TRADE, INVESTMENT AND FINANCIAL INTEGRATION

IN EAST ASIA

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EXECUTIVE SUMMARY

This report consists of three major components:

- Trend analysis of trade, investment and financial integration in East Asia, with special focus on the last ten years,
- Policy prescriptions for sequencing economic integration for growth and financial stability in the region, and
- Policy recommendations on exchange rate cooperation and macroeconomic policy coordination and assessment of the feasibility of monetary union for the ASEAN +3 region.

The major findings and recommendations in the report are summarized as follows.

1. 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
    - East Asia should push as vigorously for liberalization of trade in services as they have for manufacturing goods.
        - Liberalize trade and FDI in services such as transport and communications for smooth functioning of regional supply chains.
        - Regulatory reforms in the services sector can generate large gains in growth.
    - The lack of fundamental institutional reforms, both domestically and regionally, together with the increasing attractiveness of China will challenge emerging Asia to increase trade competitiveness and compete for global FDI.

- 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 of regional financial integration may be moot.

2. 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?

- Multi-speed approach to integration is the practical way forward. Countries whose capital and labor are less sector specific and entrepreneurs more adaptable will have lower adjustment costs and thus could integrate first. However, any design for a sub-regional RTA should anticipate enlargement.

- Agreements should be formulated according to 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.

- Inconsistencies with WTO should be isolated and made distinct, so that eventual integration with WTO can avoid wholesale renegotiation.

3. Given the proliferation of sub-regional RTAs, 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.
    - Focus on domestic banking sector reforms and development of independent regulatory and supervisory frameworks first and then develop domestic financial markets.
    - For regional financial integration to be successful, domestic financial sectors must be developed first.

- To achieve these aims, external pressure of regional financial cooperation should complement internally-driven financial reform initiatives.

- To ensure financial deepening and stability, weak forms of financial cooperation should be used as stepping stones towards stronger-form coordination.
    - We suggest that countries begin with weak forms of financial cooperation (e.g. technical assistance and information sharing) before pursuing stronger forms of cooperation and integration (e.g. liberalization of laws governing cross-border M&A activity).
    - We emphasize that weak form cooperative efforts would place particular emphasis on regional research organizations and think tanks (e.g. SMU's MFMI).

- Paralleling trade and investment integration, financial integration must adopt a multi-speed approach reflective of the economic and political diversity of ASEAN+3 members. Financial liberalization should not be postponed for too long due to the crucial role it plays in intensifying real integration.

- In its most mature and complete form, investment and financial integration should feature independent supranational institutions with regulatory and supervisory oversight.

    - Regional institutions will be able to better handle more delicate and politically charged regional issues.
    - Regional institutions will necessarily require deep political involvement and mutual surveillance

4. When and how should capital account liberalization take place?

- To minimize instability, sound and sustainable macroeconomic polices as well as sound institutional framework are pre-requisites to effective capital account liberalization.

- Capital controls should be lifted gradually and non-uniformly (e.g. long term flows such as FDI should be liberalized before short term flows) to reduce risks associated with short term capital flows.

5. How can exchange rate cooperation best support trade, investment and financial integration?

- 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
    - A return to rigid exchange rates would increase vulnerability to speculative attacks and create the need for elaborate crisis management in support of pegs
    - Instead, each country should evaluate its exchange rate flexibility with respect to an equilibrium exchange rate that reflects both trade and longer-term capital flow considerations.
    - A sensible approach that would increase flexibility in the immediate term would be the adoption of a flexible Basket-Band-Crawl (BBC) featuring varying bandwidths around an equilibrium exchange rate that reflects both trade and capital flow considerations.
    - In the intermediate and long-run, countries should consider the adoption of a flexible CPI-inflation targeting regime, where an some explicit concern for exchange rate stabilization can be added to CPI-inflation and real sector stabilization (e.g. output gap) stabilization.
    - Exchange rate stabilization should be one based on an equilibrium exchange rate that reflects both trade and capital flow considerations.
    - Regime weights should be welfare optimal. Therefore, across the region these weights should look very different for different economies.

- 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.
    - In doing so, policymakers must recognize the endogeneity of the exchange rate and the significant risks of attempting to directly control the exchange rate.
    - Cooperating on one dimension of macroeconomic policy at the exclusion of the others would likely result in one-sided strategic advantages.
    - Policymakers should also recognize that the economic diversity of ASEAN+3 will necessarily imply a diversity of optimal sovereign monetary policy regimes.

- To the extent that regional exchange rate cooperation is pursued, policymakers should focus research cooperation on determining the extent to which the exchange rate has a distinctive role, if any, as a stabilization target above and beyond its effect on CPI-inflation.
    - At a minimum, this role is likely to vary considerably across countries.
    - The basis for exchange rate stabilization should be with respect to an equilibrium exchange rate that reflects both trade and longer-term capital flow considerations. Not only would use of this domestic benchmark be superior to current efforts that reference to the nominal effective exchange rate (NEER), but such an approach will prove useful in calculations for region-wide benchmarking or in any efforts to cooperate on regional exchange rate stabilization.
    - Policymakers should also focus research cooperation on determining the efficacy of alternative discretionary targeting regimes, ones that may engender more policy commitment and inertia into private sector expectations.

- 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 intraregional exchange rate volatility, policymakers should develop a region-wide exchange rate coordination mechanism based on both trade and longer-term capital flows, something we call the Asian Currency Unit Plus (ACU+).

    - Like the ECU, the ACU+ should be initially developed as a benchmarking mechanism.
    - As with the ECU, we expect that the role of the ACU+ will expand beyond its initial benchmarking role to that of both an official unit of account of any future Asian Community and the basis of private sector created Asian debt instruments.
    - However, unlike with the ECU, perspectives on stabilizing the ACU+ should be formed within the context of a region-wide synthetic monetary policy regime, such as a synthetic region-wide flexible CPI-inflation targeting regime.
    - Unlike the Eurozone, ASEAN+3 members should construct country-specific and revisable parities to the regional ACU+ benchmark based on their own country-specific micro and macro fundamentals.
    - Unlike the Eurozone, ASEAN+3 members should weight the importance of deviations from their individual ACU+ parity from the perspective of optimal

domestic monetary policy. These differential weights across the region should be encouraged according to a multi-speed approach to regional integration and cooperation.

6. What cooperative and/or coordination mechanism(s) should ASEAN+3 promote for increased macroeconomic cooperation and exchange rate stabilization?

- We recommend the ACU+ as the appropriate benchmark for any policy cooperation on regional exchange rate stabilization.
    - We emphasize that sovereign monetary policies and regional monetary cooperation should be anchored to underlying domestic fundamentals.
    - However, we recognize that deeply-held concerns for excessive regional exchange rate volatility and strategic exchange rate behavior may require explicit policy cooperation on regional exchange rate stabilization.
    - To achieve both domestic and regional policy aims, we advocate that the pursuit of any cooperative regional exchange rate stabilization effort be done within the context of a synthetic, region-wide flexible CPI-inflation targeting regime framework, where regional regime weights are chosen to implicitly optimize region-wide welfare.
    - The implied weight on region-wide ACU+ stabilization thus provides a benchmark on the extent to which the ACU+ should float against external currencies, such as the US dollar and Euro.
    - Country-specific parities to the ACU+ can then be formulated and revised in a manner that reflects both trade and longer-term capital flow considerations of sovereign economies.
    - The weight that each country then chooses to place on stabilize its sovereign exchange rate around its ACU+ parity should be formulated according to optimal sovereign welfare.
    - This approach would incorporate a multi-speed dimension which would allow countries to deviate from optimal weights due to special economic and/or political considerations.
    - These country-specific parities and the weights accorded by each country toward stabilizing their exchange rate around their ACU+ parity thus provide additional benchmarks on the extent to which deviations from ACU+ parities should be considered in policy cooperation discussions.
    - Countries who find it optimal to stabilize their nominal exchange rate around its ACU+ parity will now have a form of exchange rate management consistent with one likely to be used for formal exchange rate coordination.

- Tracking of an ACU+ benchmark within a flexible CPI_inflation targeting framework contributes to macroeconomic policy cooperation on several dimensions.
    - There will be a dramatic increase in regional surveillance and information sharing, particularly on the research front.
    - There will be a clearer indication of the importance of domestic exchange rate flexibility.

    - There will be a clearer sense of the importance of exchange rate stabilization in the context of a welfare-based monetary policy.
    - There will be a clear and economically-robust benchmark for exchange rate cooperation and formal exchange and monetary policy coordination.
    - There will be a clear indication of what monetary union would imply for exchange rate behavior.

- Deeper monetary coordination should demand that coordinated policy lead to an expected economic performance that is both superior to sovereign policy designs over the long term and robust to large, adverse outcomes.
    - Asian policymakers must be willing to sacrifice some of the net strategic benefits of exchange rate, fiscal and commercial policies.
    - Asian policymakers considering monetary policy coordination must be willing to accept not only that coordinated welfare is the ultimate objective of policy coordination but that ongoing policy coordination will require increased mutual surveillance and transparency.
        - Asian policymakers should be clear about the ultimate objective of monetary policy coordination.

- Macroeconomic cooperation would be achieved through three complementary efforts, each of which benefits from increased regional surveillance, 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 should still be determined for each country, along with the appropriate trade and capital flow parity with the ACU+.
    - Optimal weights on CPI inflation, 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 change.
    - However, countries will now have a clear basis for cooperation, formal coordination, and even monetary union.

7. What is 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 extensive monetary coordination or 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 that Asian monetary authorities will avoid competitive devaluations and ensure that realized exchange rate depreciations are market-based rather than strategic in nature.

- 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.
    - In order to gain a better understanding of underlying microeconomic behavior, more research is needed on price-setting, indexation, pass-thorough, habit persistence, intertemporal and intratemporal elasticities, market structure, political economy, and regional spillovers.
    - We encourage continued research on alternative discretionary targeting beyond flexible CPI-inflation targeting and exchange rate stabilization
    - We encourage research on cooperative and coordination schemes that will protect against risks of strategic policy yet will offer Pareto improvements above non-cooperative discretion.

- 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.

- We believe that limited exchange rate cooperation within a sovereign monetary policy framework can provide a coordination mechanism to address deeply-held concerns over the exchange rate without sacrificing sovereign policy discretion.
    - We advocate such cooperation through the creation of an ACU+ benchmark and ACU+-based parities within a flexible CPI-inflation framework.
    - ACU+ coordination will necessarily require increased surveillance, transparency, and information sharing.
- We expect that within two decades, the successes of an 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 must 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 occur
    - 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 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 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.

Part I

Trend Analysis and Sequencing of Economic Integration

I Trends in East Asian Trade, Investment and Financial Integration

Introduction

We examine dimensions of integration and cooperation in East Asia in a two-paper series. This first paper looks at recent trends and offers a set of policy prescriptions for sequencing economic integration. The second paper explores regional exchange rate coordination and monetary union within the context of ongoing efforts to pursue regional integration. The goal of each paper is to develop a consistent and robust set of principles with which East Asia can gauge the process, pace, and prospects of reform.

We begin with an analysis of trends in trade, investment, and financial integration in East Asia. We focus special attention on the past decade, the period which witnessed the confluence of three dramatic economic shifts: the peak of the ASEAN boom, the Asian Financial Crisis and its aftermath, and the rise of China as a regional and global force. Based on these trends and both theoretical and empirical perspectives on regional cooperation, we present a plan for optimally sequencing further economic integration. We conclude with a series of policy recommendations that aim to promote sustained growth and financial stability.

I.1 Characterizing Trade Integration

I.1.1 Trade Trends

Current Status of Trade

East Asian trade is characteristically open and global. Table 1 gives the regional countries' average trade share for the period 2001 to 2003. [1]

Table 1: Trade Shares, (2001-2003)

Country	BRN	CAM	CHN	HKK	IND	JPN	KOR	LAO	MLY	MYN	PHL	SIN	THL	VNM
Japan	32.6	2.9	16.5	8.7	19.4		14.7	2.3	14.1	4.6	17.5	10.5	19.2	13.8
Korea	9.1	3.0	7.2	3.4	6.4	6.0		0.5	4.1	4.8	5.6	3.9	2.8	7.2
China	4.5	6.2		41.7	6.0	13.3	13.1	6.4	6.5	15.7	5.1	6.4	6.3	9.8
Hong Kong	1.2	8.9	11.8		1.7	3.5	3.7	0.6	3.8	1.7	5.3	6.0	3.4	3.0
Brunei		0.0	0.0	0.0	0.1	0.2	0.2	0.0	0.2	0.0	0.0	0.3	0.3	0.0
Cambodia	0.0		0.0	0.1	0.1	0.0	0.0	0.2	0.0	0.0	0.0	0.2	0.4	0.6
Indonesia	1.6	2.0	1.3	0.6		2.8	2.3	0.2	2.1	1.4	1.3	3.6	2.4	1.9
Lao	0.0	0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	0.0	0.0	0.4	0.4
Malaysia	5.8	2.2	2.1	1.7	3.5	3.0	2.4	0.3		6.1	4.0	17.1	5.0	2.6
Myanmar	0.0	0.0	0.1	0.0	0.1	0.0	0.1	0.0	0.2		0.0	0.2	0.8	0.0
Philippines	0.4	0.2	0.9	1.2	1.1	1.9	1.5	0.0	2.1	0.1		2.3	1.8	1.2
Singapore	12.8	7.9	2.3	3.4	10.4	2.5	2.6	2.5	16.9	11.7	6.8		6.3	9.8
Thailand	7.7	12.3	1.4	1.4	2.8	3.1	1.2	46.9	3.9	21.7	3.2	4.4		3.5
Vietnam	0.0	5.5	0.5	0.2	0.8	0.6	0.8	12.3	0.6	0.2	0.5	1.2	0.9	
ASEAN	28.3	30.1	8.7	8.6	18.8	14.3	11.0	62.3	26.0	41.2	15.7	29.3	18.4	20.2
ASEAN+3	74.5	42.3	32.4	62.5	50.6	33.5	38.8	71.5	50.6	66.3	43.9	50.2	46.6	51.1
APEC	92.0	82.1	64.7	78.2	69.5	67.3	66.6	74.6	75.7	76.1	74.3	74.1	67.3	67.9
CER	7.4	0.2	1.9	1.1	4.3	3.4	2.9	0.9	2.4	0.6	1.7	2.6	2.6	4.5
E.U.	6.8	12.4	14.6	11.2	13.1	14.2	12.0	12.9	12.2	8.1	12.7	12.6	13.2	14.4
US	8.3	27.0	15.4	13.2	11.6	23.1	17.5	0.7	17.7	6.6	21.8	15.0	14.7	8.4
NAFTA	8.3	27.7	17.3	14.5	12.8	25.6	19.7	0.9	19.1	7.2	23.2	15.8	16.0	9.1

Notes: Table reads as follows:
total trade share of a country in the left hand column with a partner country in the top row
e.g: starting top left - Brunei's exports to and from Japan as percentage of Brunei's total trade
Source: IMF, Direction of Trade Statistics, 2004.

While most countries have large trade volumes with the EU and the U.S., intraregional trade within ASEAN+3 (APT) is significant. Half of ASEAN trade with within APT and over one-third of industrialized Asia's trade is within APT. [2] With China's rapidly expanding economy still in its early stages, intra-Asian trade can be expected to drive the future growth of

[1] Notes for all tables: 1) Total trade = sum of imports and exports. 2) Singapore does not report its trade with Indonesia to the IMF. Therefore, Singapore's trade with Indonesia is estimated using data from Indonesia. 3) All trade data excludes Taiwan. APEC Countries are as follows: Australia, Brunei, Canada, Chile, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, Mexico, New Zealand, Papua New Guinea, Peru, Philippines, Russia, Singapore, Thailand, USA, and Vietnam. CER countries are Australia and New Zealand. NAFTA is Canada, Mexico and United States.

[2] "Industrialized Asia" refers to Japan, Korea, and China.

ASEAN economies. However, much of this intra-trade is still dependent on final demand in the US and Europe rather than in Asia.

Table 1 also highlights the lack of substantial intraregional trade within ASEAN itself. For the largest five economies of Singapore, Thailand, Malaysia, Indonesia, and Thailand, trade volume in 2003 within ASEAN exceeds 20% only for Singapore (28.2%) and Malaysia (28.7%). This discrepancy between intra ASEAN and intra-Asian economic activity will be a recurrent theme throughout this paper.

To better understand the recent trends in East Asia of both export and import trade, we can turn to time series comparisons with similar data from competing trading blocs.

Intraregional Trade

Tables 2a and 2b provide trend data on imports and exports for intraregional merchandise trade within major regional trading blocs.

Table 2: Intraregional Merchandise Trade within Regional Group (as share of group total)[3]

(a) Imports

	80	85	90	96	97	98	99	00	01	02	03
APEC	55.2	62.4	62.9	67.3	67.4	68.6	68.7	68.1	66.9	65.8	66.9
ASEAN	18.2	19.7	16.4	19.6	20.5	23.1	23.5	24.3	23.5	24.3	26.5
ASEAN+3	30.0	32.9	30.9	39.2	39.6	40.1	41.5	42.1	41.7	43.5	44.9
All East Asia	33.1	38.0	39.1	45.3	45.8	47.1	47.9	49.1	47.8	49.5	50.4
E.U	46.6	50.4	55.5	53.3	54.1	54.7	60.6	58.0	57.7	58.7	59.1
NAFTA	32.8	34.4	33.9	40.0	40.6	41.0	41.1	40.6	40.2	38.9	37.4

(b) Exports

	80	85	90	96	97	98	99	00	01	02	03
APEC	55.7	65.4	65.0	68.6	68.2	66.4	68.3	69.7	69.6	70.2	69.4
ASEAN	18.7	19.8	19.8	25.4	24.9	23.9	22.4	23.9	23.2	23.7	22.1
ASEAN+3	29.4	26.7	27.0	36.6	34.4	33.5	31.3	33.5	34.2	34.7	35.3
All East Asia	33.7	33.1	36.5	45.8	44.8	42.7	40.1	42.7	43.6	45.0	45.9
E.U	60.8	51.8	65.9	61.4	55.5	57.0	63.3	62.1	61.3	61.1	61.4
NAFTA	33.6	43.9	41.4	47.6	49.1	51.7	54.6	55.7	55.5	56.7	56.1

We make three observations pertinent to APT. One, relative to other regional trading blocs, ASEAN itself is not particularly integrated. Within-group percentages are far below those in EU, NAFTA, and even greater East Asia. In fact, it turns out that only Singapore is among the top five trading partners of each ASEAN country. In contrast, the Philippines does not make the top ten of any ASEAN nation, for either imports or exports.[4] Although import shares have been trending upwards, they remain far below those of other blocs.

Two, the asymmetry of import and export figures between Asia and NAFTA and the constancy of the APEC figures suggests that the post-war relationship between North America and Asia continues to predominate. For much of this era, Asia has pursued an export-oriented development strategy and exchange rate policy focused primarily on US markets, either directly or indirectly through industrial Asia. Most recently, the result of this symbiotic relationship has

[3] Source: IMF, Direction of Trade Statistics, 2004.
[4] From the Direction of Trade Statistics, International Monetary Fund, 2001, Singapore is either in the top five of exports or imports for each ASEAN country.

been (a) diverging trends between rising intra-Asian import trade shares and falling intra-NAFTA import trade shares, (b) flat or falling intra-Asian export trade shares and soaring intra-NAFTA export trade shares, and (c) relative constancy of intraregional trade shares within APEC. With the US continuing to grow trade deficits with Asia and while keeping the bulk of its exports within North America, one can expect this interdependent trading zone to power the Asian growth machine for the foreseeable future.

Three, as pointed out by Sakakibara & Yamakawa (2003a), intraregional export trade within ASEAN has actually been in a downward trend for the past decade. After a steady rise from 1980-1996, ASEAN exports to other ASEAN members have fallen each year since. ASEAN countries have continued to direct exports toward the markets of industrial countries, first toward Japan, then toward the US and now increasingly toward China, rather than toward themselves. While both intra-ASEAN and intra-APT imports have continued to grow, regional exports trends suggest that the age of ASEAN as a self-contained regional trading bloc has not yet arrived. As such, claims of ASEAN or APT as an optimal currency area (OCA) in the classical sense of Mundell (1961) or McKinnon (1963) do not appear to have much empirical support.

It should be noted, however, that European monetary integration, from its beginnings in the Exchange Rate Mechanism to the Euro, did not fulfill the OCA requirements either. Political imperatives are often the drivers of economic and monetary integration. This may well prove to be the case for APT. The expansion of the EU and prospective expansion of NAFTA to encompass Latin America and the Caribbean, plus the establishment of the Euro may well provide the political impetus towards greater East & Southeast Asian integration, economic pre-conditions notwithstanding. However, it should not be forgotten that ASEAN itself was founded,

not to promote economic integration, but to foster peace and stability in the face of the then aggressive and expansionist communist Vietnam and to halt the perceived possibility of a domino-effect.

Time Series Trends of Trade Shares

Since the mid-1990s, China's demand for ASEAN raw materials and intermediate goods to feed its export-orientation toward global markets has dramatically shifted the trends that were in place prior to the Asian Crisis.[5] To see these developments more clearly, we turn to a set of time series of Asian trade shares found in the Appendix.[6]

Figures A1-A5 present ASEAN export trade shares to ASEAN, Japan, China, the US, and the EU. Conveniently, we can divide ASEAN export share trends into three phases.[7] Phase I, roughly the years through the late 1980s, represents the formative period in which Japan and increasingly the US and the EU were direct targets of export growth for ASEAN countries. Phase II, essentially from the late 1980s to the mid 1990s, was marked by the rapid integration of intra-ASEAN export trade. Phase III, beginning with the mid 1990s, is characterized by both the consolidation of trade with Japan, the US, the EU and ASEAN and by the rapid rise in export trade toward China.

[5] Interestingly enough, the exponential rise of Chinese trade seemed to originate at the same time as the devaluation of the Chinese yuan in 1994. Initially, many including Bergsten (1997) argued that the devaluation resulted in a sharp loss in cost competitiveness among ASEAN countries and a downward revision in expected growth forecasts. However, subsequent analysis by Fernald et al. (1998) found that from 1994 to 1998, the yuan actually appreciated in real terms. They found that given the prevailing unofficial black market exchange rate, the official 35% devaluation was really only tantamount to an actual 7% nominal devaluation. As many including McKinnon (2003) pointed out, China's maintenance of the yuan peg to the US dollar may have saved Asia from an even deeper crisis.
[6] Each graph in the appendix comes from the IMF's Direction of Trade Statistics (DOTS), 2004.
[7] The ASEAN transition economies of Myanmar, Laos, Cambodia, and Vietnam often showcase development patterns more similar to Asian growth patterns from earlier years: a large focus on Western markets. However, given their relatively small markets, the growth pattern of the ASEAN transition economies has not been large enough to change the overriding trend for ASEAN exports.

What had been a strong movement toward ASEAN integration in the 1990s has been replaced with a movement of equal vigor toward integration with APT, particularly with China. The implications of China as the newly favored export destination will be far reaching and have profound consequences for all regional initiatives, ranking from trade integration to proposals for exchange rate coordination and monetary union.

We should expect this tandem growth trend of increased APT trade integration with China and increased Chinese penetration into global markets to continue for some time. There are several reasons for this.

Integration with China: Role of Production Networks

A key factor driving the increase in intraregional trade in East Asia has been the formation of a tight web of production networks in the region. As noted by Sakakibara and Yamakawa (2003b), Transnational Corporations (TNCs) play a key role in establishing regional production chains by locating each stage of a production process according to the comparative advantage of individual countries. In particular, as part of the adjustment to China's integration to the world economy, non-Chinese manufacturing firms have relocated more labor intensive manufacturing plants to lower wage economies in the region. Such regional supply chains have in turn given rise to a growing intensity in intra-industry trade between East Asian countries. Table 3 presents the increasing shares of total trade growth due to intra-industry trade growth in several developing regions.

Table 3. Share of Total Trade Growth due to Intra-industry Trade Growth

Region	Shares of Total Trade Growth due to Intra-industry Trade Growth (%)		
	1986- 1990	**1991 - 1995**	**1996 - 2000**
Africa, sub-Saharan	30.0	30.5	13.0
Asia			
East Asia	42.5	26.9	75.0
South Asia	31.2	21.8	34.4
Middle East and North Africa	6.4	5.8	26.1
Western Hemisphere			
Caribbean and Central America	25.9	39.3	34.5
South America	4.6	32.1	34.0

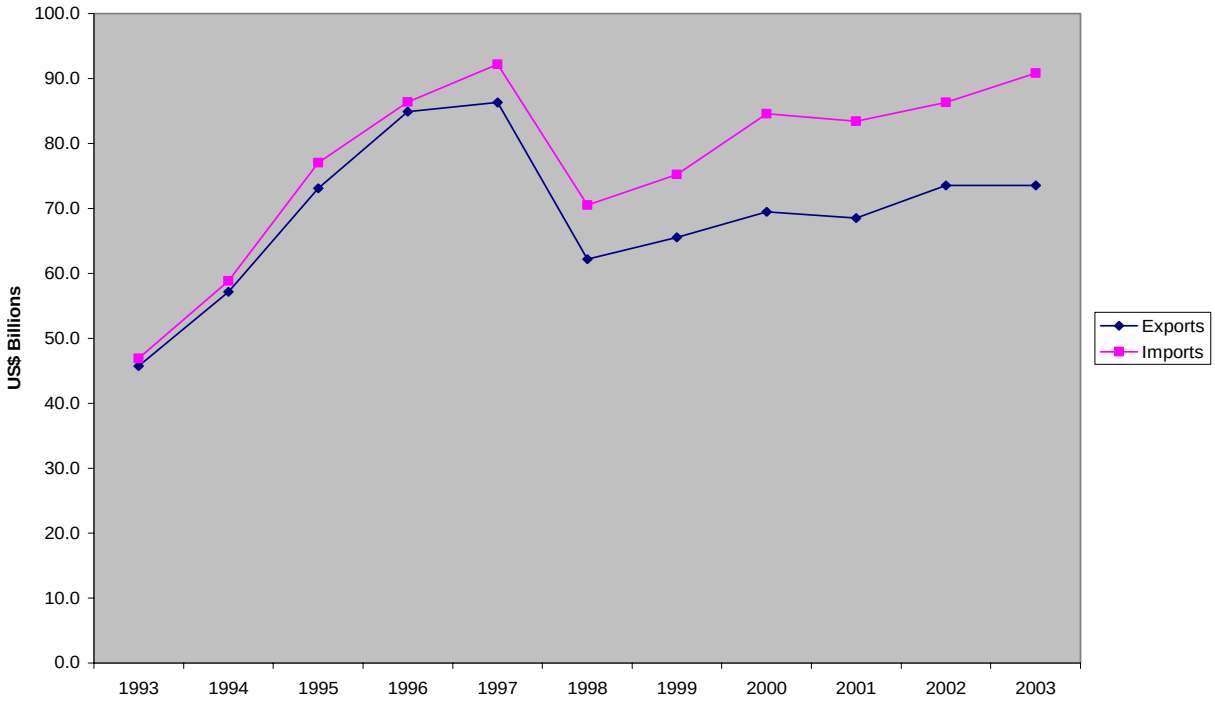
Note: Figures are calculated by IMF staff using data from the UN Comtrade database at the SITC 2-digit, and are based on the methodology by Menon & Dixon.

Source: World Economic Outlook, Sep 2002, International Monetary Fund, Chapter III, Table 3.8, p. 126

Integration with China: Importance of Trade in Services

The establishment of regional production networks will also increase the extent and importance of service transactions. The fragmentation of goods production depends on reduced transaction costs in insurance, transportation, and with information and communication technology (ICT) services. Figure 1 gives the trade volume in commercial services by ASEAN countries over the past decade. The service trade has remained robust throughout the 1990s and into 2003. As information technology and other high value-added human capital services become more essential to commercial portfolios, the existence of regional production networks will increasingly benefit East Asia's trade in corporate services.

Figure 1: Trade in Commercial Services by ASEAN Countries[8]



Going forward, regional trade in services, particularly in service exports, will be further boosted by China's GATS (General Agreement of Trade in Services) commitment to remove most restrictions on foreign entry and ownership over the next few years (Srivastava & Rajan, 2004). The dismantling of these trade barriers should lead to greater demand for services by China, particularly in the areas of distribution, professional and infrastructure services, areas in which other APT nations are well positioned to exploit.

Integration with China: Room for Growth

While remaining at low levels, intraregional imports from ASEAN have been growing. Figures A6 and A7 chart import trends of industrial Asia and ASEAN6 toward ASEAN6 goods.

[8] Source: ASEAN Statistical Yearbook, 2004.

Import trade shares from ASEAN countries represent only 10-15% of industrialized Asia's imports and still only 15-25% of ASEAN6 countries' imports. However, these shares have grown considerably since the time of the Asian Crisis. The close proximity of several trading nations to each other, especially relative to trading partners in the Americas and Europe, and the cost competitiveness of goods from Asia suggest that the share of intraregional trade within Asia should continue to increase, particular with a growing China and recovering Japan.

At the same time, while on a clear upward trend for some time, shares of goods going from China to both ASEAN and industrialized Asia also remain low. Figures A8-A10 plot shares of imports of APT countries coming from China. Although surging in recent years, Chinese import penetration into ASEAN6 economies is still remarkably low (only 6-9% of import shares). Penetration is only slightly higher in the transition economies, where China receives 10-12% of import shares. For industrialized Asia, the strong growth trend of import shares from China from 1980-2003, has only recently reached 20% and 10% in Japan and Korea, respectively.

While Chinese import shares have steadily grown, shares of imports coming from the US and EU have fallen steadily across all of Asia (see Figures A11-A15). Were China to mount a serious challenge to the US, the EU, and Japan for high-end value added goods, we could expect the share of Chinese imports to trend upwards for the foreseeable future.

Finally, exports to China are only getting started. We saw in Figure A3 that it was only around the onset of the Asian crisis that exports from ASEAN6 to China began to grow. Even with six years of rapid growth, exports to China still only comprise 6-12% of total exports of ASEAN6 economies. Figures A16-A18 suggests that industrialized Asia has already started to target the massive Chinese market. Figure A16 indicates that shares of exports going to China from both Japan and Korea has been growing at an exponential rate, while Figures A17 and A18

indicate that the share of ASEAN6 exports going to the US and the EU have been falling steadily over time. While the trends are unmistakable, and the shares of exports going to China from Japan and Korea have already reached 21% and 13% respectively, it is hard to imagine why this upward trend would not continue. The growth of Chinese middle class consumerism and future APT cooperative efforts to integrate and liberalize trade and finance likely means that China will soon be among the US, the EU and Japan as the world's favorite export destinations.

Integration with China: Implication of Trade, Investment, and Financial Liberalization

APT has only recently started to liberalize trade, investment, and finance. Two of the three industrial engines of regional growth, China and Korea, have among the stiffest trade barriers. With increased financial liberalization, a larger percentage of trade-oriented firms will have access to capital on better and on more flexible credit terms. Increased financial integration with a giant and rapidly growing China at the early stages of its development suggests that the shift of both ASEAN and industrial Asia toward China has only just begun.

China and Japan

But what of Japan? Like the US and EU, Japan's import and export shares with APT economies have fallen steadily over time. We saw in Figure A2, that while still large, shares of ASEAN6 exports to Japan have slowly declined. Figures A19 and A20 show that this decline in export share to Japan also characterizes trade both with industrialized Asia and with the transition economies of ASEAN. The import picture within Asia toward Japan is no better. Figures A21-A23 show that Japanese import shares have fallen steadily across Asia since the mid-1980s. Clearly, with her surging regional trade volumes with East Asia, reliance on regional

production networks, and established foothold in the US and EU markets, China will soon join Japan as a second engine of growth driving APT.

With two industrial powerhouses in the same region, there is no shortage of profound policy questions, including those regarding regional institution building and policy coordination. Prospective Chinese dominance of trade in the real sector and the flow of currencies that accompanies that trade clouds visions of what roles China and Japan will and must play in an integrated APT.

I.1.2 Regional Trade Agreements

The pursuit of real integration of the regional economies has given rise to a slew of regional trade agreements (RTAs). Tables 4-5 list the most recent trade agreements involving at least one East Asian country that have been proposed, negotiated or signed.

Table 4a. Bilateral or Trilateral Initiatives with Asian Countries: Existing FTAs

Parties		Type	Initiated
Korea	Chile	FTA	2004
Korea	Chile	SA	2004
China	Macao	FTA	2004
China	Macao	SA	2004
China	Hong Kong	FTA	2004
China	Hong Kong	SA	2004
USA	Singapore	FTA	2003
USA	Singapore	SA	2003
EFTA	Singapore	FTA	2003
EFTA	Singapore	SA	2003
Singapore	Australia	FTA	2003
Singapore	Australia	SA	2003
Singapore	Jordan	FTA	2003
Singapore	Sri Lanka	CEPA (incl FTA)	2003
Japan	Singapore	FTA	2002
Japan	Singapore	SA	2002
New Zealand	Singapore	FTA	2001
New Zealand	Singapore	SA	2001

Note:
FTA = Free Trade Agreement
SA = Services Agreement
CEPA = Comprehensive Economic Partnership Agreement
Source: Evenett, et al. (2004) and Rajan (2004)

Table 4b. Bilateral or Trilateral Initiatives with Asian Countries: Proposed

Parties			Type	Initiated	Status
Korea	China	Japan	FTA	2003	Joint task force established
Singapore	New Zealand	Chile	FTA	2003	Under Negotiation
Japan	Australia		TEF	2002	Official Discussions
Japan	Canada		FTA	2002	Proposed and under study
Singapore	India		CECA (incl FTA)	2002	Under Study
Singapore	Canada		FTA	2001	Under Negotiation
Korea	USA		FTA	2001	Under Negotiation
Korea	Thailand		FTA	2001	Proposed and under study
Thailand	Croatia		FTA	2001	Proposal
Thailand	Czech Rep		FTA	2001	Proposal
Singapore	Chile		FTA	2000	Under Negotiation
Singapore	Korea		FTA	2000	Proposed and under study
Singapore	Taiwan		FTA	2000	Proposed and under study
Korea	Australia		FTA	2000	Official Discussions and under study
Korea	Mexico		FTA	2000	Official Discussions and under study
Korea	New Zealand		FTA	2000	Official Discussions and under study
Singapore	Mexico		FTA	1999	Under Negotiation
Korea	Japan		FTA	1998	Official Discussions and under study
Japan	Mexico		FTA	1998	Under Negotiation
Korea	China		FTA		Proposed and under study
Japan	Chile				Proposal
Thailand	Australia				Proposal
Thailand	Japan				Proposal

CECA = Comprehensive Economic Cooperation Agreement
Source: Evenett, et al. (2004) and Rajan (2004)

Table 5. Regional Trade Agreements

Parties		Type	Initiated	Status
ASEAN	Korea	FTA	2002	Official Discussions
ASEAN	China	FTA	2001	Official Discussions and under study
ASEAN	CER2	CER1	1999	
ASEAN		AFTA	1992	Signed and Implemented
ASEAN	Japan	CEP		Official Discussions and under study
ASEAN	India			Proposal
P5				Proposal

P5 = Singapore, Australia, New Zealand, USA, & Chile
CEP = Comprehensive Economic Partnership
AFTA = Asian Free Trade Agreement
CER1 = "Closer Economic Relations"
CER2 = Australia and New Zealand

Source: Evenett, et al. (2004) and Rajan (2004)

In recent years, there has been a marked proliferation of bilateral and plurilateral trade pacts. This development can be attributed, at least in part, to regional frustration with the slow progress in global trade and investment liberalization and with the protracted and cumbersome negotiations in the multilateral arena. Consequently, several regional economies have pursued a second track to liberalization via the formation of RTAs while concurrently embracing the multilateral liberalization framework under the GATT/WTO. Interestingly, many of the FTAs are trans-regional rather than regional in character.

Asia's pragmatism to push ahead with trade liberalization while simultaneously continuing work on multilateral accords should bode well for future prospects of regional integration. However, there remains a risk that regional and trans-regional agreements will be pursued in lieu of multilateral trade liberalization, a prospect that would potentially create large non-tariff costs in terms of trade lawyer fees and bureaucratic delays which may nullify diplomatic efforts to increase trade integration. As suggested by Burton (2004), of vital

importance is ensuring that "…regional and bilateral trade initiatives remain consistent with broad participation in the global economy." The same principle is also evident in the concept of open regionalism espoused by others: a guiding principle which may help avoid fundamental inconsistencies and contradictions in the growing number of trade accords. Others, like Jagdish Bhagwati, however, view the initiatives as creating a 'spaghetti bowl' effect that will hinder WTO-type negotiations. Indeed, although FTA-like agreements may confer some first-mover advantage, their proliferation would surely erode it. Analysts would be hard put to quantify the benefits and costs, even in terms of static trade-creation and trade-diversion effects, let alone dynamic ones.

I.2 Characterizing FDI Integration

The East Asian region has long enjoyed market-driven integration not only through trade, but also through foreign direct investment (FDI). Indeed, FDI reforms in regional countries have contributed to the development of export platforms in the region. Table 6 gives the inward and outward FDI flows as a percentage of gross fixed capital formation for APT countries.

Table 6: FDI flows, 1992-2003

Percentage of gross fixed capital formation

Country	Direction	(Ann Avg) 92-97	98	99	00	01	02	03
Japan	Inward	0.1	0.3	1.1	0.7	0.6	1.0	0.6
	Outward	1.6	2.3	1.9	2.5	3.6	3.4	2.6
Korea	Inward	0.8	4.8	7.1	5.4	2.6	1.8	2.1
	Outward	1.7	4.5	3.2	3.1	1.7	1.6	1.9
China	Inward	13.7	13.6	11.3	10.3	10.5	11.5	12.4
	Outward	1.3	0.8	0.5	0.2	1.5	0.5	0.4
Hong Kong	Inward	18.4	29.4	58.6	138.9	55.7	25.8	38.4
	Outward	48.7	33.8	46.2	133.2	26.6	46.5	10.7
Taiwan	Inward	2.4	0.4	4.4	6.8	7.8	2.9	0.9
	Outward	5.3	6.1	6.7	9.2	10.4	9.8	11.3
India	Inward	2.0	2.9	2.2	2.3	3.2	3.0	4.0
	Outward	0.1	0.1	0.1	0.5	1.3	1.0	0.8
Country	**Direction**	**92-97**	**98**	**99**	**00**	**01**	**02**	**03**
Brunei	Inward							
	Outward							
Cambodia	Inward	35.0	65.7	48.3	29.1	21.0	16.0	12.3
	Outward	0.8	5.4	1.9	1.3	1.0	0.7	1.4
Indonesia	Inward	6.4	-1.0	-6.6	-13.9	-9.7	0.4	-1.8
	Outward	2.2	0.2	0.3	0.5	0.4	0.3	0.4
Lao PDR	Inward	26.7	14.4	15.7	9.1	6.2	6.9	5.2
	Outward				45.0	0.8	15.7	20.3
Malaysia	Inward	18.0	14.0	22.5	16.4	2.5	14.5	10.8
	Outward	5.6	4.5	8.2	8.8	1.2	8.6	6.0
Myanmar	Inward							
	Outward							
Philippines	Inward	8.5	16.0	11.9	8.4	6.9	11.9	2.2
	Outward	1.3	1.2	-0.2	-0.7	-1.1	0.4	1.1
Singapore	Inward	29.3	25.0	57.8	62.8	60.1	25.6	45.7
	Outward	18.1	9.7	27.0	19.3	68.2	16.5	22.2
Thailand	Inward	4.1	29.9	23.8	12.4	14.4	3.7	5.2
	Outward	0.9	0.5	1.4	-0.1	0.6	0.4	1.6
Vietnam	Inward	34.5	23.1	20.1	15.0	13.6	11.4	15.2
	Outward							

Source: World Investment Report, 2004; Annex Table B.5
Original Source: UNCTAD FDI/TNC Database

Large net inflows suggest that inward FDI stock has increased dramatically over the past decade. However, as with trade trends, closer inspection reveals that FDI trends within Asia have considerable room to improve.

FDI into ASEAN

Table 7 showcases FDI Inflows into ASEAN countries by ASEAN host country.

Table 7: FDI Inflows into ASEAN by ASEAN host country

(who is getting the FDI inflows)

	97	%	98	%	99	%	00	%	01	%	02	%	03	%
Brunei	702	2.1	573	2.6	748	2.7	549	2.3	526	2.7	1035	7.5	3123	15.4
Cambodia	168	0.5	243	1.1	232	0.8	149	0.6	149	0.8	145	1.1	87	0.4
Indonesia	4678	13.7	-356	-1.6	-2745	-9.9	-4550	19.5	-3279	16.9	145	1.1	-596	-2.9
Laos	86	0.3	45	0.2	52	0.2	34	0.1	24	0.1	25	0.2	19	0.1
Malaysia	6323	18.5	2714	12.1	3895	14.0	3788	16.2	554	2.9	3203	23.3	2473	12.2
Myanmar	879	2.6	684	3.1	304	1.1	208	0.9	192	1.0	191	1.4	128	0.6
Philippines	1261	3.7	1718	7.7	1725	6.2	1345	5.8	982	5.1	1111	8.1	319	1.6
Singapore	13533	39.7	7594	33.9	16067	57.7	17218	73.6	15038	77.6	5730	41.7	11431	56.3
Thailand	3882	11.4	7491	33.4	6091	21.9	3350	14.3	3886	20.1	947	6.9	1969	9.7
Vietnam	2587	7.6	1700	7.6	1484	5.3	1289	5.5	1300	6.7	1200	8.7	1450	7.1
ASEAN	34099		22406		27853		23379		19373		13733		20304	

Source: ASEAN Statistical Yearbook, 2004, Table VI.1, p139

Since 2000, more than three-quarters of FDI into ASEAN has gone into Singapore and Malaysia, two of the least populated countries in ASEAN. On a per capita basis, these figures point towards a remarkable concentration of FDI inflows into ASEAN. The source of these inflows is just as interesting. Table 8 gives FDI Inflows into ASEAN by source country.[9]

[9] ** Includes FDI into Cambodia, Reinvested Earnings from the Philippines, and Inter-Company Loans in Cambodia. Source: ASEAN Statistical Yearbook, Table VI.2.

Table 8: FDI Inflows into ASEAN by Source Country, 1995-2003

(US$ millions)

	95	96	97	98	99	00	01	02	03	95-03
ASEAN	4654	4272	5236	2731	1789	1195	2392	3557	2069	27894
REST OF THE WORLD	23425	25643	28695	19433	25461	22210	16959	9911	17277	189015
Asian NIEs (total)	2845	2242	3521	1930	1629	1831	70	103	991	15163
Hong Kong	1271	928	1885	1162	698	1297	-294	-353	482	7075
South Korea	660	504	722	91	529	-31	-269	68	282	2556
Taiwan (ROC)	914	810	914	678	403	566	632	388	227	5532
China	137	118	62	291	63	44	61	-157	13	631
India	108	69	90	93	42	58	-6	131	83	667
Japan5	5649	5283	5230	3938	1688	944	1422	1759	2061	27973
EU-15	5050	7362	6334	5554	9806	8387	9179	3791	7083	62545
Other EU	1172	2121	1993	1308	2242	1100	-46	679	1604	12173
Canada	609	205	1111	-207	-14	61	-483	281	-372	1191
USA	4318	5177	4950	3222	5932	5335	4881	-1018	2920	35717
Australia	535	325	246	-302	-935	-42	-391	746	46	227
New Zealand	35	31	29	25	80	23	4	106	90	424
All OTHERS	2967	2710	5130	3581	4929	4471	2269	3490	2758	32305
Total	28080	29915	33931	22164	27251	23405	19351	13468	19346	216909
Total**	28231	30209	34099	22407	27853	23379	19373	13733	20304	219587

FDI inflows remain less than two thirds of inflows received at the peak of the ASEAN boom. Although the combination of the Sept 11th attacks and SARS makes these inflows hard to interpret, what is evident is that the volume is down considerably from the mid-1990s. Moreover, it is interesting to see that FDI flows from APEC have also fallen considerably. Inflows from the Asian NIEs, industrial Asia, and the US are nowhere near what they were in the mid 1990s.

At the same time, FDI into China continues a strong upward trend. Figure 2 presents FDI time series for China.

Figure 2: FDI into China[10]

Comparing Figure 2 with Table 2, we can see that flows into China dwarf those going into ASEAN. Scale alone suggests that the existence of China as a direct investment alternative will continue to draw away FDI from ASEAN, even if investment conditions in ASEAN were to be considered attractive.

Among ASEAN countries themselves, FDI flows into ASEAN have stalled. Table 7 presents FDI inflows into ASEAN from ASEAN countries. From 2000 to 2003, only Thailand has increased FDI inflows into ASEAN. The two largest sources for FDI in the mid-1990s, Singapore and Malaysia, have curtailed activity dramatically. With the exception of the SARS year of 2002, FDI inflows into ASEAN from ASEAN countries have fallen steadily over the past

[10] Source: Ministry of Foreign Trade and Economic Cooperation, China.

decade as a share of FDI inflows. By 2003, ASEAN shares represented only 10.7% of FDI inflows into ASEAN.

Table 9: FDI inflows into ASEAN from ASEAN countries (US$ millions)

Source Countries	1995	1996	1997	1998	1999	2000	2001	2002	2003		1995-2003
Brunei Darussalam	311.3	353.1	384.9	247.2	4.3	10.6	10.6	21.2	36.8		1,380.0
Cambodia	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		0.0
Indonesia	608.9	193.3	272.5	-38.4	-427.8	-232.6	-240.0	1,336.6	384.0		1,856.5
Lao PDR	6.5	102.6	64.4	28.3	31.4	13.7	3.1	7.9	3.0		260.8
Malaysia	1,676.5	1,475.8	2,261.5	469.9	536.0	258.1	80.0	0.0	251.1		7,009.0
Myanmar	96.7	228.6	323.3	153.9	41.2	74.0	67.4	25.1	28.6		1,038.7
Philippines	241.6	74.9	142.9	106.9	110.9	126.5	222.3	37.9	175.1		1,239.0
Singapore	1,165.1	1,206.7	941.6	794.6	632.1	353.0	356.9	704.7	420.0		6,574.6
Thailand	160.6	308.1	297.5	569.6	572.0	389.0	1,650.0	1,223.0	670.0		5,839.8
Viet Nam	387.3	328.7	547.2	398.7	289.3	202.4	241.5	200.4	100.4		2,695.8
ASEAN *)	4,654.4	4,271.8	5,235.7	2,730.8	1,789.3	1,194.9	2,391.7	3,556.9	2,068.9		27,894.4

Source: Asian Statistical Yearbook, 2004, Table VI.3

FDI Rankings

The emergence of China as a viable and promising investment destination has increased competition for FDI in the region. To evaluate a given country's investment potential, the United Nation Conference on Trade and Development (UNCTAD) has designed an indexed ranking that has become popular with international firms. Table 10 provides UNCTAD's inward FDI potential rankings for 2003 taken from 140 countries.[11]

[11] We focus on ASEAN instead of ASEAN+3 since FDI figures for advanced industrial economies do not reflect the overall attractiveness of a country for investment purposes.

Table 10: Inward FDI Potential Index rankings, 1988-2002[12]

Country	88-90	89-91	90-92	91-93	92-94	93-95	94-96	95-97	96-98	97-99	98-00	99-01	00-02
Japan	13	12	12	10	8	8	11	7	12	13	13	14	16
Korea	20	20	26	25	21	17	19	18	21	18	21	20	18
China	45	43	55	61	60	57	47	41	43	41	43	44	39
Hong Kong	17	17	18	16	13	13	13	13	14	12	11	11	12
Taiwan	21	21	27	24	23	21	23	24	24	22	22	22	21
India	74	72	99	94	97	93	92	98	96	94	97	91	89
Brunei	31	31	24	23	22	27	32	27	27	29	30	27	35
Cambodia													
Indonesia	43	44	57	55	55	64	42	61	79	70	75	81	82
Laos													
Malaysia	37	36	40	38	36	31	34	33	32	32	31	33	32
Myanmar	118	118	126	126	128	120	118	108	106	101	99	77	74
Philippines	77	78	78	71	73	71	57	52	54	53	57	55	57
Singapore	12	13	15	13	7	4	4	3	2	2	3	3	4
Thailand	40	40	51	45	46	42	45	50	50	51	53	54	54
Vietnam	80	81	101	93	92	87	64	82	86	79	73	72	67

In recent years, while eight of the fifteen economies of APT rank among the top half of all countries for which there are figures, the rest of the region does not rate as an attractive locale for overseas direct investment. As a point of comparison, in 2003, no EU country ranked below #37 (Greece), with ten of the EU15 in the top 20. The NAFTA region appeared equally as attractive, with both the US (#1) and Canada (#5) in the top five.

Of course potential FDI is one thing but actual FDI performance, the attraction of actual FDI, is another. Table 11 provides UNCTAD's FDI performance index rankings since 1988,

[12] Source: World Investment Report, 2004. Original Source: UNCTAD Inward FDI Potential Index. Note: calculation takes into account real GDP growth, GDP per capita, total exports, telephone, mainlines, mobile phones, energy use, R&D expenditures, students at tertiary level, country risk, exports of natural resources, imports of parts/accessories of electronics and automobiles, exports in services, and inward FDI stock.

where performance is measured as FDI inflows relative to inflows that would otherwise be expected given GDP.[13]

Table 11: FDI Performance Index rankings, 1988-2003

Outward

Country	88-90	89-91	90-92	91-93	92-94	93-95	94-96	95-97	96-98	97-99	98-00	99-01	00-02	01-03
Japan	16	17	21	37	48	46	48	39	46	51	48	46	41	41
Korea	32	34	40	41	42	37	37	32	34	33	34	44	44	47
China	36	39	35	30	35	39	60	60	61	64	69	60	59	58
Hong Kong	5	5	2	1	1	1	8	2	3	3	2	2	2	6
Taiwan	6	10	12	17	25	23	29	21	24	25	27	25	24	24
India	82	84	86	94	91	87	90	86	95	107	91	71	63	61
Brunei		64	73	34	21	33	41	45	52	58	67	63	75	69
Cambodia														
Indonesia	71	73	48	46	28	27	35	55	70	88	85	81	80	80
Lao PDR														
Malaysia	28	31	42	28	13	8	14	11	17	22	24	30	29	32
Myanmar														
Philippines	62	59	56	43	44	43	63	64	66	81	102	125	122	96
Singapore	9	9	5	7	2	2	10	3	4	7	12	6	5	3
Thailand	45	45	50	54	50	48	45	42	57	59	77	72	84	62
Vietnam														

Inward

Country	88-90	89-91	90-92	91-93	92-94	93-95	94-96	95-97	96-98	97-99	98-00	99-01	00-02	01-03
Japan	105	105	119	124	128	129	133	134	136	134	129	130	131	132
Korea	81	83	99	105	116	118	121	121	113	102	95	97	107	120
China	46	50	43	19	9	11	15	20	31	42	51	56	50	37
Hong Kong	3	15	18	14	8	13	14	15	14	12	3	2	2	9
Taiwan	49	58	76	86	98	100	100	106	120	117	110	101	103	117
India	98	103	118	113	112	108	104	103	111	116	118	121	121	114
Brunei	103	106	117	108	115	17	7	4	3	4	7	7	4	2
Cambodia														
Indonesia	56	56	59	59	65	58	50	54	77	118	138	138	139	139
Lao PDR														
Malaysia	4	3	4	3	5	6	10	13	19	33	50	71	70	75
Myanmar														
Philippines	30	46	51	42	37	43	48	66	72	79	82	89	90	96
Singapore	1	1	2	5	4	2	3	3	5	5	6	4	6	6
Thailand	17	19	29	40	58	73	76	74	53	44	44	59	80	87
Vietnam	47	20	12	6	3	3	6	9	12	21	37	44	51	39

Source: World Investment Report, 2004; Annex Tables A.I.5 and A.I.6

[13] Taken from UNCTAD. Figures are three-year moving averages. Note: The FDI performance index is defined as the ratio of a country's share in global FDI flows to its share. in global GDP. The indexed is normalized around a country which receives an amount of FDI in line with their relative economic size. Countries with an index greater than one attract more FDI than might be expected given relative GDP.

Once again, the reader may be surprised at how poorly ASEAN has done as a whole. Several countries were among the worst rated of 2003, most notably Indonesia (#139). Four of the five biggest ASEAN economies were in the bottom half with the Philippines at #96, Malaysia (#75), Thailand (#87), and Indonesia (#139). Only the small kingdom of Brunei (#4) and the island city state of Singapore (#6) ranked among the top ten.

The low FDI inflows relative to GDP appear to reflect an abrupt shift in investor sentiment following the Asian Crisis. Indonesia's ranking plummeted beginning in 1998. Malaysia has been in the top ten from 1988-1996 and since then has performed steadily worse at attracting FDI inflows. This was largely due to the negative image it projected after it imposed capital controls in 1998, during the Asian Currency Crisis. The Philippines has fallen each year since 1994, going from rankings in the 30's to its present position at #96. Thailand had been in the top 20 from 1988-1991, but fell to the 70s in the years leading up to the Asian Crisis and has now been ranked in the 80s for two consecutive years. Vietnam had been in the top 20 during the ASEAN spurt of 1989-1996, but has since drifted down to #39. Of the major ASEAN economies, only Singapore has been successful at consistently attracting FDI inflows. In fact, its current ranking of #6 is its "worst" since 1988.

The Competition over FDI

Why have developing ASEAN nations been unable to attract more FDI? There seem to be two competing explanations. One explanation suggests that the deep institutional fragility highlighted by the Asian Crisis has not since improved measurably or in some cases has worsened. These institutional building blocks include the rule of law, transparency, economic democracy, the regulatory environment, accountability, and enforcement. Without reforms that

can restore credibility and trust in the intermediate and long term, inward FDI flows are likely remain below those justified by GDP. Yet such an explanation does not fully explain the considerable flow of short and longer term funds *into* ASEAN in the late 80s through 1996, when the institutions in place were on far weaker footing.

A competing explanation argues that investor interest in China has diverted funds away from ASEAN economies. The potential of the immense Chinese market, the stability of the Chinese government, and the willingness of the government since Deng Xiao Ping to develop China's economic infrastructure has dramatically changed the global face of China. Firms who might have otherwise expanded operations in Indonesia, Thailand, or other ASEAN countries have now turned their attention towards China.

The evidence for this latter explanation is also mixed. Chantasasawat, et al. (2004) found that while the level of China's FDI is negatively related to the ASEAN's share of total FDI into Asia, FDI into China has generally raised the level of FDI into the larger ASEAN countries. Their results suggest that while the slice of the FDI pie going toward ASEAN countries has become narrower, the pie itself has grown,. Given the relative size of China, such a result is perfectly understandable. However, the large investor interest in China does suggest that at the margin, investors are preferring to put their money into China. Coupled with the growth of Chinese imports into ASEAN countries, the inability of ASEAN to attract FDI flows should be of great concern to those ASEAN policymakers wishing to repeat the performance of the early 1990s, when ASEAN markets were seen as much for their own potential, rather than as indirect gateways into China.

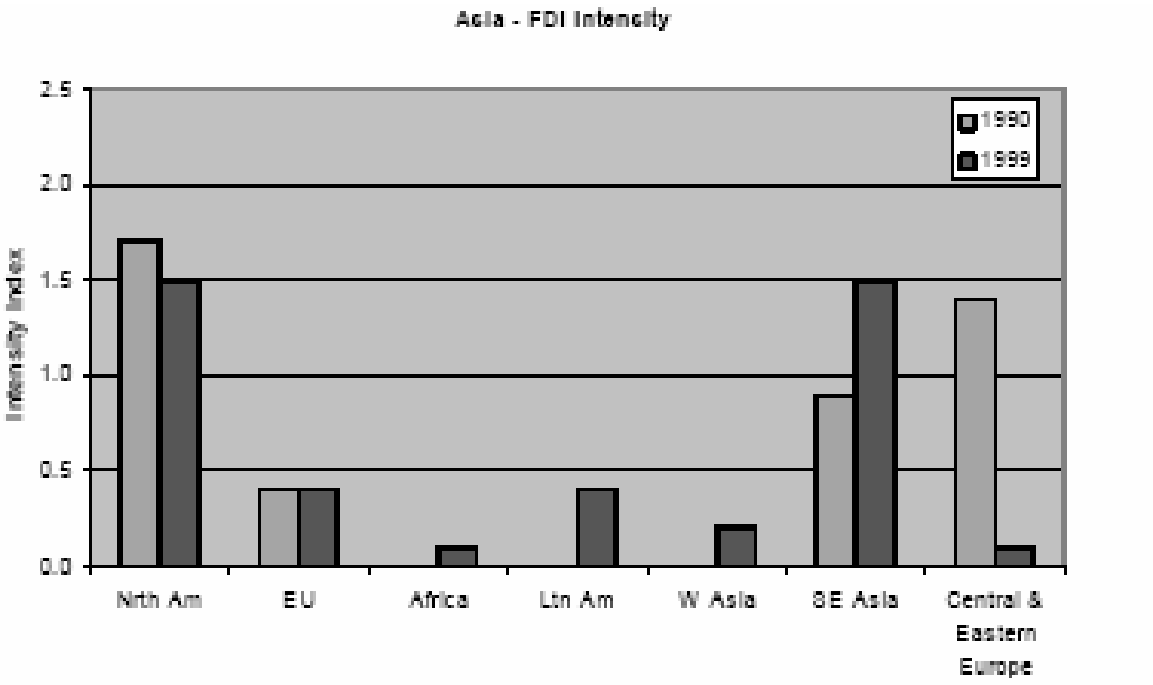
The chronically poor ratings on both performance and potential FDI rankings should serve as a wake-up call to APT policymakers to what is essentially a fierce battle over technology transfer, jobs, and stable capital flows. Institutional credibility, access to talented human capital, and economic opportunity will continue to direct longer term investment toward those countries which have done their utmost to both attract and to reassure investors.

Intraregional Concentration

The potential for China to increase its outward investment in the region has increasingly led East Asian countries to place their own FDI into the region. Figure 3 shows Asia's FDI intensity index, a measure of the ratio of the share of the partner [e.g. the US] in Asia's FDI stock to the share of the partner in world FDI stock.[14] We observe that despite the region's dependence on investment from the US and EU, there has been an increasing bias towards intra-regional investment.

[14] Source: Sakakibara and Yamakawa (2003a).

Figure 3. Asia's FDI Intensity Index, 1990 and 1999



However, from 1995-2003, Singapore was able to garner 48.9% of all FDI inflows into ASEAN. In fact, together with Malaysia (16.4%) and Thailand (14.5%), these three countries received nearly 80% of all FDI inflows for the past decade![15] This extremely asymmetric concentration of FDI inflows within ASEAN should be of concern to regional policymakers. Furthermore, given the growth of China and the success of certain ASEAN economies in targeting Chinese growth patterns, the competition over FDI inflows within Asia and within ASEAN itself only promises to intensify.

[15] See Graphic VI.4, ASEAN Statistical Yearbook 2004, p 141.

Sectoral Patterns

Finally, it is important to realize that the importance of trade in services has its FDI equivalent. Table 12 presents share of services in total inward FDI for 1990-2002.

Table 12: Share of services in total inward FDI, 1990-2002

In Percentages

	Flows					Stock				
Country	90-94	95-99	00-02	01	02	90	95	00	01	02
Japan	53.3	63.4	78.6	84.9						
Korea	38.3	41.9	44.2	42.9	64.8	37.8	35.2	34.9	34.7	42.0
China		36.1	27.4	28.2	24.7				32.5	31.4
Hong Kong		84.1	96.4	101.4	80.1		91.7	92.0	92.4	93.0
Taiwan	39.4	44.4	59.5	60.8	55.9	27.2	31.4	41.5	43.5	44.3
India	10.5	28.3								
Brunei		0.4	28.3	1.2	56.6					
Cambodia	84.2	57.6	59.2	44.7	55.6			39.7	38.1	36.4
Indonesia		28.5	22.4	33.5	4.0		17.2			
Lao PDR		48.9	34.6	24.0	62.7					
Malaysia		3.0	0.6	2.4		35.4	33.5			
Myanmar		8.7	28.3	24.8	31.1	23.0	31.9	35.1	35.1	34.7
Philippines	25.0	57.8	49.3	61.6	22.0	23.5	28.0	45.2	46.2	43.9
Singapore		70.7	58.1	54.8	72.6	58.5	61.7	63.3		
Thailand	61.8	68.6	30.3	25.7	15.7	47.6	57.9	62.2	58.0	56.8
Vietnam		37.8	23.0	29.6	9.2	20.6	45.8			

Source: World Investment Report, 2004; Annex Table A.I.22
Original Source: UNCTAD, FDI Database
Note: Multiple-year entries are moving averages

While it is hard to spot a definitive trend in flows, it is clear that the accumulated stock of investments in the service industry have been considerable.

Table 13 provides additional data on the sectoral share of FDI inflows.

Table 13: Share of FDI inflows into ASEAN by Economic Sector[16]

Economic Sectors	1999	2000	2001	2002	2003	1999-2003
Agriculture, Fishery and Forestry	-0.1	0.6	0.0	3.6	0.9	0.8
Mining and Quarrying	7.7	5.0	10.9	13.1	21.1	10.9
Manufacturing	24.1	33.4	33.8	40.3	23.9	30.1
Construction	-0.3	-0.7	7.8	-6.8	0.6	0.5
Trade/Commerce	15.9	8.6	7.1	17.6	11.6	12.0
Financial Intermediation and Services						
(Incl. Insurance)	24.0	27.8	-43.1	49.6	27.9	16.3
Real Estates	2.3	3.0	7.0	2.4	3.6	3.6
Services	7.8	6.0	1.7	10.8	-1.4	4.9
Others (Not Elsewhere Classified)	18.6	16.3	74.7	-30.7	11.8	20.9
Total	100.0	100.0	100.0	100.0	100.0	100.0

From 1999-2003, a higher portion of FDI inflows into ASEAN went into services (financial/insurance or other services) than into manufacturing. FDI inflows into financial intermediation were the largest share of FDI inflows from China, second largest from US, EU, and Taiwan (behind manufacturing), and the third largest from Japan (behind manufacturing and trade/commerce).[17]

Countries with highly trained and multilingual human capital, like Singapore, will be well positioned to exploit the region's increasing trade in professional services, particularly with increased financial integration and liberalization.

I. 3 Characterizing Financial Integration

While East Asia has focused on real integration through RTAs, the region has also begun working towards financial integration. The 1997-98 Asian crisis raised awareness on two fronts.

[16] Source: Asian Statistical Yearbook, 2004, Table VI.18
[17] Table VI.16, ASEAN Statistical Yearbook 2004, p.160

One, countries needed to strengthen their domestic financial sectors in order to handle the efficient absorption of capital inflows and meet the financial intermediation needs of high-growth development. Two, countries needs to develop the institutional capacity to contain cross-country contagion and resolve common financial problems. Addressing both national and regional aspects of financial integration will provide additional scope for regional financial cooperation and coordination.

There are essentially three broad dimensions to financial integration: market, institutional, and commercial.[18]

Market integration refers to the extent to which market prices for similar instruments have converged. These prices include government and corporate bond yield spreads; secured and unsecured money market rates; spreads on credit to firms and consumers; and perhaps even equity market returns. Although true convergence would require that the information set, expectations, and investor preferences be identical across the region, instrument price convergence has been at the heart of econometric work on international financial integration.[19] Owing to its quantitative nature, market integration is perhaps the most transparent and quantifiable dimension of financial integration.

Institutional integration refers to the extent to which economic structure and legal institutions for similar investment and business objectives have normalized. Highly competitive financial sectors are more likely to offer firms and investors a wider and more diversified range of financial products at more competitive cost structures. Consistent legal codification, regulatory frameworks, and enforcement mechanisms can reduce the uncertainty associated with

[18] This description modifies Collins (2004).
[19] See for example Marston (1995).

bureaucratic red tape and prevent more serious outcomes, which though unlikely, cannot easily be hedged. Compared with market integration, institutional integration refers to the qualitative aspects of integration, some of which can justify investment decisions that would otherwise appear unattractive.

Commercial integration concerns itself with the movement of capital, labor, contracts, and economic entities that integrate economies through more tangible and physical means. Commercial integration can be seen as the twin of real integration in which the actual delivery of goods and services, and not the potential for such trade, measures the extent of trade integration. The extent of commercial integration best reflects deeper political and sociocultural exchanges, not the least of which involves technology transfer and the sharing of ideas, values, perspectives, and processes. Traditionally, this dimension of integration has been left as a catch-all to explain the lack of market convergence or persistent differences in legal and economic environments. However, the experience of European integration suggests that commercial integration should be considered in its own right. Some examples of commercial integration include realized intraregional capital flows, cross-border M&A activity, expansion of branch locations, and cross-border entrepreneurial initiatives.[20]

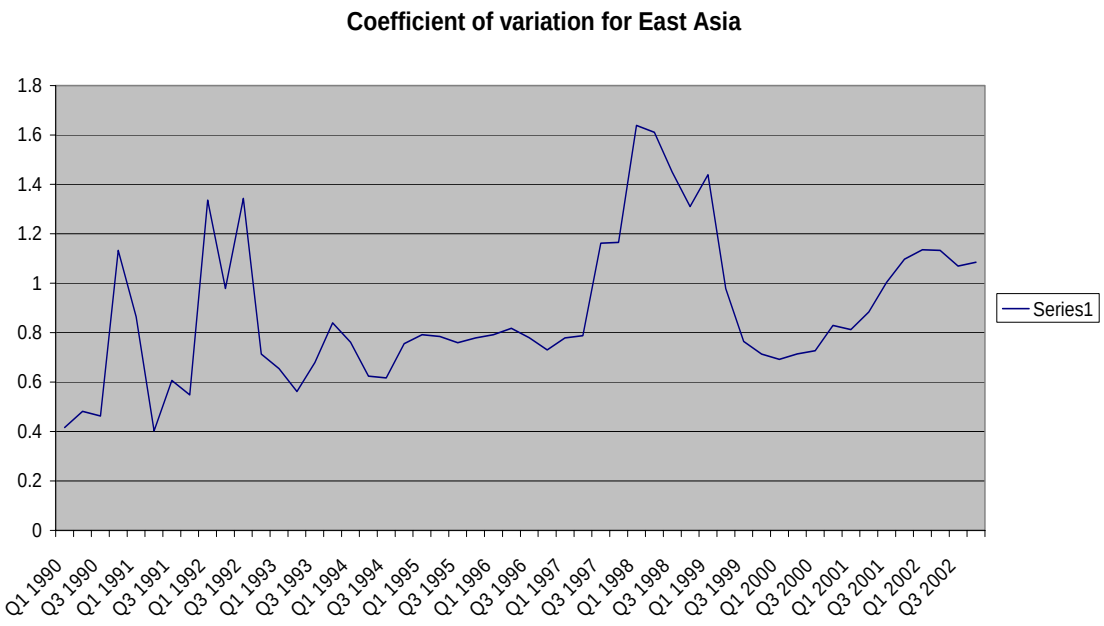
I.3.1 Market Integration in East Asia

Figure 4a plots the coefficient of variation of short term interest rates for the countries in East Asia. Rather than converging and due in large part to the Asian Currency Crisis, short term interest rates in East Asia have become more divergent in recent years. Despite significant

[20] See Collins (2004) for an in depth presentation on the political economy of subsidiary banking vs. branch banking.

increases in trade and continued FDI inflows, the evidence pointing towards deeper market integration in East Asia is mixed.

Figure 4a. Coefficient of Variation of Short Term Interest Rates: East Asia



How does the convergence of short-term interest rates in East Asia, or lack thereof compare with similar measures of market integration in other regional groupings? We look compare results for East Asia with those for NAFTA and MERCOSUR.

Figure 4b. Coefficient of Variation of Short Term Interest Rates: NAFTA

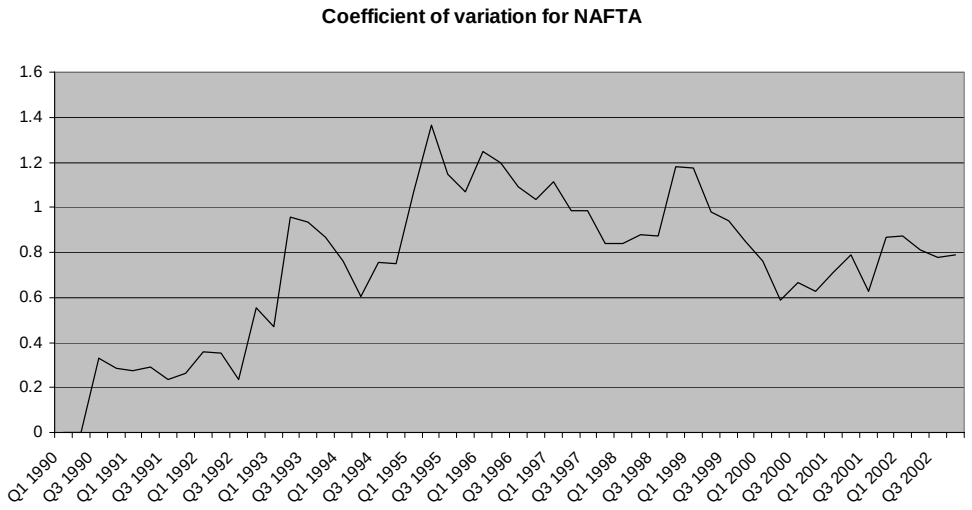
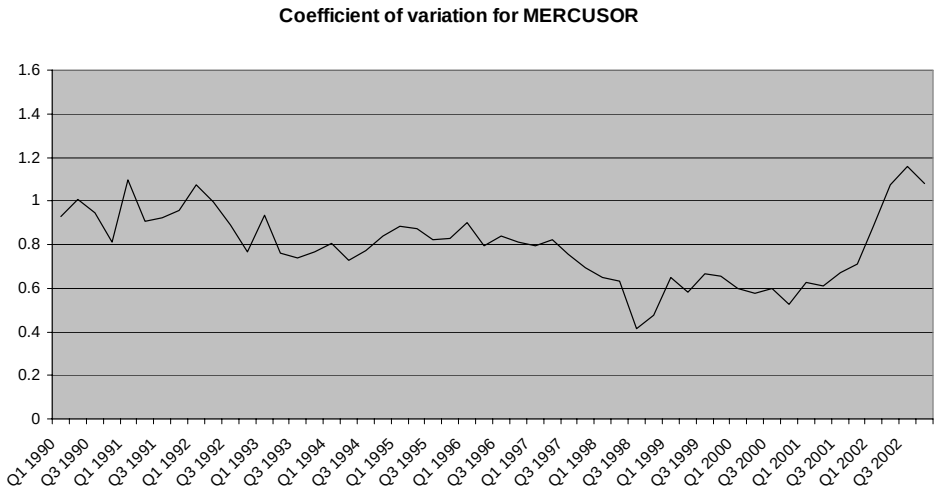


Figure 4c. Coefficient of Variation of Short Term Interest Rates: Mercosur



While imperfectly so, it appears that short-term rates in NAFTA have in fact been converging since the early 1990s. Not counting the turbulence in 2001-2002 associated with the Brazilian elections, in which the leading candidate ran on a strictly-leftist platform, and the

financial implosion of Argentina, rates in MERCOSUR had also been converging consistently over the 1990s.

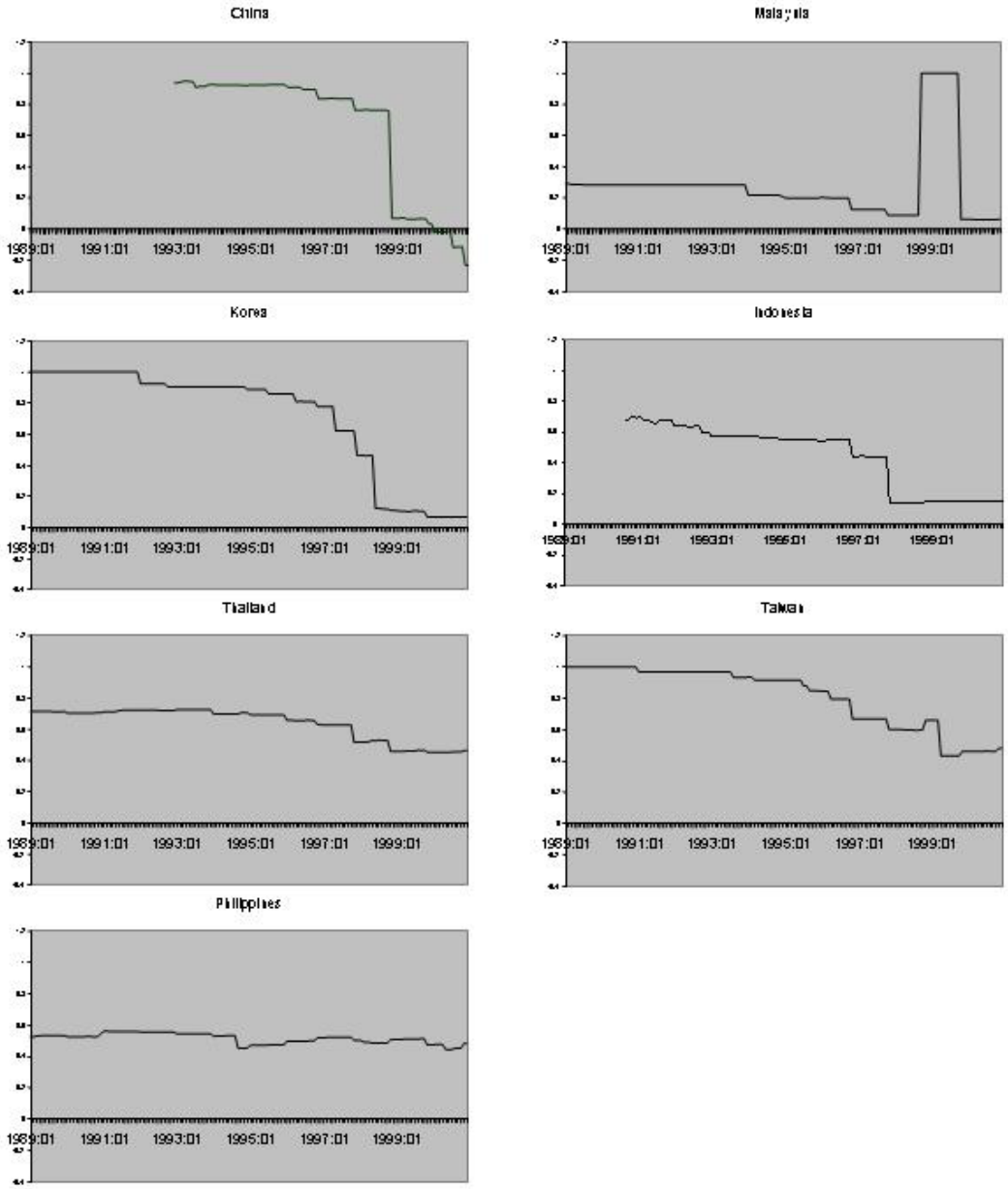
Obviously, the convergence of short-term rates is only one metric with which to measure market integration. However, it is perhaps the easiest standard to achieve. Longer term instruments, whether private or public, incorporate exchange rate, credibility, default and other credit risks. The lack of shorter-rate convergence suggests that far greater financial liberalization and harmonization is needed to integrate financial markets.

I.3.2 Institutional Integration in East Asia

We examine institutional integration by considering to measures of legal and economic restrictions faced by investors and firms. First, we use a measure developed in Edison and Warnock (2003) based on the restrictions on foreign ownership of equities[21] Figure 5 plots this measure for various East Asian countries.

[21] The authors refer to these restrictions as the "intensity of capital controls."

Figure 5: Intensity of Equity Restrictions



The plots indicate rapid liberalization in the post-crisis period.[22]

Second, we present in Table 14 a wide range of controls on the current and capital accounts as reported to the IMF.[23]

Table 14: Current Account and Capital Account Liberalization

	Short Term Inflows Restrictions						Capital Account Restrictions						Surrender Export Receipts					
Country	90	96	97	98	00	03	90	96	97	98	00	03	90	96	97	98	00	03
Japan			o	o						o	o							
Korea			o	o	o	o	o	o	o	o	o	o	o	o				
China	-	-	o	o	o	o	-	-	o	o	o	o	-	-	o	o	o	o
Hong Kong																		
Brunei	-	-					-	-	o	o	o	o	-	-				
Cambodia	-	-	o	o	-		-	-	o	o	o	o	-	-	o	o	o	o
Indonesia			-	o	o	o			o	o	o	o						
Laos	-	-	o	o	o	o	-	-	o	o	o	o	-	-				
Malaysia			o	o	o	o			o	o	o	o	o	o	o	o	o	o
Myanmar	-	-	-			-	-	-	o	o	o	o	-	-	o	o		
Philippines	o	-	o	o	o	o	o	o	o	o	o	o	o					
Singapore				o	o													
Thailand			o	o	o	o	o	o	o	o	o	o	o	o	o	o	o	o
Vietnam	-	-	o	o	o	o	-	-	o	o	o	o	-	-	o	o	o	o

o : indicates that the specific practice is feature of the exchange system
- : indicates that data were not available at the time of publication
[ ] (no entry) : indicates that the specific practice is not regulated

Whether emerging markets should fully open their capital accounts remains a hot topic for academic and policymakers alike. Some authors, most recently Bekeart, et al. (2004) and Forbes (2004), find that that the benefits from capital market openness to growth and efficient investment outweigh the risks associated with capital controls. However, a growing literature argues that fully liberalizing the capital account when either the open-economy trilemma remains

[22]Thanadsillapakul (2000) presents UNCTAD's integration framework and demonstrates that ASEAN has been integrating in accordance with the 1998 framework agreement of the ASEAN Investment Area (AIA).

[23] Source: International Monetary Fund, Annual Report on Exchange Rate Arrangements and Exchange Restrictions, various years.

unresolved (Obstfeld, 2004b) or when financial sector development is at an intermediate stage (Aghion, et al., 2004) can be destabilizing.

Regardless of the merits of capital restrictions, ASEAN members clearly boast a wide range of experiences with openness. The region hosts countries from Singapore, one of the most financially open countries in the world, to several extremely closed economies (e.g. Cambodia, Laos, Myanmar) to several previously open economies who have since reinstituted capital controls (e.g. Malaysia).

Of course, these measures of institutional integration are but two of many that must be considered negotiable as the region attempts to build a more formal infrastructure for financial integration. Perhaps the most challenging of these will be those which require increased regionalism despite cleared expressed sovereign preferences to retain policy discretion control under national auspices.

Presently, East Asia lacks anywhere near the regional institutional breadth and depth of the European Union.[24] However, at some point in its drive to deepen regional integration, ASEAN and East Asia will be confronted with the necessity to build those regional institutions, the ASEAN distaste for domestic meddling notwithstanding.

[24]See Wyplosz (2001a and 2004) and Eichengreen (2004) for how Asia might learn from the EMU experience. For a simple but fascinating comparison of institutional perspectives between the EU and ASEAN, read the remarks by Pierre Gramegna and Lim Chin Beng (1997) before the United Nations University in 1997.

I.3.3 Commercial Integration in East Asia

We distinguish commercial integration by identifying actual movement of capital, labor, contracts, and economic entities that further economic integration. The most obvious of these are capital flows into and within the region. Table 15 gives the capital flows in the region over the past decade.

Following the Asian crisis, we can observe the sudden and sharp reversal of short term capital from the region, particularly from the crisis countries. While net capital flight has stopped and net capital flows have recovered somewhat for developing Asia as a whole, the recovery has come from the most developed and industrialized Asian countries and not from the crisis countries. Most ASEAN countries have not fully recovered from the ramifications of the Asian crisis. Unquestionably, the SARS epidemic, the war with Iraq, and the continued investment and trade attractiveness of China has made recovery within ASEAN a far more difficult task. However, unless ASEAN members embark on financial sector reforms deemed credible in the international financial community, the economic health of ASEAN will remain dangerously dependent on the health of industrial economies, both within Asia, and outside of the region, namely those of the US and the EU.

Table 15: Capital Flows, 1990 - 2003

(US dollar bn, 1990 Prices)

	TI	91	92	93	94	95	96	97	98	99	00	01	02	03
BRN	NC													
	DI													
	P													
CAM	NC	n.a	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	DI	n.a	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	P													
CHN	NC	0.8	0.0	1.9	2.1	2.1	2.0	1.0	-0.3	0.3	0.1	1.7	1.6	2.6
	DI	0.4	1.0	2.2	2.2	2.0	2.0	2.2	2.2	1.9	1.9	2.2	2.5	2.3
	P	0.1	0.0	0.3	0.3	0.0	0.1	0.4	0.0	0.0	0.4	0.1	0.1	0.4
HKK	NC	n.a	n.a	n.a	n.a	n.a	n.a	n.a	-4.7	0.6	2.5	-4.0	-12.3	-11.1
	DI	n.a	n.a	n.a	n.a	n.a	n.a	n.a	8.1	14.1	36.8	14.3	6.0	8.6
	P	n.a	n.a	n.a	n.a	n.a	n.a	n.a	-1.9	33.5	27.6	-0.7	-0.7	0.6
IND	NC	5.2	5.2	4.4	2.7	6.7	6.6	-0.3	-3.5	-1.8	-2.3	-2.0	-0.3	n.a
	DI	1.4	1.5	1.6	1.5	2.8	3.7	2.7	-0.1	-0.8	-1.3	-0.8	0.0	n.a
	P	0.0	-0.1	1.4	2.8	2.7	3.0	-1.5	-0.7	-0.5	-0.5	-0.1	0.3	n.a
JPN	NC	-65.6	-95.5	-96.1	-79.5	-59.8	-26.2	-110.7	-104.7	-35.5	-72.1	-44.7	-59.3	67.5
	DI	1.2	2.6	0.1	0.9	0.0	0.2	2.9	3.0	11.3	7.6	5.7	8.5	5.9
	P	123.4	9.1	-5.7	60.3	55.9	62.4	72.7	51.1	116.1	43.7	56.1	-18.8	76.2
KOR	NC	6.2	6.0	2.6	8.3	12.8	16.9	-6.2	-5.3	7.9	7.7	1.8	4.2	8.0
	DI	1.1	0.6	0.5	0.6	1.3	1.6	1.9	3.4	5.8	5.7	2.1	1.4	1.8
	P	2.7	5.1	9.1	6.7	10.8	15.2	9.0	0.5	4.9	7.7	7.2	3.1	12.5
LAO	NC	0.0	0.0	0.0	0.0	0.1	0.1	0.0	0.0	0.0	0.1	0.1	n.a	n.a
	DI	0.0	0.0	0.0	0.1	0.1	0.2	n.a	n.a	n.a	0.0	0.0	n.a	n.a
	P													
MYL	NC	5.5	8.1	9.6	1.1	6.4	7.6	1.7	-1.9	-4.7	-4.4	-2.7	-2.1	n.a
	DI	3.9	4.8	4.4	3.7	3.5	4.1	4.0	1.6	2.8	2.6	0.4	2.2	n.a
	P	0.2	-1.0	-0.6	-1.4	-0.4	-0.2	-0.2	0.2	-0.6	-1.5	-0.5	-0.6	n.a
MYN	NC	0.3	0.2	0.2	0.2	0.2	0.3	0.5	0.5	0.3	0.2	0.4	n.a	n.a
	DI	0.2	0.2	0.1	0.1	0.3	0.3	0.4	0.3	0.3	0.3	0.2	n.a	n.a
	P													
PHL	NC	2.5	2.5	2.4	3.5	3.4	6.6	3.6	0.2	-1.1	-1.8	-0.3	-1.0	-2.2
	DI	0.5	0.2	0.9	1.1	0.9	0.9	0.7	1.1	0.8	0.6	0.4	0.7	0.1
	P	0.1	0.1	0.7	0.6	1.7	3.0	0.3	-0.2	3.6	0.5	0.4	0.6	0.4
SIN	NC	2.3	1.7	-1.1	-7.9	-1.3	-8.0	-10.5	-15.4	-10.5	-1.6	-12.5	-12.6	n.a
	DI	4.7	2.1	4.3	7.6	10.0	7.9	11.4	6.3	10.9	10.3	8.9	4.9	n.a
	P	-0.2	1.3	2.6	0.1	-0.2	0.8	-0.4	0.6	2.6	-1.7	0.2	-1.0	n.a
THL	NC	11.1	8.6	9.2	10.2	17.3	14.6	-8.5	-9.2	-7.2	-6.7	-2.3	-1.8	-5.0
	DI	1.9	1.9	1.6	1.1	1.6	1.7	2.8	4.8	4.0	2.2	2.5	0.6	1.2
	P	-0.1	0.8	4.8	2.1	3.2	2.7	3.3	0.2	-0.1	-0.4	-0.3	-0.4	0.2
VNM	NC						2.9	2.1	1.6	1.1	-0.3	0.4	2.1	
	DI						2.4	2.2	1.7	1.4	1.3	1.3	1.4	
	P													

Source: International Financial Statistics; Asian Development Bank (Key Indicators)

Note: Net Capital inflow, Direct investment inflow and portfolio inflow data taken from IFS.

Figures were deflated using the CPI index from ADB Key Indicators Tables.

ND = CPI not available - figures not deflated

TI = Type of Inflow

DI = Direct investment

NC = Net Capital

P = Portfolio

Another measurement of commercial integration is the extent of cross-border business undertaken by financial institutions. Table A1 in the appendix provides cross-border mergers and acquisitions purchases and sales for East Asia. Although the data are for global M&A activity and not solely restricted to the region, they do reflect how open Asia has been to M&A activity. We observe that cross-border M&A activity have increased considerably in East Asia. Yet regional activity still only represents 10% of global sales and 8% of global purchases. One of the hallmarks of a healthy and vigorous financial system is global M&A. Should they persist, formal and informal restrictions on cross border deals will continue to slow down East Asian financial liberalization.

II Sequencing of Regional Economic Integration

A key consideration when proceeding with regional integration is sequencing. Sequencing concerns the order in which reforms are undertaken within and across sectors. The goal of sequencing is to design a path of adjustments that will enhance the long-term regional welfare gains. This path must be time-consistent. Dramatic short-term adjustment costs, particularly those resulting from structural, financial, and political constraints, can derail even the best sequencing plans.

In this part of the report, we propose a series of regional integration and liberalization based on the trend analysis provided in Part I of this paper. If implemented, these measures should positively impact economic growth and promote the financial stability and deepening of East Asian countries.

We present our optimal sequencing plan in three sections. We begin by presenting the functional scope of real integration. We focus on the various sectors identified in regional trade agreements (RTAs). We explain the main factors that will lead to a natural expansion of RTAs—from manufactures only, to both goods and services, to a more broadly defined trade that would include foreign direct investment. We then follow with a closer look at the liberalization necessary to achieve financial integration. Importantly, we consider financial liberalization in conjunction with its mutually reinforcing relationship with real integration. We place particular emphasis on domestic financial reforms and the proper sequencing of capital account liberalization necessary given the disparate levels of financial sector development presently in East Asia. Finally, we present arguments on the need for an effective regional institution or set of institutions and discuss the key determinants affecting the enlargement process of RTAs. To do so, we examine institutional mechanisms and the national membership of regional initiatives.

II.1 Sequencing Real & FDI Integration

II.1.1 RTA on Manufactures: Intensity of Competition

The ability of East Asian exporters to define the terms of access to regional markets has increased with the high and rising intensity of intra-East Asian trade flows. As we have seen, competition within the East Asian markets is getting more intense with other East Asian countries. This development has been largely driven by two related factors. First, the increasing integration of China into the world economy continues to exert downward pressure on the world market prices of labor intensive manufactures. The result of this pressure has been described as a

"knife-edge" comparative advantage whereby small variation in costs could lead large shifts in competitive advantage (Bhagwati, 1997). Second, the spread of cross-border production networks means firms are increasingly aware of the potential cost shifts facing their particular industry. Without such awareness and preparedness, firms may no longer have the option to remain integral to the regional production network.

Pricing pressures and cross-border production networks have increased competition considerably in East Asia. Further expansion of RTAs will likely trigger defensive responses from East Asian exporters in excluded countries as they suffer a loss of relative competitiveness. Therefore, the benefit cost calculus of any RTA proposal must be based on its estimated net marginal benefit across all relevant factors and agents. One such measure, as used in Evenett, et al. (2004), is the extent of current tariff protection on manufactured goods.

We see from Table A2 in the appendix that the average tariff rates in East Asia over the past two decades have come down considerably. Importantly, rather than increase calls for protectionism following Asian Crisis of 1997-1998, regional fiscal authorities have continued to promote this downward trend in average tariffs. Yet, upon closer inspection, tariffs within Asia remain widely distributed. Table 16 presents average tariffs by country and manufactured good

.

Table 16: Simple Avg MFN applied tariff rates by MTN category[25]

MTN	Description	CHN	HKK	TWN	INDO	JPN	MLY	PHL	KOR	SING	THAI	EU	CAN	USA
1	Wood, pulp, paper, and furniture	14.1	0	4.6	7.9	1.3	10.9	8.9	5.9	0	13.8	2.2	1.5	0.8
2	Textiles and clothing	26.8	0	9.4	14	7.6	13.5	12.6	10.1	0	25.4	8.5	12.2	9.4
3	Leather, rubber, footwear, and travel goods	17.7	0	5.9	10.7	6.7	14	7.7	8	0	26.3	4.2	6.1	4.4
4	Metals	9.8	0	6	8.5	1.4	9.3	5.9	6.1	0	12.5	2.5	2.3	2.2
5	Chemicals and photographic supplies	11.4	0	3.7	6.6	2.3	3.6	4.2	7.3	0	10.4	4.9	3	3.4
6	Transport equipment	23.3	0	11.6	12.1	0	18.5	8.2	5.5	0	23.6	4.1	5.5	3.2
7	Non-electric machinery	14.4	0	4.9	2.3	0	3.7	3.5	6.4	0	9.2	1.7	1.4	1.2
8	Electric Machinery	16.1	0	5.3	7.7	0.2	6.7	5	6.1	0	13.2	2.5	2.3	1.9
9	Mineral products and precious stones and metals	12.1	0	4.2	6	0.8	8.8	5.5	5.9	0	10	2	1.7	1.9
10	Manufactured products not elsewhere specified	18	0	4.8	10.3	1.1	5.1	5.5	6.8	0	15	2.6	2.8	2.1
11	Fish and fish products	21.5	0	27.1	5	5.9	2.4	9	16.2	0	57.6	11.2	1.1	1.1
12	Fruits and vegetables	22.6	0	28.7	5	8.4	2.9	10.4	55.6	0	58.9	9.8	2.7	7.8
13	Coffee,tea, maté, cocoa, and preparations	26.1	0	13.8	4.9	11.6	9	18.9	55.3	0	60	5.8	1.4	2.6

[25] *Source:* WTO Integrated Trade Database, as reported in Bora (2003)

14	Sugars and sugar confectionary	27.9	0	27.3	3.8	10.1	2.8	18.9	20.1	0	46.3	11.4	4	6.2
15	Spices, cereal, and other food preparations	31.4	0	20.2	5.2	12.5	2.6	9	112	0	42.5	5	3.7	3.1
16	Grains	54.4	0	2.8	2	1	0	18.5	193	0		5.4	11.5	2.2
17	Animal and products thereof	20.7	0	26.3	4.6	7.8	0.5	27.1	24.7	0	50.3	5.3	4.4	3.4
18	Oil seeds, fats and oils and their products	31.1	0	8.2	4	1.7	1.7	6.3	14.3	0	28	3.2	3.1	9.1
19	Cut flowers, plants, vegetable materials; lacs, etc.	12.4	0	9.2	5.7	0	0	3.2	28.1	0	38.5	2.4	0.7	1.2
20	Beverages and spirits	50.6	0	28.1	80	9.4	9.4	10.7	29.1	0	0	11.3	4.4	1.8
21	Dairy products	40.3	0	18.6	5	3.6	3.6	5	72.2	0	35.8	7.7	7.4	13.5
22	Tobacco	56.7	0	25.4	10.7			8.4	33.2	0		39.7	7.3	204
23	Other Agricultural products	12.3	0	3.7	4.4	0.7	0.7	3.2	10.1	0	29.1	1.3	0.8	0.8
	Simple Average MFN Tariff Rate	24.9	0	13	9.8	4.3	5.9	9.4	31.8	0	28.9	6.7	4	12.5
	Median Tariff rate	21.5	0	9.2	5.7	2	3.7	8.2	14.3	0	26.3	4.9	3	2.6

Average tariffs in China, Thailand, and Korea remain very high, while those in Hong Kong and Singapore are non-existent. In general, East Asian tariff rates exceed those in Europe and US, with North East Asian countries having tariffs rates that are generally higher than those in South East Asia. Therefore, one can expect that the creation of new RTAs or the expansion of existing RTAs will alter considerably the relative competitiveness of exporting firms within Asia.

Firms that are adversely affected will certainly lobby to protect their profits.[26] In the context of a trading agreement, they are likely to do so by demanding that the scope of negotiations be enlarged to cover their interests. If so, we should expect to see "snowballing" whereby one phase of enlargement induces other applications for admission that lead to further enlargement (Evenett et al. 2004). An example of snowballing came as the US-Mexico FTA triggered a flood of requests for bilateral FTAs with the US from South American countries. Such a competitive liberalization process would result in even greater openness to trade, a beneficial development for the region. Most empirical studies have found international trade in goods to be growth-inducing.[27]

Table 17 shows the welfare effects on East Asian economies of four potential RTAs, as estimated in Scollay and Gilbert (2001). We note that a RTA for APT will yield greatest benefit for the regional countries.[28] However, if agriculture is excluded, the potential gains are reduced substantially. For example an RTA for APT will enhance ASEAN GDP by 1.5% but exclusion of agriculture will reduce the enhancement effect to only 0.6%.

Table 17: Impact on GDP of Regional Trade Agreements (Percentage Change)

East Asian RTAs	ASEAN		China		Korea		Japan	
China + Korea + Japan	-0.3	(-0.2)	0.1	(-0.2)	1.0	(0.6)	0.1	(0.2)
ASEAN+China	0.9	(0.5)	0.0	(0.1)	-0.1	(-0.1)	0.0	(0.0)
ASEAN+Japan	1.1	(0.2)	-0.1	(-0.1)	-0.2	(-0.1)	0.0	(0.1)
ASEAN+China+Korea+Japan	1.5	(0.6)	0.1	(-0.2)	1.1	(0.8)	0.2	(0.2)

Notes:
(a) Figures in parentheses refer to net GDP changes (in %) when agricultural liberalization is excluded
(b) Calculations for ASEAN include only Indonesia, Malaysia, Philippines, Singapore, Thailand and Vietnam
Source: Scollay and Gilbert (2001, 2002)

[26] As in Baldwin's theory of "domino regionalism" (Baldwin, 1994).
[27] See Berg and Krueger (2002) for a survey.
[28] Given the high degree of trade within the APEC, it would be worth exploring the potential impact of free and open trade and investment in APEC's industrialized countries by 2010 and region-wide by 2020.

These expected gains from tariff reduction should increase as the negotiation process surrounding trade agreements broaden to address non-tariff measures (NTMs). Though far more difficult to quantify, the most recent evidence suggests that while NTMs worldwide have fallen considerably over the past two decades, they remain significant in certain countries and sectors, particularly in those export markets most valued by developing Asia. Michalopoulos (1999) found that NTMs in the larger ASEAN5 were concentrated in quotas and outright prohibition of goods. Fujii and Endo (2002), calculated that NTMs in China, Japan, and the US, were 40%, 26%, and 65% the size of tariff measures, respectively. They also found that NTMs in selected ASEAN countries remained extremely large: 40% tariff equivalency in Singapore, 59% in Malaysia, and 61% in Indonesia. Looking more broadly across sectors, Bora, et al. (2002) found that NTMs in ASEAN countries were actually lower than in the US, or the EU, which in turn were lower than in industrialized Asia given by Taiwan, China, and Japan. Table 18 presents their calculations.

Table 18: Non-Tariff Measures Quantified

Description	BRU	THL	THL	MLY	PHL	SIN	VNM	JPN	CHN	HKK	TWN	EU	US
Primary Products	6.49	4.43	6.32	3.02	0.74	0.61	0.43	7.49	6.46	0.35	21.17	1.98	4.69
Agriculture	7.61	3.35	6.67	3.53	0.76	0.72	0.41	7.69	7.30	0.41	22.79	2.30	4.56
Mining	0.00	10.84	4.22	0.00	0.61	0.00	0.54	6.31	1.51	0.00	11.60	0.47	5.44
Manufactures	2.43	1.07	3.30	2.41	1.92	0.13	1.23	5.08	8.00	0.49	7.48	10.77	5.23
Iron & Steel	0.00	1.87	0.00	7.97	0.00	0.00	21.74	0.48	44.85	0.44	8.21	51.94	42.44
Chem	3.41	1.56	0.24	0.75	4.67	0.00	0.12	1.15	3.90	2.19	15.30	4.18	3.35
Other Sem-Mnf	6.72	1.22	1.47	0.90	0.60	0.00	0.41	0.64	1.36	0.00	0.76	0.86	4.59
Mach & Trans Eqp	2.90	1.92	1.39	4.29	1.92	0.56	0.00	0.05	14.02	0.00	8.28	2.41	5.18
Textile & Clothing	0.00	0.00	13.50	0.30	0.00	0.00	0.00	23.06	2.85	0.00	0.00	87.21	1.13
Other Cons Gds	0.00	0.00	0.00	4.31	2.65	0.00	0.00	0.68	5.05	0.00	11.93	4.82	0.92
Other Products	0.00	0.00	0.00	0.00	8.33	0.00	0.00	0.00	0.00	0.00	33.33	0.00	0.00
ALL Products	**3.35**	**1.82**	**3.97**	**2.54**	**1.68**	**0.24**	**1.03**	**5.61**	**7.62**	**0.46**	**10.59**	**5.79**	**5.08**

Source: Bora, Bijit, Aki Kuwahara and Sam Laird, 2002, "Quantification of Non-Tariff Measures," UNCTAD Policy Issues in Intl Trade and Commodities, Study Series No.18, New York.
Latest Available Year

Taken together, these studies on explicit tariffs and NTMs indicate that East Asia should initially focus on concrete policy measures: tariff reductions, production harmonization and standardization, and the elimination of quotas. These are easily measurable, verifiable, and enforceable. Besides such instruments, the World Bank has shown that trade facilitation measures, such as improvements in ports, regulatory systems, standards, and electronic commerce, would increase trade significantly among APEC members by about US$280 billion (Wilson, et al., 2002).[29] Only when there are the regional institutions in place to handle more delicate and politically charged items should trade negotiations concentrate on prohibited goods and more subtle forms of protectionism.

II.1.2 RTA on Services: Policy Complementarities

As pointed out by Evenett et al. (2004), policy complementarity across different sectors suggests that RTAs on manufactured goods will inevitably expand over time to cover liberalization of the services trade. The realization of gains from trade reform in manufactured goods is dependent on reforms in other sectors such as transportation and communication. In particular, the efficient distribution of production of goods into regional production networks is contingent on reducing cross-border transaction costs brought about by services sector deregulation (Deardorff, 2001). Smooth functioning of regional supply chains requires skills in inventory management, accurate assessment of demand patterns, and rapid delivery. It follows that time-to-deliver, customization and reliability have become key determinants of export competitiveness. In light of the large trade in services within ASEAN, particularly in financial services, these policy complementarities suggest that firms in East Asia should push as

[29] Also see Mann, et al. (2003).

vigorously for liberalization of trade in services as they have for manufacturing and agricultural goods.

To illustrate this point further, Table 19 gives a 100 point scale index of non-tariff barriers toward FDI in several services sectors of East Asian economies. This measure assesses the level of restrictiveness placed on regional trade in services, since the service trade requires the simultaneous movements of labor and capital in the form of FDI.

Table 19: Index of Non-tariff Barriers in Services Sector (on a 100 point scale)

Economy	Business Services	Communications	Distribution	Financial Services	Transportation
Hong Kong	2	35	5	23	9
Indonesia	56	64	53	55	53
Japan	6	35	5	36	11
Korea	57	69	63	88	57
Malaysia	32	42	8	61	12
Philippines	48	76	48	95	98
Singapore	26	52	25	38	25
Thailand	78	84	78	88	78
USA	1	35	0	20	3

Notes: Indices of the Restrictive Effect of Policies Toward Foreign Direct Investment,1997 (No restrictions=0, Maximum Value of Index = 100)
Source: Hardin and Holmes (1997)

As we saw with real sector NTMs, Table 19 suggests that there is ample scope for reducing barriers to foreign direct investment in the service sector across the region

Regulatory reforms in the services sector are expected to deliver large gains on growth. Not only will attendant reductions in the costs of such services bolster the competitiveness of domestic firms, but direct exports of these services should also expand. Mattoo, et al. (2001) found that economies with fully liberalized telecommunications and financial sectors can grow up to 1.5% per annum faster than those countries with more restrictive policies.

However, there are caveats to liberalization. The premature internationalization of the services sector in a weak and ineffective regulatory and supervisory environment should be avoided. Without sound institutional mechanisms in place, severe instability can result in individual service sectors and in the economy as a whole. The latter can be expected in light of the substantial linkages that services have with the rest of the economy. As many have argued, the East Asian crisis was caused in part by the ill-timed and ill-sequenced liberalization of the financial sector.[30]

II.1.3 Investment Agreement: Mutually Reinforcing FDI and Trade Flows

Distinct from earlier trade agreements which tended to limit negotiations to specific trade sectors, recent RTAs have been deeper in scope and issue coverage. These RTAs have often extended beyond trade to encompass investment agreements, thus acknowledging the mutually reinforcing process of trade and FDI flows.

Trade liberalization tends to promote investment. Trade agreements which enlarge market size are sure to attract export-oriented FDI. Furthermore, the consequent reduction of import tariffs will reduces input costs for foreign affiliates, thus facilitating the procurement of intermediate goods and components from within the region (Sakakibara and Yamakawa, 2003b). According to UNCTAD, "…membership in a regional integration agreement conducive to the establishment of regional corporate networks…" will attract efficiency-seeking FDI.

The removal of restrictive policies and the creation of an environment for cross border transactions are essential for the linking of production facilities across the region. At the same time, production-fragmenting FDI creates vertical intra-firm trade in intermediate components

[30] Eichengreen, et al., (1998), Johnston (1998), Lintjer (2002) and Rajan and Bird (2002).

and finished products between parent corporations and their foreign affiliates.[31] Kawai and Urata (1998) use a gravity model for bilateral trade applied to Japanese data and find that FDI promotes exports, particularly in sectors where vertical intra-industry trade has been developed.

More generally, it is widely recognized that FDI in the manufacturing sector has been the driver of the substantial intra-industry and intra-regional trade growth in East Asia. FDI inflows have deepened regional integration and have prompted calls for more formal cooperation and coordination. Since trade and investment agreements are mutually promoting, it is not surprising that recent RTAs such as the Japan-Singapore New-Age Economic Partnership Agreement have gone beyond merchandise and services trade liberalization to include a wide range of investment matters.

Some argue that for RTAs to successfully attract investment, its members should include countries at various levels of economic development. This idea suggests that creating the multiple opportunities for investment will help capture the benefits of intra-regional specialization (Sakakibara and Yamakawa, 2003b). Firms would be able to take advantage of the diversification by locating each stage of a production process according to the comparative advantage of individual countries. East Asian countries, already highly diversified in terms of the capability of workforce and resources, would then work towards a seamless production network through regional cooperation.

An indication of the region's firm level capacity to contribute to the regional production networks can be found in the share in foreign assets held by regional transnational corporation (TNCs).[32] Table 20 presents TNC data for selected East Asian firms.

[31] See Kawai (2004a) for a discussion on the "FDI-Trade nexus".

Table 20: Home Countries/Regions of the Top 50 Non-financial TNCs from Developing Economies

	Share in total foreign assets					
	of top 50 (%)			Number of entries		
Region/Country	2000	1999	1998	2000	1999	1998
West Asia	0.5	-	-	1	-	-
Latin America	21.8	22.0	28.3	12	10	9
Africa	4.4	5.9	6.3	4	4	3
South, East and Southeast Asia	73.3	72.0	65.7	33	36	38
China	3.9	-	8.8	3	-	3
Hong Kong	38.9	26.4	22.0	11	11	10
India	-	0.7	0.8	-	1	1
Korea	13.4	23.2	16.7	5	9	6
Malaysia	7.2	7.0	6.3	5	5	6
Philippines	1.1	1.1	1.5	1	1	1
Singapore	7.4	11.2	7.2	6	7	9
Taiwan	1.4	2.4	2.4	2	2	2
Average/totala	100.0	100.0	100.0	50	50	50
U.S.	27.2			23		
EU	53.0			49		
Japan	10.7			16		
Source: Sakakibara and Yamakawa (2003), Table 4.9						

Clearly, TNCs in East Asia have been utilizing foreign assets, perhaps with an eye to build further upon current production networks.

FDI contributes positively to domestic economic growth though channels such as enhanced productivity, injection of greater competitive forces, the importation of equipment, the introduction of managerial innovations, and the restructuring of underperforming firms.[33] However, the magnitude of these benefits depends on the presence of complementary factors such as the availability of disciplined and well-trained employees as well as competitive factor

[32] This indicator is also a measurement of commercial integration within the region.
[33] An OECD (2002) literature review of sixteen recent empirical studies concluded that, in general, FDI does raise income growth in host countries.

and service markets. Furthermore, it is important to emphasize that trade and investment policies need to be coordinated and mutually supporting in terms of objectives and efficient implementation (Sakakibara and Yamakawa, 2003b). Decisions about production, investment and trade are closely interlinked in an increasingly globalized world. Well-coordinated trade and investment policies will lead to synergies that could promote growth more than if they were dealt with separately. [34]

II.1.3 Multi-speed Approach to Regional Integration

The process of liberalization—trade, FDI and financial—often requires sectoral adjustments. Since both labor and capital are commonly sector specific and thus not readily transferable between sectors, policymakers must consider short term costs in terms of unemployment and income distribution effects that are often localized to sectors and or geographic regions (Nsouli et al., 2002). Because of such costs, policymakers may prefer to take a more graduated approach to liberalization. Doing so offers them more opportunity to balance domestic economic priorities and the promotion of external economic interests.

We suggest that East Asia adopt a multi-speed approach to integration as the practical way to move forward. While the integration of developmentally similar economies represented the ideal for architects of the European Union,[35] the integration of industrial and developing economies can bring significant benefits to the developing partners (see Blomstrom and Kokko, 1997). Countries whose labor markets are less rigid, capital and labor less sector specific, and entrepreneurs more flexible and adaptable will have lower adjustment costs and thus could integrate first.

[34] See UNCTAD (1996).
[35] See Wyplosz (2004).

However, the design of an RTA for a regional subgroup should anticipate enlargement. Specifically, it is necessary for RTAs to be comprehensive in sectoral coverage in order to serve a prototype for other East Asian countries (Sakakibara and Yamakawa, 2003b). Some have criticized the current proliferation of RTAs as resulting in "spaghetti bowl" effect, thereby reducing the efficiency of regional trade (see Scollay and Gilbert, 2001). Maintaining some standardization and consistency with WTO principles will be important as it will facilitate the merging of disparate negotiations into a broader agreement over the long term, and integration with WTO without wholesale renegotiation. This approach should also help to lessen the risk of trade fragmentation and political tension arising from an uncoordinated process.

II.2 Sequencing Financial Integration

Prior to the 1997-98 crisis, regional economic integration efforts in East Asia largely focused on trade and FDI. The crisis, however, provided the impetus for regional financial cooperation. The sequencing proposal that follows will suggest that East Asia first work through weaker forms of financial cooperation before tackling stronger forms that require far greater institutional commitment and political will.

II.2.1 Weak and Strong Forms of Cooperation & Coordination

Weaker forms of regional financial cooperation begin with information exchange, technical assistance, training programs, and research cooperatives. Such informal exchanges of

services and expertise require little to no changes in law and loss of sovereign control. The institutions that would be created under weaker forms of regional cooperation, such as research institutions or think tanks, would be consultancies by nature rather than institutions with direct administrative or policy control. An example of weak form cooperation was the October 1998 establishment by ASEAN Finance Ministers of an ASEAN Surveillance Process to provide an early warning system against any future currency/financial crisis.

A somewhat stronger form of regional financial cooperation would internationalize financial relationships by leveling the playing field for foreign and domestic providers of financial services. Implicit in such an effort are specific policy actions to remove barriers, to encourage and legalize cross-border operations and flows, and to permit financial innovations to propagate freely across the region. These measures will help increase market and commercial integration and set the stage for more profound institutional integration.[36]

A higher level of financial cooperation was achieved by the Chiang Mai Initiative, agreed to by APT at Chiang Mai on 2 May, 2000. The Initiative involves an expanded ASEAN Swap Arrangement that would include all ASEAN countries, and a network of bilateral swap and repurchase agreement facilities among ASEAN countries, China, Japan and the Republic of Korea. The swap arrangement amounted to US$29.5 billion.

The strongest form of regional financial cooperation would be the creation of independent regulatory and supervisory institutions. Such entities would be responsible for the harmonization, standardization, and implementation of those financial services deemed to be in

[36] Of course, if countries opt to relinquish sovereign control, then supranational institutions would have even greater independence from national authorities. However, even under this scenario, true independence is but a mirage. The survivability of such an institution in a given country would remain subject to popular mandate.

the best interest of the region as a whole. As with all multilateral bodies, regional institutions, even if independent by design, would remain effective only insofar as their policies are approved by domestic authorities. However, with weak forms of control over policy and enforcement, regional institutions with independent voices would command leadership positions on issues which today remain defined in domestic terms.

These different types of financial cooperation impose varying degrees of restrictiveness on the discretion that each member country can exercise over its own macroeconomic policies. In general, the external pressure of regional financial cooperation helps to complement internally-driven financial reform initiatives.

II.2.2 Domestic Financial Sector Development

Domestic financial sector reform is the key to successful integration. Since a regional coalition is only as strong as its weakest link, efforts at deepening regional financial integration must not detract from domestic financial development. In particular, the multitude of financial crises that hit emerging markets over the past 15 years remind us that it is far more prudent to implement structural reforms which aim to develop and strengthen the domestic financial institutions, markets and instruments *before* fully liberalizing the capital account.[37] Unfettered access to foreign funds, while beneficial to economies with the tools to absorb and distribute capital efficiently and robustly across market distortions, increases the vulnerability of those economies which have yet to develop such institutional capacity, regardless of the soundness of

[37] See Aghion, et al. (2004), Obstfeld (2004) and Eichengreen et al. (1998).

fiscal and monetary policy. Studies have shown that most countries avoided a crisis after liberalizing capital flows had a sound financial system in place.[38]

Immediate Priorities

In East Asia, domestic financial sector reform should focus on (i) building up a healthy banking sector, by raising the capital adequacy ratio and reducing the portfolio of non-performing loans; (ii) furthering the development and enforcement of regulatory and supervisory frameworks; and (iii) diversifying financial sectors through the development of non-bank financial institutions (Srinivas, 2004)..

As long as credit allocation is targeted to favor priority sectors, the banking sector will remain vulnerable. Bad loans will rise from the moral hazard. Instead, if the price mechanism is to be allowed to perform its task, credit allocation must be allowed to respond to market signals. As such, East Asia should give top priority to bank restructuring, the closing of chronically troubled banks, industry consolidation, the promotion of industry competition, and other banking reforms that would help increase domestic and international credibility.

Essential to robust banking sector reforms is the development of independent regulatory and supervisory frameworks. These institutional mechanisms must reflect prudential regulation, establish transparent due process, protect legal rights, and maintain vigilance over the health of the banking sector. A critical mass of such reforms should be reached before proceeding with the development of financial markets.[39] Once in place, these regulatory and supervisory institutions must independently and credibly enforce the law without submitting to local or national political forces. Latin America has long been held hostage to the lack of independent regulatory agencies

[38] See IMF (2001).
[39] See Nsouli, et al. (2002).

who prosecute their roles to the letter of the law.[40] Although East Asia has no tradition in building such institutions, the remarkable wealth creation in the past thirty years and the region's push toward industries which rely crucially on the protection of intellectual property rights or on financial intermediation suggests that the region's renowned pragmatism will help foster their creation.

Finally, East Asia needs to diversify its financial sectors through the development of non-bank financial institutions. The developmental process alters the financial structure appropriate for a given level of financial market development (Sakakibara and Yamakawa, 2003b). When legal and accounting systems are weak or contract enforcement poor, financial markets tend to rely upon the banking system. However, when these regulatory institutions are relatively immature, strong banks are able to use their strategic power to apply pressure on government for favorable treatment (e.g. relaxation of banking standards) and on firms for increased shares of rent (e.g. unfavorable debt repayment terms). In contrast, when financial institutions are healthy and regulated according to sound legal and economic principles, financial markets will shift from bank-based systems to more market-based systems. Capital markets, such as those for government securities markets, can then develop and help countries diversify away macroeconomic and industry-specific risk.

Secondary Priorities

Ideally, the move toward market-based financial systems should be pursued after the establishment of a sound institutional environment. The institutional reforms that will prompt such a move include adequate accounting rules, consistent auditing and disclosure practices, and

[40] See surveys on economic freedom by The Fraser Institute (2004) and The Heritage Foundation (2004). In both reports, Latin American countries, despite their full-fledged political democracies, score incredibly low on simple measures of economic democracy on account of poor legal and regulatory credibility.

efficient payment systems (Eichengreen et al., 1999). With such reforms, firms that traditionally relied on the banking sector for financing will now have the option of utilizing the corporate bond markets as an alternative method of financing.

Another approach is the creation of a regional bond market. Developing such a market across the region will help defray the large expenses that would be associated with creating viable bond markets in every member country (Sakakibara and Yamakawa, 2003b). Furthermore, sheer scale would allow countries to pool risk, which would enable smaller countries, such as Laos and Cambodia, to gain access to liquid capital at competitive rates.

The region should work towards having thicker and deeper financial services. Well-developed financial sectors that are sound and stable will promote investment and growth (Khan and Senhadji, 2000). A well-developed financial sector allocates resources efficiently, spreads risks, mobilizes savings, facilitates wealth accumulation, and fosters development and growth. Financial development also enhances competition in the industrial sector by allowing for easier entry, which eliminates incumbents' rents (Bhattacharya, 1999). It is also pertinent to note that, financial development has been shown to benefit poorer segments of society directly and through improved income distribution (World Bank, 2001).

The Pace of Reforms

Fortunately, most East Asian countries have high savings rates. Therefore, realizing the benefits of access to foreign capital vis-à-vis more efficient financial intermediation and lower cost of capital, has no crucial immediacy. Countries can adopt a more gradual approach to liberalizing of the capital account while they develop their domestic financial frameworks (Johnston, 1994). In cases where availability of external funds is critical, capital account

liberalization and domestic financial sector development can be undertaken simultaneously. Nevertheless, policymakers have to ensure that the former does not outpace the latter (Eichengreen, et al. 1998).

II.2.3 Sequencing Capital Account Liberalization

The careful sequencing of capital account liberalization is pertinent to the financial stability of a country. Perhaps no clearer illustration exists than the 1997-98 Asian Crisis. Significant capital account liberalization in the early 1990s permitted the sudden reversal of capital flows from Asia. While capital account liberalization reduces foreign exchange pressure over the longer term and is desirable in the long run, the potential instability it can cause might last for several years. Wyplosz (2001a) found that immediately after capital account liberalization, developing countries' GDP are boosted by nearly 15% of GDP, but that such gains are short-lived and followed by sharp contractions.

The greatest risk of fully opening up the capital account would be borne by those countries with greatest exposure to foreign exchange-denominated debt, such as was the case for Thailand and Korea during the Asian Crisis. Ironically, countries that re-imposed capital controls, such as Malaysia, and countries that maintained their capital controls, such as China, emerged relatively unscathed, despite their "heretical" policy actions. Countries that followed economic orthodoxy but which carried dangerous levels of dollar-denominated debt, such as Indonesia, were severely punished by the confidence crisis that ensued and still persists to this day.

To defuse this linkage to instability, sound and sustainable macroeconomic polices, both fiscal and monetary, as well as a sound institutional framework are prerequisites to effective

capital account liberalization.[41] As for sequencing, long-term capital flows such as foreign direct investment should be liberalized before short term flows since the latter's higher volatility may increase the country's vulnerability to crisis. In general, portfolio inflows in debt and equity instruments are likely to produce positive effects, but only if domestic financial markets and infrastructure are well developed.

When properly carried out, capital account liberalization helps promote economic growth through three predominant channels: (i) domestic and foreign investment; (ii) technology spillover (particularly for FDI); and (iii) the deepening of domestic financial markets (Sakakibara and Yamakawa, 2003b). While the cumulative evidence from the literature does not point to a strong positive linkage between capital account liberalization and growth, there is some evidence that different types of capital flows may have different effects on growth (Prasad et al., 2003). In general, FDI tends to be positively associated with domestic investment and growth, while the effects of other forms of capital flows are less robust.[42] From Part I, we concluded that ASEAN countries must focus on attracting from FDI, a challenge made all the more urgent by the explosion of FDI toward China that seems to have occurred at the expense of ASEAN member countries.

II.2.4 Financial Liberalization Intensifies Integration

While some progress has been made with real integration, East Asia is only in the early stages of financial integration. The primary reason behind this asymmetry is the inherently different speeds of adjustment between the real and financial sectors. For instance, the response of production structure, investment and ownership patterns to economic reforms are typically

[41] See Blanchard (2004) and Chari and Kehoe (2004) for the need for pursue a combination of sound fiscal and monetary policy. See Angeletos (2004) for a recent theoretical contribution.
[42] See World Bank (2001).

much slower than adjustment rates of financial variables (Nsouli et al., 2002). Since goods markets take much longer to clear than financial asset markets, trade liberalization should be carried out before capital account liberalization. Were domestic factor markets and foreign trade still heavily distorted when the capital account is liberalized, capital may end up in inefficient domestic industries, further exacerbating the misallocation of resources. The consequences of such a distribution can be destabilizing both economically and politically, with either result having the potential of dramatically delaying further attempts at integration. [43]

However, capital account liberalization and more generally financial liberalization should not be postponed for too long due to the crucial role it plays in intensifying real integration, (IMF, 2002). Indeed, the liberalization of cross-border financial flows facilitates both trade and investment integration. For instance, financial integration increases the availability of trade financing that greases the wheels of trade. Similarly, easier access to project financing promotes cross-border investments. Furthermore, financial integration supports the establishment of regional production networks as it permits the diversification of risks internationally, i.e. insurance via financial markets. This endogeneity between trade and financial openness suggests that there is some minimum threshold of openness, development, and institutional maturity that must be in place before liberalization has a reasonable chance for success. A mistake would be to delay liberalization until these institutions were perfectly formed. However, it might be a bigger mistake, at least as measured by the number of financial crisis in emerging markets over the past 15 years,[44] to push too hard, too early. Impatient economic zeal can force countries to withdraw

[43] Both the extreme fluctuations of the 1970s and the ERM crisis of 1992-93 added years to the original 1980 target for monetary union set by the Werner Plan (Boiscuvier and Steinherr, 2004).
[44]Demirguc-Kunt and Detragiache (1998), Chan-Lau Chen (1998), Detragiache (1999). For a Survey, read Mishkin (2001).

from financial markets before sufficient institutional development and political commitment have coalesced and delay what would otherwise have been successful economic development.

However, it is clear that financial liberalization results in market integration, which in turn fosters the development of domestic capital markets. Internationalization through the opening of the domestic sector to foreign competition helps build more robust and efficient financial systems by (i) introducing international standards and practices; (ii) improving quality, (iii) extending the efficiency and breadth of financial services and (iv) allowing for more stable sources of funds (Srinivas, 2004). The elimination of costs that exist in fragmented domestic financial markets and the convergence of policies and regulations will not only deepen and broaden regional financial markets but also diminish the degree of intraregional financial segmentation. These benefits are particularly important for East Asia where financial systems are small and hence, tend to under-perform. It follows that countries with relatively less developed financial markets stand to gain most from market integration (De Gregorio, 1998).[45]

Unfortunately, cross-country financial market linkages also have their drawbacks. Integration without sufficient financial innovation can heighten the speed and magnitude of international spillovers. The effects of real shocks such as productivity, terms of trade or fiscal shocks are often transmitted quicker though and amplified by financial channels (Prasad et al., 2003). Furthermore, there is also a risk of being caught up in financial market bubbles. In particular, individual country stock markets may become susceptible to the destabilizing behavior of international investors such as herding behavior and momentum trading. Since finance supports and facilitates real economic processes, these potential instabilities can in turn

[45] Whether developing countries benefit in general from capital account liberalization remains a hot topic for debate. Some including Gourinchas and Jeanne (2004) find that welfare gains to emerging markets from opening up to perfect capital mobility appear fairly limited.

be transmitted to the real economy. Hence, increased financial deepening and its requisite institutional reforms must be encouraged to develop concurrently with increased cross-country financial linkages.

Measures to enhance financial stability typically involve a tradeoff between efficient allocation of financial resources and the ability to reduce or eliminate risks to the financial system (Prasad et al., 2003). For instance, imposing exchange restrictions may help to exclude certain risks related to international capital flows. However, such measures also limit the efficiency of the domestic financial market. In order to proceed with financial liberalization in a manner that promotes long-term growth without sacrificing short-term stability, it is imperative that countries vigorously pursue all weak forms of regional financial cooperation. Once these efforts are sufficiently implemented, countries should pursue the further deepening of financial integration. To do so, countries will need to commit to increasingly strong forms of cooperation. Should countries balk at institutionalizing regional financial integration, they risk losing the political capital built with weaker forms of cooperation, and with it, any hard-won stability.[46]

II.2.5 The Case for Regional Institutions

Regional cooperation in East Asia has reached a level where a dynamic set regional institutions with greater capacity to promote of trade, investment and finance is needed. In Europe, architects of the EU considered institution building to be the second most important factor (after pragmatism) of Europe's successful integration progress (Wyplosz, 2001b). By moving towards the establishment of supranational bodies, East Asia can become more structured and disciplined in its approach to regional and global challenges. Institution building

[46] The failure of Denmark in 1992 to ratify the EU constitution created a confidence crisis that brought down the ERM and effectively delayed the EMU and introduction of the Euro for several years.

appears to be essential if East Asia is to escape from the "problem-response-problem-response" dynamic endemic to discretionary policymakers. As was the case for the EU, regional institutions have the potential to transform research projects into concrete and effective policy (Sakakibara and Yamakawa, 2003b).

However, unlike the EU, East Asia has historically preferred noninterference in the domestic concerns of neighboring countries.[47] Throughout Western Europe, communitarian rhetoric was heard on the road toward to EU and the EMU. In stark contrast, ASEAN has taken great pride in consensus building using a non-confrontational, political approach, making sure domestic affairs were kept off the table. This preference for sovereignty notwithstanding, the liberalization of financial markets and lifting of restrictions on short-term capital flows created an immense pool of funds that are highly reactive to national macroeconomic policies. Hence, there is a growing willingness to engage in a codified and legally justifiable form of mutual surveillance. At the bare minimum, this willingness to debate domestic issues at the regional level is required for meaningful financial cooperation to go forward. Moreover, cross-border spillover of national policy measures points to the need for combining "issue linkage" in an RTA with mechanisms that will incorporate credible and verifiable forms of commitment (Evernet et al. 2004). Only a set of mutually consistent and harmonized supranational entities will have the requisite powers to monitor compliance and impose penalties.

Regional Surveillance and Resource Pooling

The establishment of effective regional institutions will facilitate financial cooperation, ranging from information exchange and regional monitoring to regional surveillance and

[47] See Gramegna and Lim (1997).

resource pooling (Montiel, 2004). Given greater cross-border spillover effects, information sharing on the region's macroeconomic and financial developments will be invaluable for formulating domestic policies. Potentially, there are information advantages and specialization benefits for monitoring such information through regional rather than global organizations. The former tend to be staffed by economists with better knowledge of regional values, culture and history. The latter are more apt to adopt "one-size-fit-all" policies to justify their charter.[48] Neighboring countries typically have more sanctions at their disposal to influence each other's macroeconomic policy actions (Montiel, 2004). However, despite their need, regional bodies with surveillance oversight need to be properly designed. Otherwise, the effectiveness of regional organizations may be severely constrained by moral hazard and adverse selection issues.

Pooling part of the region's reserve stocks would safeguard against financial crisis. An Asian Bond Fund could administer these monies (Bird and Rajan, 2002). The lack of global governance and the professional sentiment against having a global lender of last resort creates the need to increase the magnitude and access to the regional resource pool. The region should work towards having a centralized, multilaterally-administered fund with a mechanism for performing due diligence on potential borrowers, designing conditionality and monitoring performance. Such a fund would be best housed in an independent regional institution with the capacity and mandate to design and enforce conditions associated with international liquidity provisions. To be effective, this independent regional institution must be free from both moral hazard problems seen so frequently in country bailouts and the one-size-fits-all financial

[48] The IMF, World Bank, and UN have all been dogged by such criticism over the years.

remedies of global lenders, whose forced austerity programs have been severely criticized in the past.[49]

Architects of the future APT must build supra-regional bodies slowly and with recognition that tremendous differences exist along almost any dimension of the region. To address such needs, Eichengreen (2001) proposed the establishment of an Asian Financial Institute (AFI) based on the APT platform. As envisaged, this institute would strengthen prudential supervision and regulation, administer training and capacity building programs for bank supervisors, securities and exchange commissioners, and negotiate region-wide financial standards and regulations. Eichengreen's AFI would accept inputs from national regulators and authorities while working in corporation with international fora in order to ensure consistency in financial standards and financial development strategies. In its mature form, an AFI of this design would require an independence of voice and political commitment that would likely come about only as the region attempts its strongest forms of cooperation.

Summary

This paper examined integration trends in East Asia and offers policy recommendations on optimally sequencing regional economic integration. We began by examining the intensity and dynamics of trade, investment and capital flows in East Asia. With special focus on intra-ASEAN dimensions, we assessed the trends of trade, investment and financial integration. We followed with proposals for deepening regional integration in a systematic and controlled manner.

[49] See Stiglitz (2002). For a counterpoint, read the reply of Rogoff (2002).

Findings

Our trends analysis reaches the following conclusions. With respect to the real economy, intra-ASEAN trade 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. 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.

Regarding the integration of investment flows, the story is not too dissimilar. ASEAN and countries hit hardest by the Asian Financial Crisis have yet to attract anywhere near the FDI and investment flows of the mid-1990s. The lack of fundamental institutional reforms, both domestically and regionally, together with the increasing attractiveness of China have made it increasingly difficult for emerging Asia to compete for global FDI. The trends highlight the importance not only for absolute improvements in institutional architecture, but for also gains relative to other emerging markets seeking FDI. However, the challenges produced by China are also coupled with great opportunity. East Asian countries are the biggest FDI sources for funds into China. Those countries, particularly those with large FDI in the services, should be well-positioned to exploit further growth in China.

Finally, financial integration has only recently begun. While robust, financial markets and cross-border commercial activity do not yet reflect convergence or sustained regional integration. The many controls and restrictions remain in place have hampered the development of legal, accounting, supervisory, and regulatory mechanisms essential to regional financial stability.

Without such fundamental reform at the domestic level, any attempt of regional financial integration may be moot.

Based on these trends, we offer the following policy recommendations for optimally sequencing economic integration. Each of these recommendations, particularly with regard to financial integration, is based on our consensus view that strong forms of cooperation are both inevitable and necessary for furthering the stability and growth of the region.

Policy Recommendations

East Asia should link trade and investment integration with an initial focus on concrete policy measures. Trade and investment should be linked given their mutually reinforcing externalities and complementarity. Efforts such as tariff reductions, production harmonization and standardization, and the elimination of quotas would be easily measurable, verifiable, and enforceable. Only when there are the regional institutions in place to handle more delicate and politically charged items should trade negotiations concentrate on prohibited goods and more subtle forms of protectionism.

Across sectors, East Asia should push as vigorously for liberalization of trade in services as they have for manufacturing goods. Each Asia should place special emphasis on trade in transport, communications, financial and other services requiring highly-skilled human capital as this will facilitate the smooth functioning of regional supply chains and since the evidence suggests that regulatory reforms in the services sector can generate large gains in growth.

Across trading partners, East Asia should develop a multi-speed approach that recognizes the status of both economic development and institutional reforms of each country. East Asia

should utilize experiences from the EU, both from its formative years to its present preoccupation with absorbing its peripheral candidates. East Asia should also recognize that promoting the "spaghettization" of trade agreements might undermine regional commitment toward liberalized trade.

With respect to sequencing financial integration, it is crucial that reforms develop along two axes. Along one axis, East Asia should begin with weak forms of financial cooperation and use them as stepping stones toward stronger and more robust forms of cooperation and integration. Along the other axis, East Asia must begin by first developing its individual domestic financial sectors before focusing on regional financial cooperation, even if regional financial integration is the primary objective.

East Asia should aggressively promote weak form cooperative efforts, particularly regional research organizations and think tanks, such as the Macroeconomic and Financial Management Institute (MFMI) proposed by Singapore Management University. These research institutions offer outstanding opportunities for countries to share knowledge, technical expertise, and perspectives in an environment conducive to cooperation.

As semi-formal cooperative ventures proliferate, East Asia should push ahead with stronger forms of financial integration. These would include harmonization and standardization of accounting systems, legal protections for individuals, firms, and intellectual property rights, and the promotion of level playing grounds for commercial activity.

Throughout the lifecycles of weak and intermediate forms of financial integration, reform efforts must focus squarely on domestic financial sectors. Reforms should start with the banking sector, which are the dominant form of financial intermediation in Asia and emerging markets in

general. East Asia should give top priority to bank restructuring, the closing of chronically troubled banks, industry consolidation, the promotion of industry competition, and other banking reforms that would help increase domestic and international credibility. When stronger forms of financial integration are in place, such as regulatory and supervisory institutions, East Asia should proceed with the development of her non-banking financial sectors, efficient payment systems, and bond markets.

Once these intermediate forms of financial integration are well established, East Asia should begin creating strong forms of financial integration, including independent regional institutions with regulatory and supervisory oversight. Examples would include settlement banks, regional trade and financial boards, and perhaps an Asian financial institute along the lines proposed by Barry Eichengreen (2001). These institutions would be supranational by nature, with charters to promote regional growth and stability.

Regionalism, particularly the subjugation of sovereign discretion to regional control, requires firm institutional commitment and political will. If neither is readily available, failed attempts at regionalism will run the risk of undermining both regional efforts and domestic credibility. For these reasons, we recommend that East Asia proceed gradually and proceed only when sufficient progress has been made with weaker forms of cooperation. This suggestion should be followed even more closely by smaller ASEAN countries, whose size and fragility might be overwhelmed by premature regionalism.

Clearly, the sequencing from weak to strong and from domestic to regional forms of financial integration will be accompanied by a direct increase in political involvement and mutual surveillance, developments considered contrary to ASEAN tradition. However, if

regionalism is to succeed, Asian countries must institutionalize interest in their neighbors' affairs. Regional institutions must be built upon the full exploitation of weaker and intermediate forms of cooperation. Doing so will prevent abortive attempts at regionalism and set the stage for sustained growth and stability.

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Appendix: Figures

Figure A1: ASEAN6 Exports to ASEAN

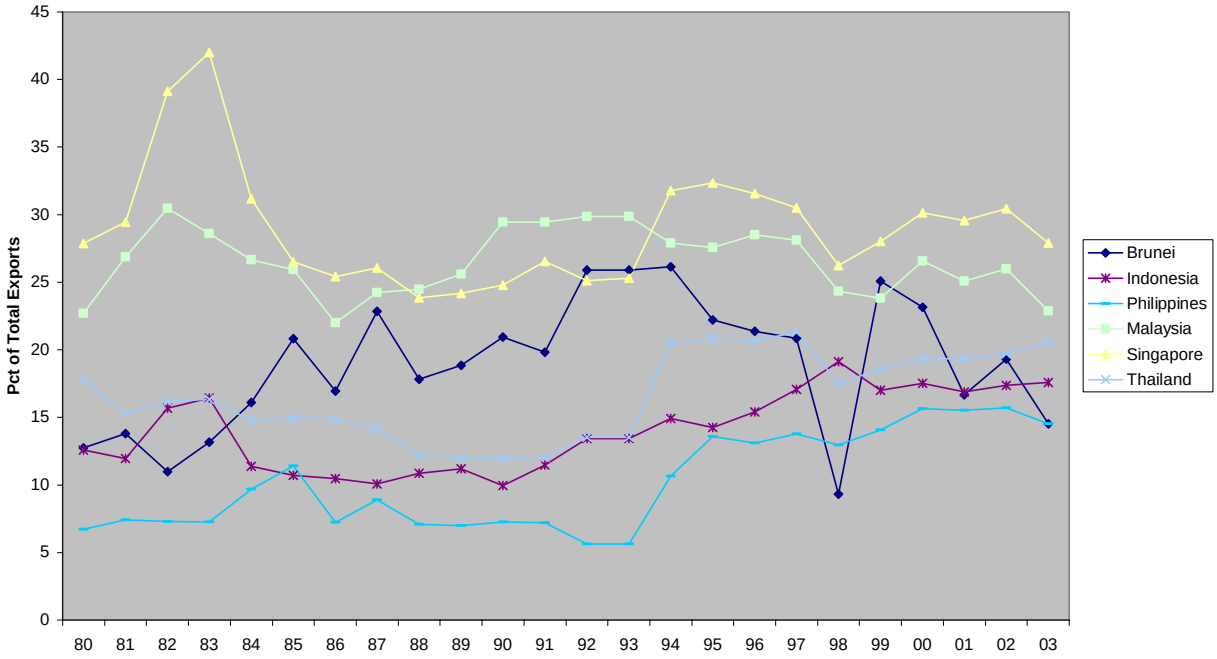


Figure A2: ASEAN6 Exports to Japan

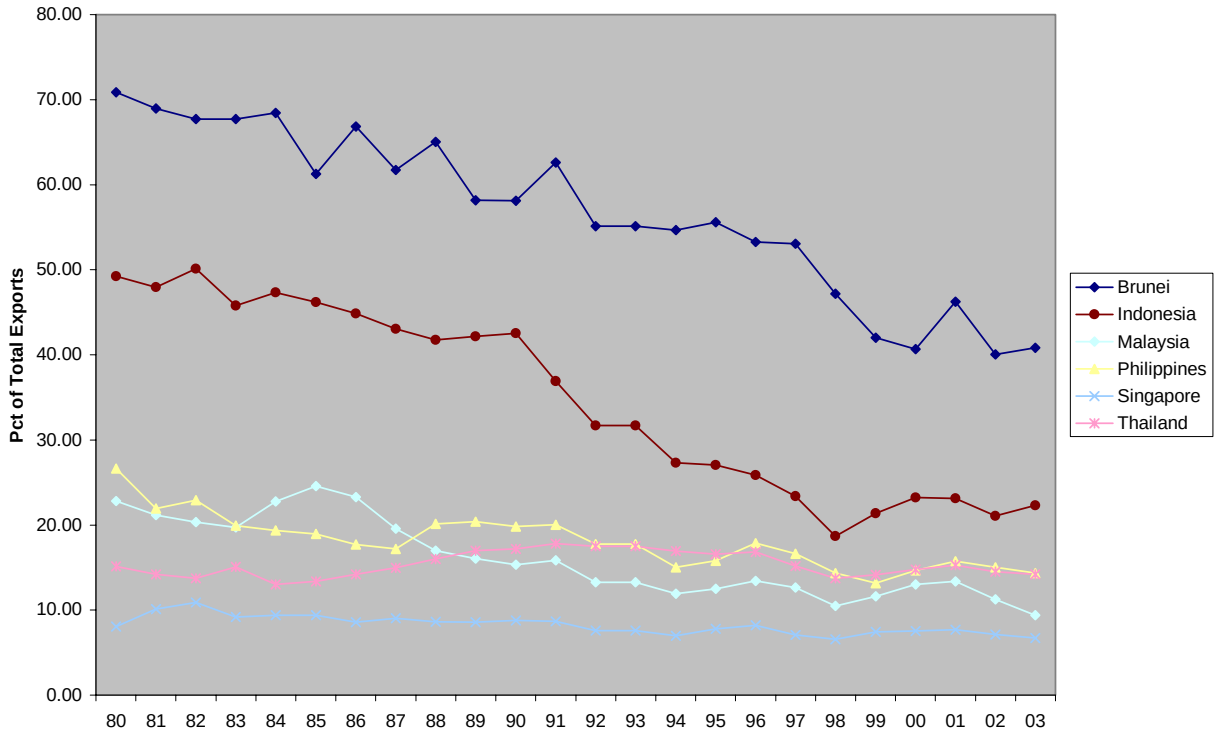


Figure A3: ASEAN6 Exports to China

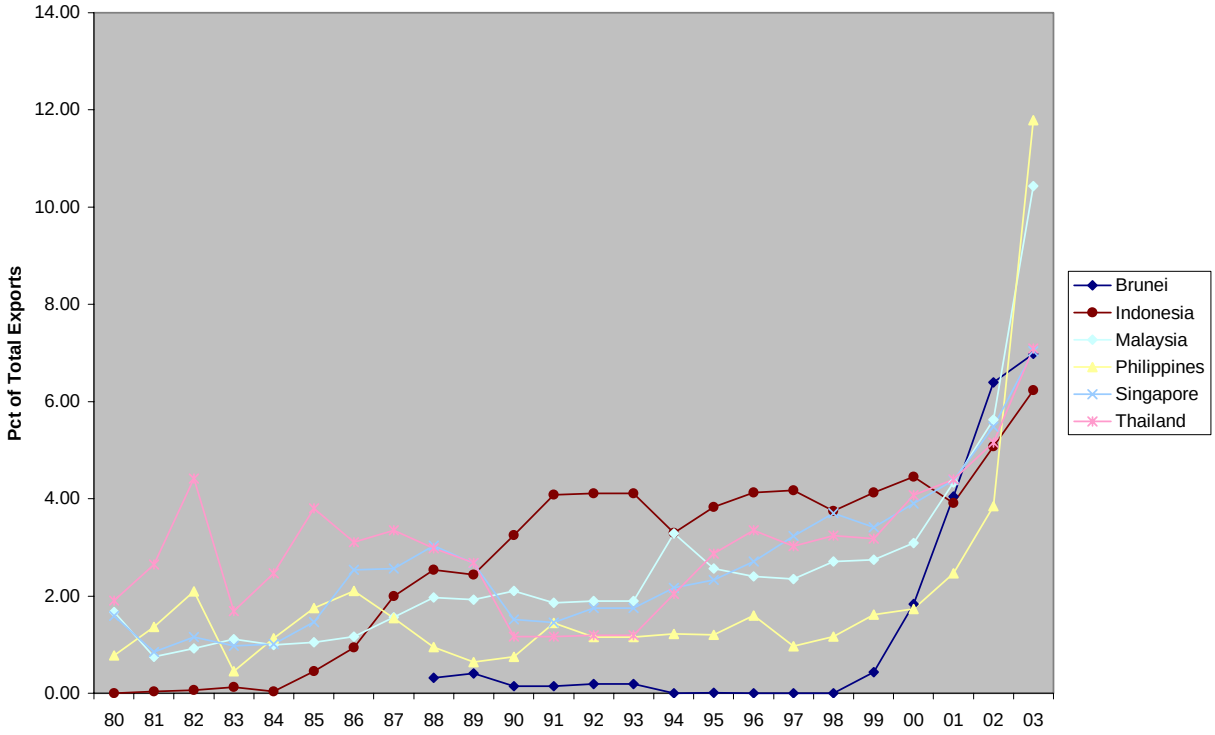


Figure A4: ASEAN6 Exports to USA

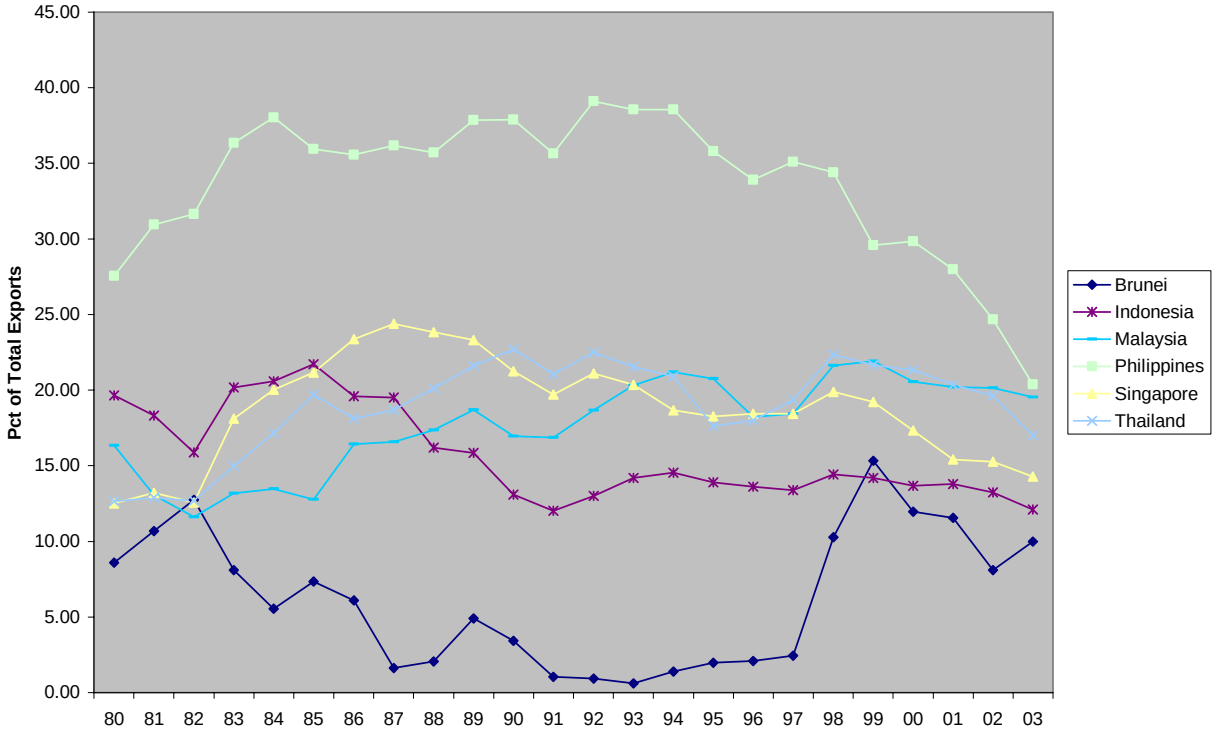


Figure A5: ASEAN6 Exports to EU15

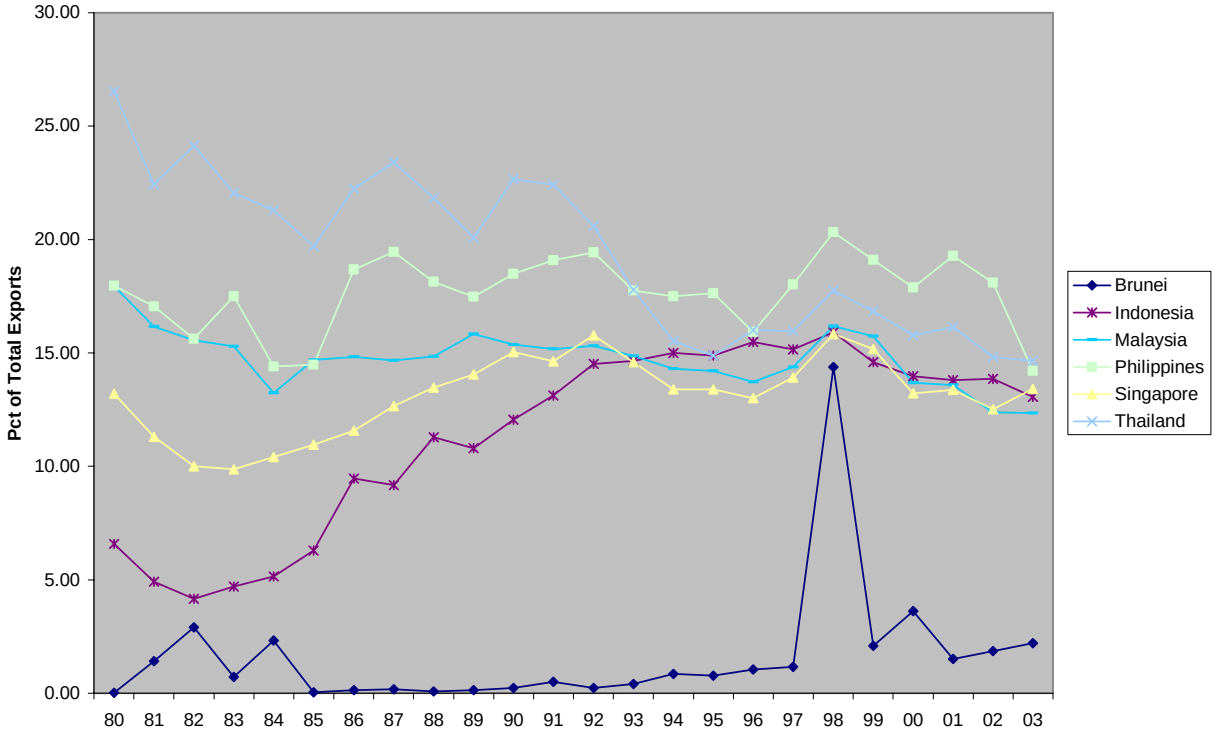


Figure A6: Industrialized Asia: Imports from ASEAN

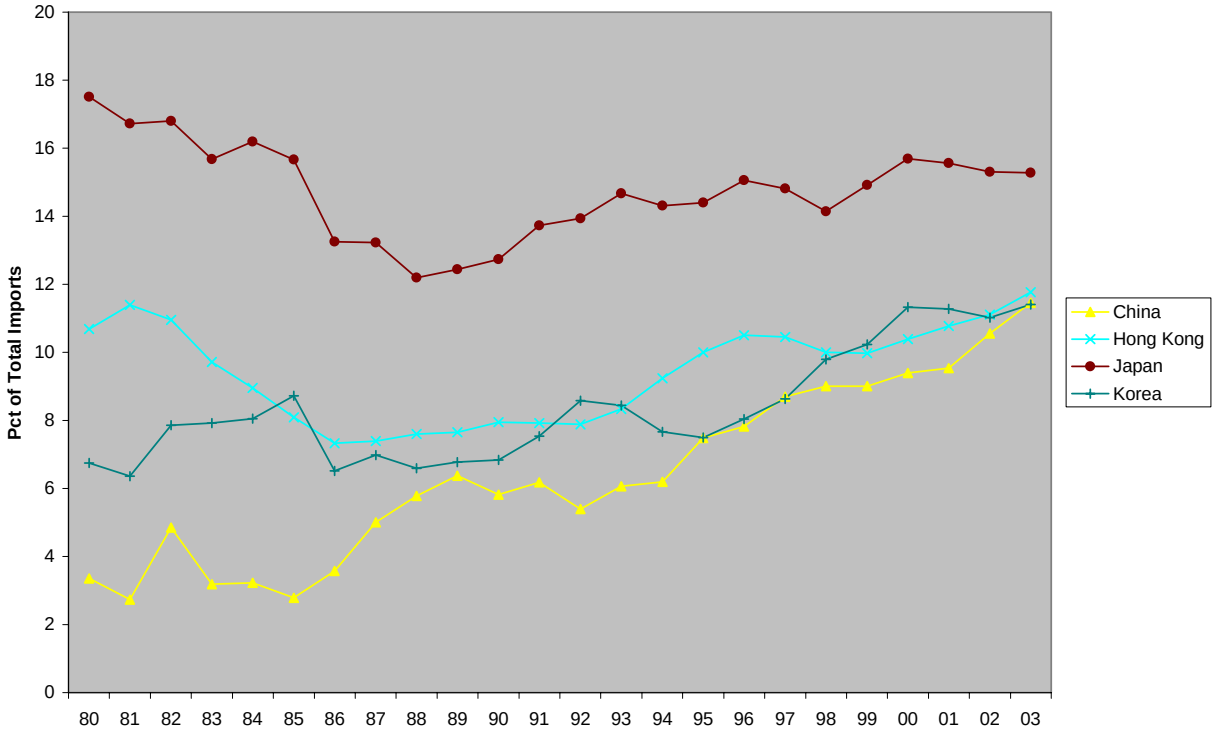


Figure A7: ASEAN6 Imports from ASEAN

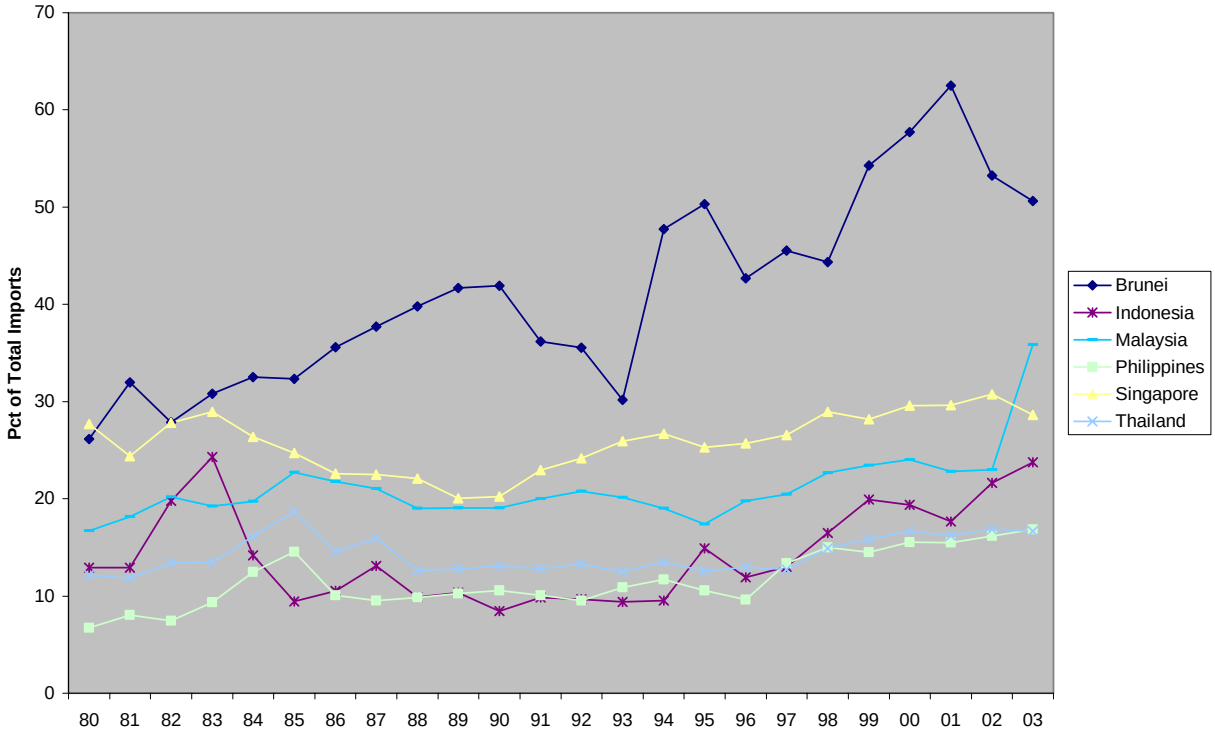


Figure A8: ASEAN6 Imports from China

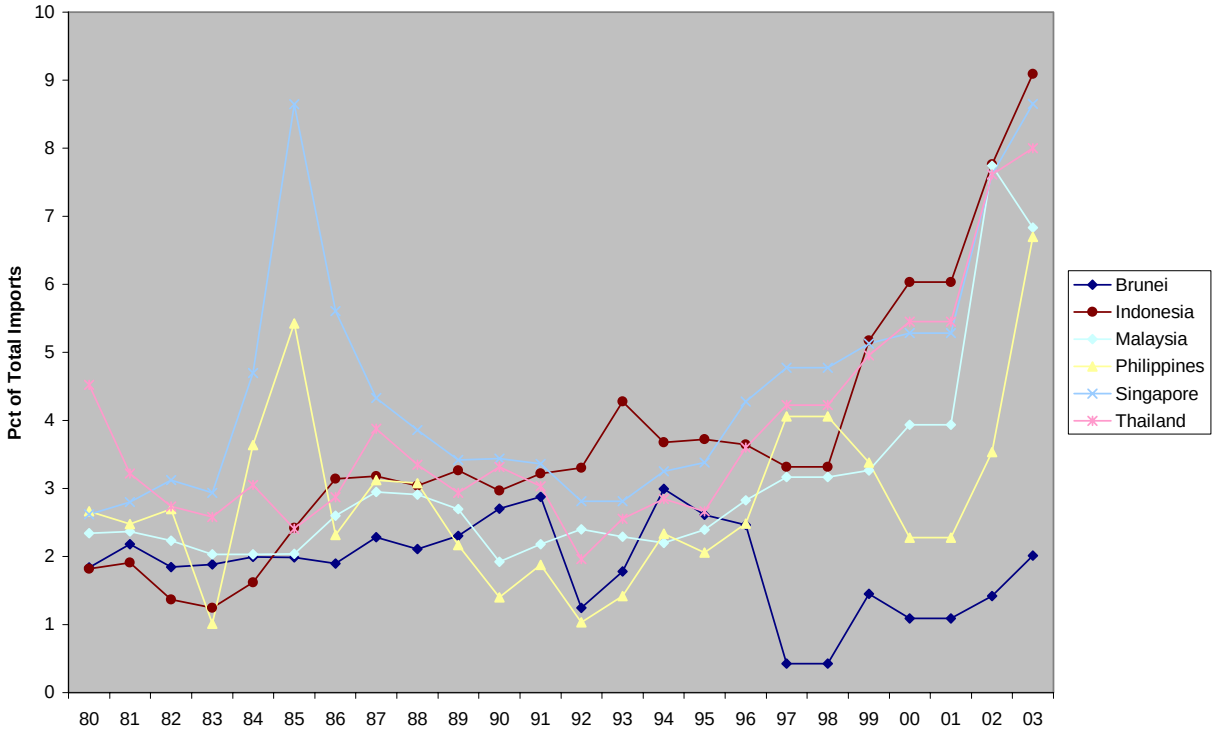


Figure A9: Transition Economies Imports from China

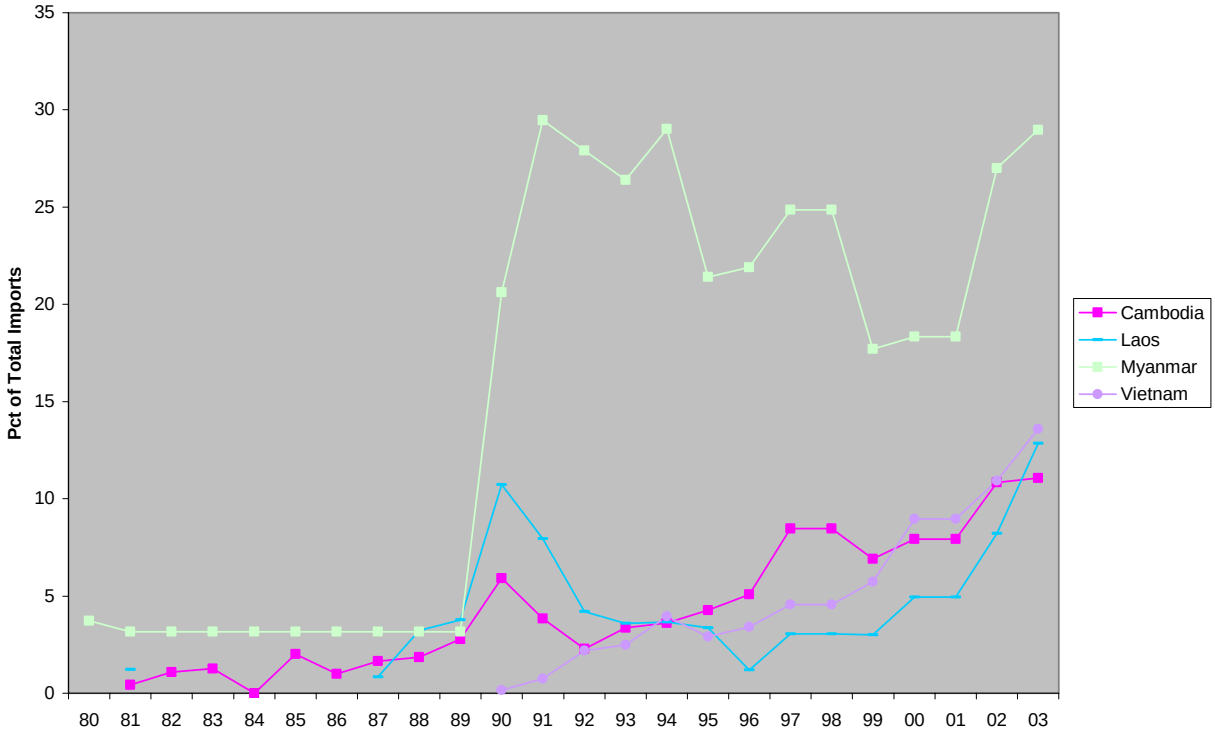


Figure A10: Industrialized Asian Imports from China

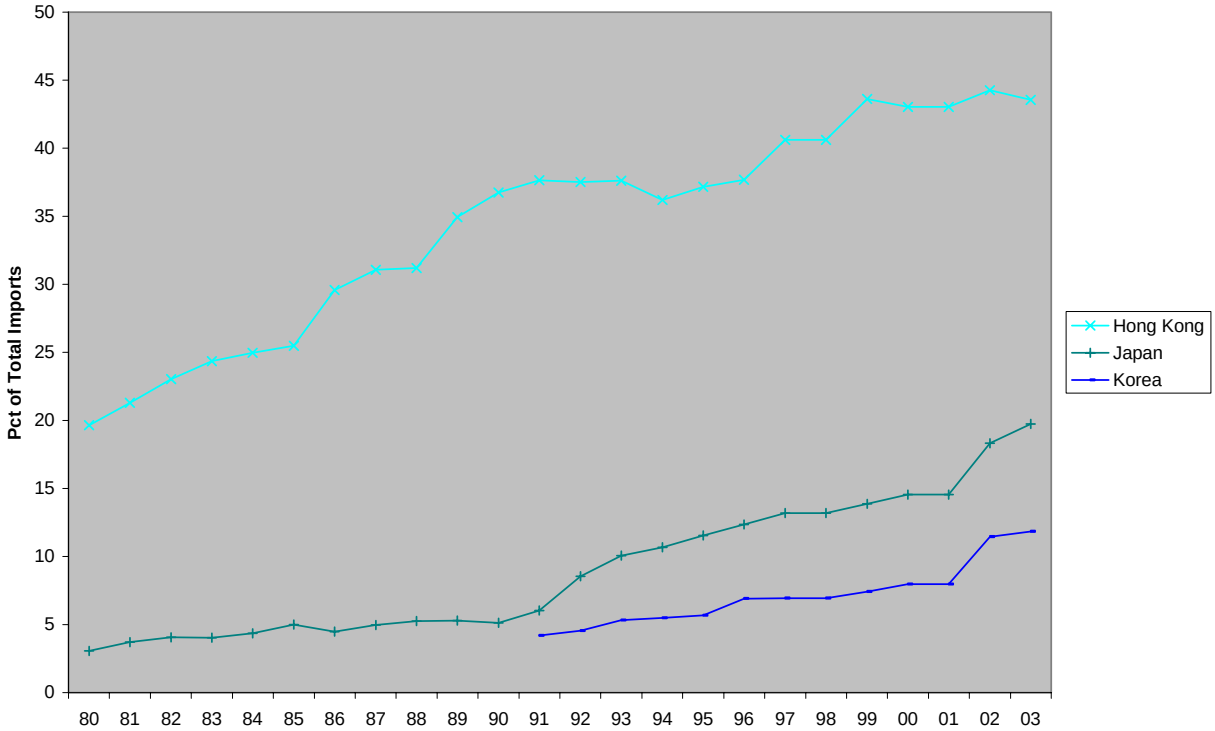


Figure A11: ASEAN6 Imports from EU15

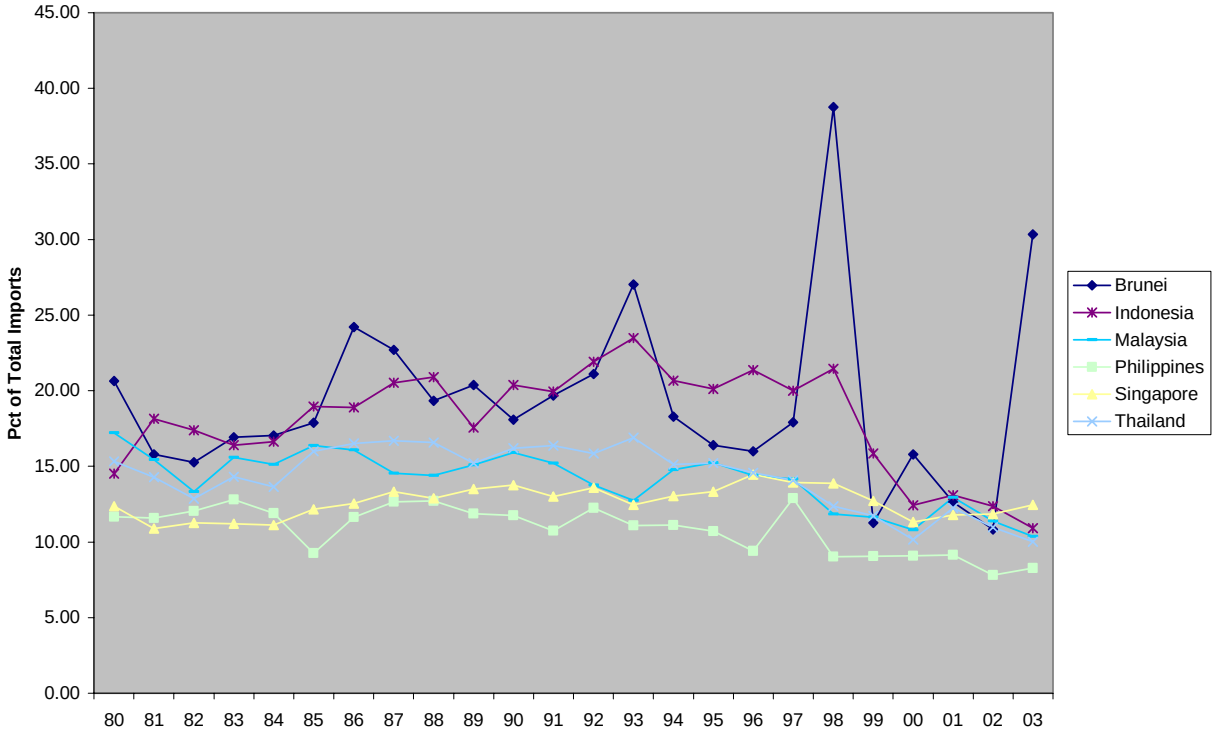


Figure A12: Industrialized Asia: Imports from EU15

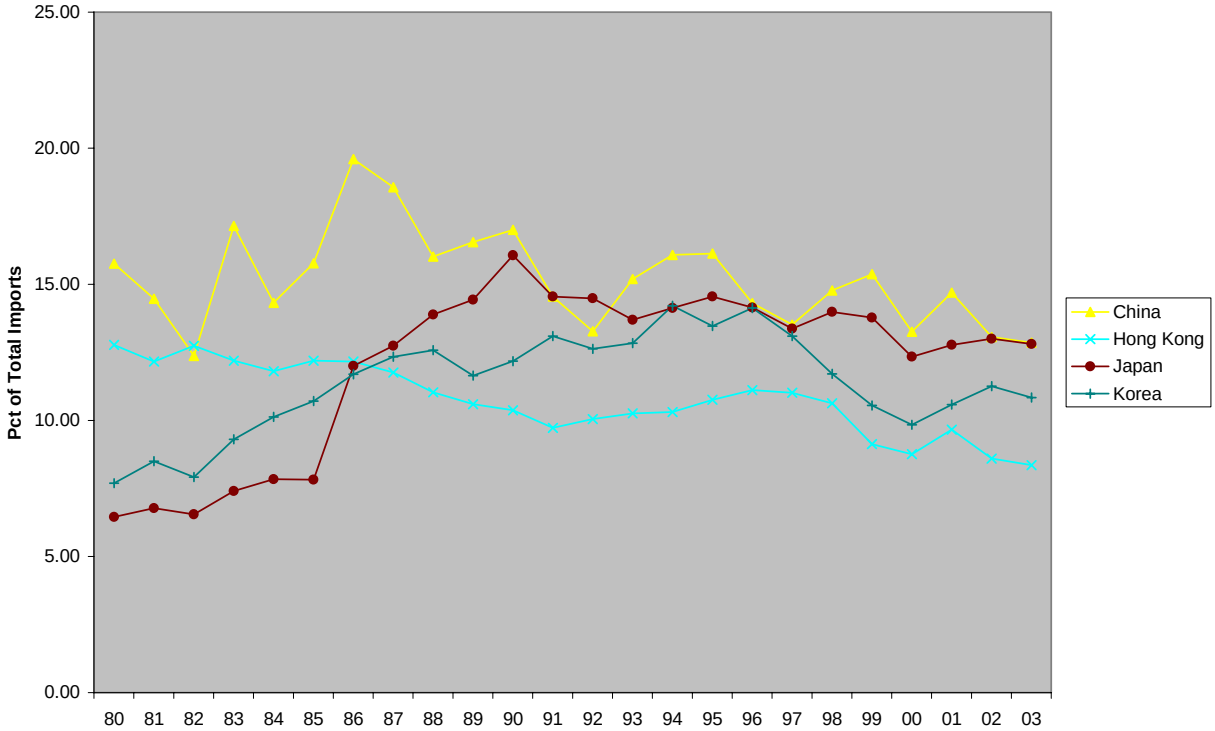


Figure A13: Transition Economies Imports from EU15

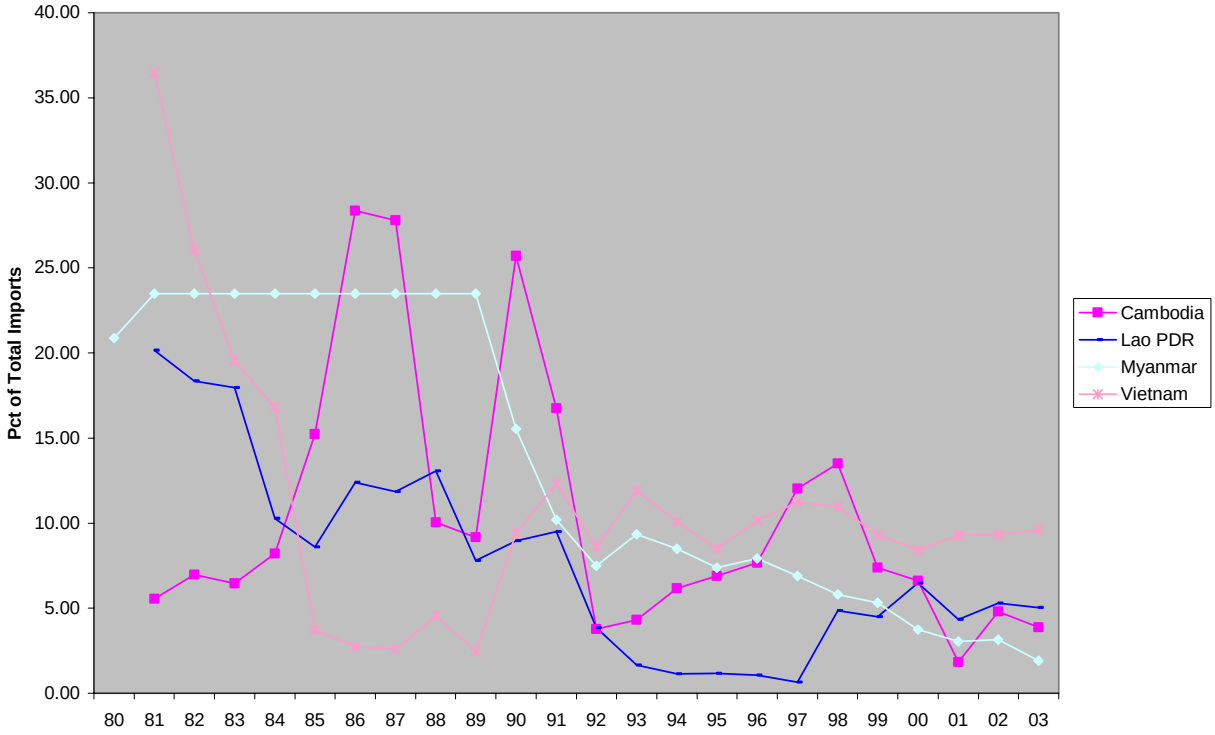


Fig A14: ASEAN6 Imports from USA

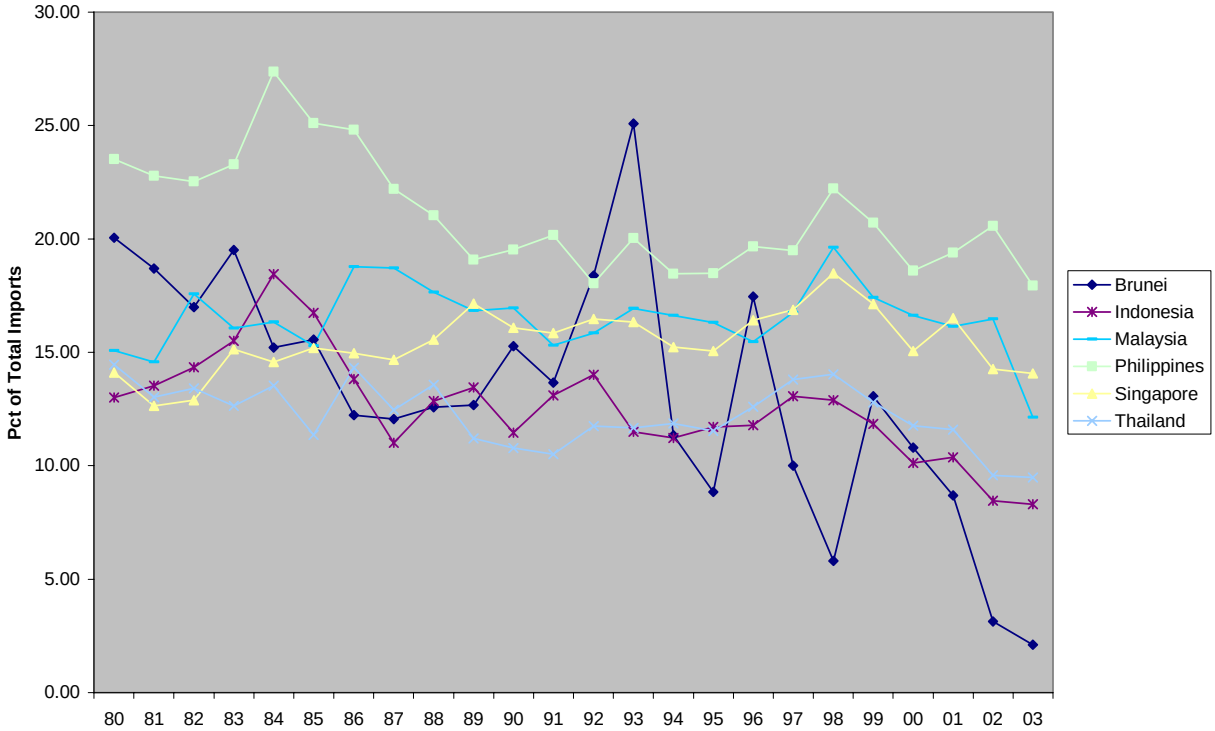


Figure A15: Industrialized Asian Imports from USA

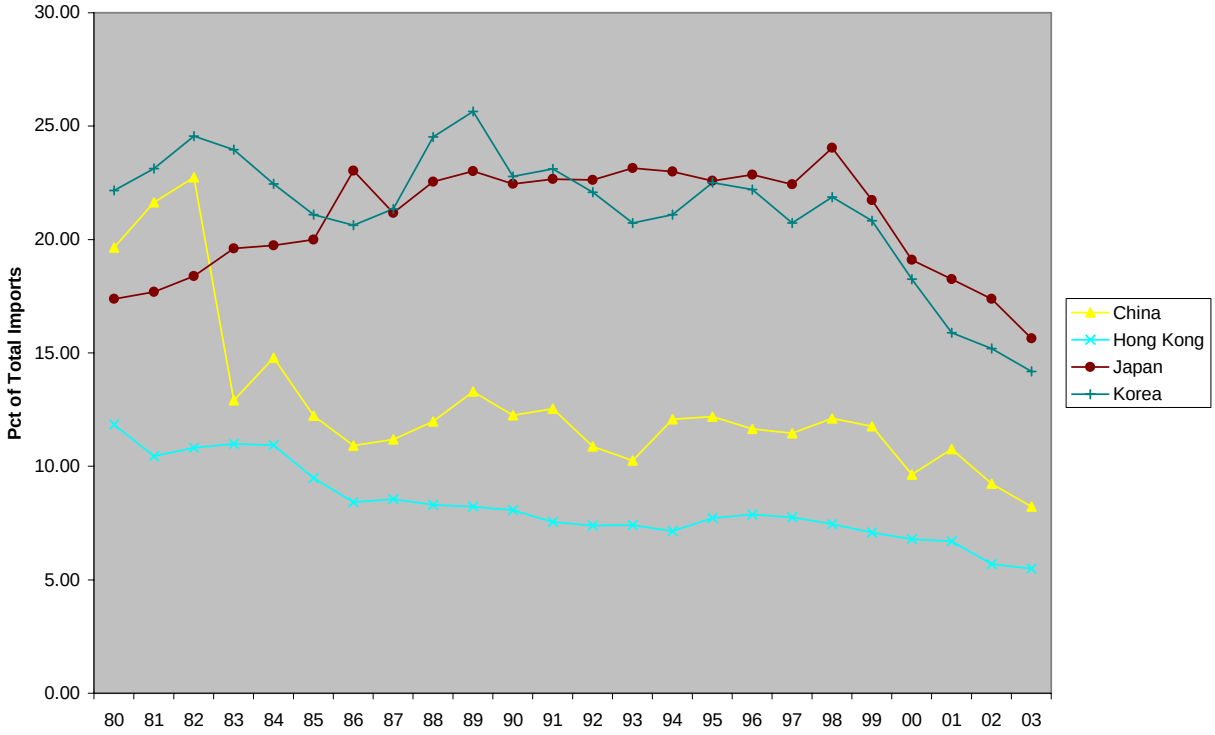


Figure A16: Industrialized Asian Exports to China

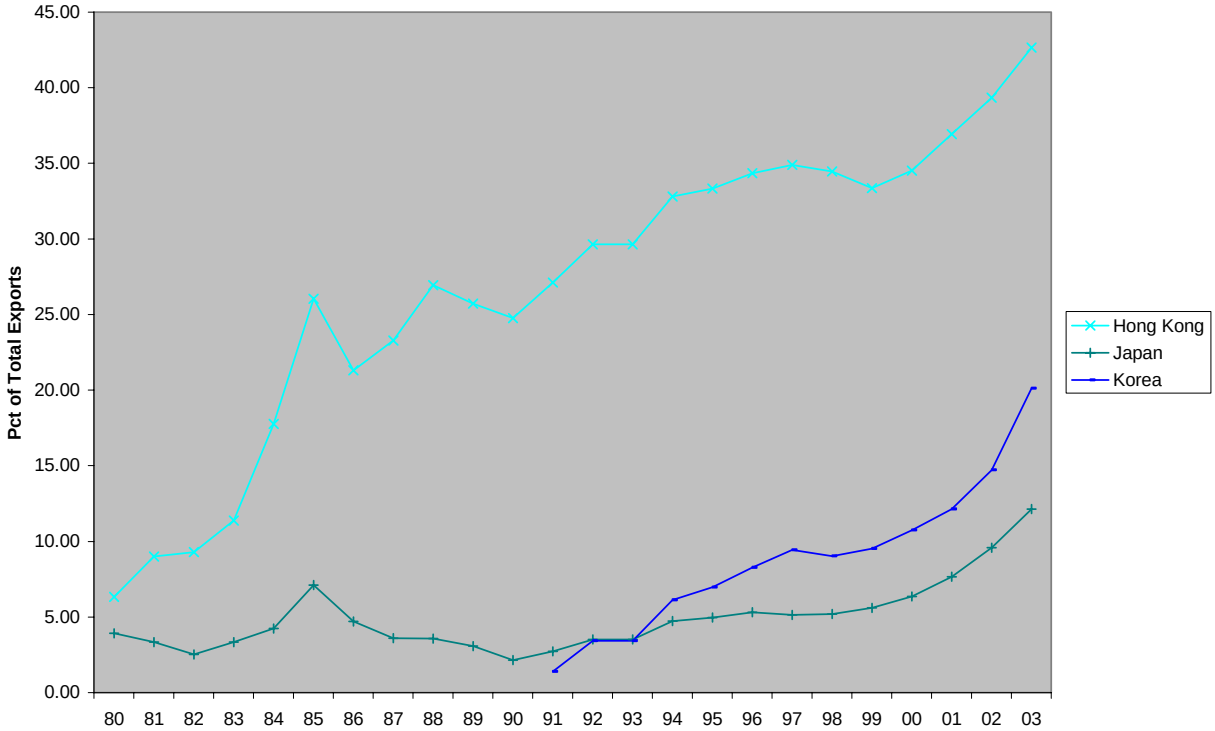


Figure A17: Industrialized Asia: Exports to USA

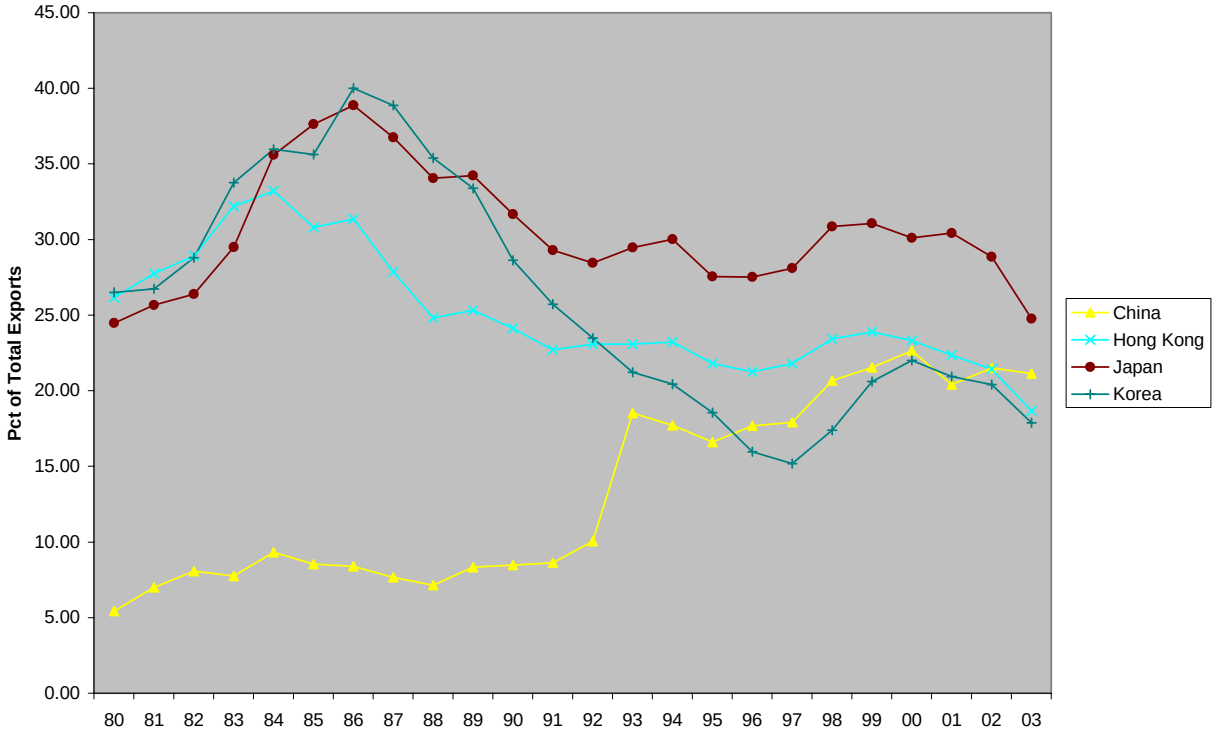


Figure A18: Industrialized Asia: Exports to EU15

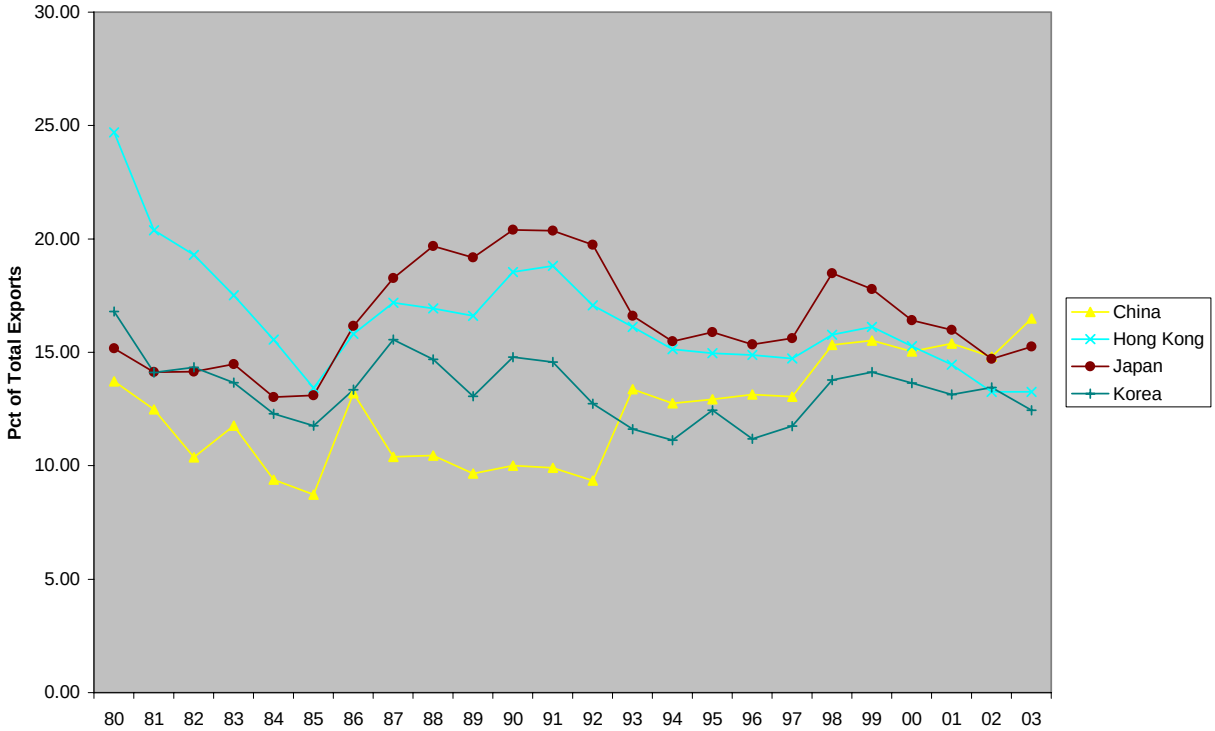


Figure A19: Industrialized Asia: Exports to Japan

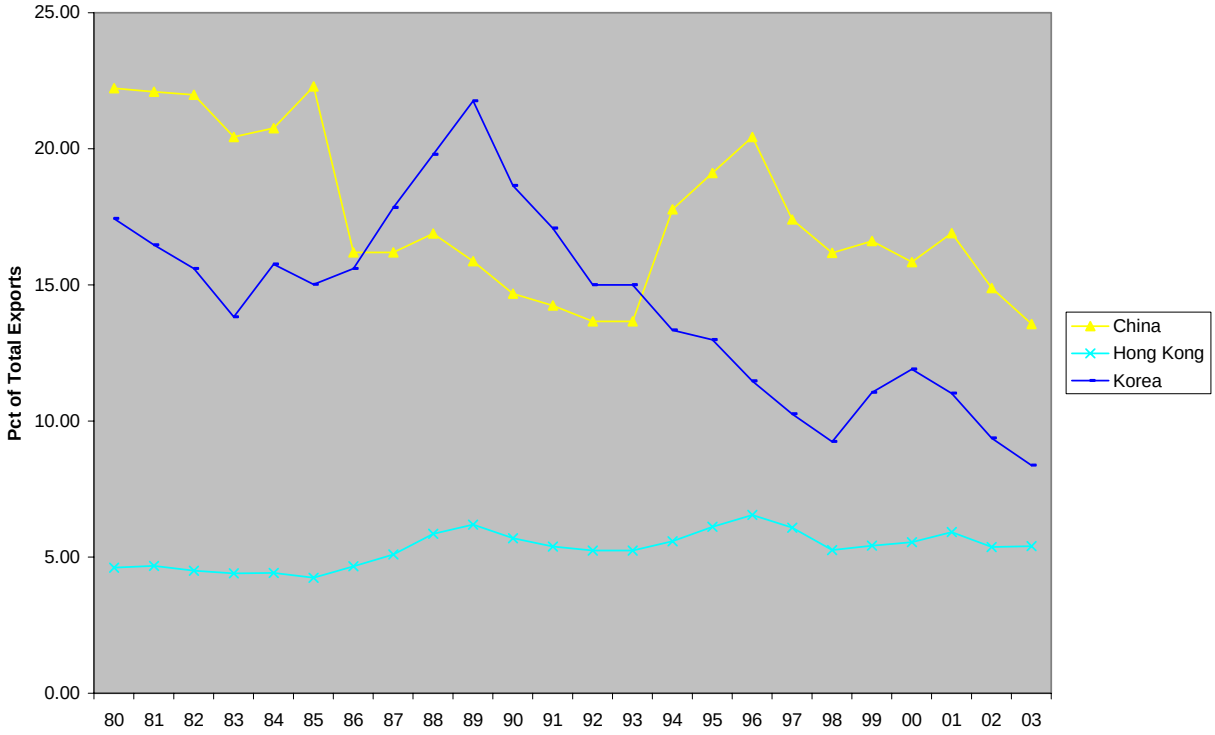


Figure A19: Transition Economies Exports to Japan

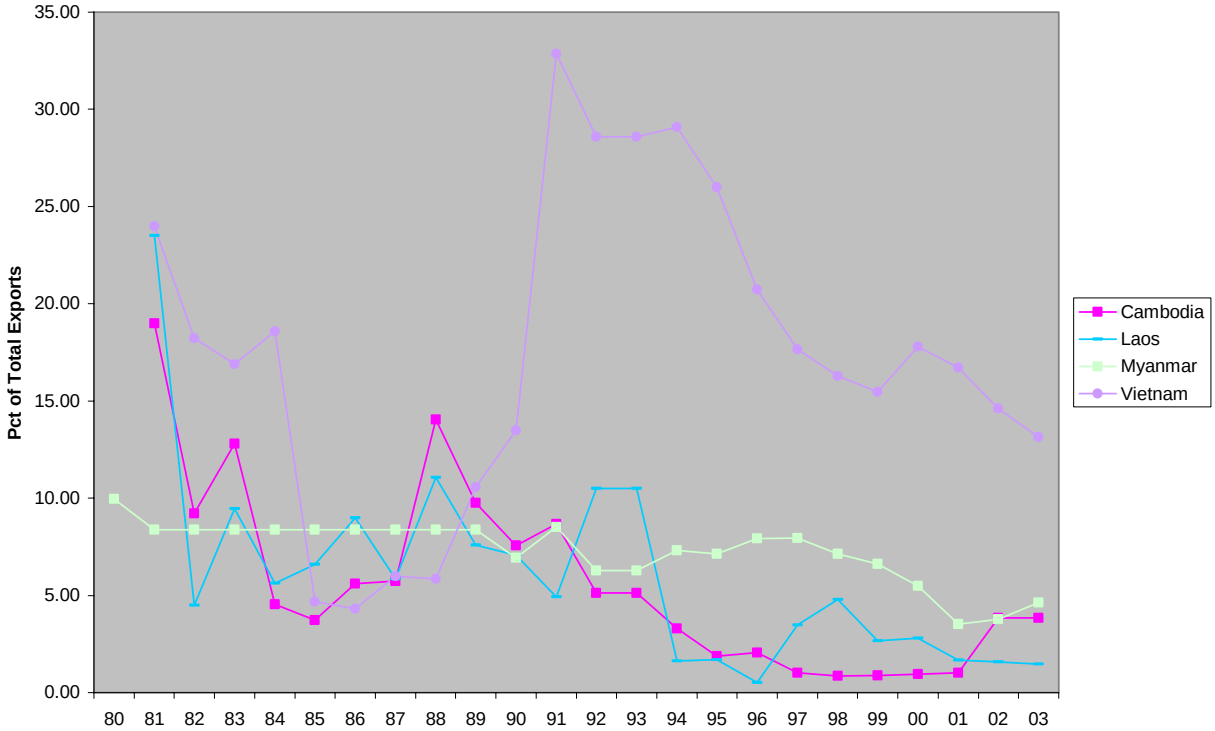


Figure A21: ASEAN6 Imports from Japan

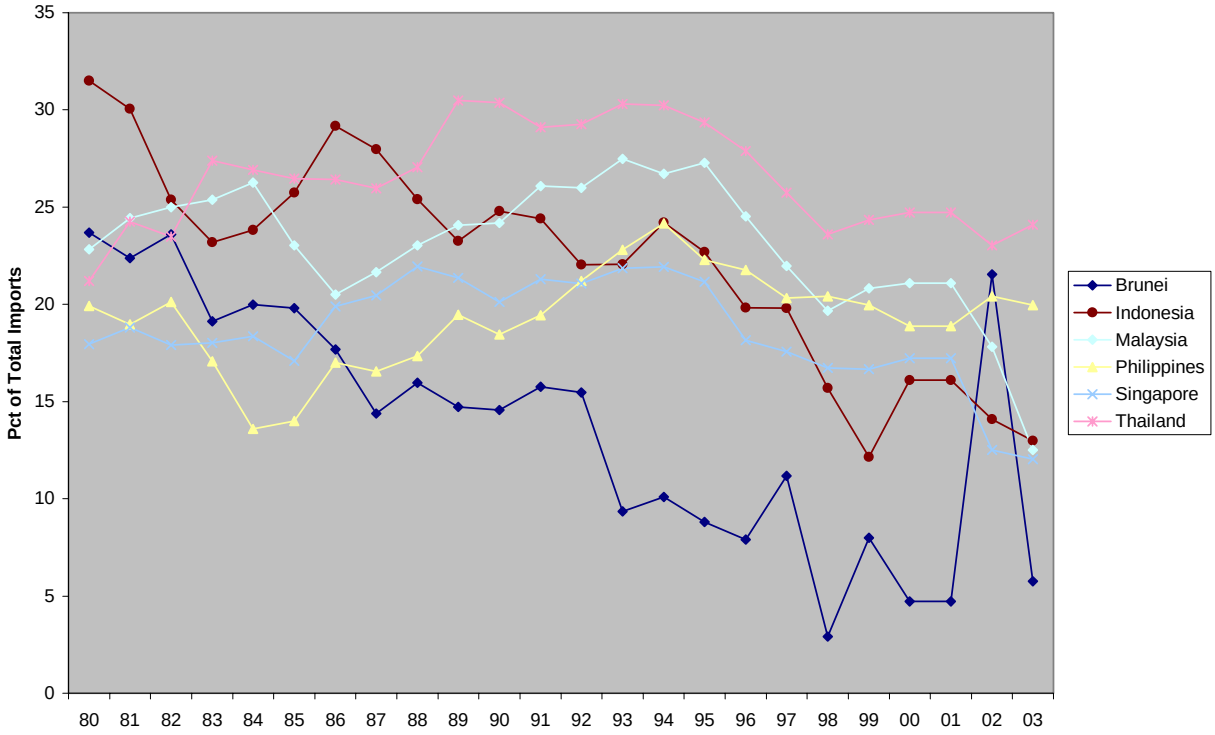


Figure A22: Industrialized Asia: Imports from Japan

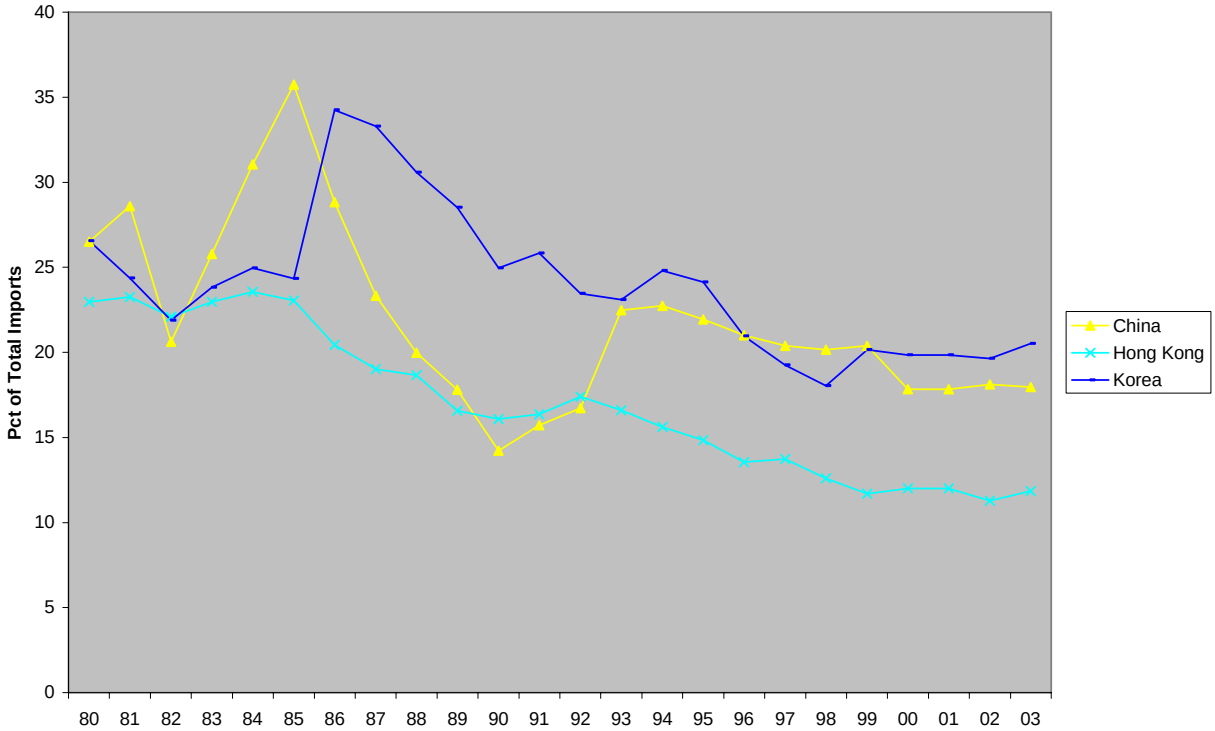
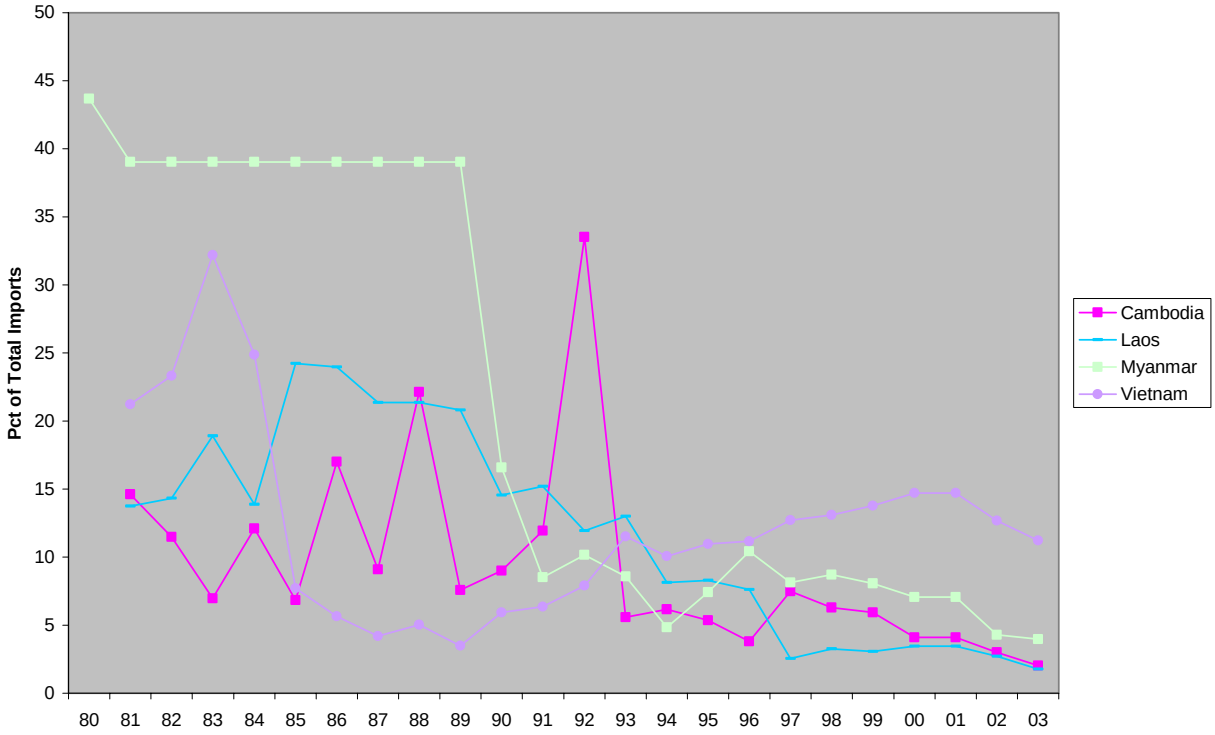


Figure A23: Transition Economies Imports from Japan



Appendix: Tables

Table A1: Cross-border M&A Activity, 1988-2003

(a) Cross-border M&A sales, by Seller

US$ millions

Country	88	89	90	91	92	93	94	95	96	97	98	99	00	01	02	03
Japan	29	1612	148	178	230	93	750	541	1719	3083	4022	16431	15541	15183	5689	10948
Korea		68		673		2	1	192	564	836	3973	10062	6448	3648	5375	3757
China			8	125	221	561	715	403	1906	1856	798	2395	2247	2325	2072	3820
Hong Kong	1046	826	2620	568	1674	5308	1602	1703	3267	7330	938	4181	4793	10362	1865	6098
Taiwan	38	9	11		3	16	16	42	50	601	24	1837	644	2493	480	422
India			5		35	96	385	276	206	1520	361	1044	1219	1037	1698	949
Brunei						2										
Cambodia										1						
Indonesia	100	150		149	233	169	206	809	530	332	683	1164	819	3529	2790	2031
Lao PDR						10								269	266	
Malaysia	20	701	86	128	46	518	443	98	768	351	1096	1166	441	1449	485	84
Myanmar						10		9		250						417
Philippines	45	161	15	63	404	136	828	1208	462	4157	1905	1523	366	2063	544	230
Singapore	262	114	1143	237	276	362	355	1238	593	294	468	2958	1532	4871	556	1766
Thailand			70	79	498	42	89	161	234	633	3209	2011	2569	957	247	55
Vietnam							2	1	6	63		59	19	4	6	18
WORLD	115623	140389	150576	80713	79280	83064	127110	186593	227023	304848	531648	766044	1143816	593960	369789	296988
ASEAN (%)	0.37	0.80	0.87	0.81	1.84	1.50	1.51	1.89	1.14	1.99	1.38	1.16	0.50	2.21	1.32	1.55
ASEAN+3 (%)	0.39	2.00	0.98	2.02	2.41	2.29	2.67	2.50	2.99	3.89	3.04	4.93	2.62	5.77	4.88	7.79
ASEAN+5 (%)	1.33	2.59	2.72	2.73	4.52	8.70	3.94	3.43	4.45	6.49	3.22	5.72	3.10	7.94	5.51	9.98

Table A1: Cross-border M&A Activity, 1988-2003

(b) Cross-border M&A sales, by Purchaser

US$ millions

Country	88	89	90	91	92	93	94	95	96	97	98	99	00	01	02	03
Japan	13514	7525	14048	11877	4392	1106	1058	3943	5660	2747	1284	10517	20858	16131	8661	8442
Korea		235	33	187	72	74	500	1392	1659	2379	187	1097	1712	175	98	662
China	17	202	60	3	573	485	307	249	451	799	1276	101	470	452	1047	1647
Hong Kong	1649	773	1198	1342	1263	4113	2267	2299	2912	8402	2201	2321	5768	3012	5062	4168
Taiwan		464	1385		131		30	122	4	433	628	408	1138	161	74	253
India	22	11		1	3	219	109	29	80	1287	11	126	910	2195	270	1362
Brunei						202		31	189							
Cambodia																
Indonesia	260		49	3	16	50	32	163	218	676	39	243	1445		197	2
Lao PDR																
Malaysia		27	144	149	148	774	812	1122	9635	894	1059	1377	761	1375	930	3685
Myanmar																
Philippines				14		25	42	153	190	54	1	330	75	254	2	1
Singapore	8	764	438	570	294	849	1174	892	2018	2888	530	4720	8847	16516	2946	5018
Thailand		269	18	59	1	38	12	144	180	55	43	154	5	699	87	176
Vietnam					6		1		11	27						4
WORLD	115623	140389	150576	80713	79280	83064	127110	186593	227023	304848	531648	766044	1143816	593960	369789	296988
ASEAN (%)	0.23	0.76	0.43	0.98	0.59	2.33	1.63	1.34	5.48	1.51	0.31	0.89	0.97	3.17	1.13	2.99
ASEAN+3 (%)	11.93	6.43	9.82	15.94	6.94	4.34	3.10	4.34	8.90	3.45	0.83	2.42	2.99	5.99	3.78	6.61
ASEAN+5 (%)	13.36	7.31	11.54	17.60	8.70	9.29	4.91	5.63	10.19	6.35	1.36	2.78	3.59	6.53	5.17	8.10

Source: World Investment Report, 2004

Original Source: UNCTAD Cross Border M&A Database/FDI Statistics

Table A2: Average Tariff Rates, 1981-2003

CD	Country	81	82	83	84	85	86	87	88	89	90	91	92	93	94	95	96	97	98	99	0	1	2	3
4	Japan								7.1	6.9		6.3	6.3	6.3	6.3	6.3	5.9	5.7	5.5	5.2	5.1	3.3	3.3	
3	Taiwan		31	31	30.8	26.5	22.8	19.4	12.6	12.3						11.2	9.7		9.1	8.8	8	7.8	7.6	
3	Singapore			0.3				0.3	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0	0	0	0	0	0
3	Hong Kong	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
3	Brunei														2.7		3.1	3.1	3.1	3.1	3.1	2.6	2.6	3.1
2	Thailand	32.3				41.2				40.8	39.8	37.8		45.6	23.3	23.1			20.1	16.9	17	16.5	15.4	16.1
2	Philippines	34.6	31.4	29.5	28.8	27.6	27.9	27.9	27.9	27.6	27.8	26	24.3	22.6	21.7	20	14.3	13.4	10.7	10.1	8.2	7.6	7.3	5.7
2	Malaysia	10.6					15.8	13.6	13	17		16.9	12.8	14.3	13		8.7	9.3	8.1	9.5	9.2	9.2	7.3	
2	Korea		23.7	23.7	21.9			22.9	18.9	14.9	13.3	11.4	10.1	8.9			13.4	13.3	11.1	13.1	12.7	12.4	9.4	8.9
2	China		49.5				38.1	39.5			40.3	42.9	41	39.9	36.3		23.6	17.6	17.5	16.8	16.3	15.9	12.3	12
1	Vietnam												11		12.7			13	13	15.2	15.1	15	16.5	16.2
1	Myanmar																5.7	5.8	5.5	5.5	5.5	4.8	4.8	5.5
1	Lao, PDR																9.5			9.6	9.6	9.5	9.5	9.5
1	Indonesia				37	27	31.5			25.2	20.6	20.3	20	19.4			13.2		9.5	8.8	8	6.8	6.2	7
1	Cambodia																35		18	18	17	16.9	16.5	16.5
4	USA								6.6	6.3	6.3	6.3	6.3	6.4		5.9	5.8	6.6	5.2	5.3	5.4	3.9	3.9	
4	EU (15)								8.7	8.7	8.7			7.7	7.6	6.8	6.7	6.2	6	5.6	4.8	4.8	4.4	4.4

Note:

All tariff rates are based on unweighted averages for all goods in ad valorem rates, or applied rates, or

MFN rates whichever data are available in a longer period.

Country codes are based on the classification by income in GEP 2002, where 1 = low income, 2 = middle income, 3 = high incone non-OECDs, and

4 = high income OECD countries.

Sources:

1998-2003; OECD, Indicators of Tariff and Non-Tariff Trade Barriers, 1996 and 2000; and IMF Global Monitoring Tariff Data.

Part II

Exchange Rate Coordination and Monetary Union in East Asia

Introduction

In this part of our report, we focus on monetary dimensions of regional integration. In particular, we examine the modalities of exchange rate coordination and prospective monetary union. To do so, we expand upon the definition of monetary policy beyond that of exchange rates alone and differentiate between weak-form cooperation and strong-form policy coordination. Our objectives are fourfold. One, we examine the argument that exchange rate coordination should accompany economic integration in Asia. Two, we consider how and why monetary policy cooperation should be sequenced beyond exchange rates. Three, we provide prerequisites and expected characteristics for successful Asian monetary union. Four, we offer a vision for future monetary policy cooperation in Asia.

In general, we can consolidate our recommendations for monetary cooperation along seven broad guidelines. One, sovereign Asian monetary authorities need to fully develop their own domestic monetary policy capability before engaging in policy cooperation. Two, optimal sovereign monetary policy requires flexibility based on welfare-optimality, such as can be found with flexible CPI-inflation targeting regimes. Three, when contemplated, the scope of policy cooperation must go well beyond exchange rates to encompass all of macroeconomic policy: monetary, fiscal, trade and industrial policies. Four, as Asia deepens its economic integration, policymakers should fully develop weak-form macroeconomic policy cooperation before contemplating formal monetary coordination. Five, if desired or warranted, regional exchange rate cooperation or coordination should be developed around flexible, fundamentals-based mechanism, the Asian Currency Unit Plus (ACU+). Six, regional policy cooperation should take

a flexible and multi-speed approach that is endogenous to underlying fundamentals and institutions. Seven, Asian governments must recognize that the commitment implicit in both formal monetary coordination and monetary union is as much political and social as economic, and thus requires regional institutions to succeed. This set of recommendations is consistent with the principles laid out for trade, investment and particularly financial integration discussed in Part I of the report.

To realize these policy recommendations, we encourage regional central banks to place their exchange rate objectives and deeply-held concerns for excessive exchange rate volatility within a flexible CPI-inflation targeting regime framework. Doing so will anchor domestic monetary policies and regional monetary cooperation to underlying welfare-based fundamentals. To the extent that regional exchange rate stabilization or cooperation is warranted or desired, we urge regional central banks to construct an Asian Currency Unit based on both trade flows and intermediate and long-term capital flows, the ACU+. We further advocate that ACU+ parities be established for each country but that exchange rates be allowed to float versus these parities to an extent deemed optimal by each monetary authority.[50] We argue that a flexible CPI-inflation targeting regime framework with an explicit ACU+ directive would allow Asian policymakers policy independence and sovereign flexibility, opportunities for deep macroeconomic policy cooperation, and an explicit exchange rate coordination mechanism.

[50] Williamson (2000) advocated using a common basket peg--whereby the US dollar, the euro and the yen are given almost equal weights--as a reference rate for exchange rate policies in the region. However, nesting the ACU+ within a flexible CPI-inflation targeting regime has three advantages. One, stabilizing intraregional exchange rates while permitting the ACU+ to float would allow external adjustments. Two, preferences for exchange rate stabilization are rooted within an explicit welfare-based monetary policy regime. Three, using the ACU+ as a reference rate has the added benefit of explicitly taking longer term capital flows into consideration.

In general, policy cooperation encompasses all ranges of shared policy activity, from weak-form policy cooperation to strong-form policy coordination. We will use the term weak-form policy cooperation to refer to those multilateral activities, including handshake agreements, declarations, and shared activities, which involve no binding or enforceable contracts. Policy cooperation can range from the weakest forms of policy cooperation (e.g. joint conferences) to deeper weak-form cooperation (e.g. a pronouncement that countries will refrain from strategic devaluation). We will refer to strong-form policy coordination when referring to formal and legalized policy agreements. Policy coordination of this type can range from loosely coordinated actions (e.g. open market operations to maintain healthy distances from agreed-upon bands) to strict coordination policy responses (e.g. calibrated instrument moves).

Exchange Rate Cooperation and Coordination

Since the current reality of Asian monetary policy is centered on the management of exchange rates, our policy recommendations for Asian monetary policy during economic integration begin with a discussion of the modalities of exchange rate cooperation and coordination. A pertinent question here is the appropriate currency regime for the regional economies. Prior to the 1997-98 crisis, many Asian currencies were *de facto* dollar pegs. In the immediate aftermath of the crisis, most Asian economies (with the notable exception of Malaysia) moved towards greater exchange rate flexibility. Despite the announced shift from exchange rate based monetary policy framework to the explicit adoption of inflation targeting (especially by the crisis countries), there has been active official interventions in the foreign markets in Asia. McKinnon and Schnabl (2004) showed that the Asian countries effectively remain a dollar bloc.

McKinnon (2001) termed such mutual exchange rate stabilization in the region "The East Asian Dollar Standard." The adoption of a quasi-dollar-peg exchange rate regime is presumably aimed at securing greater exchange rate stability.

However, such exchange rate policy may not be optimal for Asia. For instance, a basket peg with greater weights placed on other currencies would do a better job at mitigating both overall bilateral rate volatility and the volatility associated with improbable but extreme events than would a specific bilateral peg.[51] Moreover, whether Asian economies should continue with explicit exchange rate policies rather than with monetary policies centered on alternative nominal anchors will become an increasingly important policy debate as regional integration proceeds. Early empirical evidence appears to support theoretical developments that discretionary targeting, such as flexible inflation targeting can be quite effective for both developed and emerging small open economies.[52] As such, we recommend the following interim guidelines for reducing unwarranted regional exchange rate volatility and promoting optimal regional monetary stability.

One, during the initial phases of regional integration, Asian monetary authorities should eschew formal exchange rate coordination and instead pursue those weak forms of exchange rate cooperation that allow for different and larger degrees of exchange rate flexibility across the region. As we saw in Part I of this paper, the stage of development and extent of integration within Asia is not only varied but quite fluid. As recently as ten years ago, Asia as a yen bloc remained a viable proposal among professional economists (see Frankel, 1995). However, as the trade and investment data clearly indicates, the dramatic rise of China challenges us with the

[51] See Ogawa, et al (2004).
[52] For example, see Svensson (2000), Blejer et al. (2000), Batini et al (2001), and Laxton and Pesenti (2004).

notion that Asia might soon consider the formation of a yuan bloc (Hefeker and Nabor, 2002). Formal regional exchange rate coordination in such a fluid environment would not only be very difficult, but it would remove much needed discretion and policy flexibility. As integration proceeds, more flexibility will be needed to accommodate the attendant adjustments in member economies (See Karcadag, et al 2004). In such circumstances, individual countries would likely desire the flexibility to manage their real effective exchange rates, particularly if real rates are inclusive of longer-term capital flows. Such management can be achieved by nesting an explicit exchange rate stabilization directive based on trade and longer term capital flows within a flexible and country-specific CPI-inflation targeting regime. Such an exchange rate takes care of the "fundamentals" of the nominal effective exchange rate inclusive of longer term capital flows, while the stabilization of prices ensures that real exchange rate movements are optimal.[53] With a number of capital controls still in place in several Asian countries, particularly within ASEAN, the benefits of increased exchange rate flexibility result in greater rather than less macroeconomic stability (see Obstfeld & Rogoff, 1996; Corsetti, et al., 1998; Fischer, 2001).

Two, while domestic exchange rate flexibility is essential, Asian monetary authorities interested in regional monetary cooperation should agree to avoid competitive devaluations and other strategic exchange rate depreciations. The export-orientation tradition of Asia has made the region sensitive to the prospect of beggar-thy-neighbor exchange rate movements. Allowing for market-determined exchange rates and limiting the use of the exchange rate as a strategic instrument would go a long way both towards increasing regional cooperation and fostering credibility with international financial markets. To verify strategic neutrality, participating

[53] As we will argue, the choice of trade and longer-term capital flows as the basis for any exchange rate stabilization directive enables policymakers to more easily move toward using the ACU+ as the basis for regional exchange rate cooperation.

countries would require deeper weak-form cooperation, particularly with respect to transparency and mutual surveillance.

Three, should Asian monetary authorities pursue exchange rate cooperation, they should ensure that joint policy efforts satisfy the following four criteria. One, it must be flexible to the economic conditions facing sovereign, partner, and global concerns. Two, it must be credible to both participants and to financial markets. Three, it must be manageable. Four, it must be robust to economic shocks and policy distortions.

Despite the conventional wisdom of the "corners hypothesis" of exchange rate regimes, only intermediate exchange rate regimes would satisfy these criteria within a pragmatic framework. The recent literature on emerging countries' exchange rates throw water on the "bi-polar" idea that only fixed and floating regimes can survive (See Frankel, 2003). Clear empirical evidence regarding the "fear of floating" suggests that intermediate exchange rate regimes, such as the basket, band, crawl [BBC] of Williamson and Miller (1987), can be a pragmatic middle-ground for developing economies (Calvo & Reinhart, 2002). Despite potential problems with verifiability (see Frankel, et al 2001), exchange-rate bands anchor expectations (see Williamson, 2000). The ability to widen bands permits more flexibility in the event of market-based appreciation or depreciation.

More recently, discretionary targeting, such as the flexible-inflation targeting regime featured in Svensson (2000), appears to provide macroeconomic policy with an alternative nominal anchor. Since 1990, inflation targeting has been implemented in over a dozen countries,

including New Zealand, Sweden, Korea, Thailand and the Philippines, with considerable success, (see (Hu, 2003) or Bernanke, et al. 2001)). Moreover, theoretical simulations have increasingly shown that flexible CPI inflation targeting continues to perform quite well across a large set of parameterizations and models (see Sutherland, 2004b). Discretionary targeting regimes may offer selected emerging markets a way to break free from the narrow scope of exchange-rate based macroeconomic policies.

Should Asian policymakers adopt the BBC format with wide and flexible bands or flexible CPI-Inflation targeting with explicit targeting of the exchange rate, careful consideration must be given to the equilibrium exchange rate around which the band should operate. As pointed out by Obstfeld (2004), the equilibrium exchange-rate must reflect more than simple trade-weights. Rather, its underlying fundamentals should be calibrated with respect to intermediate and longer-term capital flows, as well as trade flows. As we will later argue, a fundamentals based equilibrium exchange rate based on both trade and capital flows provides the most natural and feasible coordinating mechanism for regional policymakers without the need to resort to more elaborate monetary policy coordination.

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For either BBC bands or flexible CPI-inflation targeting regimes with explicit exchange rate stabilization to be credible, regional central banks must provide unequivocal and unlimited support to support weak-form exchange rate cooperation. Regional funds must be made available to support increased flexibility. To do this, not only should the Chaing Mai initiative expand well beyond its US$100 billion size, but regional central banks must offer unlimited, but contingent

support. In addition, bands (BBC) or equivalently weights on stabilization variables (flexible CPI-inflation targeting) should accommodate the economic diversity and political realities of the region.[54] Countries in need of more time to restructure monetary policy and development robust financial institutions should be allowed added flexibility in setting the width of bands under a BBC or its weights on stabilization variables. This multi-speed approach will enhance the credibility of policymakers seeking to deepen regional macroeconomic policy cooperation.

Four, the growing but fluid dominance of China suggests that Asian exchange rate policies remain flexible above and beyond the flexibility needed to accommodate regional integration. The sheer size of China, its varied speeds of development, and its successful courting of FDI (see Chantasasawat, et al. 2004) poses great challenges to the rest of developing Asia. As suggested by Samuelson (2004), China's productivity gains in products for which it does not hold comparative advantage may seriously challenge the gains from trade in both industrial and developing countries. While the Samuelson result is not without its critics (see Bhagwati, et al (2004)), the speed and breadth of Chinese development suggests additional policy flexibility may be needed to handle the expected impact of China.

[54] For example, the basic small open-economy flexible CPI-inflation targeting regime given in Svensson (2000) has weights on stabilizing CPI inflation around a target, on stabilizing the output gap around a target, and on stabilizing changes in the short-term interest rate to allow for financial stability. Note: the "flexible" in flexible inflation targeting refers to the face that monetary policy does not simply worry about price stability ("strict" inflation targeting), but places weight on some explicit output directive (see Svensson, 2000).

Sequencing Policy Cooperation Beyond Exchange Rates: Why and How

The prospect of monetary policy cooperation or formal policy coordination brings to mind two overriding questions. One, how are we to model monetary policy cooperation or coordination in a manner that reflects rational expectations and optimizing behavior in the face of market imperfections? Two, once we have designed an adequate model, how are we to compare alternative forms of cooperation?

In Asia, the openness and trade-orientation of post-World War II growth has meant that historically, monetary policy has almost exclusively been characterized in terms of the exchange rate. While supportive of Asia's dramatic early development, such an approach has placed great limits on current debates over sovereign macroeconomic policies going forward. Not only is the literature on coordination rightfully based on monetary policy rather than on simple exchange rate coordination, but its most recent contributions (e.g. Obstfeld & Rogoff, 2002; Canzoneri et al, 2004; and Sutherland, 2004a) allow for direct welfare comparisons. While it seems clear that exchange-rate stabilization in Asia will remain a topic of great concern, the extent to which policymakers should coordinate policies through the exchange rate remains open to great debate. As such we make the following recommendations on why and how policy cooperation should be sequenced beyond the narrow confines of exchange rates.

One, Asian monetary authorities should broaden the scope of monetary policy beyond exchange rate management. Even for a region as open as Asia, exchange rates remain only one dimension of monetary policy. The modern new open economy macroeconomics (NOEM)

literature has generated a considerable theoretical debate over whether exchange rate stabilization should even be given a distinct focus within monetary policy.[55] Moreover, alternatives to purely exchange-rate based monetary policy, such as inflation targeting, have done well both theoretically and empirically (see Svensson, 2000; Hu, 2003; Sutherland, 2004b). Therefore, broadly redefining existing discussions in terms of monetary policy coordination rather than exchange rate coordination would bring to light a number of variables that have been shown to be theoretically important. These variables include the output gap, price and wage stickiness, competitive environment, policy inertia, price setting, consumer behavior, natural rates of interest and exchange rates, various market frictions and distortions, sectoral productivity shocks, local currency pricing, non traded goods, and the elasticity of substitution between home and foreign consumption. An understanding of these variables would help Asian monetary authorities better address the welfare implications of sovereign versus coordinated monetary policy.

With reference to the policy trilemma for economies with open capital accounts, it is well accepted that fixed exchange rates and discretionary monetary policy cannot be pursued simultaneously. Subsequently, it was shown by Svensson (2000) and others that the joint pursuit of both exchange rate and inflation targeting may produce policy tradeoffs that reduce steady-state welfare. Work by Corsetti and Pesenti (2001 and 2004a), Devereux and Engel (1998, 2000, 2001, and 2004), Galí and Monacelli (2002), Obstfeld (2002 and 2004b), Duarte and Obstfeld (2004), and Sutherland (2004b) has demonstrated that the extent of this tradeoff depends crucially on both the economic organization of firms and on the microfoundations of price-

[55] See for example Svensson (2000), Gali and Monacelli (2002), Obstfeld (2003 & 2004), and Duarte and Obstfeld (2004).

setting behavior. However, it is clear that were monetary policy to inappropriately stabilize exchange rates, domestic interest rates would follow suit and respond suboptimally to shocks either concurrently or with lags.[56] This policy-generated variability in the real interest rate would in turn generate instability in the real sector of the economy. In particular, ill-conceived exchange rate targeting in East Asian economies could lead to increased and suboptimal volatility in real interest rates, an effect consistent with empirical evidence that fluctuations in the nominal exchange rates are strongly associated with volatile capital flows. (Park and Song, 2001) We thus recommend that the scope of domestic monetary policy as well as regional policy cooperation go beyond mere exchange rate management.

Two, to help shift policy discussions toward monetary policy coordination, Asian central banks should expand weak-form cooperation around a NOEM approach. Asian policymakers should place particular focus on developing modern monetary research programs, expanding informational and training exchanges, developing crisis management guidelines, increasing transparency, and encouraging regional surveillance. Although some of these elements are already in place at local central banks, in-house monetary policy operations remain largely based on the legacy of Bretton Woods: exchange rate management and balance of payments adjustments. Furthermore, while central bank transparency has its limitations (See Mishkin, 2004), Asian monetary policy operations are notably opaque. As regional integration deepens, macroeconomic policy will have to become more flexible. In doing so, central bank research staff will need to be trained within the NOEM framework in order to help policymakers consider nominal anchors other than the exchange rate.

[56] If monetary policy were to focus exclusively on stabilizing exchange rates, then domestic interest rates would be largely tied to global interest rates.

Three, with a focus on overall monetary policy rather than just exchange rate management, Asian monetary authorities should differentiate between the management of regional crises and the conduct of monetary policy. By definition, regional crisis management requires deeper forms of cooperation and likely formal coordination. In contrast, the day-to-day conduct of monetary policy does not necessarily require either cooperation or coordination. Whether or not crisis management involves preventive measures, it must be designed around the prevailing regional monetary policies, not the other way around. As pointed out by Wyplosz (2004), discussions on strengthening regional exchange rate coordination have been to a large extent a defensive response to the Asian Financial and Currency Crisis of 1997-98. However, at its core, the crisis and its subsequent contagion was the result of domestic phenomena. Just as the ERM crisis of 1992-1993 showed, even best-designed regional coordination system will not prevent the markets from overwhelming policies that are inconsistent with either underlying fundamentals or private sector expectations.[57]

Four, before contemplating formal regional policy coordination, Asian monetary authorities should focus on optimizing sovereign monetary policy. The past decade of emerging market currency crises have been largely domestic in the making: poorly regulated banks, lack of transparency, the accumulation of currency-mismatches, short-term liabilities, and persistent moral hazard problems. Solutions to these problems lie not with external monetary policy coordination, but with committed focus on designing the optimal domestic monetary policy. To achieve this, Asian monetary authorities should develop modern NOEM research programs. This approach will enable robust modeling of consumer, firm, and government behavior. It will also

[57] See Eichengreen et al. (1994) and Obstfeld (1994).

allow for central banks to better understand the influence of the prevailing institutional environment on economic behavior. With such a program in place, Asian monetary authorities will be in a much better position to determine which policies would be optimal to their sovereign economies.

Five, Asian monetary authorities should continue expanding weak-form cooperation around broader and more flexible monetary policies. The move from exchange rate-based policy to broader monetary policy will offer opportunities for countries to cooperate on policy research, informational and training exchanges, crisis management, transparency, and regional surveillance. Once again, full implementation of weak-form cooperation should be anchored within the context of strong and well-founded sovereign monetary policy. Should Asian monetary authorities then contemplate entering into formal monetary coordination, they will be in a much better position to assess its relative costs, benefits, and trade-offs.

Selecting a Domestic Monetary Regime with an Explicit Coordination Mechanism

In order to anchor domestic monetary policies to underlying welfare-based fundamentals and to address the issue of intraregional exchange rate volatility, we advocate that countries nest regional exchange rate objectives within a flexible domestic CPI-inflation targeting regime framework.

In its most basic form, flexible CPI-inflation targeting requires that monetary authorities stabilize a weighted average of deviations of CPI-inflation and the output gap[58] from their optimal targets.[59] Weights on each target variable are determined optimally based on underlying domestic fundamentals. More generally, an explicit exchange rate or interest rate stabilization is added. As pointed out by Svensson (2000), Gali and Monacelli (2003) and Sutherland (2004b), flexible CPI inflation targeting regimes perform well and quite robustly across simulations of NOEM models for small open economies. These regimes do well on welfare comparisons without alternative discretionary regimes by combining a primary focus on price stability together with the stabilization of output-based variable, such as the output gap. Empirically, flexible-CPI inflation targeting has a short but rather impressive track record among small open economies, including emerging markets (See Bernanke, et al 2001).

Within such a welfare-based monetary policy framework, we argue that regional exchange rate cooperation should be pursued by including an explicit exchange rate stabilization objective designed around the ACU+.[60] Not only would use of this domestic benchmark be superior to current efforts that reference to the nominal effective exchange rate (NEER), but such an approach will prove useful in calculations for region-wide benchmarking or in any efforts to cooperate on regional exchange rate stabilization.[61]

[58] Where the output gap is defined as actual output less flexible-price output. See Gali (2002).
[59] See Svensson (2000), Walsh (2003a), or Woodford (2003).
[60] To avoid the possibility of severe short- and intermediate-term disequilibria, we recommend that weights on the ACU+ be time varying at frequencies far greater than once every five years as was the case for the ECU.
[61] Interestingly enough, the foreign exchange model of Goldman Sachs, Jim O'Neill's "broad balance of payments model" is also based on both trade and longer-term capital flow considerations.

Like the ECU, the ACU+ should be initially developed as a benchmarking mechanism for any policy cooperation on regional exchange rate stabilization. Although we emphasize that sovereign monetary policies and regional monetary cooperation should be anchored to underlying domestic fundamentals, we also recognize that deeply-held concerns for excessive regional exchange rate volatility and strategic exchange rate behavior may require explicit policy cooperation on regional exchange rate stabilization. To achieve both domestic and regional policy aims, we advocate that the pursuit of any cooperative regional exchange rate stabilization effort be done within the context of a synthetic, region-wide flexible CPI-inflation targeting regime framework, where regional regime weights are chosen to implicitly optimize region-wide welfare.

The implied weight on region-wide ACU+ stabilization thus provides a benchmark on the extent to which the ACU+ should float against external currencies, such as the US dollar and Euro. Country-specific parities to the ACU+ can then be formulated and revised in a manner that reflects both trade and longer-term capital flow considerations of sovereign economies. The weight that each country then chooses to place on stabilize its sovereign exchange rate around its ACU+ parity should be formulated according to optimal sovereign welfare.

This approach would incorporate a multi-speed dimension which would allow countries to deviate from optimal weights due to special economic and/or political considerations. These country-specific parities and the weights accorded by each country toward stabilizing their exchange rate around their ACU+ parity thus provide additional benchmarks on the extent to which deviations from ACU+ parities should be considered in policy cooperation discussions.

Countries who find it optimal to stabilize their nominal exchange rate around its ACU+ parity will now have a form of exchange rate management consistent with one likely to be used for formal exchange rate coordination.

Tracking of an ACU+ benchmark within a flexible CPI_inflation targeting framework contributes to macroeconomic policy cooperation on several dimensions. One, there will be a dramatic increase in regional surveillance and information sharing, particularly on the research front. Two, there will be a clearer indication of the importance of domestic exchange rate flexibility. Three, there will be a clearer sense of the importance of exchange rate stabilization in the context of a welfare-based monetary policy. Four, there will be a clear and economically-robust benchmark for exchange rate cooperation and formal exchange and monetary policy coordination. Finally, there will be a clear indication of what monetary union might imply for exchange rate behavior.

As with the ECU, we expect that the role of the ACU+ will expand beyond its initial benchmarking role to that of both an official unit of account of any future Asian Community and the basis of private sector created Asian debt instruments. However, unlike with the ECU, perspectives on stabilizing the ACU+ should be still formed within the context of a region-wide synthetic monetary policy regime, such as a synthetic region-wide flexible CPI-inflation targeting regime. Moreover, unlike the Eurozone, ASEAN+3 members should construct country-specific and revisable parities to the regional ACU+ benchmark based on their own country-specific micro and macro fundamentals. Furthermore, unlike the Eurozone, ASEAN+3 members should weight the importance of deviations from their individual ACU+ parity from the

perspective of optimal domestic monetary policy. These differential weights across the region should be encouraged according to a multi-speed approach to regional integration and cooperation. This multi-speed approach would be possible by allowing for deviations from optimal weighting for those countries needing additional flexibility in weighting schemes due to special circumstances, political or otherwise.[62]

All said, operation of flexible CPI-inflation targeting regimes with explicit ACU+ based exchange rate directives would provide Asian policymakers policy independence and sovereign flexibility, opportunities for deep macroeconomic policy cooperation, and an explicit exchange rate coordination mechanism. 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 on CPI inflation, exchange rate, output gap stabilization would be determined for each country.

Macroeconomic cooperation would then be achieved through three complementary efforts, each of which benefits from increased regional surveillance, transparency, standardization among central banks, and information sharing. One, the formulation of both the ACU+ and the individual parities would require a cooperative effort. Two, 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. Three, deviations from

[62] In essence, the actual weight on say CPI-inflation stabilization would be the product of the optimal weight (estimated by the central bank) and a proportional factor equal to one if the actual weight is set equal to the optimal weight, less than one if less than optimal CPI inflation stabilization is warranted, and more than one if greater than optimal CPI inflation stabilization is warranted.

optimal weights would allow for a multi-speed approach to reflect special political considerations and changing economic conditions. 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. As countries implement structural reforms that reflect greater integration and economic efficiency, optimal weights and permitted deviations will change.

The construction of an ACU+ and the determination of country pegs to the ACU+ would create an explicit exchange rate coordination mechanism without sacrificing macroeconomic policy discretion or flexibility. Without policy cooperation, countries would be free to place weights on exchange rate stabilization as they see fit, although stabilizing around an equilibrium exchange rate that recognizes both trade and longer term capital flows would remain warranted. With policy cooperation, regional policymakers could cooperate on stabilizing deviations from the ACU+ parity. Like the bands that featured prominently in the ERM or BBC, different weights placed on deviations from parity would allow countries flexibility. At the same time, convergence objectives would be achieved by ensuring that weights on exchange rate stabilization become ever closer to estimated optimal weights.

A flexible CPI-inflation targeting regime with an ACU+ based exchange rate would improve upon the rigidity of common basket pegs and even upon the flexibility of BBC-type regimes by combining the stabilization of variables central to consumer welfare with the explicit stabilization of the nominal exchange rate around a coordinated and fundamentals-based parity.

This combination will ensure welfare-enhancing flexibility within a sovereign monetary policy framework that can accommodate more ambitious regional exchange rate objectives.

Supporting Trade, Investment and Financial Integration

To better handle regional economic integration and the fluidity of regional economic dynamics, Asian monetary authorities should increase domestic flexibility. To provide immediate flexibility, we suggest that countries either adopt a basket-band-crawl (BBC) system or go directly to our recommended monetary regime: flexible CPI inflation targeting with an explicit ACU+-based exchange rate directive.

The last twenty years of speculative attacks has demonstrated beyond doubt the vulnerability of fixed pegs even when macroeconomic fundamentals are otherwise sound.[63] The structural reforms needed to carry out integration and liberalization will place added pressure on crisis management facilities whose traditional function has been to support fixed pegs. Therefore, domestic monetary policy flexibility will help accommodate adjustments arising from regional integration and from the fluidity of Asian economic relationships.

Should countries feel more comfortable leaving their fixed exchange rate policies for a flexible but purely exchange rate-based regime, then a flexible BBC centered on a parity with weights that reflect both trade and capital flow considerations (ACU+) would be a reasonable

[63] See Obstfeld (1994).

option. Cooperation for several countries running a BBC would require varied band-widths to accommodate a multi-speed approach.

However, while the BBC approach has its merits and is a marked improvement over monetary policies whose *raison d'etre* is to stabilize all exchange rate fluctuations, countries with sufficient research capacity should proceed to flexible CPI-inflation targeting with an explicit ACU+ based exchange rate directive. The combination of inflation, exchange rate, and output objectives would be more in line with consumer welfare and would enhance monetary policy credibility and consumer confidence.[64]

While we encourage domestic flexibility and a welfare-based monetary policy in support of economic integration, what about regional monetary cooperation? 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. In doing so, policymakers must recognize the endogeneity of the exchange rate and the significant risks of attempting to directly control the exchange rate. Policymakers should also focus research cooperation on determining whether the exchange rate has a distinctive role as a policy target above and beyond its effect on CPI-inflation, a role that remains theoretically controversial.[65]

Before contemplating formal monetary coordination, policymakers should fully support optimal domestic policies through weak-form macroeconomic policy cooperation, especially

[64] As has been shown in Clarida et al (1999), increased credibility of the monetary authority enables monetary policy to impact private sector expectations and "buy" a lower steady-state rate of inflation.
[65] For example, see Obstfeld (2002, 2004b), Duarte and Obsteld (2004), and Sutherland (2004b).

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 weighted ACU+. However, domestic currencies should still float versus their ACU+ parity, allowing countries more flexibility and discretion on whether to stabilize exchange rates.

Sequencing Macroeconomic Policy Cooperation Beyond Monetary Policy

Even if countries are able to expand monetary policy beyond exchange rates, the complexities of international policy cooperation demand that policymakers expand the scope of policy cooperation to encompass all dimensions of macroeconomic policy.

One, Asian policymakers should transit towards the independent, though cooperative, conduct of macroeconomic policies. The dominance of one-party governments and relatively immature democracies has meant that monetary policy has not been conducted with much independence from fiscal and industrial concerns. Instead, Asian countries have proceeded with what amounts to be an overall macroeconomic strategy. However, in anticipation of greater liberalization and integration, ASEAN+3 governments should consider institutional reforms that would allow for independent, though cooperative, conduct of monetary, fiscal, and commercial policies. The independence of central banks has been firmly established as one of the great pillars of effective monetary policy (See Cukierman, 1992). Allowing for the independent formulation of fiscal and industrial policies will enable sovereign policymakers to manage the distribution of public goods more efficiently and to design strategic industrial policies more

effectively. As the region looks to increased cooperation, formal coordination, or even full-fledged monetary union, negotiations over relinquishing full control over sovereign policies will necessarily involve all dimensions of macroeconomic policy.

Two, as regional integration proceeds, Asian policymakers should include fiscal policy dimensions in discussions of macroeconomic policy cooperation and coordination. As the Eurozone experience suggests, economic liberalization can create serious adjustment issues that can derail or even reverse further integration. Traditionally, it has been fiscal policy which has been called upon to alleviate problems arise from such adjustments. One of the main agreements leading to the introduction of the Euro was that sovereign members retain full control over fiscal policy (Frankel, 2004). Yet, fiscal policy spillovers will have a direct impact on optimal monetary policy.[66] Therefore, despite the consensus view that explicit fiscal policy coordination is likely to be politically infeasible, cooperative talks on monetary policy should take into account the impact of fiscal policy spillovers. These discussions might include those countries with larger short-term debt, currency mismatches, or those likely to need fiscal stimuli during the integration process. As Germany and France are currently demonstrating, sovereign controls over fiscal policy can put great strain on even the most democratic of monetary arrangements.

Three, to fully develop discussions on regional monetary cooperation, Asian policymakers should expect to include strategic industrial policies. Despite the cooperative spirit underlying integration and policy coordination, it remains that Asian economies are their own toughest competitors. If monetary policy cooperation prohibits beggar-thy-neighbor exchange rate movements and limits fiscal policy spillovers, the only strategic policy tool remaining to

[66] For recent approaches, see Lane and Ganelli (2002), Gali and Monacelli (2004), and Canzoneri, et al, (2005).

policymakers would be an interventionist set of industrial policies. Coordinating monetary policy with another country with superior strategic policies would be effectively tying one's hands. All else equal, coordination would then result in a strategically inferior position.

Prerequisites to Formal Monetary Policy Coordination

Once Asian policymakers have instituted reforms that enable the conduct of sound monetary policy, monetary authorities will be in a better position to weigh the prospects of strong-form monetary policy coordination. However, before policymakers relinquish full sovereign control, the following must occur:

One, Asian policymakers should demand that coordinated policy lead to an expected economic performance that is both superior to sovereign policy designs over the long term and robust to large, adverse outcomes. The time-inconsistency nature of policy planning is such that without a proper commitment technology, policymakers will always have the incentive to use discretion to deviate in the short-term (see Clarida, et al, 1999). In this light, formal monetary policy coordination becomes an attractive option only when it offers sovereign countries the prospect of generating large enough welfare gains over the long run to make short-term deviations extremely costly. Furthermore, monetary policy coordination would be even more attractive if it could be designed in such a way that did not tie one's hands in the face of large negative shocks. Without such a provision, the risk associated with highly improbable events would undermine the credibility of any coordinated policy.

Two, Asian policymakers must be willing to neutralize the net strategic benefits of exchange rate, fiscal and commercial policies. It would be safe to say that no country would be willing to commit to policy coordination in which they are left at a strategic disadvantage relative to their competitors or relative their performance under sovereign policy. Since any of the three facets of macroeconomic policy can be operated strategically, negotiations over formal coordination are unlikely to proceed unless countries are willing to make monetary policy coordination a risk-neutral proposition. Without this willingness, countries should limit their joint pursuits to weak-form cooperation.

Three, Asian policymakers considering monetary policy coordination must be willing to accept not only that coordinated welfare is the ultimate objective of policy coordination but that ongoing policy coordination will require increased mutual surveillance and transparency. At its most fundamental level, formal monetary policy coordination is a shared commitment to improve the welfare performance of two or more countries. It is a commitment that from time to time will place joint welfare over sovereign welfare. As such, it requires a regional spirit that will place limitations on nation-centric objectives. Countries unwilling to accept this commitment will not be ready for formal coordination and should consider only weak-form cooperation. Countries that are willing to commit to formal policy coordination, must also be willing to increase policy transparency and open themselves to increased surveillance of day-to-day operations.

Four, Asian policymakers should be clear about the ultimate objective of monetary policy coordination. Asian monetary union does not seem realistic at this time. However, should there

be a credible commitment to monetary union as the ultimate political and social objective, monetary policy coordination could be interpreted as an important intermediate step on the road toward monetary union. With such a credible commitment, the calculus comparing the welfare benefits of monetary policy coordination to sovereign monetary policy would change dramatically. One can witness this idea in reverse when considering the collapse of the ERM in 1992-93. The Danish rejection of a referendum on European monetary union called into question the viability of European monetary union. By doing so, the vote also challenged the logic of the ERM, a monetary arrangement that was deliberately-designed as an intermediate step towards eventual monetary union. By creating doubt as to the plausibility of the end goal, the intermediate step itself was subject to that same doubt. As a consequence, it was attacked quite spectacularly by speculators, forcing a number of countries completely off of the ERM, while widening the exchange rate bands and creating new parities for the rest (see Eichengreen, et al, 1994).

Characteristics of Formal Monetary Policy Coordination

Should Asian countries satisfy our prerequisites for formal monetary policy coordination, the successful implementation of that formal monetary policy coordination will be characterized by the following:

One, the design of monetary policy coordination will have to be country-specific. Within Asia, there are differences among countries in terms of exposure to external and internal shocks. With fully open economies such as Singapore and Hong Kong, monetary policy must almost exclusively handle external shocks. At the same time, countries with large domestic economies,

like Japan and increasidngly China, must formulate monetary policy with considerations for both external and internal shocks. However, optimal policy coordination will not be limited to economic factors, but will also include political and social elements. ASEAN+3 countries represent the most diverse set of countries in the world. Within the group, is the world's richest nation (Japan) and two of the world's poorest countries (Laos and Cambodia); the world's largest country and second-largest economy (China) and two city states (Brunei and Singapore); seven countries with one party political systems or dominance (China, Laos, Vietnam, Cambodia, Myanmar, Brunei, and Singapore) and four countries with youthful democracies (Korea, Philippines, Indonesia, and Malaysia); countries which have flexible monetary policies (Japan and Singapore), countries which have adopted inflation targeting (Korea and the Philippines) and countries which operate de facto fixed exchange rate regimes (e.g. Malaysia (See Fukuda, 2002)). Uniform implementation of coordination without sensitivity to current economic and political realities would clearly be fraught with risk.

Two, regional policy coordination will have to be implemented according to a multi-speed approach that promoted similarity and preparedness. In order to facilitate smooth transition, regional policy coordination will have to be promoted more heavily among those countries with similar economic and political characteristics. Countries which share similar size, economic structures, behavioral patterns of consumers and firms, legal and policy processes, political will, and policy objectives will have to be the first to attempt explicit coordination. These countries are more likely to satisfy two key Optimum Currency Area criteria: reduced vulnerability to asymmetric or idiosyncratic shocks and similar transmission mechanisms of shocks to the economy. In addition, inflation targeters will coordinate with inflation targeters,

crawling bands with crawling bands, etc. In addition, countries not yet ready or willing to formalize coordination will have to be brought in slowly. For some countries, the relinquishment of full sovereign control over monetary policy will not occur so easily. For these countries, the demands of the underlying economic and political infrastructure will dictate the timing of coordination.

Three, monetary authorities will have to avoid the wholesale promotion of ideological policies, but instead will have to coordinate policies in a manner that explicitly addressed initial conditions, particularly with respect to reducing the risks associated with implementation. As the literature on emerging market exchange rates suggests, the promotion of deeply held beliefs with regards to corner solutions in monetary policy can rarely be justified upon either theoretical or practical grounds (see Calvo and Reinhart, 2002; or Frankel, 2004). Policy interpretation of theoretical debates regarding fixed versus floating exchange rates, policy coordination versus the strict pursuit of domestic policy, and monetary union versus sovereign monetary policy must be tempered by economic and political realities of countries contemplating monetary coordination. Successfully implemented monetary policy coordination will have to be coordinated according to relevant initial conditions, including the degree of dollar invoicing, currency mismatching, capital controls, incomplete or shallow financial markets, market structure, the convertibility of currency, short-term debt, foreign-exchange debt, adjustment costs of structural reforms, large government foreign-asset holdings, and the influence of political interest groups.

Four, successful monetary policy coordination will embrace broader aspects of macroeconomic policy rather than remain focused on monetary policy or exchange rates. Within

Asia, the current lack of monetary policy independence and the predominance of concentrated political power suggest that policy coordination will be susceptible to fiscal policy spillovers and distortions from strategic industrial policies. As such, for formal monetary policy coordination to succeed, policy negotiations will have to consider all three dimensions of macroeconomic policy as important parts of the coordination process. Negotiations will have to neutralize the net strategic benefits of fiscal and commercial policies to better gauge the separate effects of coordinated monetary policy.

Five, formal monetary policy coordination will have to retain flexibility in the face of changing economic and political conditions, particular with respect to China. In particular, Asian policymakers seeking policy coordination will have to address the growing influence of China with extreme flexibility. Whether or not ASEAN members want to form a coordinated periphery around China, coordinated directly with China, or simply manage sovereign monetary policy around the influence of China is not so clear. Clearly, for formal monetary policy coordination to succeed, the actual form of policy coordination will have to be flexible enough to allow for learning, inertial adjustments, and rapid changes in domestic and regional economies due to increased integration.

Six, time consistency phenomena will require increased regional surveillance and transparency. Without increased surveillance and transparency, countries will not want to risk coordinated policy. Increased information and clearer understanding of participants' objectives and constraints must have been sufficient enough to reduce the risk of relinquishing sovereign policy in favor of a multilateral approach.

Prospective Monetary Union

At this moment in time, it is too early to determine whether monetary union in Asia would be a worthwhile or even plausible objective. While the region is unquestionably as integrated as Western Europe was at inception of its push toward economic and monetary union, the economic diversity of Asia, the lack of supranational institutions, and the lack of social and political regionalism does not suggest that the Asia is quite ready to consider pursue monetary union. However, should integration develop and satisfy a number of prerequisites, the prospects for Asian monetary union may brighten.

Prerequisites for Asian Monetary Union

One, the pursuit of monetary union must be endogenous to the underlying economic structure and social-political fabric. The exogenous imposition of monetary union onto peoples neither willing nor prepared for its demands would deal a blow to organic regionalism already taking root. In economic terms, endogeneity speaks to the credibility of monetary union and to the risk premium that will be levied on premature and misplaced efforts. Should an ill-conceived monetary union dissolve, the impact on economic, political, and social life within the region could be costly.

Two, 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. Persistently high unemployment rates in Europe

(OECD, 2005) and flat growth trends have recently increased demands for more flexible fiscal rules under EMU. Moreover, differential benefits from EMU, have begun to test the fiscal and strategic restraints that form the basis of monetary union. The myriad of regional institutions that accompanied EMU have left little room for Eurozone policymakers to use conventional policy tools available to sovereign countries. Rather than representing exceptional circumstances, the current debate over the restrictions of European monetary union should be considered an integral dimension of monetary union. Before Asian countries form a monetary union, Asian policymakers and citizens alike must be fully prepared to curtail calls for sovereign discretion during trying times.

Three, Asia needs to develop a "cult of regionalism." More than simply macroeconomic policy, monetary union is also an important step towards the formation of a regional identity. Success of any proposed monetary union in Asia requires regional institutions, regional approaches to policy design and implementation, region-wide operating standards; intra-regional mobility of all forms of capital and perhaps most importantly, the willingness on the part of policymakers and the populace alike to place regional interests ahead of sovereign concerns. Unquestionably, such a phenomenon was fomented in Europe in its run-up to the Euro. The success of this campaign has been quite dramatic, so much so that centuries-old displays of nationalism were rapidly replaced by a pan-European identity. More than peripheral, these social-political matters are at the heart of whether monetary union can succeed.

Four, Asia needs to develop political and cultural will to commit to monetary union: from inception to implementation to institutional permanence. Ultimately, the success of any proposed

monetary union in Asia will be determined by the political and cultural will to commit credibly to the permanence of monetary union. The transition towards regional governance will be nontrivial, even for a set of countries which might nominally satisfy the classic criteria for an optimum currency area. In the early 1970s, Europe had planned on achieving monetary union by 1980. Instead, global economic and political conditions together with the collapse of the ERM in 1992-93 delayed EMU for another twenty-plus years. Domestically, structural rigidities and regional loyalties will generate regional and sectoral interest groups who will defend their towns and livelihoods. These lobbies will demand fiscal and perhaps strategic commercial compensation for potential losses suffered from monetary union. Without endogenous support, the premature pursuit of monetary union may exact such a large cost as to dissolve the contractual commitment. Should sovereign governments or their peoples break their commitment to monetary union, the political and economic fallout would not likely be inconsequential.

Five, experiences with weak-form cooperation and stronger form coordination must unambiguously support prospective monetary union. The successful implementation by optimizing sovereign monetary authorities of exchange rate cooperation, weak-form monetary policy cooperation, and stronger-form monetary coordination will give policymakers and citizens alike a better sense of whether future monetary union is warranted or even desired. Each successive step of policy cooperation offers participating nations an opportunity to learn more about their partner countries. In particular, they can observe first-hand the degree of policy independence, research quality and assimilation, and political influences on the policy process. They will also be able to determine the extent to which policy objectives are shared or compatible and take note of the internal effectiveness of structural and institutional reforms.

Finally, they will be able to measure the private sector response to cooperative and coordinated policy efforts. Together, the intimate understanding of how cooperation and coordination actually takes place should ultimately inform policymakers on whether all parties are in fact ready to formalize monetary union. No other set of indicators will offer a clearer indication for the prospects of monetary union.

Six, 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. As we are strongly emphasizing, monetary union is not only an implicit commitment to cooperative on all aspects of macroeconomic policy, but also a political and social contract to promote regionalism ahead of sovereign concerns. The traditional Asian approach to multilateralism has been to avoid institution-building. However, successful monetary union will require a set of institutions (see Wyplosz, 2004) that can promote a new approach to consensus building in Asia. Unquestionably, monetary union will create winners and losers. Monetary union will create uneven structural adjustments while leaving sovereign policymakers with one less tool to offset idiosyncratic shocks. Monetary union will require a shift toward a more rules-based, accountable, and representative approach to policymaking. To handle the challenges of monetary union, Asia must develop an appropriate set of regional institutions that can meet the exacting demands of monetary union. For guidance, we suggest a framework along the lines of the EU institutions that preceded the ECB.

Characteristics of Monetary Union

Should the prerequisites to Asian monetary union be satisfied and monetary union become a reality, the experience of European monetary union suggests that successful implementation will itself satisfy five prerequisities.

One, Asian monetary union will have to adopt a multi-speed approach with a generous timeline. As was the case with formal monetary coordination, countries which share similar size, economic structures, behavioral patterns of consumers and firms, legal and policy processes, political will, and policy objectives will have to be the first to attempt monetary union. Countries not yet ready or willing will have to be given more time and more incentives to implement the necessary reforms to enable successful entry into monetary union. In Europe, the former eastern bloc countries, such as Poland and the Czech Republic, have to be brought about very slowly under flexible terms. Before full membership is granted, these countries will have to undergo considerable structural reform to conform to the criteria set forth by the EU and ECB. In Asia, the challenges will be even greater. The core Asian countries are strikingly dissimilar and lack the common philosophical roots to modern government that the EU15 shared prior to pursuing monetary union. As such, successful Asian monetary union will have to adopt a multi-speed approach with a more flexible and generous timeline than witnessed in Europe.

Two, convergence and membership criteria will have to be based on economic and political fundamentals and not on arbitrary limits. As the recent European experience clearly indicates, arbitrary limits completely unrelated to either economic fundamentals or prevailing

economic and political conditions can do great damage to the credibility of monetary union. While these limits can serve as reasonable warning indicators, much like the fixing of exchange rates, the strict imposition of unrelated policy limits may result in sudden and dramatic pressures on the existing monetary arrangement. Monetary unions are no exceptions to these phenomena. In Asia, the historical preferences for budget surpluses will ease the political pressures of negotiating convergence and membership criteria. However, as the region integrates and develops, one can expect public sector budgets and the prospects for budget deficits to increase. Therefore, we expect that successful and credible monetary union in Asia will feature convergence and membership criteria consistent with underlying economic and political fundamentals.

Three, Japan and China will have to resolve to work together to build a strong center to the monetary union. The strength of a monetary union ultimately lies with the health of the center country or countries. In Europe, special concessions and allowances were made to Germany and France as the two co-centers of the EU. In Asia, we expect political pragmatism to be no less flexibile. Japan and China represent the wealthiest and largest economies, respectively. However, the historical acrimony between these two countries has not yet been completely resolved. For Asia-wide monetary coordination to have to be successfully implemented, China and Japan will have to forge a new bond and demonstrate credible leadership and a clear determination to promote regional identity over that of their sovereign countries. This characteristic of successful monetary union should prove to be the most challenging and potentially the most rewarding.

Four, social and political compatibility will have to be as important as economic similarity. One is struck with how many countries in Europe are keen on being identified as part of the European Union. In particular, smaller countries and peripheral countries have grown weary of the rhetoric of nationalism. Instead, these countries seek membership in a regional community for which the Euro has become its most enduring symbol. When finally eligible for entry into the EU and Eurozone, many of the former Eastern Bloc countries, such as the Czech Republic, Poland, Hungary, and now the Ukraine, will be more suitable due to their social and political compatibility with European regionalism than due to their economic similarity with the EU15. For example, Polish unemployment hovers at around 19%. Yet, the voice in support of EU and EMU is louder than ever. The vastness and diversity of Asia will make such compatibility a daunting challenge. Successful monetary union will depend crucially on the popular acceptance of regionalism.

Five, the success of Asian monetary union will have hinged on how much latitude was given to fiscal discretion and strategic industrial policies. The surrender of discretionary monetary policy means that only fiscal and industrial policies can address country-specific or differential shocks, frictions, and market imperfections. When considering monetary policy coordination, we argued that countries must be willing to relinquish fiscal discretion and strategic industrial policies for negotiation. However, under monetary union, the union must consider increasing fiscal discretion and strategic industrial policies in order to preserve the union. Just how well, such discretion and latitude is nuanced across member nations will have played an important role in the sustainability of monetary union. However, as the case of Europe

instructs, latitude towards fiscal discretion is likely to be more uniform than with respect to strategic industrial policy, since the latter can be focused outside of the union.

Monetary Union and the Long-term Vision for ASEAN+3

While monetary union remains an intriguing and somewhat romantic ideal for Asia, an economic union characterized by a high degree of economic integration, supranational institutional development, and macroeconomic cooperation is not only more important for regional economic welfare but also far more politically feasible. Moreover, as the economic success of the UK and Sweden suggests, the institutional and cooperative benefits of economic union have clearly benefited countries regardless of whether they decided to closely coordinate monetary policies or join the Eurozone.[67]

In a manner parallel to developments within sovereign economies, we expect that monetary policy cooperation will continue to broaden beyond exchange rates.[68] To do so, policy discussions should encompass each of the fundamental dimensions of macroeconomic policy: monetary, fiscal, strategic, and industrial. As the recent American experience instructs, monetary policy does not exist independent of fiscal policy, particularly when considering macroeconomic cooperation. At the same time, policy cooperation that ignores strategic behavior (i.e. competitive devaluations) or industrial policies (e.g. government subsidies to key growth

[67] On both growth and inflation measures, the UK and Sweden have outperformed Eurozone countries since 1999. Both the U.K. and Sweden maintained policy independence following the collapse of the ERM in 1992. Denmark, the only other Eurozone country to qualify for the Euro but remain outside of the Eurozone, nevertheless pegs the kroner to the Euro.

[68] Korea, Thailand, the Philippines, and most recently Indonesia, have already moved towards inflation targeting as the official monetary policy.

industries) will prevent deeper cooperation or strong-form coordination from taking root. We expect that as economic union begins to take shape in Asia, each essential dimension of macroeconomic cooperation will be open for frank discussion.

As both domestic monetary policies and monetary policy cooperation continue become more flexible and go beyond narrow exchange rate management, we expect monetary policy management to be differentiated from crisis management. The current procedures for crisis management were designed with fixed exchange rates in mind. As regional development and economic integration causes exchange rates to loosen their grip on regional monetary policies, we can expect crisis management to fade into the backdrop along with foreign exchange rate reserves as secondary aspects of macroeconomic management.

While monetary flexibility and weak-form monetary policy cooperation have obvious welfare benefits, the precise form of future sovereign monetary policies and regional monetary arrangements remain uncertain. Perhaps the best explanation for this uncertainty is the absence, especially among ASEAN central banks, of a modern research agenda based on the new open economy macroeconomics (NOEM). Beginning with early work by Svensson and Van Wijnbergen (1989) and the seminal contributions of Obstfeld and Rogoff (1995, 1996a), progress in the study of open economy macroeconomics has built upon clearer understanding of underlying microeconomic behavior. Subsequent papers include those by Corsetti and Pesenti (2001, 2004a), Obstfeld (2002, 2004b), Duarte and Obstfeld (2004), Obstfeld and Rogoff (2002), Clarida, Gali and Gertler (2002), McCallum and Nelson (2000), Gali and Moncaelli (2002), Monacelli (2003), Devereux and Engel (1998, 2000, 2004) and Sutherland (2004a and 2004b)

among others. These papers have highlighted the importance of price-setting, indexation, pass-thorough, habit persistence, intertemporal and intratemporal elasticities, market structure, policy inertia, political economy, and regional spillovers on the design of optimal sovereign monetary policies and optimal monetary policy coordination. We fully expect that Asian research institutions will fully develop this level of intimacy with microfoundations so that research on alternative discretionary targeting will continue beyond flexible CPI-inflation targeting and exchange rate stabilization. We also expect and encourage research on cooperative and coordination schemes that will protect against risks of strategic policy yet will offer Pareto improvements above non-cooperative discretion.

Rather than impose economic convergence for the sake of politically-motivated monetary union, we expect that deeper regional cooperation and integration will foster greater economic convergence, which will in turn increase calls for greater cooperation and coordination. Whether endogenous demand will demand monetary union or simply deeper cooperation, the closer economic ties will result in policies closely linked to underlying fundamentals.

We argue that our future vision for Asian economic union requires neither currency union nor explicit monetary coordination. Economic union entails deep integration, weak-form cooperation and supranational institutions. However, as NAFTA continues to prove, successful economic integration does not require formal monetary coordination or monetary union. If anything, the persistent economic malaise of Eurozone countries demonstrates that monetary union neither a necessary nor sufficient condition for welfare-maximizing monetary policy.

That said, we do agree that if monetary coordination must take place due to mercantilist or political reasons that limited exchange rate cooperation so long that it is anchored 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. At this time, we advocate coordination with the ACU+ within a flexible CPI-inflation framework. Successful ACU+ coordination will necessarily require increased surveillance, transparency, and information sharing, cooperative ventures that provide important regional policy benefits of their own accord. Over the long-term, we expect that research findings from a regional NOEM agenda will refine discretionary targeting in a manner that improves upon our flexible CPI-inflation cum ACU+ framework, perhaps reducing the need for explicit exchange-rate targeting.

Within the next two decades, the successes of economic union among ASEAN+3 countries 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 will need to unambiguously support prospective monetary union. While we are confident that political and economic cooperation will reach new heights, the desire for monetary union will be determined as much by depth of integration and cooperation as by a clear and robust willingness to commit to a political and social contract of regionalism.

If monetary union is to be successful, the following prerequisites must occur. One, the pursuit of monetary union must be endogenous to the underlying economic structure and social-political fabric. If social welfare is to be maximized, policy must be made consistent with underlying consumers. Two, 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. Not only will domestic interest groups be affected in every participating country, but many of these groups will resist the loss of sovereign policy. Three, Asia needs to develop a "cult of regionalism." Social acceptance of pan-regionalism is perhaps the most striking aspect of European Monetary Union, a development that reduces the economic risks associated with monetary union. Four, Asia needs to develop political and cultural will to commit to monetary union: from inception to implementation to institutional permanence. The imposition of monetary union upon a populace lacking commitment to its challenges will pose greater risks to regional cooperation than if monetary union had not been attempted. Five, experiences with weak-form cooperation and stronger form coordination must unambiguously support prospective monetary union. The greatest evidence and best indicator for readiness for monetary union will be the behavior of countries, institutions and individuals to deeper cooperation and coordination. Finally, 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. Supranational institutions will have to utilize their independence from domestic political constraints to further regional causes if monetary union is to succeed.

Summary

In this paper, we explored the modalities of exchange rate coordination and prospects of monetary union in Asia. In doing so, we necessarily expanded monetary policy beyond exchange

rates in a manner that followed the sequencing of economic integration. We also emphasized the need to differentiate between weak-form policy cooperation and strong-form policy coordination.

In general, we suggest that sovereign Asian monetary authorities need to fully develop their own domestic monetary policy before engaging in policy cooperation. The gains from a domestic reform agenda will likely outstrip those from formal policy coordination. We also argued that regional monetary policy cooperation should encompass all of macroeconomic policy, and not just exchange rates or monetary policy, particularly as integration deepens. We further emphasized that as Asia deepens its economic integration, cooperation should follow suit and develop from strictly domestic monetary policy to weak-form exchange rate cooperation to formal monetary coordination, with explicit negotiations over all of macroeconomic policy. We challenged that the commitment implicit in both formal monetary coordination and monetary union is as much political and social as economic. Finally, we cautioned that regional policy cooperation must take a flexible and multi-speed approach that is endogenous to underlying fundamentals and institutions.

To support an ambitious agenda of economic integration with sovereign flexibility, ample room for policy cooperation and an explicit mechanism upon which to base exchange rate cooperation, we advocate for a flexible CPI-inflation targeting regime framework with an explicit ACU+ based exchange rate directive. Implementation of a welfare-based regime would allow Asian policymakers policy independence and sovereign flexibility, opportunities for deep macroeconomic policy cooperation, and an explicit exchange rate coordination mechanism.

A Final Thought

One final idea worth contemplating is the notion that formal monetary arrangements be used to force reform upon domestic policy institutions that are too politically entrenched to reform from within. While controversial, it lay at the heart of several European efforts with respect to the EU and EMU. In terms of future research, it would be worth exploring the hypothesis that an exogenously imposed institutional structure, such as a monetary union, might create more economic welfare than domestically-based policies dominated by the interests of political elites.

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