support a strong positive correlation between growth and domestic savings.

Exchange Rates in East Asia

The study finds that real exchange rates in the East Asian countries, including Japan, display mean reverting when the non-linear components are included. Results illustrate that adjustments from purchasing power parity (PPP) rates follow a smooth transition autoregressive process (STAR) that is mean reverting. The asymmetric adjustment toward PPP suggests that transaction costs alone cannot fully explain the dynamics of the Asian currencies. Non-linearities in exchange rates may also arise because of government intervention.

PPP is robust to the financial crisis, meaning policy makers may not worry too much about the long-run consequences from the changing relationship between consumer prices and exchange rates. Some studies have reported that it is the exchange rate that aided the convergence to long-run PPP.

Policy Recommendations

Exchange rate coordination is necessary. First, exchange rate instability discourages both trade and investment. The statistical evidence in the study seems to suggest that after a sharp depreciation, the spillover effect has spread across the region. Thus, limiting large swings of exchange rates would tend to limit the scope of contagion. Third, exchange rate coordination is also necessary to avoid competitive devaluation.

On the sequencing of trade, investment and financial integration for the ASEAN+3, it has been recognized that trade reforms, current account liberalization, and capital account liberalization can greatly enhanced economic growth. Sequencing of reforms must distinguish between proposals for developing countries and transition economics. The consensus is that fiscal and monetary stabilization and institutional reforms should occur early in the reform process.

Trade reform has been debated extensively and there is widespread agreement on the benefits of dismantling trade barriers. Liberalizing the capital account involves the lifting of restrictions on inflows and outflows of FDI flows and the use of long- and short-term financial instruments. A sound institutional environment, including adequate accounting rules, auditing, disclosure practices and development of banking systems, are key prerequisites for success.