Chapter 2

Asian Regionalism: Context and Scope

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

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

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

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

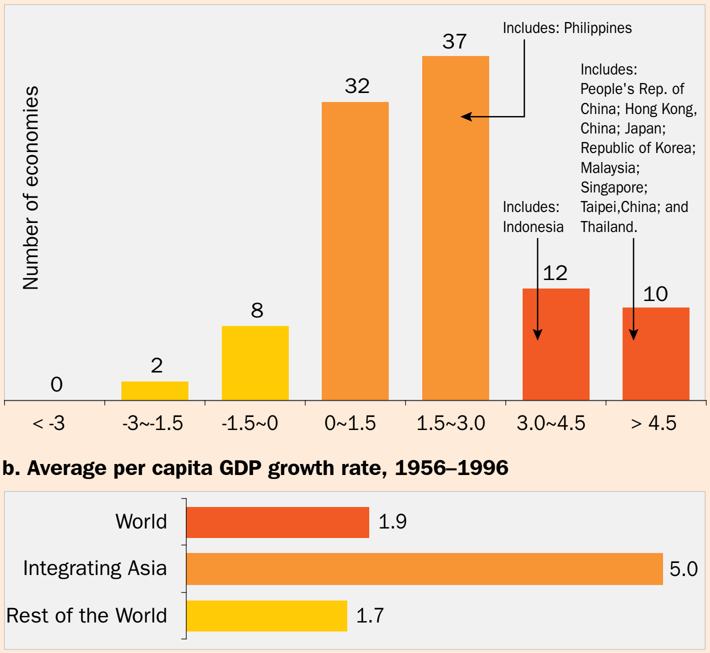
This chapter traces the progress of Asian integration and explores its implications for the future. It begins by exploring the connections between Asia's development patterns and economic integration. It then examines the challenges interdependence poses for policy, setting the stage for subsequent chapters.

2.1. Growth and integration

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

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

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



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

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

Flying in sequence

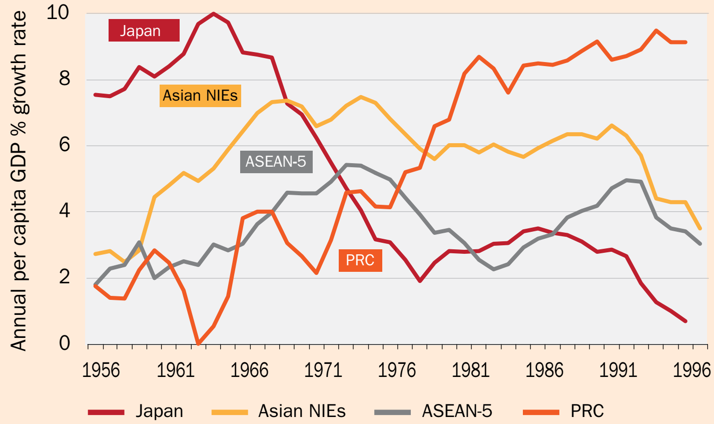
Competition in global markets is at the heart of what is now understood as the East Asian development model (Kuznets 1988). When the model emerged in the 1950s, its focus on labor-intensive exports was new; the prevailing "big push" development strategy favored large, coordinated investments in a bid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

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

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

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

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



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

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

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

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

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

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

The crisis and its legacy

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

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

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

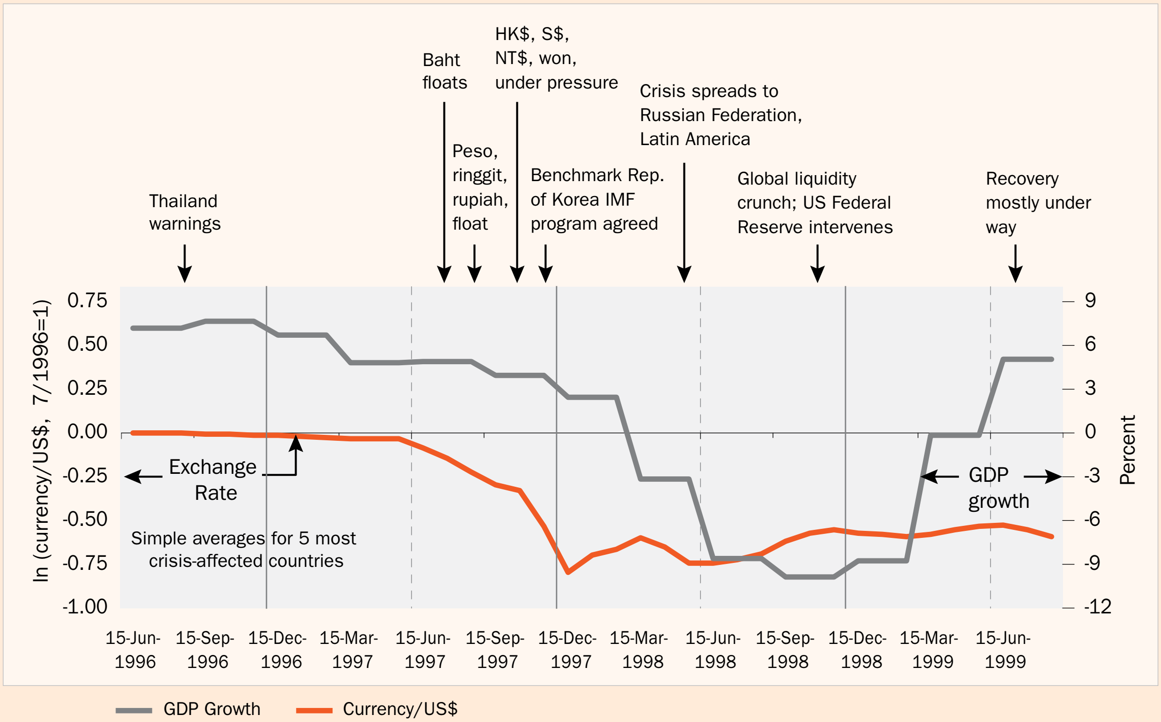
The details of the crisis, which are summarized in Figure 2.3, have been extensively analyzed.[6] On 2 July 1997, Thailand abandoned its short but costly defense of the baht against speculative attack. The baht plunged. The attacks then spread to Indonesia, Malaysia, the Philippines, and eventually Hong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

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

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

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

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



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

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

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

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

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

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

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

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

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

Renaissance

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

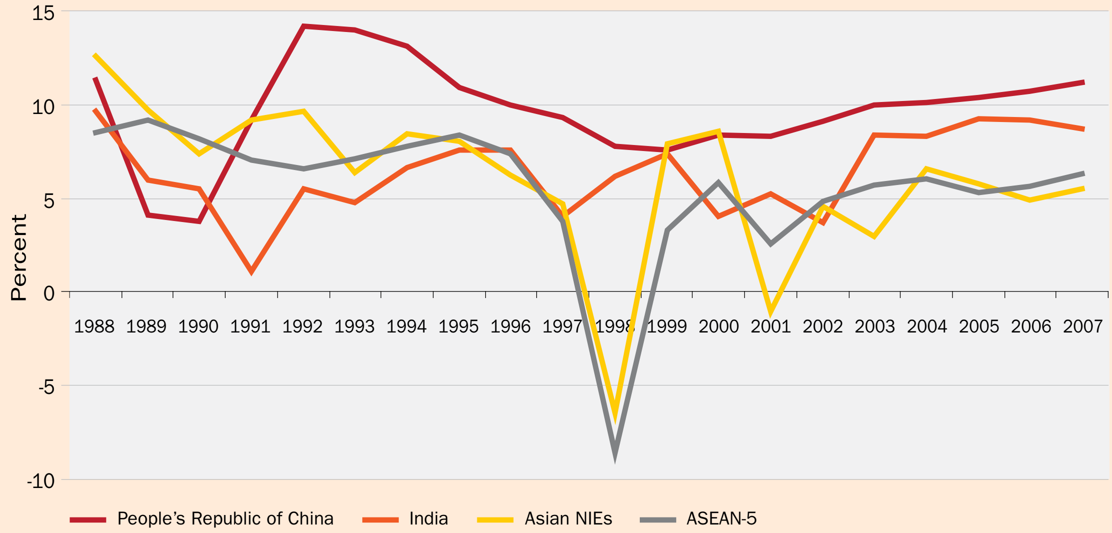
The slowdown of growth in most crisis-affected economies reflects a decline in their rates of investment.[9] In the newly industrializing economies, for example, the share of investment in GDP fell from

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

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

Figure 2.4. Asia's robust recovery

Real GDP growth rates of selected Asian economies



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

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

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

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

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

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

Asia in 2020

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

Table 2.1. Population and GDP projections for 2020

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

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

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

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

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

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

2.2. The rise of regionalism

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

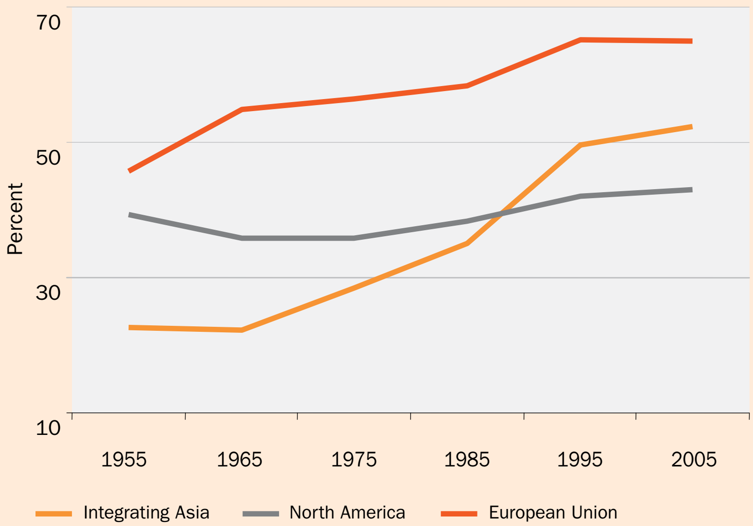
[10] The long-term projections were prepared by Asian Development Bank (ADB) staff in 2006 as background for strategic analysis. They have been adjusted to take account of new purchasing power parity (PPP) estimates (ADB 2007f). The underlying growth rates lie within a fairly broad range of estimates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

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

Measuring interdependence

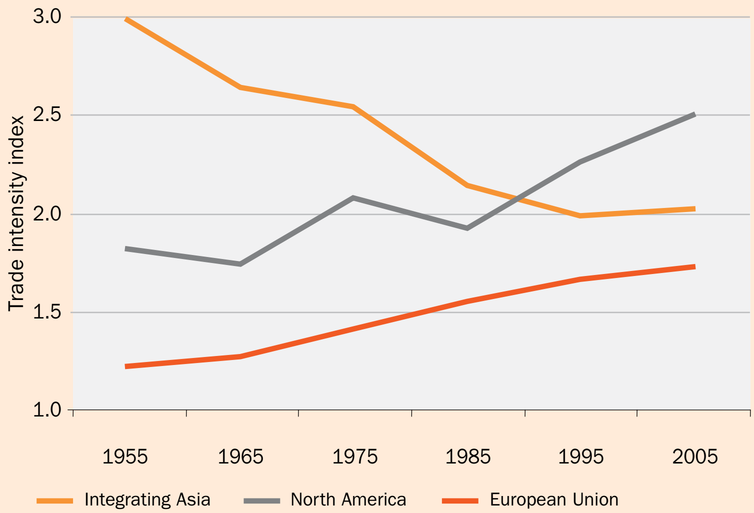
The most common measure of interdependence—the share of a region's total trade conducted within it—has risen in Asia from around a fifth in the aftermath of World War II to a third or so in the 1980s, and to over half in recent years (Figure 2.5). Asia is now broadly as interdependent in trade as the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

Figure 2.5. Increasing intraregional trade shares
Long-term trend: 1955–2005



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

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



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

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

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

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

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

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

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

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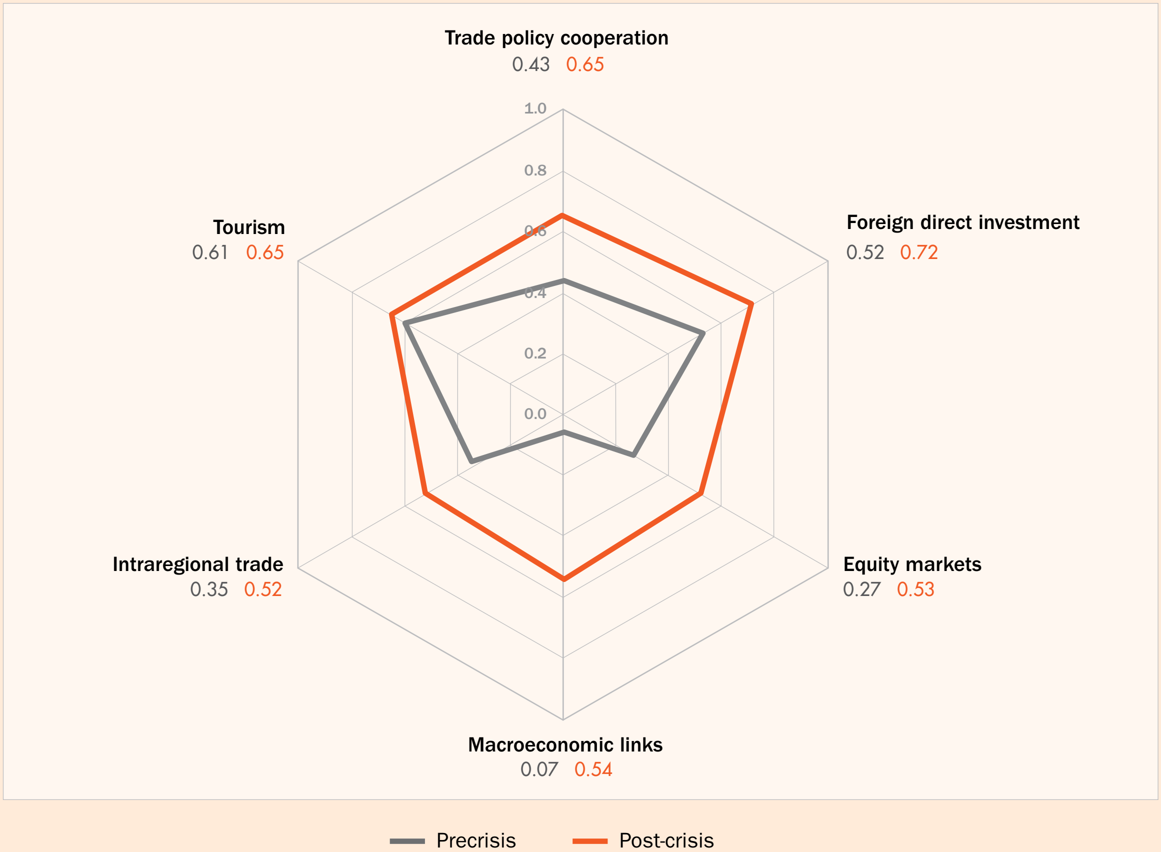
[12] Regional integration is not confined to Asia. Although technological change is supposedly making the world "flatter," around the world regional trade flows are increasing more rapidly than extraregional ones (Mansfield and Milner 1999, Ravenhill 2003).

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



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

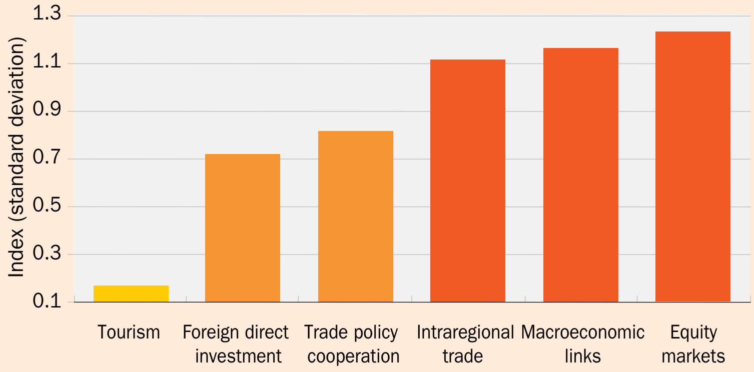
Which areas of interdependence have been strengthened the most? Figure 2.7 shows all interactions deepening, but does not provide a basis for comparing changes across indicators. To help judge how an indicator has changed over time and the extent to which it differs across economies, it is useful to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

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

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

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

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



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

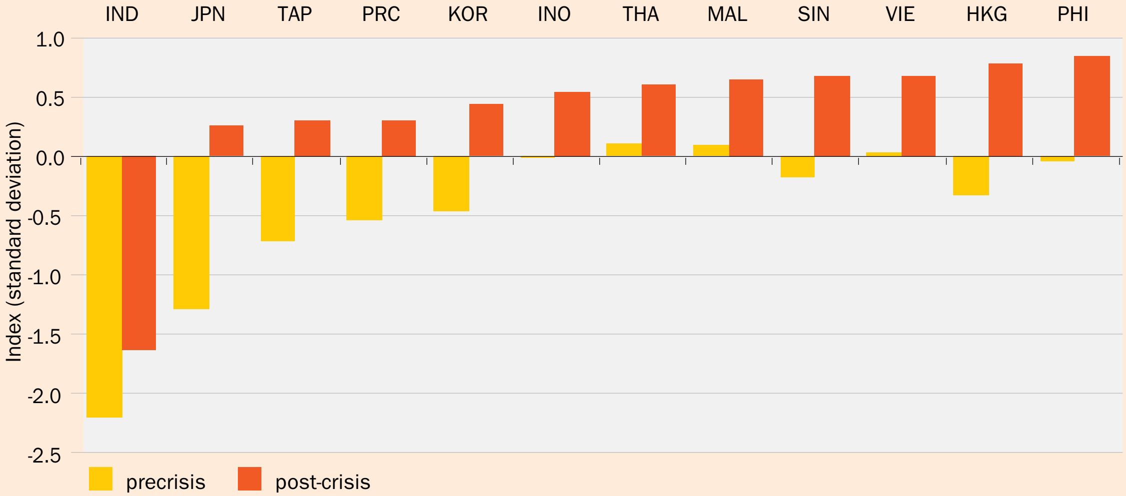
were roughly equal to long-term regional averages before the crisis, but were typically one-half or more standard deviations above these averages after the crisis. The AII values are in some cases negative in the precrisis period for the region's largest economies (the PRC, the Republic of Korea, and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

How markets drive integration

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

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

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



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

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

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

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

How policy makers are responding

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

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

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

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

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

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

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

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

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

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

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

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

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

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

2.3. The emerging regional agenda

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

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

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

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

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

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

Production

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

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

Financial markets

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

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

Macroeconomics

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

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

Social and environmental issues

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

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

Cooperation

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

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

Chapter 2: appendix

Lessons from the crisis

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

Sources of vulnerability

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

Policy responses

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

Crisis resolution mechanisms

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

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

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

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

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