ASIAN ECONOMIC INTEGRATION MONITOR

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Abbreviations and Acronyms

ADB	Asian Development Bank
ADO	Asian Development Outlook
AEC	ASEAN Economic Community
AEIM	Asian Economic Integration Monitor
AFAS	ASEAN Framework Agreement on Services
AFC	Asian financial crisis
AH	Asian Highway
AIF	ASEAN Infrastructure Fund
AIIB	Asian Insfrastructure Investment Bank
APEC	Asia-Pacific Economic Cooperation
ARIC	Asia Regional Integration Center
ASEAN	Association of Southeast Asian Nations (Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Viet Nam)
ASEAN+3	ASEAN plus the People's Republic of China, Japan, and the Republic of Korea
ASEAN-4	Indonesia, Malaysia, the Philippines, and Thailand
ASEAN+6	ASEAN+3 plus Australia, India and New Zealand
ATF	Agreement on Trade Facilitation
BOP	Balance of payments
BRICS	Brazil, Russia, India, the People's Republic of China and South Africa
CAP	Common Agricultural Policy
CAREC	Central Asia Regional Economic Cooperation
CMIM	Chiang Mai Initiative Multilateralization
CPIS	Coordinated Portfolio Investment Survey
DMC	developing member countries
ECB	European Central Bank
EDC	eurozone sovereign debt and banking crisis
ESRB	European Systemic Risk Board
EU	European Union
eurozone	Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain
FDI	foreign direct investment
FSM	the Federated States of Micronesia
FTA	free trade agreement
FY	fiscal year
G3	Group of Three (eurozone, Japan, and the United States)
G20	Group of Twenty (Argentina, Australia, Brazil, Canada, the People's Republic of China, France, Germany, India, Indonesia, Italy, Japan, the Republic of Korea, Mexico, Russian Federation, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States, and European Union)
GDP	gross domestic product
GFC	global financial crisis
GMS	Greater Mekong Subregion
GTA	Global Trade Alert
IMF	International Monetary Fund
Lao PDR	Lao People's Democratic Republic
LHS	left-hand scale
LPI	logistics performance index
MFI	monetary and financial institution
MIP	macroeconomic imbalance procedure
MRA	mutual recognition arrangement
NDB	New Development Bank
NIE-3	Newly Industrialized Economies (Hong Kong, China, the Republic of Korea and Singapore)
ODA	official development assistance
OECD	Organisation for Economic Co-operation and Development
OREI	Office of Regional Economic Integration
PICTA	Pacific Island Countries Trade Agreement
PNG	Papua New Guinea
PPP	public-private partnership
PRC	People's Republic of China
q-o-q	quarter-on-quarter
RCEP	Regional Comprehensive Economic Partnership
RCI	regional cooperation and integration
RHS	right-hand scale
ROW	rest of the world
saar	seasonally adjusted annualized rate
SME	small and medium enterprises
TAR	Trans Asia Railway
TPP	Trans-Pacific Partnership
VAR	vector autoregression
UNESCAP	United Nations Economic and Social Commission for Asia and the Pacific
US	United States
WB	World Bank
WEO	World Economic Outlook
WTO	World Trade Organization
y-o-y	year-on-year

HIGHLIGHTS

Regional Economic Update

- The external recovery has been tentative this year after G3 economic growth slipped during the first half—the better United States (US) growth outlook has yet to benefit Asia, there is some uncertainty over Japan's prospects, and the eurozone economy continues to struggle.

- Developing Asia's resilient growth is partly due to stronger domestic and regional demand; although it varies across subregions—rising gross domestic product (GDP) growth in South Asia is offset by a slowdown in Southeast Asia and Central Asia, while East Asia's growth is flat.

- There are five downside risks to the outlook: (i) delays in planned reforms in the region; (ii) the impact on developing Asia of a faster People's Republic of China (PRC) slowdown; (iii) increasing corporate sector external debt; (iv) weaker recovery in advanced economies, particularly Europe; and (v) capital outflows or financial volatility from early US monetary tightening.

- Taken together, these risks underscore the reasons why Asia's policymakers must continue their national agenda for structural reform, while keeping macroeconomic fundamentals strong.

Progress in Regional Cooperation and Integration

- Despite tepid global growth, Asia's regional integration continues to deepen, with cross-border trade and investment flows, holdings of Asian financial assets, and migration and tourism stable or growing; regional cooperation between governments also continues to strengthen.

- Asia's trade integration, after reaching high levels during the 2000s, has stabilized despite weaker intermediate goods trade, a growing shift in Japanese production to the region, and rising trade impediments; policies that strengthen domestic and regional demand are increasingly important.

- "Mega-regional" trade agreements could help consolidate many bilateral free trade agreements (FTAs), although any early agreement remains remote; for now, unilaterally multilateralizing preferences can address multiple rules of origin, maximize trade creation, and eliminate trade diversion.

- Asian financial assets continue to draw investors from both within and outside the region; the share of intraregional financial assets continues to grow, with investors expanding debt holdings while reducing their share of equities.

- In addition to utilizing domestic resources through tax revenues, including through public-private partnership, developing Asia's local currency bond markets has been a preferred choice to finance long-term investment; improving market efficiency and liquidity can be helped by reestablishing securitization markets, fostering financial literacy, and facilitating greater cross-border bond transactions, among others.

- Intraregional bank lending to Asia continues to strengthen with increased lending from Australia, Japan, and other non-traditional Asian lenders—providing greater liquidity and buffers to cope with possible financial market volatility; US and European bank credit also rose, but are more erratic compared with Australia and Japan.

- Regional cooperation remains critical for increasing new infrastructure, but the substantial gap between what is needed and what is in the pipeline is widening; innovative mechanisms are urgently needed to help mobilize public finance, attract greater private sector participation, and tap additional sources of long-term capital, including new regional financing initiatives.

- The rise in labor mobility across Asia strengthens the region's economic and cultural ties; though difficult and sensitive challenges remain that could be managed through closer regional cooperation.

Macrointerdependence between the Pacific Developing Member Countries and Asia

- Asia's robust economic growth, open trade, and growing middle class offer new demand for the Pacific's exports; nonetheless, microeconomic reforms are needed to enhance the business environment, promote private sector development, and further open trade and investment to tap into Asia's dynamic growth.

- The Pacific and Asia have strengthened economic ties over the past decade with Pacific goods trade shifting from the US to Asia; the share of PRC and Southeast Asia is increasing while that of Australia and New Zealand is declining. Trade in services—mostly tourism-related—has benefitted from more flights and better marketing, although more could be done.

- FDI has been extremely volatile, well below official development assistance flows, and is more often directed toward resource extraction concentrated in a few Pacific economies; labor migration is a key source of livelihood, with remittances a sizeable portion of GDP.

Special Chapter: Regional Financial Integration and Crisis in Asia and Europe—A Comparative Analysis

- The impetus for European integration grew out of political necessity—it followed a more institution-based structure where some sovereignty was exchanged for the regional core and procedures. Asia's integration has been market-driven, pragmatic, bottom-up, with institutions designed primarily to harmonize rules and regulations; provide surveillance and financial safety nets; and facilitate the gradual opening of trade, investment, finance, and people mobility.

- Prior to the eurozone crisis, low real interest rates in the Periphery attracted capital flows from the Core. Prior to the Asian financial crisis (AFC), the biggest impetus for capital flows was investor overconfidence in the region's economic prospects. However, the underlying cause of Europe's crisis and the AFC was the same—massive private capital flows directed toward unproductive investment led to vulnerability and eventual crisis. In Europe, integration preceded crisis; in Asia, crisis spawned deeper integration.

- For Asia and Europe, macroprudential policies must be strengthened to better manage the size, composition and direction of capital flows and to mitigate systemic risk: while asset-side macroprudential tools may help reduce the risk of financial instability, a new set of better targeted macroprudential policies are needed to limit the systemic nature of crisis, for example, when capital flows expand non-core bank liablities.

- The future path of integration in Asia will likely be different than in Europe. Asia will continue to strengthen efforts to harmonize rules and regulations especially in the financial sector, and to further unilateral trade and investment liberalization supported by infrastructure connectivity. Regional arrangements and initiatives such as the ASEAN Economic Community and FTAs will lend further push to such liberalization. Managing the region's diversity remains an important goal, and strengthening national economy by cooperating with other economies is always Asia's approach of integration.

EXECUTIVE SUMMARY

As in the previous volumes, the November 2014 *Asian Economic Integration Monitor* (AEIM) begins with the summary of developing Asia's macroeconomic outlook. It examines the progress and recent trends of Asian integration. And in this issue, we delve into a comparative analysis of how economic integration has developed in Asia and Europe, and posit what the future may bring.

Overall, developing Asia has continued to exude economic resilience and growth—even during the 2008/09 global financial crisis (GFC) and its corresponding market volatility. Slowing demand from advanced economies only accented the need for Asia to rebalance its sources of growth more toward domestic and regional demand. The rising trend in cross-border trade flows, investment, financial assets, and people has clearly bolstered Asia's economic strength as it has deepened integration. Governments and the private sector continue to band together in pursuing regional cooperation and integration (RCI) when it supports the national or corporate agenda.

For developing Asia's more open economies, external conditions always matter. Europe's slowing growth continues to affect the region; while Asia awaits expected benefits from the recent, still ongoing United States (US) recovery. The region's economies have responded relatively well to these shifting external conditions. Domestic and regional demand helped the region's economic output expand a projected 6.2% this year (compared with 6.1% in 2013) (see *Regional Economic Update*, page 10). But Asia's diversity means performance varies across subregions—with stronger growth in the Pacific (5.3%) and South Asia (5.4%)—mostly driven by India—steady growth in East Asia (6.7%) despite a managed slowdown in the People's Republic of China (PRC) (from 7.7% to 7.5%), and a slowdown in Southeast Asia (from 5.0% to 4.6%). Assuming growth in advanced economies improves as forecast—and Asia mitigates downside risks—growth is expected to rise to 6.4% in 2015.

Aside from the risk of slower growth in Europe (from economic stress or geopolitical conflict) any faster slowdown in the PRC can also hurt prospects across the rest of Asia. Indeed, during the last few years interdependence between the PRC and the rest of Asia has been steadily rising, given strong production networks and the PRC's high demand for primary inputs.[1]

Another widely discussed risk involves the impact of normalizing (US) monetary policy. With the US Federal Reserve's intentions clarified through frequent dialogue with the region's authorities—and the end of US quantitative easing as planned—the probability of any surprise has been reduced. This gives Asia's policymakers the opportunity to better prepare for possible capital outflows. Nonetheless, given the significant impact of ultra-easy money policy on capital flows, risks associated with flow reversals and volatility remain.

Still, Asia's growth as a region remains highest in the world. And while domestic demand remains strong, regional demand adds further impetus, strengthening the region's resilience. As a share of the total, intra-Asian trade remains high (54%), as does cross-border foreign direct investment (FDI) (51%) **(Table 1, Figure 1)**.

Within subregions, trade integration is lowest in South Asia (6%), Central Asia (7%), and the Pacific and Oceania (7%). But their trade share with the rest of Asia is much larger, especially in the case of the Pacific and Oceania (63%)—and it continues

[1] Taking into account the direct and indirect effects of trade in intermediate goods—and based on a series of international input-output tables—the coefficient of interdependence (CoI) between the PRC and selected Asian economies increased from less than 1.9 before the onset of the 1997/98 Asian financial crisis (AFC) to 2.6 after the GFC. The trade link goes beyond traditional exports of primary goods and commodities to—and consumer goods imports from—the PRC. An example is the PRC's efforts to cool down excessive growth in real estate. The sector has strong backward linkages not just domestically but with the rest of Asia as well. Thus, each time an attempt is made to ease the sector's growth, construction suffers, hurting capital-goods-exporting economies—notably Japan and the Republic of Korea. The inter-economy multipliers of real estate and construction are among the highest in the region.

Table 1: Progress in Regional Integration

	Production Networks and Trade		Capital Markets		Macroeconomic Links	Migration	
Subregions	**Intra-subregional FDI (%) 2012**	**Intra-subregional Trade (%) 2014**	**Intra-subregional Equity Holdings (%) 2013**	**Intra-subregional Bond Holdings (%) 2013**	**Intra-subregional Output Correlations 2008–2013**	**Intra-subregional Tourism (%) 2012**	**Migrant to Population Ratio (%) 2013**
ASEAN+3[1] and Hong Kong, China	53.91 ▼	45.37 ▼	20.57 ▼	11.04 ▲	0.47 ▲	80.67 ▼	0.61 ▲
Central Asia	0.63 ▼	6.95 ▲	0.83 ▲	–	0.21 ▲	31.46 ▲	1.26 ▼
East Asia	54.67 ▲	33.53 ▼	15.43 ▼	7.89 ▲	0.52 ▲	70.05 ▼	0.29 ▲
South Asia	0.82 ▼	5.51 ▲	–	1.57 ▲	0.22 ▲	12.07 ▲	0.63 ▼
Southeast Asia	16.22 ▼	24.24 ▼	8.63 ▼	11.00 ▲	0.42 ▲	70.05 ▲	1.04 ▲
The Pacific and Oceania	4.84 ▲	6.74 ▼	5.84 ▼	3.16 ▲	0.08 ▲	20.57 ▼	2.64 ▲
Subregions	**Inter-subregional FDI (%) 2012**	**Inter-subregional Trade (%) 2014**	**Inter-subregional Equity Holdings (%) 2013**	**Inter-subregional Bond Holdings (%) 2013**	**Inter-subregional Output Correlations 2008–2013**	**Inter-subregional Tourism (%) 2012**	**Migrant to Population Ratio (%) 2013**
ASEAN+3[1] and Hong Kong, China	3.71 ▲	10.08 ▲	4.10 ▼	5.47 ▼	0.30 ▲	4.87 ▲	0.13 ▲
Central Asia	21.57 ▲	28.78 ▼	11.96 ▼	13.95 ▲	0.26 ▲	3.62 ▼	0.08 ▲
East Asia	6.99 ▼	18.38 ▲	3.68 ▼	6.22 ▼	0.35 ▲	13.45 ▲	0.13 ▲
South Asia	16.10 ▼	29.42 ▼	–	19.30 ▼	0.29 ▲	36.26 ▲	0.12 ▲
Southeast Asia	32.67 ▲	44.02 ▲	33.49 ▼	20.93 ▼	0.33 ▲	22.60 ▼	0.45 ▲
The Pacific and Oceania	33.52 ▲	62.76 ▲	10.31 ▼	4.45 ▲	0.20 ▲	43.02 ▲	0.39 ▲
TOTAL	**FDI (%) 2012**	**Trade (%) 2014**	**Equity Holdings (%) 2013**	**Bond Holdings (%) 2013**	**Output Correlations 2008–2013**	**Tourism (%) 2012**	**Migrant to Population Ratio (%) 2013**
Asia[2]	50.58 ▼	54.47 ▼	23.16 ▼	15.97 ▲	0.28 ▲	78.72 ▼	0.77 ▲
ASEAN+3[1] and Hong Kong, China	57.62 ▼	55.45 ▼	24.68 ▼	16.51 ▲	0.36 ▲	85.54 ▼	0.74 ▲
Central Asia	22.20 ▲	35.73 ▼	12.79 ▼	13.95 ▲	0.25 ▲	35.08 ▼	1.34 ▼
East Asia	61.66 ▼	51.91 ▼	19.12 ▼	14.12 ▲	0.37 ▲	83.50 ▼	0.43 ▲
South Asia	16.92 ▼	34.92 ▲	–	20.86 ▼	0.28 ▲	48.32 ▲	0.75 ▼
Southeast Asia	48.89 ▲	68.26 ▲	42.13 ▼	31.92 ▼	0.35 ▲	92.65 ▼	1.49 ▲
The Pacific and Oceania	38.36 ▲	69.49 ▼	16.15 ▼	7.60 ▲	0.18 ▲	63.59 ▲	3.02 ▲

▲ = increase from previous period; ▼ = decrease from previous period; – = data unavailable.

Note: Data calculated for Asia unless otherwise noted. 2014 data until end of June 2014.

[1]ASEAN+3 includes ASEAN member countries (Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Viet Nam) plus the People's Republic of China; Japan; and the Republic of Korea.

[2]Total Asia equals total intra-Asia (using intraregional data).

Trade—national data unavailable for Bhutan, Kiribati, Nauru, Palau, Timor-Leste, and Tuvalu; no data available on the Cook Islands, the Marshall Islands, and the Federated States of Micronesia.

Equity holdings—based on investments from Australia; Hong Kong, China; India; Indonesia; Japan; Kazakhstan; the Republic of Korea; Malaysia; New Zealand; Pakistan; the Philippines; Singapore; Thailand; and Vanuatu. Data unavailable for Azerbaijan, Bhutan, the Federated States of Micronesia, Palau, Samoa, Tonga, Turkmenistan, and Tuvalu.

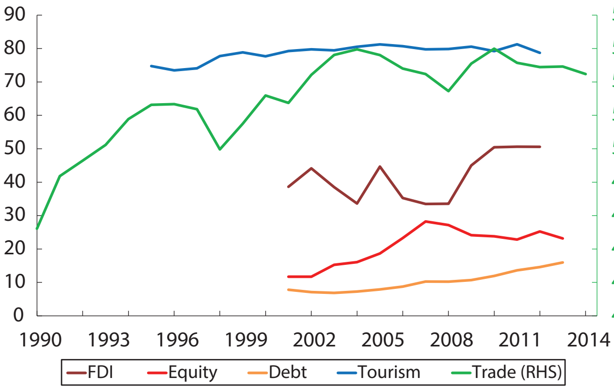
Bond holdings—based on investments from Australia; Hong Kong, China; India; Indonesia; Japan; Kazakhstan; the Republic of Korea; Malaysia; New Zealand; Pakistan; the Philippines; Singapore; Thailand; and Vanuatu. Data unavailable for Azerbaijan, Bhutan, the Federated States of Micronesia, Palau, Samoa, Tonga, Turkmenistan, and Tuvalu.

Output correlations—based on simple averages of 3-year rolling bilateral correlations of annual growth rates (difference of natural logarithms) of gross domestic product series in constant prices. Data unavailable for Afghanistan, the Cook Islands, the Marshall Islands, the Federated States of Micronesia, Myanmar, Nauru, Palau, Timor-Leste, and Tuvalu. 2008–2013 average compared with 2000–2007 average.

Migrant to population ratio—share of migrant stock to population in 2013 (compared with 2010).

Source: ADB calculations using data from ASEAN Secretariat; *Asia Regional Integration Center,* Asian Development Bank; CEIC; *Coordinated Portfolio Investment Survey,* International Monetary Fund; *Direction of Trade Statistics,* International Monetary Fund; Organisation for Economic Co-operation and Development; *Trends in International Migrant Stock*, Department of Economic and Social Affairs; United Nations; United Nations Conference on Trade and Development; United Nations World Tourism Organization; and World Economic Outlook Database April 2014, International Monetary Fund.

Figure 1: Regional Integration Indicators—Asia
(intraregional as % of total)



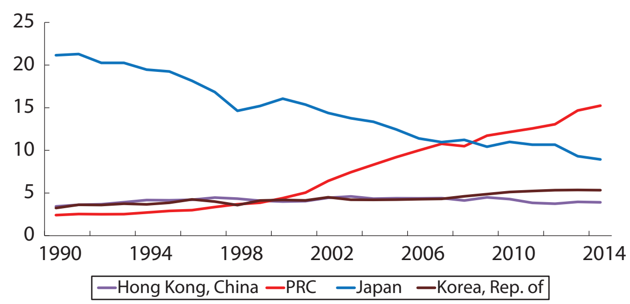
FDI = foreign direct investment, RHS = right-hand scale.
Notes:
FDI—Data start from 2001.
Trade—national data unavailable for Bhutan, Kiribati, Nauru, Palau, Timor-Leste, and Tuvalu; no data available on the Cook Islands, the Marshall Islands, and the Federated States of Micronesia.
Equity holdings—based on investments from Australia; Hong Kong, China; India; Indonesia; Japan; Kazakhstan; the Republic of Korea; Malaysia; New Zealand; Pakistan; the Philippines; Singapore; Thailand; and Vanuatu. Data start from 2001.
Bond holdings—based on investments from Australia; Hong Kong, China; India; Indonesia; Japan; Kazakhstan; the Republic of Korea; Malaysia; New Zealand; Pakistan; the Philippines; Singapore; Thailand; and Vanuatu. Data start from 2001.
Source: ADB calculations using data from ASEAN Secretariat; *Asia Regional Integration Center,* ADB; CEIC; *Coordinated Portfolio Investment Survey,* International Monetary Fund; *Direction of Trade Statistics,* International Monetary Fund; Organisation for Economic Co-operation and Development; United Nations Conference on Trade and Development; and United Nations World Tourism Organization.

to rise. With its ever-expanding open trade system and middle class, Asia offers huge market potential for many Pacific island countries. The constraint, however, is mostly on the domestic supply side (infrastructure, human capital, and technology, among others). One-third of Central and South Asian trade is with other Asian economies, and this too is expected to increase. During the last several years, India has intensified efforts to expand trade with East and Southeast Asia and to join their production network. The new government appears eager to boost those efforts. And Myanmar's continued opening offers a natural conduit for *inter*-subregional integration to take off.

For now, Asia's largest intra-subregional trade is within ASEAN+3 (45%).[2] ASEAN itself has strong trade links with the rest of Asia (44%), while intra-ASEAN trade has been stagnant for some time (below 25%). However, with the ASEAN Economic Community's (AEC) 2015 milestone, both ASEAN's intra- and inter-regional trade will likely increase in the coming years.

But looking at only the volume of cross-border trade may miss the bigger integration trend, as trade flows closely interact with FDI. By deliberate policy, FDI from Japan, the Republic of Korea and the PRC heading to the rest of Asia—particularly ASEAN—has been increasing steadily. Many investments target local or regional markets. Japanese FDI in ASEAN is an important example. The fast-growing middle class and its strong purchasing power makes the ASEAN market a favorite. So, increasingly, goods and products produced by Japanese firms are no longer imported from Japan, but produced and marketed within ASEAN itself. This explains why Japan's share of total ASEAN trade is declining **(Figure 2)**. On the other hand, since the PRC's accession to the World Trade Organization in early 2000, trade between the PRC and ASEAN has increased dramatically. Republic of Korea-ASEAN

Figure 2: Trade share with Southeast Asia—PRC; Hong Kong, China; Japan; and the Republic of Korea (%)



PRC = People's Republic of China.
Note: Trade share is calculated as $(t_{ij}/T_{iw})*100$, where t_{ij} is the total trade of ASEAN with economy "j" and T_{iw} is the total trade of ASEAN with the world. 2014 covers trade values from January–May.
Source: ADB calculations using data from *Direction of Trade Statistics,* International Monetary Fund (IMF).

[2] ASEAN+3 comprises the Association of Southeast Asian Nations (ASEAN)—Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Viet Nam—plus the PRC; Japan; and the Republic of Korea. Hong Kong, China was included in the analysis due to its strong ties with the PRC.

trade has also increased steadily though more slowly. FDI from these two economies has also increased. The combination of, for example, rising labor and other domestic costs (supply factors) and large populations with rising income (demand factors) are behind these trends. Thus, Asia's integration continues to be particularly strong in trade and investment.

Cross-border flows of financial instruments, on the other hand, remain small if rising. Bank credit flows within the region continue to grow—particularly lending from Japanese and Australian banks. After several years of deleveraging, European banks have resumed strong Asian lending. And lending from US, Canadian, and Latin American (Chilean) banks are also rising. Asia's strong economic prospects against low returns in other economies are driving this trend.

For those flowing through capital market, intra-Asian equity flows are slightly less than a quarter of the region's total—and have been fluctuating, largely in tandem with the increased volatility in global equity markets. In debt markets, on the other hand, intra-Asian investments continue to grow, although the level remains small (16%). Indeed, the region's financial markets have always been integrated more globally than regionally—US investors dominate equities; European investors debt markets. This has several important implications. It shows how open Asian financial markets are—despite remaining controls in economies like the PRC. And it highlights the need to harmonize regional markets further to attract more intraregional flows, strengthen the domestic investor base, and streamline regulations and policies to augment market liquidity.

The main objective is still to use Asia's growing liquidity for investments within the region. The demand for infrastructure financing (hard and soft) is huge, and bank capacity to finance these massive amounts is increasingly limited—even without Basel III rules. This is in addition to the standard financial integration benefits, like creating greater opportunities and diversification for savers and investors, efficiency, policy discipline, and risk sharing. Better risk sharing is particularly important in Asia. The emergence of institutions focusing on infrastructure financing—regionally and globally—can further strengthen resources needed for infrastructure development. The recent "New Silk Road" strategy proposed by the PRC could also foster greater cross-border trade flows and deepen RCI through trade, investment, energy, as well as infrastructure.[3]

The continued increase of intraregional migrant flows is another important integration trend. In particular, migration from Central and South Asia to other Asian economies has been increasing. But in terms of the ratio of migrants to population, the Pacific and Oceania continues to have the highest (2.6% intra-subregionally, and more than 3% intra-Asia). Southeast Asia ranks second. Job opportunities and income differentials remain the dominant reason, with remittances offering a means to spread risk and mitigate income shocks. As anywhere in the world, foreign worker migration always poses difficult and sensitive challenges. It requires closer cooperation between source and host economies.

Tourism is another important indicator of regional integration—boosting economic and cultural ties. More than three quarters of region's tourists travel within Asia. Southeast Asia is the most Asia-centric, where more than 90% of tourist flows come from within Asia. The April *AEIM* highlighted the risk of heightened geopolitical tension on the region's tourism—given the decline in bilateral tourist arrivals between the PRC and Japan during 2010-2013. Japanese tourist arrivals in the PRC from January to September this year compared with the same period last year shows a continuing decline. But PRC tourist flows to Japan has started to increase again. Regional cooperation in tourism can help maintain high tourist flows, which is important for people-to-people contact and building mutual

[3]But making financial resources available does not necessarily translate into infrastructure development. The persistently low spending on infrastructure during the period of massive capital inflows (driven by ultra-easy monetary policy in advanced economies) has clearly underscored the disconnect between fund availability and infrastructure spending. Therefore, a better way must be found to channel liquidity into infrastructure investment. Strengthening sources of public finance through taxes and other means should be accompanied by better use of private resources—through public-private partnerships (PPPs) for example.

understanding, holding benefits far beyond pure economics.

To summarize, amid slowing global growth and an uncertain global environment, Asia's economic integration continues to increase. This has helped strengthen the region's resilience by cushioning the slowdown in external demand. Continued efforts to harmonize rules and regulations across economies have played some role, but market-driven private activity—facilitated by unilateral liberalization—remains the dominant force behind the trend. This is precisely what distinguishes Asia's integration process from Europe's. The two regions pursued and continue to pursue integration for different reasons. The impetus for European came almost as a political necessity. It grew to follow a more institution-based structure where some sovereignty was given up for the regional good. This is far from what Asia's integration is all about. To gain better understanding of the difference, a special chapter in this issue focuses on the comparative analysis of how economic integration has developed in Asia and Europe. The main chapter highlights follow.[4]

Unlike Europe, Asia's institutions for regionalism are primarily designed to harmonize rules and regulations; and to facilitate the gradual opening of trade, investment, finance, and people's mobility. Progress on all of these must jive with national policies, which evolve to match the times. Because of Asia's sharp diversity, integration must also account for different levels of development. Capacity building, especially for weaker partners, is always a high priority—to promote convergence and to ensure regional initiatives benefit all. Another feature is how institutions emerge, with an eye to minimize the costs of integration—including crisis management. For example, the ASEAN+3 Macroeconomic Research Office, which conducts and manages macro-financial surveillance in support of the Chiang Mai Initiative Multilateralization (CMIM), a regional safety net, provides crisis prevention and crisis management, respectively. This illustrates Asia's integration process as pragmatic, less ideological, and not based on any fixed set of beliefs.[5]

In Europe, from the beginning it was clear that easing intraregional trade meant that European policymakers would try limiting exchange rate fluctuations—particularly between its relatively small and open economies. Over the decades, the process eventually led to monetary union and the adoption of the euro (introduced in 1999, it completely replaced old currencies in 2002).

Studies show intraregional exchange rate stability has a positive effect on intraregional trade. This also holds for Asia. But for reasons described earlier, there is no attempt to formally cooperate on exchange rates. Having said that, the increasing use of PRC renminbi in cross-border trade and settlement could—over time—reduce some problems associated with exchange rate instability. But even this is happening without any collective regional policy.

The euro's introduction does not appear to have boosted intraregional trade significantly. This is in contrast with many early studies that pointed to the expectation of a large increase in intraregional trade. After the adoption of euro, the share of total cross-border trade within the eurozone in fact decreased slightly or remained relatively flat (see *Special Chapter: Regional Financial Integration in Asia and Europe—A Comparative Analysis*, page 40). Interestingly, there was also no marked difference in the level of intra-regional trade between Asia-11 and the eurozone, in both cases below 50%.[6] In the case of total Asia and European Union, the figures are 54% and 64%, respectively. If there is one significant trend since the euro was adopted, it is in geographical trade patterns—the fast-growing trade deficit in the South against huge surpluses in the North. Post-GFC, the North's surplus continued—dominated by Germany—while the South's deficit

[4]This summary is based on joint-research conducted by ADB and Bruegel, a European think-tank, analyzing the process and impact of integration in Europe and Asia. Bruegel produced two reports: "Background and Progress of Economic and Financial Integration in Europe" and "Challenges, Lessons and Policy Considerations from European Economic and Financial Integration."

[5]I.J. Azis. 2014. Integration, Contagion, and Income Distribution. In P. Nijkamp, A. Rose, and K. Kourtit, eds. *Regional Science Matters*. Berlin: Springer.

[6]Asia-11 includes which inlcudes the People's Republic of China; Hong Kong, China; India; Indonesia; Japan; the Republic of Korea; Malaysia; the Philippines; Singapore; Taipei,China; and Thailand.

gradually declined. This has some impact on global trade, and hence possible repercussions for Asia.[7]

While this was happening, Asia's trade integration was growing steadily—as was intraregional FDI—reflecting the strength of the region's production network. And this occurred without monetary union or single currency. A combination of strong supply chains exploiting each economy's comparative advantage—and good growth prospects supported by prudent macroeconomic policies and unilateral trade liberalization—all back this trend.

Europe's monetary union also led to a surge in capital flows, the biggest portion heading South.[8] Diverging inflation rates between economies and converging capital returns or yields implied lower real interest rates in the South—even if the dispersion of interbank lending rates remained high, similar to Asia (see *Special Chapter: Regional Financial Integration in Asia and Europe—A Comparative Analysis*, page 40).[9] The ample liquidity helped push growth. But with most credit ending up in real estate and consumption—not in productive sectors—bubbles appeared. When they burst, crisis erupted and growth stalled. The accumulated debt amplified the impact, making the problem more difficult to solve. This was in fact similar to what happened in Asia before the 1997/98 Asian financial crisis (AFC). Before 1997, massive capital inflows—mostly short-term and unhedged—also wound up in unproductive sectors like housing and real estate, creating asset bubbles. The AFC started when these bubbles burst, and the double currency and maturity mismatch aggravated the crisis impact.

Capital flows in Europe largely originated from within the region—from the North—although a significant amount was actually raised outside, including the US.[10] In Asia, especially in economies most severely affected by the crisis—Indonesia and Thailand—the largest lending source was Japanese banks. But the sources varied for other Asian economies , from banks and nonbanks outside the region. Another similarity is, in both cases, capital flows came largely through debt, not equity. In Europe, flows were intermediated through the wholesale banking market, whereas in Asia they were either channeled directly to corporate borrowers or through corporate-owned banks.

But in financial integration, there is a fundamental difference between the two regions. Unlike in Europe, where low real interest rates in the South attracted most capital flows, the biggest impetus for inflows to Asia at the time was investor over-confidence in the region's economic prospects. Relatively good macroeconomic performance and stability was a further incentive. Thus, in Asia's case, the increase in capital inflows had less to do with regional financial integration. In fact, it was the crisis itself that led to further integration and cooperation—opposite from the eurozone sequence. Realizing the importance of avoiding the double mismatch and to provide alternative short-term liquidity if crises occur, ASEAN+3 policymakers became determined to develop stronger bond markets in the region through the Asia Bond Markets Initiative—thus fostering financial integration—and supplying emergency liquidity through the CMIM. In other subregions, providing financial safety nets through regional cooperation has also been broached (for example in South Asia) or is currently being discussed (in Central Asia).

Another similarity was in risk-sharing. To the extent most capital flows were in debt rather than equity, risk sharing in both cases was limited. Since risks in Europe are concentrated in just a few economies —not shared—it is difficult to revive the economy from a crisis even with an integrated union. In less-integrated Asia, selecting and implementing crisis response policies was entirely a national affair.

[7]The widely discussed global imbalances that preceded the GFC were characterized by a huge deficit in the US current account and large surplus in the PRC. Some argued this is one of the reasons the major 2008 shock was inevitable. With constant efforts to rebalance given the huge impact of such a major crisis, both the US deficit and PRC surplus have declined markedly since. Yet, overall global imbalances continue, with Germany now holding the world's biggest surplus.

[8]Intraregional portfolio flows are significantly higher, nearly 60%, compared with less than 20% in Asia.

[9]Cross border retail banking did not expand much in Europe despite the monetary union. Most lending has been through wholesale banking. Cross-border ownership of banks is also limited, and mergers rare.

[10]I.J. Azis and H.S. Shin. Forthcoming. *Managing Elevated Risk: Global Liquidity, Capital Flows, and Macroprudential Policy—an Asian Perspective.* Berlin: Springer.

Clearly, however, the underlying process of Europe's crisis and the AFC was the same—massive private capital flows directed toward unproductive investment led to vulnerability and eventual crisis. The risks associated with financial vulnerability and excessive reliance on government support, directly or indirectly (moral hazard), were clearly overlooked.

On this basis, the future path of integration in Europe and Asia will be different. Europe will likely focus more on further strengthening regional institutions—especially on financial safety nets, the banking union, and fiscal policy. This is to ensure recovery from current difficulties and a better working monetary union presaging full economic integration. Asia, on the other hand, will likely continue efforts to harmonize rules and regulations—especially in the financial sector—and further unilaterally liberalize trade and investment. Regional arrangements and initiatives—like the AEC, free trade agreements, and infrastructure connectivity—will further drive liberalization. Strengthening the national economy by cooperating with others will continue as Asia's approach of integration. And managing the region's diversity will remain an important goal.

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