



ADB

# EMERGING ASIAN REGIONALISM

A Partnership for Shared Prosperity



## HIGHLIGHTS

Asian Development Bank

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# Foreword



Asia today is an economic dynamo. But Asia's success story is about more than rapid development, poverty reduction, and an ever-expanding middle class. It is more than the production and distribution networks that place Asian goods within easy reach of consumers around the globe. It is more than labor-intensive industries, high-tech production of intermediate goods, or the final products assembled in Asia's myriad plants and industrial estates.

Part of Asia's success story is also growing integration—a phenomenon that is increasingly garnering the attention of observers outside the region and, more importantly, the policy makers and the public they serve. The trend toward integration is gaining momentum through enhanced dialogue between countries and people—from the simple contact brought about by intraregional tourism to formal meetings of government officials, ministers, and political leaders. Intraregional trade and investment are expanding rapidly, financial markets are becoming closer and more efficient, and economies are becoming more interdependent. Regional infrastructure projects are increasing connectivity, and countries are working together to provide regional public goods in areas such as the environment and health.

Emerging Asian regionalism offers a new platform for economic development that is good for individual economies, good for Asia, and good for the world. It is a “partnership for shared prosperity.”

The evolving approach to integration in Asia is market-friendly, multitrack, and multispeed, allowing for a healthy dose of pragmatism among a collegial group of economies. This approach is workable for a region of such size and diversity, and holds several advantages. First, any group of territories, economies, or subregions can integrate according to its particular levels of development and the specific opportunities that regionalism offers. Second, as partnerships strengthen, smaller groups are more likely to merge into larger ones, leading to wider and deeper relations across an ever-growing swathe of Asia. Third, this approach ensures that Asia's economic integration remains market-friendly—that its framework continues to be responsive to private sector needs as expanding business and open markets power Asian economies ahead.

Subregional cooperation is the building block of Asia's regional integration, and a logical way to move forward, given the region's diversity and size. Whether in the Greater Mekong Subregion, East Asia in its entirety, South Asia, Central Asia, or the Pacific Island nations, the scope and speed of regional cooperation will inevitably differ. As partnerships develop, bridges naturally form across subregional boundaries, leading eventually to wider and more comprehensive cooperation and integration. Such cooperation and integration have been seen most clearly in the aftermath of the Asian financial crisis, which triggered a period of significant progress in regional cooperation as much out of necessity as opportunity.

This study analyzes the nature of Asia's emerging regionalism, providing a basis for understanding its dimensions and further discussion on ways to move forward. The dynamic and outward-looking style of Asian regionalism can have a significant impact in an increasingly globalized world. Regionalism can be a stabilizing factor when shocks arise, whether region-based or externally imposed. Being pragmatic and flexible does not mean taking a *laissez faire* outlook. Regionalism carries the responsibility of proper management, effective communication, and (when required) policy coordination or the creation of common regional institutions. Regionalism can also be an effective policy tool to help markets adjust and adapt when a crisis looms.

Whether providing new regional public goods, managing natural disasters and epidemics, easing trade in products and services, moving capital and people, building common positions in international forums, or working together in correcting global market failures, emerging Asian regionalism will rely on the sort of experience, research, and analysis that make up this study so they can develop and properly manage strategies that can effectively deal with the challenges Asia will face.

This study, led by the Office of Regional Economic Integration, is a flagship project of the knowledge departments of the Asian Development Bank. It builds on the Eminent Persons Group report of March 2007, which suggests as one of its three complementary themes that ADB shift its focus from a primarily national one to a regional and ultimately global focus. It also contributes to the achievement of ADB's long-term strategic framework by helping to define the relevance of regional integration and cooperation as a platform for poverty reduction and promotion of economic development.

The study has greatly benefited from the work and contributions of many people. I wish to express deep appreciation to the excellent team of authors, advisers, reviewers, and editors, both outside and within ADB, who worked on the report and provided guidance and innovative ideas. The principal consultant, Peter Petri, coordinated the work of chapter authors and drafted the introduction, the chapter on deepening interdependence, the conclusion, and the *Highlights*. Michael Plummer drafted the chapter on integrating production; Jenny Corbett and Maria Socorro Gochoco-Bautista, that on financial systems; Shinji Takagi, that on macroeconomic links; Shiladitya Chatterjee and Aniceto Orbeta, that on social and environmental issues; and Peter Drysdale that on the architecture of cooperation. Philippe Legrain served as economics editor. The study was conceived and led by an ADB team comprising Masahiro Kawai, Jong-Wha Lee, Srinivasa Madhur, and Giovanni Capannelli. The financial contribution of the Government of Japan for this project is gratefully acknowledged.

How Asian regionalism evolves will affect the lives of the 3.7 billion people who inhabit the region, and will impact the world as a whole. Asia's contribution to the global economy is growing faster than that of any other region. The emergence of Asian regionalism, powered by new generations of Asians who have been raised amid exceptional economic progress and cooperation among nations, will help establish a lasting prosperity and peace.



Haruhiko Kuroda  
President  
Asian Development Bank

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This study was conceptualized and implemented by an Asian Development Bank (ADB) management team comprising Masahiro Kawai, former Head of the Office of Regional Integration (OREI) and currently Dean of the Asian Development Bank Institute (ADBI), Jong-Wha Lee, Srinivasa Madhur, and Giovanni Capannelli, respectively current OREI Head, Director, and Senior Economist. A Steering Committee including Masahiro Kawai, Bindu Lohani, Rajat Nag, Kunio Senga, Kazu Sakai, Ifzal Ali, Jong-Wha Lee, and Ann Quon provided overall guidance to the project.

A team of external consultants and ADB staff prepared the draft chapters of the main report and the highlights. Peter A. Petri of Brandeis University served as principal consultant. He was involved in overall coordination of the study and had a pivotal role in drafting the final report. The following authors provided draft chapters included in the final report: Peter Petri wrote chapters 1 (Why Asian Regionalism?), 2 (Deepening Interdependence), and 8 (The Way Forward); Michael Plummer of the Johns Hopkins University, chapter 3 (Integrating Production); Jenny Corbett of the Australian National University and Maria Socorro Gochoco-Bautista of the University of the Philippines (with the assistance of R. V. Fabella, M. Debuque-Gonzales, M. S. Milo, and R. E. Reside, Jr.), chapter 4 (Integrating Financial Markets); Shinji Takagi of Osaka University, chapter 5 (Managing Macroeconomic Interdependence); Shiladitya Chatterjee of ADB and Aniceto Orbeta Jr. of the Philippine Institute for Development Studies, chapter 6 (Making Growth Inclusive and Sustainable); and Peter Drysdale of the Australian National University, chapter 7 (Creating an Architecture for Cooperation). The study *Highlights* were drafted by Peter Petri. Philippe Legrain provided economics editing and prepared the executive summary.

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# Abbreviations and Acronyms



ABF	–	Asian Bond Fund
ABMI	–	Asian Bond Markets Initiative
APEC	–	Asia-Pacific Economic Cooperation
ASEAN	–	Association of Southeast Asian Nations
ASEM	–	Asia-Europe Meeting
BIMP-EAGA	–	Brunei Darussalam Indonesia Malaysia Philippines-East Asia Growth Area
CMI	–	Chiang Mai Initiative
EAS	–	East Asian Summit
ERPD	–	Economic Review and Policy Dialogue
EU	–	European Union
FTA	–	free trade agreement
GDP	–	gross domestic product
HIV/AIDS	–	human immunodeficiency virus/acquired immunodeficiency syndrome
IMF	–	International Monetary Fund
MDG	–	Millennium Development Goal
PRC	–	People’s Republic of China
SARS	–	severe acute respiratory syndrome
US	–	United States
WTO	–	World Trade Organization



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# 1. Introduction



The center of gravity of the global economy is shifting to Asia. Asia's gross domestic product (GDP) is already similar in size to those of Europe and North America, and its influence on the world continues to increase. In many Asian economies, the cycle of poverty has been broken; in others, this historic aim is within sight. Asia's extraordinary success has brought new challenges: while rapid economic growth remains a priority, citizens demand that it also be sustainable and more inclusive. And Asia is now so important to the world economy that it must also play a larger role in global economic leadership. Regional economic cooperation, a relatively new dimension of Asian development, will be essential for addressing all of these challenges.

The *Highlights* reports on the principal findings of *Emerging Asian Regionalism*, an in-depth study of Asia's increasing integration and its implications for regional economic cooperation. Analytical and empirical support is presented in the main study and background papers for it. The study focuses on 16 Asian economies that have made substantial progress in linking their economies (Table 1).<sup>1</sup> This "integrating Asia" accounts for 87% of Asia's total population and 96% of its output, so in this study is often referred to simply as "Asia." In some respects, those economies are already as closely intertwined as those of Europe's single market. Yet they are also remarkably diverse: they include some of the world's wealthiest countries and some of its poorest, large continental powers as well as small city states, and continuously independent countries and former colonies.

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<sup>1</sup> The group is dominated by East Asian economies because of their long-standing commitment to outward-oriented development and extensive regional interactions. India's links with the group are now also growing rapidly. The definition of such a group is inherently arbitrary, since it could arguably include other economies with which the region has strong economic links and cooperative relationships. Given the region's intrinsic economic dynamism, the shape of integrating Asia is fluid and likely to expand over time.

■ Highlights of Emerging Asian Regionalism

**Table 1. Integrating Asia: basic indicators 2007**

Economy	Population (million)	GDP		Average GDP growth rate 1986–2006 (percent)		Trade/GDP (percent)
		(\$ billion)	(per capita)	(\$ billion)	(per capita)	
Brunei Darussalam	0.4	12	30,750	1.5	-1.1	90.4
Cambodia	14.2	8	579	8.5	6.2	120.5
China, People's Republic of	1,321.5	3,241	2,452	9.7	8.6	66.0
Hong Kong, China	6.9	207	29,846	5.3	4.2	346.9
India	1,138.0	1,166	1,025	6.3	4.4	32.5
Indonesia	225.4	433	1,922	5.2	3.7	50.0
Japan	127.9	4,380	34,246	2.2	1.9	28.2
Korea, Republic of	48.5	970	20,246	6.5	5.7	71.5
Lao People's Democratic Republic	5.8	4	696	6.0	3.6	60.8
Malaysia	27.2	187	6,868	6.4	3.8	195.7
Myanmar	57.0	11	193	5.2	3.6	56.9
Philippines	88.7	145	1,634	4.1	1.8	84.7
Singapore	4.6	161	35,076	7.0	4.5	386.2
Taipei, China	23.0	383	16,680	5.6	4.7	130.3
Thailand	65.7	246	3,737	6.1	4.8	125.7
Viet Nam	86.4	71	824	7.0	5.2	138.0
<b>Integrating Asia</b>	<b>3,241.4</b>	<b>11,626</b>	<b>3,587</b>	<b>4.1</b>	<b>2.6</b>	<b>62.5</b>
Total Asia	3,714.0	12,081	3,253	4.0	2.5	62.9
European Union	461.3	16,586	35,958	2.4	2.0	64.3
United States	301.1	13,841	45,963	3.1	2.0	22.4
<b>World</b>	<b>6,615.0</b>	<b>50,609</b>	<b>7,651</b>	<b>3.8</b>	<b>1.7</b>	<b>50.5</b>

ADB = Asian Development Bank, GDP = gross domestic product.

Notes:

GDP data for Brunei Darussalam for 2006 and 2007 are ADB staff estimates based on national sources.

GDP data for Myanmar for 2005, 2006, and 2007 are ADB staff estimates based on the Economist Intelligence Unit 2008.

GDP data for Taipei, China are sourced from the Directorate General of Budget, Account and Statistics, Executive Yuan. Available: <http://eng.stat.gov.tw>. Accessed March 2008.

GDP series for Cambodia start from 1994.

World GDP for 2007 was estimated by ADB staff based on IMF 2008.

Trade/GDP shares refer to 2006 values.

GDP growth rates are calculated at constant 2000 US dollar prices.

Total Asia includes integrating Asian economies plus all other ADB developing member countries for which data are available. The countries are Afghanistan; Bangladesh; Bhutan; Fiji Islands; Georgia; Kiribati; Kyrgyz Republic; Marshall Islands; Federated States of Micronesia; Mongolia; Nepal; Pakistan; Papua New Guinea; Samoa; Solomon Islands; Sri Lanka; Tajikistan; Tonga; Uzbekistan; and Vanuatu.

Sources: Data from ADB 2007b. Available: <http://www.adb.org>. Accessed: March 2008; and World Bank 2007. Available: <http://www.worldbank.org>. Accessed: March 2008.

Asia's strength derives precisely from the openness, diversity, and dynamism of its interconnected economies.

Asian economies are principally connected through markets—through trade, financial flows, direct investment, and other forms of economic and social exchange. But where markets lead, governments are following. Asian leaders have committed to work together more closely and have already taken concrete steps in some areas. The 1997/98 financial crisis,<sup>2</sup> in particular, was an important catalyst for this emerging regionalism and gave rise to a range of new initiatives and institutions. Asian regionalism has not sought to replicate the European Union (EU), but has rather focused on finding new and flexible forms of cooperation that reflect the region's diversity and pragmatism. It aims to build on the region's remarkable achievements to address the daunting challenges it still faces.

The stakes could not be higher. A dynamic and outward-looking Asian regionalism could bring huge benefits to Asia and to the world. Whereas a volatile and fractious Asian economy could play a corrosive role both regionally and globally, a vibrant and integrated one could boost productivity and competitiveness, raising living standards in Asia and around the world. A cohesive and productive Asia would help to stabilize and power the world economy, and is thus in everyone's interest. In short, emerging Asian regionalism could develop into a partnership that advances regional and global prosperity.

As this study goes to press, the repercussions of the subprime mortgage crisis in the United States (US) are still working their way through the global financial system. The course of the unfolding global economic slowdown is still unclear. What is clear is that Asia now has a wider range of tools for managing its economic prospects than ever before. It needs to monitor economic and financial developments closely and it should be prepared to adopt coordinated policies that support the region's continued growth. The uncertain global context adds particular urgency to this study's recommendations on strengthening the region's financial stability and mechanisms of macroeconomic cooperation. Yet the focus of this study is the intermediate, rather than immediate, future: the steps that Asia could collectively take by, say, 2020 to ensure rapid, inclusive, and sustainable economic growth.

Drawing on the Asian Development Bank's 42 years of experience in financing, analyzing, and advising on the region's economic

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<sup>2</sup> The crisis started on 2 July 1997. Its duration varied between places, but was generally 1–2 years.

## ■ Highlights of Emerging Asian Regionalism

development, this study examines the drivers of integration; explores realistic strategies for building a dynamic, open Asian economic community; and seeks to provide insight on major issues that will shape Asia's economic future.



## 2. Asian regionalism: context and scope



Until recently, Asia's development path involved sequential—and sometimes competing—ties to markets outside the region, and did not yield strong economic links within Asia itself. This has changed—while the region's economic policies remain predominantly nondiscriminatory and outward-oriented, Asia's economies have grown large and prosperous enough to have become very important to each other. Their trade and financial transactions are deeper, their macroeconomic links are stronger, their people have more contact with each other, and their governments are experimenting with new forms of cooperation. In short, Asia is integrating. But should integration lead to regionalism?

This study finds that

- the financial crisis of 1997/98 underscored Asia's interdependence and shared interests, and gave a strong impetus to emerging Asian regionalism;
- Asia's economies are broadly and increasingly interconnected through trade, finance, macroeconomic links, and other important economic relationships;
- Asia's continued growth will reinforce its integration, but will also require solutions to complex social and economic challenges; and
- official cooperation will need to intensify, based on sound economic principles.

The step from interdependence to regionalism—from market-led to policy-led integration—is neither automatic nor self-evident. With reasonable access to global markets, Asian economies have made exceptional progress individually. They have also developed strong regional ties with relatively few formal agreements. But just as regional integration generates new commercial opportunities, it

also creates new demands for intergovernmental cooperation and institutional development.

## The logic of regional collective action

The economics of regionalism has a complex and troubled history. In the 1930s, shrinking international trade led to the emergence of preferential trading blocs, which further damaged the global trading system and accelerated the downward spiral of economic activity. This experience was foremost in the mind of the architects of the postwar global economic system as they adopted the principle of nondiscrimination as a central pillar of the General Agreement on Tariffs and Trade (GATT), the forerunner of the World Trade Organization (WTO). The case for Asian regionalism must be consistent with WTO principles: a “fortress Asia” is no more desirable than a fortress Europe or a fortress North America would be. But the open, outward-oriented regionalism that is emerging in Asia today need not pose such a threat. Much of the evidence assembled in this report suggests that Asia has—and will continue to have—a fundamental stake in both regional and global integration.

The case for collective action arises from market failures that would reduce economic welfare in the absence of official measures. The case for regional collective action is still more specific: it addresses the problems that are inherently regional or that, for other reasons, cannot be solved at the global or national level. Economic theory argues for such action in the presence of regional cross-border externalities and spillovers, and when policies need to be coordinated to deliver joint public goods. In line with these requirements, Asia’s regional initiatives should focus on the following important priorities:

- **providing new regional public goods**, such as mechanisms to head off epidemics; resources to address financial crises; and rules to enable countries to integrate financial, goods, and services markets;
- **managing spillovers among economies** resulting from closer macroeconomic relations, greater capital and labor flows, and environmental degradation;
- **exercising Asia’s influence in global economic forums** to help sustain open and competitive global markets;
- **liberalizing trade and investment** beyond levels achievable through global negotiations; and

- **adding value to national policy making**, notably by sharing “best practices” and highlighting priorities that may be opposed by domestic special interests—such as measures to enhance competition and regulatory oversight, reduce poverty and inequality, and control environmental externalities.

In other words, this study argues for regional cooperation not as a goal for its own sake, but as a means of achieving more fundamental aims. Regionalism can be a powerful, and even essential, tool for coping with the consequences of interdependence in trade and investment, finance, macroeconomic links, and social and environmental issues. Asia’s links are deepening in each of these areas, and new institutions are emerging or will be needed to manage its cooperative efforts.

## Watershed: the financial crisis of 1997/98

Asian economic cooperation has been discussed for some time—for example, in 1990, Malaysian Prime Minister Mahathir Mohammed proposed the establishment of the “East Asian Economic Group,” which did not gain traction until the financial crisis of 1997/98 (for brevity, referred to subsequently as the “crisis”). The crisis was a watershed: it sharply focused the region’s attention on its interdependence and shared interests. It also exposed weaknesses in the global financial architecture and led to new regional initiatives.

The crisis began on 2 July 1997, when Thailand abandoned a short but costly defense of the baht against speculative attack. The attacks quickly spread to Indonesia, Malaysia, and the Philippines. Later they spread to Hong Kong, China; the Republic of Korea; and Taipei, China. Although the People’s Republic of China (PRC) and Hong Kong, China also came under pressure, they did not allow their currencies to float or devalue. The crisis was short: most currencies had bottomed out by January 1998, and nearly all East Asian economies were expanding again by 1999. But it was also severe: in many countries it also involved a serious banking crisis, the collapse of credit markets, and deep recession. Scars remain: poverty rates rose sharply in affected countries and, in most, investment and growth have yet to regain precrisis levels.

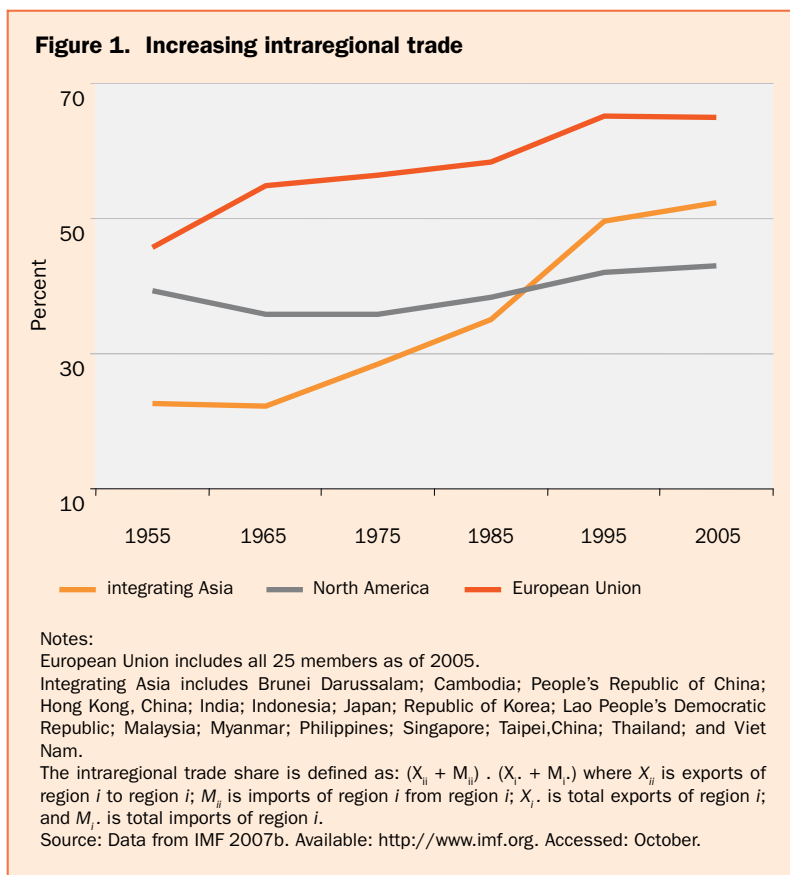
A decade later, debate continues on whether the crisis was triggered by macro- or micro-economic fundamentals, or simply

too many investors “rushing for the exit” (Radelet et al. 1998). Its suddenness, rapid geographic spread, and brevity suggest that financial panic was an important—perhaps a dominant—cause. But as with most complex economic phenomena, the crisis probably had multiple causes (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.

Yet the crisis did have a silver lining: most Asian economies—including those not directly affected—used it as an opportunity to undertake systemic reform. Domestically, they restructured and strengthened their financial systems; regionally, they established mechanisms for cooperation and emergency financing. The lessons of the crisis are examined in the main study; two conclusions stand out. First, rapid development creates structural tensions, such as the lagging development of Asia’s financial sector, that are 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, more significant spillovers, and (hence) a larger stake in each other’s stability than previously understood. Asia requires cooperative mechanisms to minimize the risks of crises and to contain and manage those that arise. Both conclusions argue for enhanced regional cooperation.

## Deepening economic interdependence

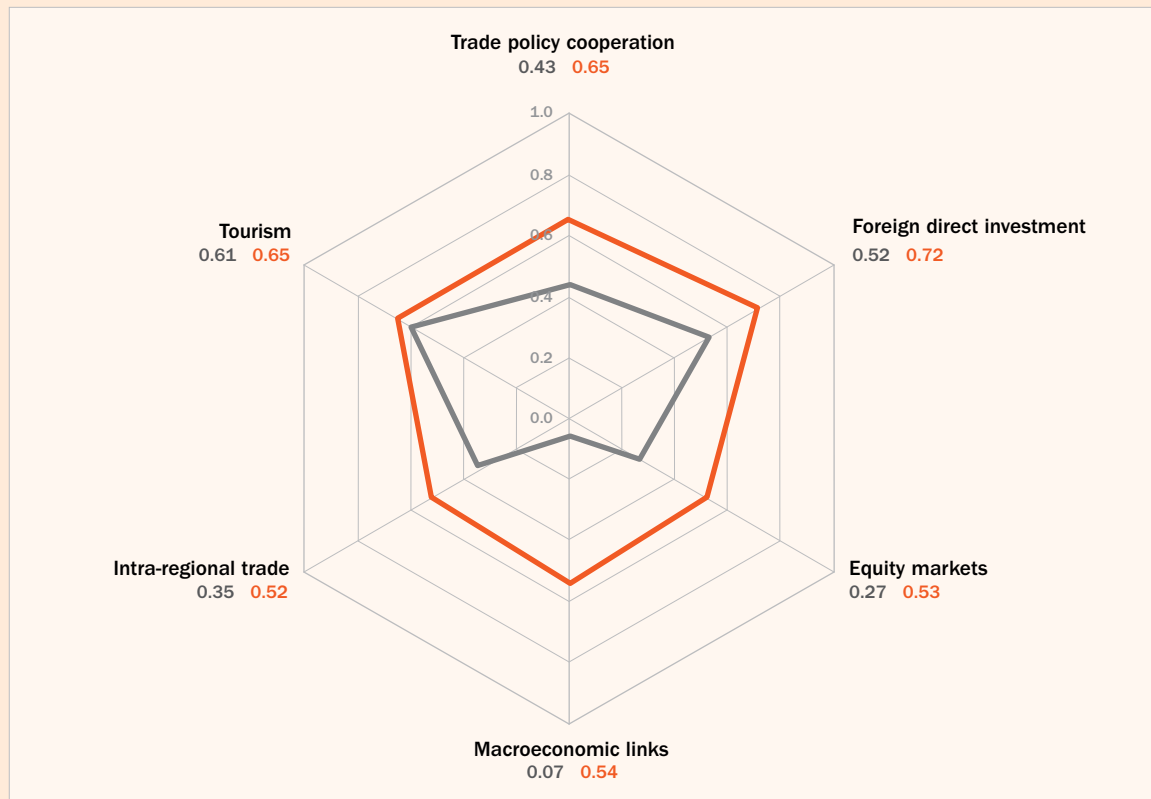
The crisis highlighted financial links, but regional interdependence is best understood as a complex, multidimensional process that encompasses several spheres of economic activity, social contacts, and strands of official collaboration. The most common measure of regional integration—the share of a region’s total trade conducted within it—has risen in Asia from about a fifth in the aftermath of World War II to a third or so in the 1980s, and to over half in recent years. Asia is now broadly as interdependent in trade as the EU and North America are (Figure 1). Indeed, Asia now trades more with itself than either the EU or North America did at the outset of their integration efforts.



A broader measure should incorporate other channels of integration, such as direct investment, financial and macroeconomic links, and personal contacts. To this end, data on six indicators of Asian economic integration were collected for integrating Asian economies before and after the 1997/98 crisis. The regional averages are shown in Figure 2. These need to be interpreted cautiously—some indicators are only proxies of economic links, and several indicators measure trends and correlations, which do not necessarily reflect causation—but it is striking that all six indicators have increased in recent years.

Regional integration is not an inevitable outcome of economic development. Most rapidly developing economies—especially large or highly specialized ones—require, and usually develop, strong global connections. Yet the network-based production systems that have emerged in recent years, as well as the investment and labor flows associated with them, have increased the relative importance

**Figure 2. Advancing integration: regional indicators, pre- and post-crisis**



— Precrisis      — 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: Intra-regional 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, 1990Q2–1996Q4; post-crisis, 2000Q1–2007Q2. 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: ARIC 2007.

Foreign direct investment: UNCTAD 2007.

Equity markets: ADB staff elaborations from Bloomberg data.

Macroeconomic links: Oxford Economics 2008, and Bureau of Economic Analysis, United States.

Intraregional trade: IMF 2007b.

Tourism: United Nations World Tourism Organization.

of regional relationships in Asia and elsewhere. Thus, while the large economies of the PRC, Japan, and the Republic of Korea remain strongly connected to the global economy, their regional links have also intensified. To some extent, these and other advanced economies act as the region's conduits to global markets. India is at an earlier stage of integration, but its regional connections are also growing very rapidly. Indeed, an overall index of regional interdependence (a composite of the six indicators) has increased for all integrating Asian economies since the crisis.

## Asia in 2020

Prediction is always hazardous, but there is good reason to expect Asia to have a bright economic future.<sup>3</sup> Even if growth in the PRC and India slows somewhat, Asia's share of world output is likely to expand from 28% in 2005 to 35% in 2020 in purchasing power parity (PPP) terms (Table 2). By then, Asia's GDP is set to be more than 50% 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%. Asia's average per capita income would rise from about \$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. At market prices, these increases are less dramatic but still very substantial. Most importantly, the projections suggest that Asia's regional links are likely to intensify further: on the demand side, the region's spending power is set to outstrip growth in the rest of the world; on the supply side, its production capabilities are likely to continue to expand and diversify.

At the heart of these projections is the continued dynamism of the PRC and India, which together account for two fifths of the world's population. The PRC's economic growth has averaged nearly 10% a year during the past 20 years; India's has reached 6%, and has exceeded 8% in the past few years. These two giants have huge markets; low-cost, relatively well-educated labor forces; and are committed to market-based development. They are large enough

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

**Table 2. Population and GDP projections for 2020**

Economies	Population		GDP at market prices			GDP at PPP		GDP per capita	
	(million)		(\$ billion)		Average growth rate	(\$ billion)		(at market prices)	
	2005	2020	2005	2020	2005–2020	2005	2020	2005	2020
Brunei Darussalam	0.4	0.5	10	20	4.7	18	37	25,754	40,910
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
<b>Integrating Asia</b>	<b>3,112.7</b>	<b>3,515.9</b>	<b>9,783</b>	<b>17,839</b>	<b>4.1</b>	<b>15,514</b>	<b>32,120</b>	<b>3,143</b>	<b>5,074</b>
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
<b>World</b>	<b>6,128.1</b>	<b>7,462.1</b>	<b>44,309</b>	<b>75,001</b>	<b>3.6</b>	<b>54,976</b>	<b>93,057</b>	<b>7,230</b>	<b>10,051</b>

GDP = gross domestic product, PPP = purchasing power parity.

Sources: Asian Development Bank staff projections based on International Comparison Program data. Data from ADB 2007b. Available at <http://www.adb.org>. Accessed: March 2008; and World Bank 2008. Available at <http://www.worldbank.org>. Accessed: March.

to enter a wide range of industries and build many sophisticated production clusters and networks simultaneously. As a result, they are powerful magnets for investment and effective locomotives for other, linked economies.

The rise of the PRC and India is reshaping the economies of the region and the world. They are formidable competitors in their areas of comparative advantage, and they offer vast markets and



highly attractive investment opportunities. Other Asian economies have largely benefited from the rise of the PRC and India—although competition in certain products and industries has taken its toll. The world has benefited too, but tensions have emerged in the markets for Chinese and Indian exports. The two economies' continued growth will help drive productivity increases as well as world economic growth, but it will require large adjustments—and is thus likely to generate continuing tensions as well as opportunities. Managing these strains within Asia and globally is a central challenge of Asian regional cooperation.

# 3. Integrating production



Outward orientation, trade liberalization, and related reforms—in Asia and globally—have helped to drive Asia’s remarkable economic rise. These forces have led to the rapid expansion of intraregional trade; broadly, Asia trades as much with itself as Europe and North America do with themselves. And trade has not shifted from non-Asian to Asian partners—rather, the growth and specialization patterns of Asian trade have resulted in especially rapid growth in intraregional trade. And because Asia’s global connections remain vital, the region needs to pursue global agreements as well as deeper regional relationships.

This study finds that

- Asia’s trade and investment have become more regionally integrated, but remain closely connected to external markets;
- these regional links are driven in large part by production networks and business process outsourcing;
- the region has stepped up its efforts to conclude bilateral and subregional trade and investment agreements; and
- Asia has a vital stake in maintaining open markets, with global and regional approaches complementing each other.

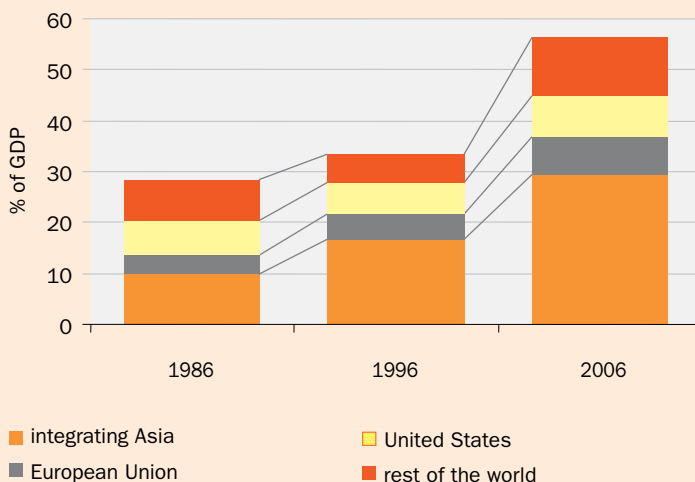
Regional integration is now central to Asia’s comparative advantage in world trade. By promoting further integration, innovation, and competition, the region can continue to consolidate its leadership in global manufacturing. But to realize the full value of this advantage, Asia needs to maintain good access to global markets. To achieve the dual objectives—regional integration and global access—Asia must play a key role in global policy making, in particular, as an advocate of open global markets.

## Expanding regional and global links

Nearly all Asian economies have internationalized—some dramatically so. Viet Nam’s total exports and imports have soared from 24% of GDP in 1985 to 142% in 2006; GDPs of the PRC and India each tripled over a similar period, as increased openness of trade is associated with growth. Recent increases have particularly favored intraregional trade (Figure 1). But trade has not been diverted from the rest of the world: on the contrary, trade with each of Asia’s four main partner groups (the region itself, the EU, the US, and the rest of the world) has increased in the last two decades—not just absolutely, but also relative to Asia’s GDP (Figure 3). For example, Asia’s trade with the EU has more than doubled as a share of GDP, from 2.6% in 1986 to 6.0% in 2006. The increase is even larger as a share of the EU’s GDP.

**Figure 3. Increasing trade links**

Trade of integrating Asia as a share of GDP, by destination



GDP = gross domestic product.

Notes:

Trade is import+export.

European Union includes the 25 countries that were members as of 2006.

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.

Source: Data from IMF 2007b. Available: <http://www.imf.org>. Accessed: October.

While intraregional trade is intensifying, external trade remains vital for Asian economies. Indeed, the increase in the share of Asia's exports destined for global markets understates their importance. The complex structure of modern production networks blurs the destination of exports: parts and components exported within Asia are often incorporated into final goods shipped to North America and Europe. A detailed analysis of Asia's trade dependency (reported in the full study) reveals that the share of Asia's total exports to Europe and North America increases substantially when parts and components incorporated into final goods exports to those markets are also taken into account.

## Production networks and Asian trade

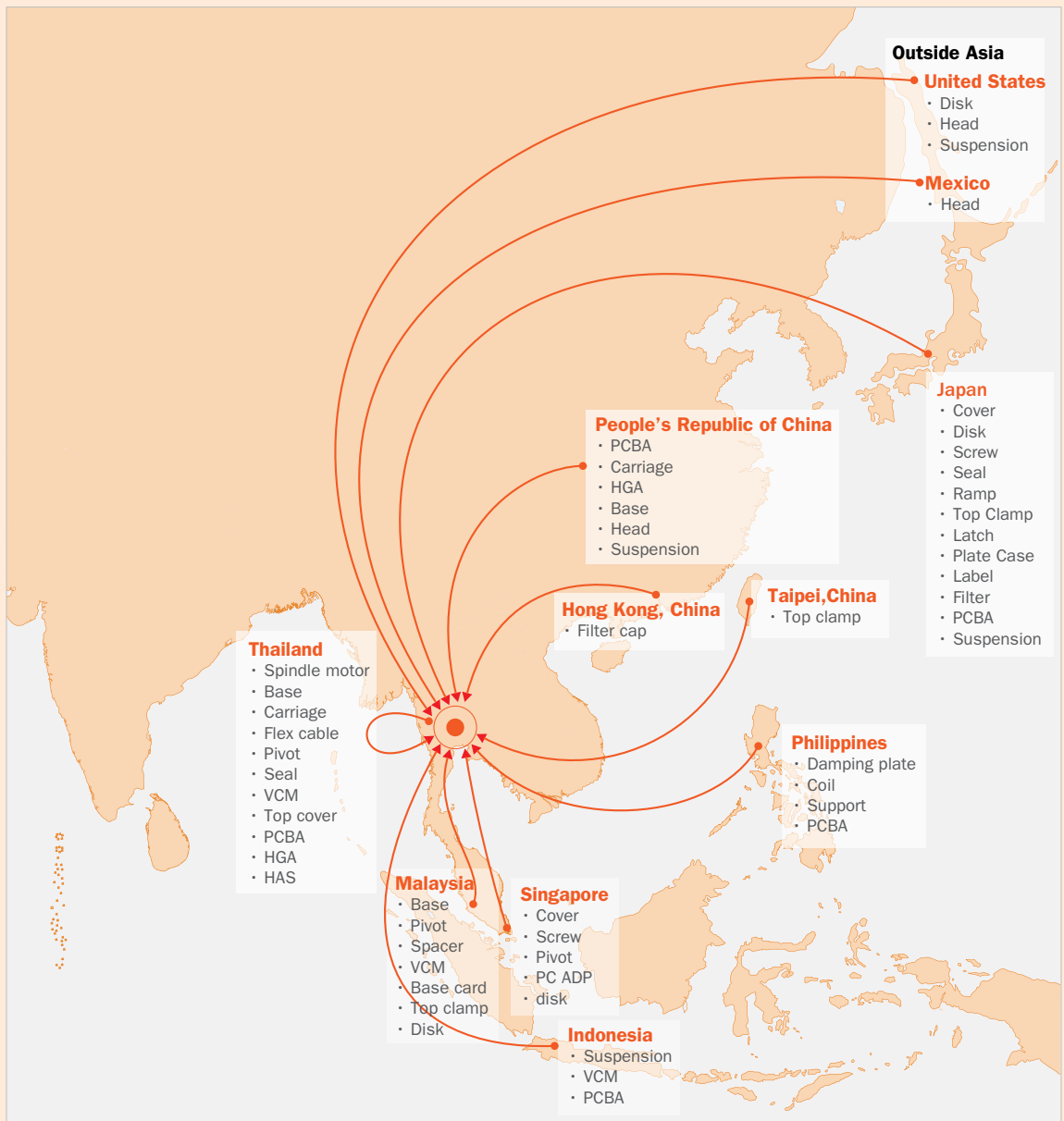
Asia's rapidly growing trade reflects the region's dominant position in global manufacturing, which is the result of a combination of low wages, increasingly educated labor forces, sophisticated technologies, high productivity growth, large markets, and (above all) the ability to bundle together diverse production advantages. Manufacturing—especially in industries such as automobiles and electronics—is now often based on breaking production chains into small steps, and producing each step in the most cost-efficient location. Firms may set up their own production facilities in various countries or they may depend on transactions with other firms abroad. These transactions may also include the outsourcing of business processes. The rise of such production networks—often called “production fragmentation”—is a relatively recent trend, driven by new information and communications technologies.<sup>4</sup> Such networks have been particularly successful in Asia because of the region's wide range of development levels, strong intraregional links, and capacity for organizational and technological change.

The PRC is increasingly at the hub of such production networks, but all economies participate. The manufacture of disk drives in Thailand offers a striking example: it spans nine Asian economies (with many parts coming from each), as well as suppliers from Mexico and the US (Figure 4). Production networks have played a central role in the massive expansion of Asia's intra-industry trade, especially in machinery parts and components. While the share of parts and

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<sup>4</sup> The theoretical and empirical literature on trade due to “fragmented production” is growing rapidly (see the main study and Ando and Kimura [2005] and Athurkoralala and Yamashita [2005]).

**Figure 4. Networking: sourcing of parts and components for a hard disk drive**



Note: The production of hard disk drives requires several parts and components. The example shows the actual sourcing of parts and components of a hard disk drive assembly firm in Thailand. The largest majority of parts and components are sourced from other integrating Asian economies. Hard disk drives are used in several electronic products. The hard disk drive assembler in Thailand exports a large share of its production to electronic firms mostly in other integrating Asian economies.

Source: Adapted from Hiratsuka 2006.

components in world manufactures trade grew by 3 percentage points between 1992 and 2003 (from 18% to 21%), it grew by 8 percentage points in Asia (from 19% to 27%). The PRC is the region's largest trader of parts and components, yet over three quarters of the trade involves other Asian economies—including Malaysia; the Philippines; Singapore; and Taipei,China—four economies where trade in parts and components is among the highest in the world as a share of GDP.

The growth of production networks increases the urgency of the need for measures to facilitate regional integration. Such networks require an attractive, predictable business climate as well as world-class transport and communications infrastructure. Most Asian economies are fairly advanced in providing a climate conducive to doing business. For example, most Asian economies have slashed tariff and other import barriers, both unilaterally and through global agreements. Two economies—Hong Kong, China and Singapore—are essentially free traders; three—Japan, the Republic of Korea, and Taipei,China—are quite open except in agriculture. The PRC cut tariffs from 16% in 2001, prior to joining the WTO, to less than 10% in 2005. Tariffs in the Association of Southeast Asian Nations (ASEAN) have also fallen, and now average below 10% in all sectors. Comprehensive measures of trade restrictiveness (Feridhanusetyawan 2005) offer more guarded results, but confirm an overall liberal trend.

Yet there is also room for improvement in many countries. Trade is still often impeded by border measures and incompatible domestic standards and regulations. Further liberalization is vital, especially in agriculture. Liberalization could substantially expand the ranks of people benefiting from regional trade, helping to reduce poverty as well as income gaps, both within countries and among them. And spreading Asia's own best practices for conducting business could help make the region's overall business environment among the most competitive in the world. While many policies need to be adopted nationally, due to Asia's rapid integration, the region as a whole is now a stakeholder in the policy environments of its individual economies.

## Policy in a fractious global environment

Most Asian economies appear ready to undertake additional reforms and trade liberalization—with willing partners. As of early 2008, the WTO's Doha Development Agenda negotiations remain deadlocked,

and new or deeper regional and bilateral arrangements are emerging across the world. Until the ASEAN Free Trade Area (AFTA) was established in 1992, Asia had not participated in any regional trade agreements, but subregional and bilateral trade agreements have now taken hold in Asia as well (Table 3). This challenges the region's traditional approach to trade policy based on unilateral and global liberalization.

**Table 3. Integrating Asia's free trade agreements**

Negotiating body	Status as of December 2007					
	Concluded	Under negotiation	Proposed	Total	of which	
					inside IA	Outside IA
ASEAN	2	4	0	6	4	2
Brunei Darussalam	3	0	4	7	3	4
Cambodia	1	0	2	3	2	1
China, People's Republic of	7	6	9	22	8	14
Hong Kong, China	1	1	0	2	1	1
India	8	10	12	30	8	22
Indonesia	3	1	6	10	4	6
Japan	8	7	4	19	12	7
Korea, Republic of	6	5	11	22	9	13
Lao People's Dem. Rep.	3	0	2	5	3	2
Malaysia	4	5	4	13	5	8
Myanmar	1	1	2	4	2	2
Philippines	2	0	4	6	3	3
Singapore	11	10	5	26	6	20
Taipei, China	4	2	1	7	0	7
Thailand	6	6	6	18	7	11
Viet Nam	1	1	2	4	3	1
<b>Total<sup>a</sup></b>	<b>44</b>	<b>49</b>	<b>41</b>	<b>134</b>	<b>30</b>	<b>104</b>

<sup>a</sup> The total avoids double-counting and does not correspond to the vertical sum of agreements by status.

ASEAN = Association of Southeast Asian Nations

Notes on status of free trade agreements:

Concluded = Signed and/or under implementation.

Under negotiation = Under negotiation with or without a signed framework agreement.

Proposed = Involved parties are considering creating an agreement, establishing joint study-groups or joint taskforces, and/or conducting feasibility studies for an agreement.

Source: Data from ARIC 2007.

The number of Asian free trade agreements (FTAs) has expanded rapidly in recent years, and nearly twice as many have been proposed or are being negotiated as have been concluded. The region's FTAs are an eclectic mix—a large majority are with partners outside the region. Accords involving developed countries such as Japan and the US often have deep and formal structures, and many go well beyond the WTO's sector coverage. The Singapore-US FTA, for example, addresses issues ranging from intellectual property rights and foreign investment to government procurement, e-commerce, technical barriers to trade, environment, labor, and several service sectors (Naya and Plummer 2005). In short, Asia's inventory of trade agreements is extensive, varied, and growing.

## Complementary regional and global strategies

Despite the proliferation of FTAs, Asia's trade policies remain consistent with the region's global, outward-oriented strategy. Asia's emerging regionalism is in large part defensive—or “market restoring” (Menon 2007)—and responds to new or deeper regional agreements in Europe, North America, and other important markets. Agreements among Asian economies often include provisions beyond trade, such as the national treatment of investment. Such agreements aim to remove domestic impediments to transactions and to create large markets and production platforms with economies of scale to match those of the PRC and India. Such agreements are likely to increase market efficiency and investment productivity.

But even though the region's agreements generally respect their international context, it would be far better to stitch together the tangled web of bilateral and subregional FTAs into a broad, comprehensive, framework consistent with the WTO. Consolidation has been discussed by ASEAN+3 and at the East Asian Summit (EAS, often also described as ASEAN+6). An even broader “Free Trade Area of the Asia-Pacific” has been also proposed in Asia-Pacific Economic Cooperation (APEC). Modeling results suggest that wider arrangements bring larger gains and help to mitigate the problems associated with the inconsistency of bilateral agreements. Asia would gain most from global free trade, roughly half as much from an ASEAN+3 or EAS arrangement, and much less from uncoordinated bilateral agreements. Given the difficulty of achieving global free



trade, a consolidated FTA would yield substantial benefits and could also advance global integration (Kawai and Wignaraja 2008).

The full integration of the region's goods and services markets is thus a central objective for Asian economic cooperation. It can be achieved with policies that do the following:

- **Support the open global trading system.** Asia's continued success depends on access to global markets, and an open, rules-based global system of trade and investment remains a high regional priority. By acting together, Asia could help lead the world to a successful conclusion of the Doha round and strengthen the WTO framework.
- **Pursue regional cooperation as widely and deeply as possible.** Because global negotiations are progressing slowly and opportunities for smaller groups to conclude deeper agreements exist, pursuing broad regional agreements is also in Asia's interest. The benefits of consolidating the region's bilateral and subregional FTAs into a single, region-wide arrangement would be substantial.
- **Develop guidelines for best practices in subregional trade agreements.** Independently negotiated trade agreements often involve incompatible rules of origin and other inconsistent provisions. Narrow, partial agreements are also more likely to harm excluded regional and global partners. To ensure that subregional trade agreements recognize regional interests and are more easily consolidated, they should be guided by regionally accepted best-practice principles. Such agreements should also prioritize sectors, such as agriculture, that have beneficial distributional effects.
- **Enhance regional connectivity.** Building a regional economy requires world-class infrastructure—transport, communications, and energy systems—to connect the region's economies, and in particular to connect the poorer economies and subregions to the region's economic centers.

# 4. Integrating financial markets



**D**ecades of bank-dominated and highly regulated financial systems have left Asian financial markets relatively underdeveloped. The crisis also made the region wary of opening capital markets. But while Asia is now making progress in strengthening and integrating its financial markets, the region's financial links are weaker than its trade ties. And financial links within the region are weaker than those with global capital markets. The challenge is to accelerate an important virtuous cycle—to attract more of Asia's substantial savings to regional markets so that these, in turn, stimulate the development of a state-of-the-art legal, regulatory, technical, and informational infrastructure for the financial system.

This study finds that

- Asian financial systems have improved substantially since the crisis;
- the region's financial connections are deepening, but Asia's capital markets remain more closely linked to global markets than with each other; and
- regional financial cooperation could dramatically strengthen national financial systems and their regional links.

Asia is home to world-class financial centers. Two—Hong Kong, China and Singapore—are ranked among the top five in the world (City of London Corporation 2007). Yet many Asian economies remain hobbled by the legacy of financial repression. Overcoming this is a regional, as well as a national, priority. If Asia can invest more of its vast savings within the region, major benefits will follow. For example, investing Asian savings would (1) bolster the development of sophisticated investment vehicles that expand regional financing options—for small companies as well as complex infrastructure projects; (2) foster innovative financial intermediation that can

identify and create “bankable” investment projects; and (3) help generate financial products that enable consumers and investors to use their incomes and assets more productively.

## Achievements since the crisis

Asian financial markets have become stronger and safer since the crisis: greater competition has been introduced; private sector ownership and foreign entry have been encouraged; and governance, disclosure, and prudential regulation have been tightened. Financial institutions’ capacity to assess and manage risks has improved. Financial deepening has been occurring faster than in the EU or US—albeit from a lower base—and as a percent of GDP Asia now has larger capital markets than the EU has (Figure 5). Capital markets, in particular, have grown very rapidly in absolute terms, as a share of total financial assets, and relative to GDP.

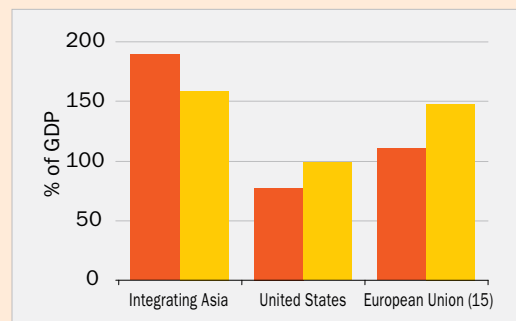
Other data also suggest improvement in Asian financial systems reforms and market efficiency. In banking, nonperforming loans have sharply declined, and capital adequacy ratios now exceed Basel I levels in most of the region. But in many markets, state-owned banks remain dominant, and require overhauling and privatization. Regulatory processes have been strengthened, but they too need more work, especially in preparation for the adoption of Basel II standards. Efficient systems to manage securities trading, payments, and settlement have become more important; they need to be expanded and connected across markets. Effective securities regulation, in turn, can help make markets safer, deeper, and more innovative; local-currency bond markets—both primary and secondary—are an especially important priority. To support these developments, efforts to improve corporate governance also need to continue, in part to make better information available for the private monitoring of markets, including by international rating agencies.

## Regional financial integration

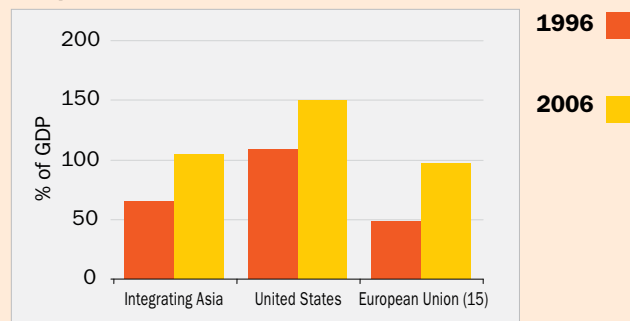
Financial interdependence has been rising, both within the region and with the rest of the world. Evidence comes partly from price movements: interest rates in Asia have increasingly converged during the last decade. Although the integration of markets is far

**Figure 5. Trends in financial deepening, 1996 and 2006 (percent of GDP)**

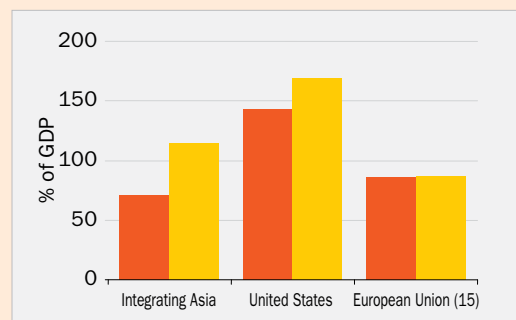
**a. Bank claims**



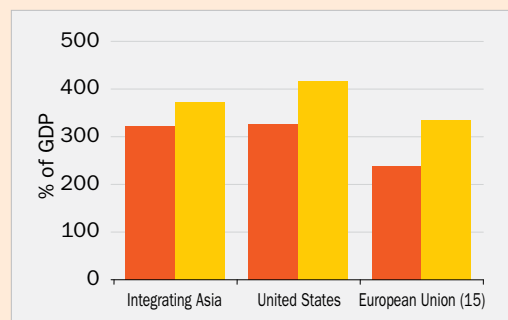
**b. Equities market**



**c. Bond market**



**d. Total financial assets**



GDP = gross domestic product.

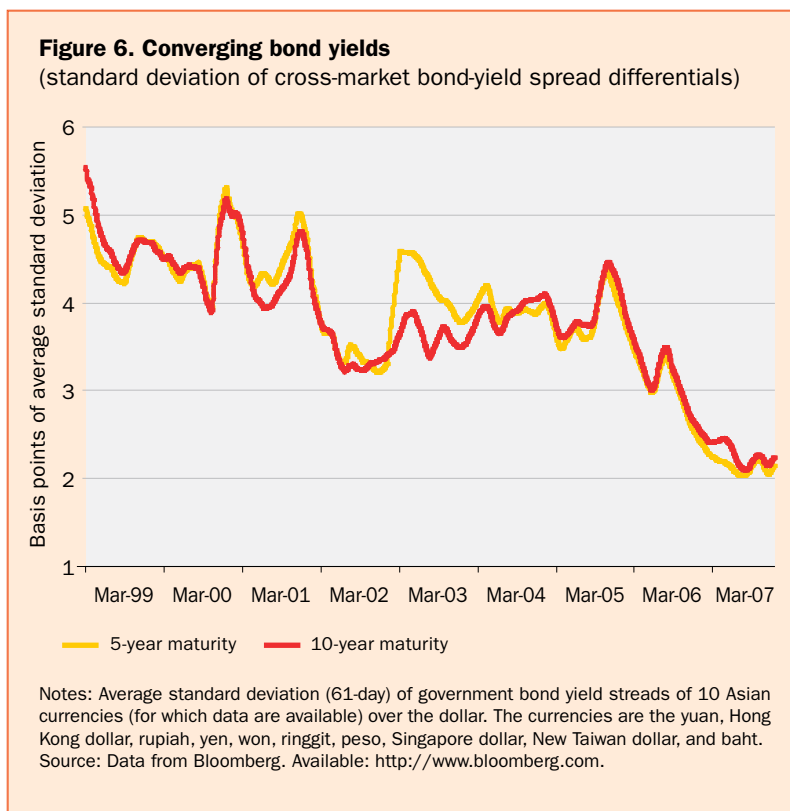
Integrating Asia = 11 economies for which data on financial markets are available: the People's Republic of China; Hong Kong, China; India; Indonesia; Japan; Republic of Korea; Malaysia; Philippines; Singapore; Taipei, China; and Thailand.

European Union includes its first 15 members.

Sources: Data from Asian Bonds Online 2007, IMF 2007b, BIS 2008, World Bank 2007, and World Federation of Exchanges 2007.

from complete, the standard deviation of cross-border bond yields has fallen sharply since the crisis (Figure 6). Correlations of equity-price indexes across regional markets have also risen, and are now higher than with US and other global equity markets. (This has not yet happened in the case of bond returns.)

Evidence on portfolio asset holdings also suggests rising interdependence (Table 4). Non-Japanese Asians invested 28% of their portfolios within Asia in 2006, up from 21% in 2001, while their holdings of US assets declined from 20% of the total to 15% during the same period. With Japan included, however, the picture changes: because Japanese holdings consist disproportionately of non-Asian securities, the share of Asian assets held regionally in 2006 is a mere



10%. Overall, non-Asian assets account for a disproportionate share of the region's total portfolio investment, although this share is declining slowly.

Thus, the region's financial markets are deeper and more sophisticated than they were a decade ago. But while legal and regulatory frameworks have improved, many countries still lag behind the best global practices (Lee 2008). In some countries, the gaps are exacerbated by restrictions on capital account transactions and on the entry of foreign banks and other financial firms (Chinn and Ito 2007). All these issues will need to be addressed nationally and regionally if more of Asia's vast savings are to be attracted into the region's own investment opportunities.

**Table 4: Deepening financial integration: portfolio investment (\$ billion)**

Reporting economy	Assets invested in					Liabilities received from				
	IA less Japan	Japan	IA	US	Total	IA less Japan	Japan	IA	US	Total
<b>2001</b>										
IA less Japan	48.6	20.0	68.6	63.6	324.8	48.6	21.8	70.4	125.0	354.0
Share	15.0%	6.2%	21.1%	19.6%	100.0%	13.7%	6.1%	19.8%	35.3%	100.0%
Japan	21.75		21.8	490.2	1,289.8	20.0		20.0	197.8	542.3
Share	1.7%		1.7%	38.0%	100.0%	3.7%		3.7%	36.5%	100.0%
IA	70.4	20.0	90.4	553.8	1,614.6	68.6	21.8	90.4	322.8	896.3
Share	4.4%	1.2%	5.6%	34.3%	100.0%	7.7%	2.4%	10.1%	36.0%	100.0%
<b>2006</b>										
IA less Japan	238.4	28.2	266.6	136.8	941.9	238.4	50.8	289.1	467.4	1,233.4
Share	25.3%	3.0%	28.3%	14.5%	100.0%	19.3%	4.1%	23.4%	37.9%	100.0%
Japan	50.6		50.6	797.6	2,343.5	28.2		28.2	585.6	1,434.9
Share	2.2%		2.2%	34.2%	100.0%	2.0%		2.0%	40.8%	100.0%
IA	289.1	28.2	317.4	934.4	3,285.3	266.6	50.8	317.4	1,053.0	2,850.4
Share	8.8%	0.9%	9.7%	28.4%	100.0%	9.4%	1.8%	11.2%	36.9%	100.0%

IA = Integrating Asia, US = United States.

Note: 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.

Source: ADB staff computations based on IMF 2007a.

## Toward efficient, integrated financial markets

Asian financial cooperation has increased markedly since the crisis and varied intergovernmental forums now support cooperation among finance ministers, central bank governors, and capital market regulators. This framework is discussed in more detail below, but some of its prominent results have included the Asian Bond Markets Initiative (ABMI, launched in 2004), which has helped strengthen

the market infrastructure for local-currency bond development, and the Asian Bond Funds (ABF) initiative, which has supported the development of regional bond funds. ASEAN's subregional efforts provide a model for still deeper cooperation: in addition to conducting regular surveillance, ASEAN has drafted a long-term roadmap for developing capital markets and liberalizing capital accounts and financial services. Its work on capital market development, for example, covers information sharing, harmonization, trading, clearing and settlement, and even the launch of an exchange-traded fund.

In theory, connections with global markets could provide all of the benefits of financial integration, with ample opportunities for raising capital, wide choices for investing it, and good options for diversifying risks. But regional financial integration can play an additional, important role. Common time zones and geographic proximity facilitate information flows and personal contacts and can help to reduce information asymmetries. Larger markets, in turn, can lead to more efficient and competitive financial services. In most major regions, these factors lead to a significant “home-region investment bias”—the tendency of a region's financial transactions to be conducted disproportionately with regional counterparties.<sup>5</sup>

However, in Asia the bias appears to be reversed—financial transactions seem to favor counterparties outside the region. These patterns likely reflect continuing impediments to cross-border financial transactions and suggest potentially significant gains from harmonizing rules, regulations, standards, and market practices, and from liberalizing capital account transactions. An integrated regional market could help to discover deeper and more timely information on Asian investment opportunities, and might be especially effective, for example, in adapting financial products and services to the needs of small and medium-sized enterprises and regional consumers and investors. An integrated financial market could also help to develop new approaches to funding the region's massive infrastructure investment requirements.

Further progress on regional financial integration will need to address fundamental causes—weaknesses in national financial systems, differences in national financial regulations, and the unevenness of market opening and capital market liberalization. There is growing consensus that much can and should be done about these

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<sup>5</sup> Home bias is often judged to be excessive relative to theoretical expectations in many countries, and in such cases is usually attributed to regulations that restrict cross-border transactions or to inadequate access to information about global investment opportunities.

issues on a regional level, both to improve the efficiency of markets and to forestall financial shocks. These goals can be achieved with policies that do the following:

- **Improve the surveillance of financial markets.** Institutions that conduct meaningful surveillance and address common regulatory issues are the sine qua non of regional cooperation. This objective would be best served by establishing a new, high-level “Asian Financial Stability Dialogue” on financial sector issues, to operate in parallel with the Economic Review and Policy Dialogue (ERPD), which addresses macroeconomic cooperation. The “Asian Financial Stability Dialogue” would bring together all responsible authorities—including finance ministries, central bank authorities, and other financial supervisors and regulators—to address financial market vulnerabilities, regulations, and efforts at integration, as well as to engage in dialogue with the private sector.
- **Promote consistent standards and mutual recognition.** Most Asian economies still need to improve prudential norms, regulation and supervision, and standards for governance and transparency. Harmonized standards would facilitate the regulation of financial activities across jurisdictions and would lower information and transactions costs for investors. Given that harmonization poses great challenges for Asia’s diverse economies, the region’s policy makers may take a two-pronged approach: develop guidelines for best practices (an ultimate basis for harmonization); and set minimum standards that can be recognized, initially at least among subsets of economies.
- **Strengthen financial markets and their infrastructure.** Deeper and more innovative financial markets can be promoted by expanding catalytic official initiatives such as the ABMI and ABF. These have increased the standards expected for disclosure and documentation and attracted new international issuers and investors to regional markets. The ABMI’s working groups are considering broad improvements, including the development of securitized debt instruments, regional credit guarantees, settlement and clearance systems, and rating agencies. Because many Asian financial markets individually lack the resources to build adequate transactions infrastructure—for credit enhancements, payments and settlements, and information



exchange—coordination among them is essential to achieve critical economies of scale.

- **Liberalize capital accounts and cross-border financial services flows prudently.** Efficient financial systems require competition and economies of scale—which ultimately entail exposing national financial markets and firms to international competition. In some Asian economies, efficient financial systems have already been built; in others, the benefits of integration still have to be balanced against the risks of liberalization. For the latter economies, progress needs to be measured and prudent; steady liberalization is essential, but it needs to be accompanied by the development of institutions that can ensure markets' continued stability.

Asian economies face the daunting, but essential, task of building world-class financial systems. The agenda is largely national, but the region as a whole is a key stakeholder. Regional financial cooperation can provide a forum for dialogue and information sharing, a framework for drafting mutually acceptable standards, and peer pressure to accelerate the adoption of difficult policies. It can foster the development of broader and deeper regional markets—and thus ultimately enhance the productivity of the region's massive savings.

# 5. Managing macroeconomic interdependence



Asia's growing trade and financial ties are rapidly translating into macroeconomic interdependence. One implication is that national authorities increasingly need to base their policies on what they expect their neighbors to do. Another is that the benefits from managing policies collaboratively—to maximize joint performance—are becoming larger. As a result, Asian policy makers are actively exploring ways to manage the propagation of global and regional shocks, and to reduce financial volatility and exchange rate misalignments. In the longer run, improved macroeconomic cooperation will also help strengthen the region's structural ties.

The study finds that

- Asia's regional macroeconomic interdependence is deepening,
- Asia's macroeconomic policies so far show little evidence of convergence,
- Asia faces potentially large macroeconomic adjustments as part of the eventual resolution of global payments imbalances, and
- regional cooperation will be important for managing regional and global macroeconomic challenges and for enhancing growth and stability.

While most Asian economies have performed well in recent years, their stability has been achieved against the backdrop of a benign global environment—which seems to have already ended with the financial turmoil that began in the US in the summer of 2007. Looking ahead, the global context is likely to require larger adjustments. For example, in the event of a US recession or global slowdown, Asia will need to refocus its growth away from slow-growing or contracting markets to faster-growing ones, including from exports to outside

Asia to demand within it. Even if these adjustments are not forced by short-term macroeconomic developments, they will be necessary in the longer run to resolve persistent global payments imbalances.

## Growing interdependence

Of the several reasons to expect that greater interdependence may cause Asian macroeconomic variables to move together more closely, three are most important. First, because Asia's trade includes a large share of parts and components, industry-specific shocks are likely to propagate rapidly across the region. Second, because Europe and the US remain major export markets for Asia's final goods, external demand shocks to Asian economies tend to be similar. Third, Asian markets themselves are becoming increasingly important drivers of regional economic activity.

Output correlations, the most frequently used indicator of interdependence, have sharply increased among integrating Asian economies (ADB 2007b, Kawai and Motonishi 2005, Kim and Lee 2008, McKinnon and Schnabl 2002). An analysis included in the main study shows that quarterly GDP co-movements rose dramatically after the Asian crisis and have remained high since—the average coefficient for pair-wise correlations in integrating Asia has risen from 0.07 before the crisis to 0.54 after it. But, as several other studies show, Asian economies remain closely connected with the rest of the world—in fact, the correlation of integrating Asia with the EU and US increased from 0.16 before the crisis to 0.51 since. These results are broadly confirmed using vector autoregression techniques in the main study.

Price links also appear stronger than before the crisis. The average correlation of quarterly consumer prices (detrended and adjusted for nominal exchange rate changes) across pairs of Asian economies increased from 0.10 before the crisis to 0.39 since. This suggests that either Asian economies face more similar price shocks from the rest of the world than before, or price shocks in one part of the region are transmitted to others with greater force, or Asian prices are more sensitive to external shocks. Correlations cannot distinguish among these alternatives, but all three are likely to be at work.

Thus, regional macroeconomic interdependence has increased: a more integrated Asia has become more sensitive to Asian shocks. At the same time, the region's sensitivity to global shocks remains significant, although it appears to be diminishing. These results

offer an interesting perspective on the debate over whether Asia is "decoupling" from the global business cycle. One side sees the current drivers of Asian economic activity as mainly regional, the other as mainly global. The study findings suggest a more subtle and dynamic perspective. Regional demand is indeed more important for Asia's economic growth than it used to be. Yet, as a result of globalization, economic activity in the EU and US remains important: these markets are still key destinations for Asia's exports. If decoupling is under way, it is taking hold only gradually as the relative importance of the drivers of Asian demand changes. In the meantime, purely national factors—the third driver of Asian activity—have clearly diminished in importance relative to regional and global forces, given the context of the region's increasingly open economies.

## Lack of policy convergence ?

Despite the convergence in regional macroeconomic outcomes, there is little evidence so far that macroeconomic policies have converged. Monetary policies have followed similar broad trends, but have diverged in detail. After converging until 2004, the region's policies since (through early 2008) have varied—from steady tightening in the PRC and Taipei, China, to sharper tightening followed by easing in Indonesia and Malaysia, and to later and more gradual tightening in Thailand and the Republic of Korea. Announced strategies also differ: Indonesia, the Republic of Korea, Thailand, and the Philippines have a formal inflation-targeting framework, while others follow more eclectic policies and in some cases specifically target exchange rate stability. In part due to these policy differences, inflation and interest rates have varied considerably in the region.

Fiscal policies have also diverged, though less so than monetary policies. Public debt levels in most Asian countries have fallen since 2000, but fiscal consolidation has been less successful in India and especially Japan, where public debt has reached critically high levels. In 2008, fiscal positions still range from deficits of about 6% of GDP for India and Japan to a surplus of 10% in Singapore. To some extent, these differences also reflect variations in the region's development levels and national policy objectives.

Exchange rate systems vary too. Before the crisis, most economies claimed to have managed floats, but in practice their currencies closely followed and were sometimes pegged to the US dollar. After the crisis

caused these systems to collapse, affected economies temporarily adopted more flexible regimes, with the notable exception of Malaysia. But as calm returned, countries again began to manage their floats to reduce currency volatility. More recently, some managed floaters, notably the PRC, are showing greater flexibility.

Although the medium-term trend of Asian currencies still follows the US dollar closely, their co-movements with the euro and yen have increased in recent years. This has produced exceptionally stable real effective exchange rates: within-region variations were lower in 2004–2006 than in any other comparable period during the past 17 years (Table 5). But this stability does not appear to be the product of deliberate policy decisions, and no formal regime exists to ensure that stability will continue. Indeed, it appears to have already ended, starting with the more tumultuous market conditions that set in as the US dollar began to depreciate in early 2006 and the yen began to strengthen in mid-2007.

**Table 5. Declining variance of real exchange rate movements**

	1989– 1991	1992– 1994	1995– 1997	1998– 2000	2001– 2003	2004– 2006
<b>Nominal exchange rates</b>	65.9	86.8	33.2	432.8	24.3	16.4
<b>CPI inflation</b>	17.0	17.7	11.0	71.8	11.3	8.8
<b>Real exchange rates</b>	62.0	45.4	37.2	234.0	32.1	22.8

CPI = consumer price index.

Notes:

Economies included in this analysis are: People's Republic of China; Hong Kong, China; India; Indonesia; Japan; Republic of Korea; Malaysia; Philippines; Singapore; Taipei, China; and Thailand.

Figures are the variances of annual percentage deviations from simple average, multiplied by 10,000 for ease of presentation. Percentage deviations are approximated by first logarithmic differences.

Sources: Computations based on IMF 2007c and ADB 2007b.

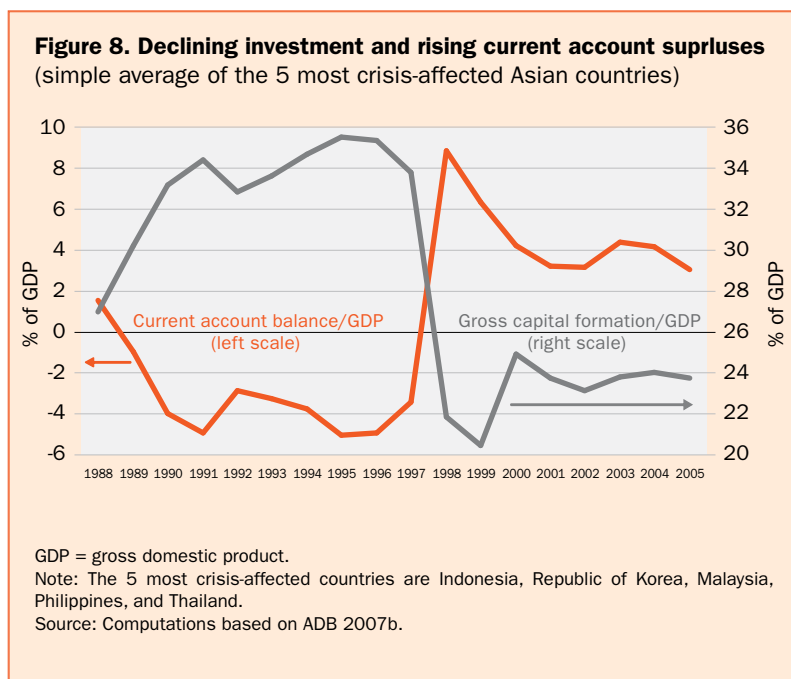
## Adjustments ahead

Asia's rapid growth and increasing interdependence ought to have led to large Asian investments in the region's own markets. Yet high savings and relatively weak domestic demand have instead produced large and persistent current-account surpluses, which have led to a huge increase in the region's foreign-exchange reserves (Figure 7). Six Asian economies—the PRC; Hong Kong, China; Japan; Malaysia; Singapore; and Taipei, China—had current account surpluses equaling 60% of the US current account deficit of \$810 billion in 2006. These imbalances may not be sustainable, especially as Asia's weight in the world economy continues to increase. Thus, there are multiple reasons to explore how Asian demand might become a more important driver of regional production.



There is ample potential for increasing investment in many Asian economies. In some, notably those most directly affected by the crisis, investment has declined sharply since the crisis and growth has not returned to precrisis levels (Figure 8). Investment has picked up recently in several economies—including Indonesia and Thailand—

but is still low compared with before the crisis. Precrisis investment rates may not have been sustainable in all Asian economies, but post-crisis rates have remained substantially below the long-term potential in several.



There is also scope for increasing consumption in some economies. Private consumption in the PRC fell from an already low 46% of GDP in 2000 to 38% in 2006. Some of the causes of high corporate and household savings are side effects of the PRC's remarkable economic growth. But others stem from its economic institutions and policies. For example, financial innovations could help to improve welfare by enabling consumers to allocate their lifetime earnings more efficiently. More balanced tax and dividend policies could allow the government to tap a larger share of the exceptional profits of the corporate sector (both private and state-owned). These resources, in turn, could be used to address the high cost of education and health care, and inadequate social safety nets and pension systems, which are themselves causes of high household saving. Many of these issues are well understood in the PRC, and plans have been adopted to increase spending in all these areas, which currently account for

only 3% of GDP (Lardy 2007). In Japan, the full recovery of personal incomes and the rising elderly dependency ratio should also lead to an increase in the consumption rate.

The resolution of global payments imbalances—regardless of what mix of expenditure changes is ultimately involved—is likely to require large adjustments in real exchange rates. This will be challenging; adjustments on the expected scale could trigger various types of disruption, in both deficit and surplus regions. There may not be much time for advance planning: US savings rates are rising and the US dollar has depreciated sharply after a prolonged period of appreciation, including against the yen. As these trends unfold, they present Asian policy makers with a dilemma: seeking to maintain exchange rate stability against a falling US dollar risks importing inflation; permitting exchange rates to rise would retain monetary autonomy but could threaten export competitiveness and would erode the value of Asia's huge dollar reserves. To compensate for low returns on reserve holdings and potential losses due to dollar depreciation, several countries have decided to reallocate some reserves to expanded or newly established sovereign wealth funds.<sup>6</sup>

## Mechanisms for macroeconomic cooperation

Regional mechanisms are clearly needed to address Asia's macroeconomic interdependence, but policy cooperation in this area is still in its infancy. A basic structure is taking shape, consisting of the Chiang Mai Initiative (CMI)—the region's emerging financing facility—and several regional forums for macroeconomic dialogue. Subregional institutions are most developed; ASEAN's surveillance process, for example, consists of confidential reports, discussions, and peer review sessions.<sup>7</sup> The ASEAN+3 Economic Review and Policy Dialogue (ERPD) is less formal and more interactive, but has a broader membership—its Finance Ministers Meeting has proven quite effective. The Executive Meeting of East Asia-Pacific Central

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6 Park (2008) estimates that the 2006 fiscal dividend of the People's Republic of China (PRC) from shifting reserves to a sovereign wealth fund could yield an extra \$43 billion in annual income.

7 The Asian Development Bank supports this process with the *ASEAN Economic Outlook*, special studies, and technical assistance.



Banks (EMEAP) serves a similar function for central banks.<sup>8</sup>

The CMI, launched in 2000, enables countries to borrow international liquidity collateralized by domestic currencies. But CMI bilateral swaps are still limited, and mainly restricted to complementing the financial support that members receive from the International Monetary Fund (IMF). The CMI has been expanded and strengthened since its inception—for example, the total amount of swap arrangements has been gradually increased to \$85 billion at the end of 2007 and the ceiling for activating swaps without an IMF program was raised from 10% to 20% in 2005. ASEAN+3 officials are now at an advanced stage in multilateralizing the CMI and promoting its closer integration with the ERPD. The CMI's continued development will encourage countries to economize on their foreign exchange reserves. Sovereign wealth funds could then provide a vehicle for diversifying reserves into higher return, albeit riskier, assets. If managed on an independent, transparent, and commercial basis, sovereign wealth funds could make a deep, steady pool of savings available for investments in the region and worldwide and could help stimulate the development of regional capital markets.

To meet the potential challenges ahead, the region's mechanisms of macroeconomic cooperation need greater focus, less overlap, and deeper institutional structure. These goals can be achieved in the following ways:

- **Making macroeconomic consultation and surveillance more effective.** To minimize duplication and, in particular, coordinate monetary and financial issues, an “Asian Secretariat for Economic Cooperation” should be established, with qualified, permanent staff. The Secretariat would most logically operate under the oversight of ASEAN+3 and in coordination with the region's central banks, although the functions it administers could have varying memberships, including economies outside ASEAN+3. The Secretariat could strengthen the principal surveillance functions of ASEAN+3 by facilitating explicit agreements on the tools, indicators, and standards used to monitor economic activity. For example, it could introduce a regional early warning system to help prevent financial crises or create a synthetic currency basket, such as an “Asian currency unit,” to monitor individual currency movements against a regional benchmark.

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8 Other, subregional central bank forums include Southeast Asia, New Zealand, Australia (SEANZA), Southeast Asian Central Banks (SEACEN), and the Association of Southeast Asian Nations (ASEAN) Central Bank Forum.

- **Strengthening Asia's short-term financing facility.** Pooling the region's massive foreign exchange reserves and improving the rules under which they are used are essential tools for effective crisis management. Multilateralizing the CMI and agreeing on rules for its rapid activation would be a critical step. The Secretariat would oversee the region's pooled resources and, in a crisis, negotiate economic policies with governments seeking support. It would thus complement the IMF's surveillance and crisis management efforts in Asia and, in time, the link between CMI activation and IMF programs could be phased out.
- **Cooperating in exchange rate and macroeconomic policy management.** As Asia's structural links deepen, exchange rate and macroeconomic policy cooperation are becoming increasingly important. Cooperation can begin with understandings on the conduct of policy, and with ad hoc coordinated actions. For example, countries could coordinate a particular wave of exchange rate adjustments against third currencies in order to hold their relative competitive positions stable. Such cooperation might emerge initially in ASEAN or other groups with closely synchronized business cycles. However, because growth in the region varies widely, any form of currency cooperation would have to be flexible enough to allow real exchange rates to adjust over time.

The recent era of relative macroeconomic stability may already be over; in any case, it will not last forever. With divergent prospects, conflicting demands on policy, and large realignments on the horizon, Asian policy cooperation will be essential. Asia needs to develop the institutions to make this possible and, because many years of cooperation are required to make such processes effective, the time to begin building such institutions has arrived.

## 6. Making growth inclusive and sustainable



**T**he goal of economic development is to improve social well-being in the broadest sense: to enable people to enjoy prosperous and fulfilling lives. Economic growth that benefits a broad cross-section of the population is essential. If the benefits of regional integration are to be shared by everyone—including the poor and socially disadvantaged—a wide range of social issues needs to be addressed. Public policies need to focus on “inclusive growth” to create opportunities for everyone, to improve people’s access to such opportunities, to provide a safety net for those who fall on hard times, and to achieve other social and environmental objectives.

Asia’s integration bolsters economic growth, and typically the poorest countries have the most to gain from it. But economic integration can be associated with negative side effects, such as greater dislocation of exposed sectors and negative impacts on the poor. A rapidly modernizing economy needs effective social policies to make growth broadly acceptable and to complement traditional mechanisms (based on extended families and small communities) for caring for those left behind. Such an economy also needs to address other issues, including threats to health, safety, and the environment.

This study notes that

- several major groups have been left behind the region’s exceptional progress,
- poverty and exclusion can be reduced with labor market and investment policies,
- increased migration and improved conditions for migrants can produce large social benefits,
- effective institutions to manage threats to health and safety are a critical priority, and

- trends in environmental degradation are serious and require regional attention.

These areas are of interest because they have large welfare implications and because they are amenable to regional—as well as national and global—action. Each requires a complex mix of national and regional policies, including extensive knowledge and experience sharing. Successful collaboration on these issues would improve equity, boost efficiency by making the most of everyone’s potential, and thus help to generate broad support for the policies required for economic growth.<sup>9</sup>

## Who is left behind ?

Given the complexity of Asia’s social problems, efforts to tackle poverty and inclusion need to rest on systematic information on which groups are left behind and why. Much progress has been made in recent years—especially in the context of the Millennium Development Goals (MDGs)—with understanding the scope and causes of poverty, in both its income and non-income dimensions. This work needs to continue, especially in pinpointing the factors that lead to exclusion—such as geography, skills, age, gender, and race—and the policies that can offset them.

Asia has made remarkable progress in reducing poverty (Table 6), but major challenges remain. The good news is that Asia appears set to meet the MDG of halving extreme poverty by 2015.<sup>10</sup> Half of Viet Nam’s population lived on less than \$1 a day in 1990; only 1 in 10 did in 2004. In the PRC, the proportion has fallen from a third to less than a seventh. In Indonesia, a country badly hit by the crisis, extreme poverty has fallen by two thirds. Yet progress has been much slower in some countries, especially on non-income measures. Nearly 2 billion people in the region are without basic sanitation, over 650 million are without clean water, 100 million under 5 years are underweight, and nearly 30 million children of primary-school age do not attend classes (ADB-ESCAP-UNDP 2007).

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<sup>9</sup> Barro (2008) finds that inequality negatively affects growth and ADB (2007b) argues that rising inequality slows the pace of poverty reduction at any given growth rate.

<sup>10</sup> ADB (2005b) estimates that the number of extremely poor people (with incomes of less than \$1 a day) fell from 921 million in 1990 to 621 million in 2003, largely as a result of rapid economic growth. Further progress is expected to occur, but by 2015, the number of extreme poor could still be as high as 347 million, with South Asia accounting for the greatest number (274 million), mainly in India

**Table 6. Gains in the battle against poverty**

Economy	Poverty index				Survey year	
	\$1-a-day		\$2-a-day		Initial	Final
	Initial	Final	Initial	Final		
China, People's Rep. of	28.3	10.8	64.5	37.8	1993	2004
Cambodia	25.5	18.5	76.5	61.6	1993	2004
India	41.8	35.1	85.1	79.6	1993	2004
Indonesia	17.4	7.7	64.2	52.9	1993	2002
Lao PDR	47.8	28.8	89.9	74.4	1992	2002
Malaysia	0.0	0.0	19.2	9.8	1993	2004
Philippines	18.1	13.2	52.7	43.6	1994	2003
Thailand	6.0	0.0	37.5	25.8	1992	2002
Viet Nam	27.3	8.4	73.5	43.2	1993	2004

Lao PDR = Lao People's Democratic Republic.

Note: Poverty index = percentage of population below the poverty line.

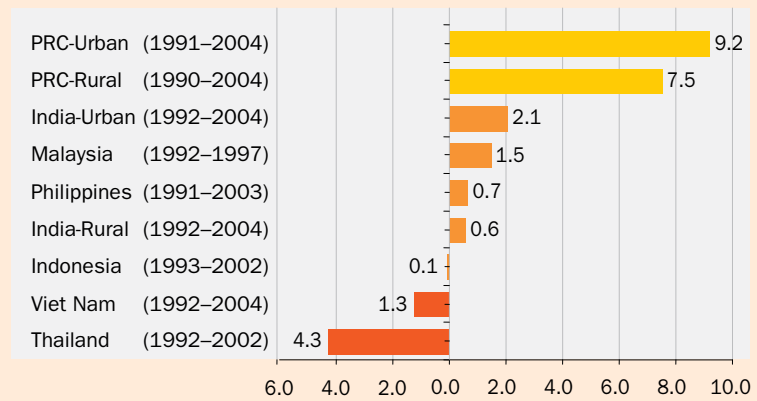
Source: Data from ADB 2007b.

Income disparities within countries are also rising. Measured by the Gini coefficient, inequality has fallen in Thailand and Viet Nam, but has risen considerably in the PRC and India (Figure 9). Fortunately, this does not involve “the poor getting poorer and the rich getting richer, but the rich getting richer faster than the poor” (ADB 2007b, 79). The region's overall development model is working, but the gains need to be shared more equally.

The causes of growing inequality vary, but, generally, the rich are better equipped to exploit the opportunities offered by economic change.<sup>11</sup> People in urban areas are on the average better off than those in rural ones, but within urban areas inequality has also widened. Some groups are systematically excluded from economic opportunities—especially women, the lower socioeconomic strata, minorities, and indigenous people. Tackling discrimination is critical:

11 Higher income groups benefit from various factors that directly affect their productivity, such as better health conditions, educational achievement, infant and child mortality, and immunization against diseases.

**Figure 9. Growing inequality**  
(changes in the Gini index)



PRC = People's Republic of China.  
 Note: The Gini index is a measure of the inequality of income or wealth distribution.  
 Source: World Bank 2007.

in the case of gender, for example, successful regional initiatives have ranged from gender-sensitive poverty reduction programs to improving access to finance and property.

People also fall behind through bad luck—by working in a declining sector or becoming unable to work. The recovery since the crisis masks the continuing inadequacy of Asian social protection systems (ADB 2003b). Demographic ageing (Table 7) will increase the stress—family and community support systems are declining rapidly and have to be complemented by public systems. Yet the cost can be manageable: for example, the United Nations World Economic and Social Survey estimates that the cost of providing a pension of \$1 a day to everyone aged over 60 in the developing countries surveyed is less than 1% of their combined GDP a year (UN 2007). Innovation—such as in microinsurance, locally based social funds (ADB 2003b), and community-based information technology support—would also help.

## Fighting poverty and exclusion

The battle against poverty and exclusion begins with creating high-productivity jobs—a central goal of Asian regionalism. But whether people have access to these jobs depends on how well labor markets

**Table 7. Ageing population**

Economy	Population 65 and over as a percentage of total population			Population 65 and over as a percentage of population 15–64		
	2005	2015	2030	2005	2015	2030
<b>Integrating Asia</b>						
Brunei Darussalam	3.2	4.3	8.9	4.8	6.0	12.7
Cambodia	3.1	4.0	5.8	5.3	6.2	8.7
China, People's Rep. of	7.7	9.6	16.2	10.8	13.4	24.4
Hong Kong, China	12.0	14.5	25.8	16.4	19.8	40.9
India	5.0	5.8	8.8	8.0	8.8	12.9
Indonesia	5.5	6.6	10.7	8.3	9.6	15.5
Japan	19.7	26.2	30.6	29.8	42.6	52.3
Korea, Rep. of	9.4	13.3	23.4	13.1	18.2	36.2
Lao's People Dem. Rep.	3.5	3.4	5.6	6.2	5.3	8.4
Malaysia	4.4	5.8	10.4	6.8	8.7	15.4
Myanmar	5.6	6.3	10.9	8.3	8.9	15.8
Philippines	3.8	4.7	7.5	6.4	7.5	11.2
Singapore	8.5	13.5	27.4	11.8	18.2	45.9
Thailand	7.8	10.2	17.4	11.1	14.5	26.6
Viet Nam	5.6	5.8	10.9	8.6	8.4	15.8
<b>World</b>						
Asia	6.4	7.6	11.7	9.7	11.2	17.4
European Union	15.9	17.4	22.6	23.3	25.8	35.9
North America	12.3	14.3	19.8	18.4	21.6	31.7
<b>World Total</b>	<b>7.3</b>	<b>8.3</b>	<b>11.7</b>	<b>11.4</b>	<b>12.6</b>	<b>18.0</b>

Note: "Asia" refers to the United Nations definition.  
Source: UN Population Division 2006.

function and how effectively the places where they live are connected with dynamic regional and global markets.

Asia's official unemployment rates are not high by global standards, but studies show that employment growth is becoming less responsive to output growth (Felipe and Hasan 2006, Kapsos 2006). This is so partly because formal employment data capture only part of the story. In 2005, about 500 million of Asia's 1.7 billion workers were reckoned to be either unemployed or underemployed (Felipe and Hasan 2006). Asia's informal labor markets are huge—accounting

for 83% of nonagricultural work in India and 71% in Indonesia. Many of these outcomes reflect barriers in labor markets, especially between urban and rural areas. Rigid labor laws, in turn, cause entrepreneurs to opt for machinery or illegal workers in place of regular employees. Weak property rights keep people from financing businesses, because untitled assets cannot be used as collateral. To remove regulations that make starting new businesses and hiring people costly and risky is often politically difficult, but still essential (Freeman 2006).

A second approach is to target sectors that are potent in poverty reduction. It is especially important to get policies right in agriculture—the mainstay of Asia’s poor. Often, national policies are misguided: for example, subsidizing staple food crops discourages diversification into higher value crops and the adoption of productive planting and marketing strategies. Focused regional policies can also make a difference. Greater opportunities for international trade in agricultural products—both within the region and beyond—could amplify national efforts to improve agricultural productivity. Aid-for-trade could also make an important, direct contribution to these efforts: in the Greater Mekong Subregion, for example, innovative programs promote cross-border agricultural trade and investment, supported by public-private partnerships on agricultural science and technology (ADB 2007b).

Even with sound policies, new formal-sector jobs often favor skilled workers, due to skill-biased technical change and the quality requirements of export markets. This benefits the economy as a whole—it boosts productivity and average incomes—but it does not help people who do not have, and are unable to acquire, the skills required for new jobs.

Thus, a third strategy is needed: reducing gaps in education and infrastructure that make it impossible for people to connect with the centers of economic growth. To do so requires a focus on basic education and on vocational and skills training. Investing in trainability—the capacity to learn how to use new technologies—is especially important. Investment climate surveys show that a lack of education and training are among the factors that prevent rural areas from developing higher productivity nonfarm enterprises (ADB 2007a). Strategic investments in infrastructure—in transport, communications, and energy—can also connect low-income regions with Asia’s dynamic core. Growth in remote areas can save substantial social, financial, and relocation costs, and benefits people who move and those who are unable to do so.



## Labor migration

Making it easier for people to move to where jobs are is broadly beneficial. This is true for migration within countries as well as among them. Of the 200 million or so international migrants in the world, the top three sending countries are in Asia—the PRC, with 35 million; India, 20 million; and the Philippines, 7 million (Global Commission on International Migration 2005). Migrants' remittances through formal channels exceed \$200 billion a year, and twice that much may be sent informally. The funds appear to be used very productively: they boost investments in education, housing, and household enterprises (Yang 2006). If rich countries let their labor forces swell by 3% through greater labor mobility, poor countries would gain an estimated \$305 billion a year—more than the combined effects of lower trade barriers, debt relief, and aid (Pritchett 2007). Migration can also match labor market surpluses in younger, poorer countries with shortages in older, richer societies, for example, in sectors such as health care.

Yet migration needs to be managed. Cooperation to curb abuses—trafficking in women and other illegal forced labor—is essential. So too is broader regional peer pressure to protect the welfare and dignity of migrant workers. International conventions, including ASEAN's declaration on the protection and promotion of the rights of migrant workers, provide a framework, but are not well enforced. Social protection systems interact in complex ways with migration: they need to become internationally portable, available to the families of migrant workers, and supportive of the reintegration of returning workers.

## Health and safety: critical public goods

Due to high population densities and limited health services in some countries, Asia is unusually vulnerable to epidemics. Regional integration and the frequent movement of people and goods increase its vulnerability. HIV/AIDS,<sup>12</sup> severe acute respiratory syndrome (SARS) and avian influenza highlight how rapidly local health problems can turn into regional ones. These threats—and potential future ones—are risks to society at large: they have devastating economic and

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12 Human immunodeficiency virus/acquired immunodeficiency syndrome.

social consequences. The brief SARS crisis cost Asian economies \$20 billion in lost tourism and output, amply demonstrating the value of international monitoring and coordination in containing epidemics (Lee and McKibbin 2003). Protecting the region from health threats is a critical “public good” and an obvious priority for regional cooperation.<sup>13</sup>

The tsunami of 2004 was a devastating reminder of the region’s vulnerability to natural disasters. Regional cooperation can help to make the response to disasters faster, more effective, and less costly. Cooperation should include regional early-warning systems where appropriate; disaster management and recovery plans; and arrangements for information-sharing, transport, and communications. Financial innovations—such as regional catastrophe-bond and flood-insurance markets—could further improve the management of such risks (Lin et al. 2007).

## Environment

Environmental concerns are increasing, particularly because economic growth in much of Asia remains propelled by production that depends on carbon fuels. Many of Asia’s major urban centers have unacceptably poor air quality. Its bodies of water—including major water supplies—are also under stress. Rapid climate change increases the risk of natural disasters and disease outbreaks. All these problems require concerted global and regional consultation and action to assess problems and identify solutions and to develop strategies for addressing them jointly so that no economy suffers disproportionately from the policies adopted.

Cross-border environmental issues are of particular concern for regional cooperation. Problems such as desertification, dust storms, forest fires, haze, and acid rain cut across national borders; their solution requires regional collective efforts. Asian countries and subregional organizations need to cooperate more closely on environmental challenges by harmonizing standards, regulations, and laws. Priorities include air pollution, land degradation, and global climate change, which tend to affect the poor the most.

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13 Priorities include strengthening the regional collection and dissemination of information on health threats; the establishment of vaccine development and production capacities; support for national capacity development, particularly in surveillance and diagnosis; and the creation of intergovernmental mechanisms to fight diseases such as HIV/AIDS and to undertake concerted action on standards, health promotion, early-warning systems, and communications.

Subregional cooperation is proving effective in some areas. The BIMP-EAGA<sup>14</sup> initiative on environmental protection, for instance, is an important effort to preserve one of the world's richest repositories of land and marine biodiversity, and ultimately to manage the long-term sustainability of the subregion's natural resources. This and other subregional initiatives offer focused interventions and models that are broadly applicable in Asia and around the world.

## A social and environmental agenda

Asian regionalism cannot fulfill its immense potential unless it addresses disparities within countries and among them. Left to market forces, Asian regional integration will bypass many people and support for it will be eroded. Governments increasingly recognize this; their vision of shared regional prosperity requires corrective action.

Regional cooperation is useful for addressing critical social and environmental issues directly; it can also help make a strong case for action—as the MDGs did globally—and mobilize national, regional, and global support. Deeper networks among policy makers, research institutions, and nongovernment organizations could improve the design and implementation of policy. And by concerted action, the region could ensure that the impact of social and environmental policies on the competitiveness of particular industries and subregions is recognized and, if necessary, addressed through complementary policies.

Based on the foregoing analysis, Asia's principal objectives are as follows:

- **Connect the poor to the thriving regional economy.** Policies will vary across countries, but they should aim to eliminate regulatory, social, and geographical barriers in labor markets; prioritize development and trade in sectors, such as agriculture, that have a strong impact on reducing poverty; encourage the integration of informal sectors into the formal economy; invest in education and training to make workers more productive; and build infrastructure to connect disadvantaged regions with economic centers.

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<sup>14</sup> Brunei Darussalam, Indonesia, Malaysia, Philippines East ASEAN Growth Area.

- **Develop cost-effective social protection systems.** With family and community mechanisms of social protection declining, low- and middle-income countries also need adequate social protection systems. Recent experiments are expanding the range of cost-effective solutions, in part with innovations that exploit technology and microfinance strategies.
- **Facilitate and manage labor migration.** National and international migration can improve the lives of migrants, their families, and the citizens of host economies. The challenge for host countries is to maximize the benefits of employing foreign labor while minimizing its potentially negative impacts and to ensure that immigrants have basic rights and protection and are treated with dignity.
- **Protect regional health and safety.** Densely populated and closely integrated Asia needs world-class systems to monitor, prevent, and (if necessary) contain epidemics. Providing the public goods of disease prevention and disaster management is a top regional priority.
- **Make development sustainable.** The environmental costs of economic activity are mounting with Asia's rapid development. Cooperation is required to set environmental standards, design interventions, and monitor results. Regional cooperation can be useful in mobilizing Asian and non-Asian resources and technologies, and is essential for addressing cross-border issues.

Sharing such regional goals will help to build a genuine Asian community. Through understanding each others' successes and failures, people and countries will develop stronger foundations for cooperation. A common, inclusive vision will also help to mobilize popular support, an essential requirement for realizing the promise of regionalism.

# 7. Creating an architecture for cooperation



**T**he case for greater regional cooperation is broad, deep, and compelling. Yet marshaling collective efforts across this vast, diverse region is a huge challenge. The examples of the EU and, to a lesser extent, the North American Free Trade Area (NAFTA) highlight some of the possibilities and difficulties. But Asia does not function exactly like Europe or North America. Asia's economics, politics, and history are different. Some forms of interdependence—in trade, for instance—are deeper in Asia today than they were in Europe in the early stages of European regionalism. But others—such as monetary policy—involve largely independent national decisions.

Against this background, the study finds that

- Asian integration is likely to intensify, while retaining its distinctive pragmatism and gradualism;
- the architecture of Asian cooperation will remain multitrack and multispeed—and is still fluid;
- the leadership to drive regionalism forward needs to come from broad coalitions;
- the vision for integration must remain pragmatic and yield step-by-step results; and
- Asian regionalism can be an engine for further global integration.

While Asia can draw on other regions' experience, Asian regionalism will ultimately follow a distinctive blueprint, building on Asian economic priorities and based on an Asian vision for a regional community. That vision is just beginning to take shape, amid spirited debate.

## Regionalism with Asian characteristics

Asia's powerful countries and centers of economic activity have many common priorities, but also differing ones. At times, the differences are amplified by history and politics. The price of cooperation is the loss of some national sovereignty and the narrowing of policy options for pursuing purely national objectives. It is understandably difficult for large, successful, and independent economies to make such compromises, and ultimately to sacrifice some authority to regional institutions. Yet understanding of the logic of regional collective action is becoming stronger, driven by the need to manage the consequences of rising interdependence. Cooperation is likely to evolve gradually, but it will intensify as countries gain confidence in the benefits of concerted action and the processes of joint decision making. Different groups of countries will progress at various speeds, using different frameworks to address subsets of policy interests.

Asia's regionalism will be distinctive in other ways as well. The region's policy-making style is pragmatic and cautious. Cooperation is aimed at making markets work better and is usually limited to specific initiatives and objectives. Intergovernmental dialogue at all levels has greatly increased, but formal regional institutions remain relatively underdeveloped. Yet recognition that the requirements for institutional capabilities are growing is widespread—for example, ASEAN has committed to increasing the capacity of its secretariat along with implementing its new blueprint for establishing an ASEAN Economic Community. In several areas the payoff to regional institutional development is high; this study has identified, in particular, the establishment of both an “Asian Financial Stability Dialogue” and an “Asian Secretariat for Economic Cooperation” as important priorities. These and other institutions that will emerge in the region are likely to be lean, carefully structured to achieve their purpose and limited in authority. In other words, even as the institutional structure deepens, intergovernmental consultation and decision making are likely to remain central features of the Asian regional cooperation.

## The architecture of cooperation

Asia's regional policy agenda is too broad and complex to be handled by a single institution, especially given Asia's vast economies and

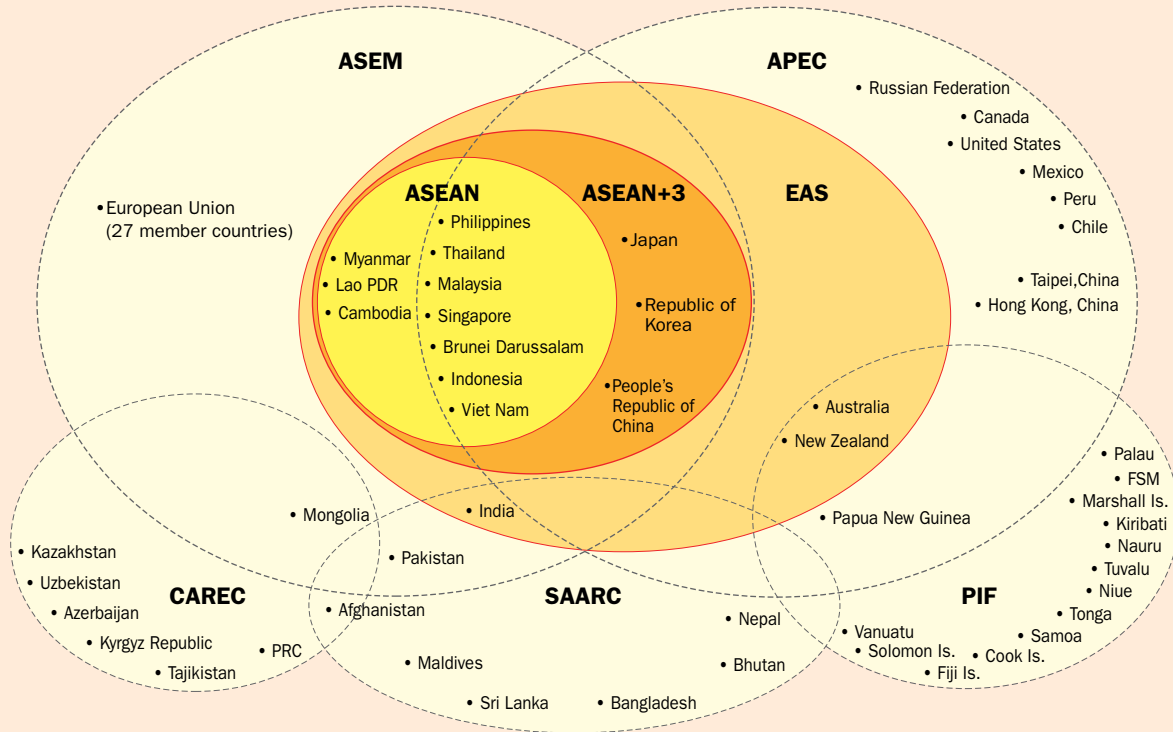
diverse interests. A flexible, multitrack, multispeed architecture will best respond to this challenge. It will emphasize the gradual intensification of cooperation—engagement in limited areas first, followed by the deepening and widening of the scope of cooperation. This will allow any group of economies to join the integration process and share in its benefits, regardless of development level. As partnerships strengthen, they can lead to deeper collaboration or the enlargement of the group. Open, gradual, and flexible regionalism will ensure that Asia’s economic integration remains market-friendly and responsive to the region’s diverse constituents.

Importantly, a flexible framework enables newcomers to regional integration to develop relationships in line with their capabilities. The smaller developing countries that are not yet fully integrated into the region’s economy often have the most to gain from internalizing the lessons of Asian dynamism. Joining regional and global production networks could dramatically raise their productivity, employment, and output levels. This study seeks to foster understanding of the requirements and implications of integration. Newcomers to integration need to adopt vigorously outward-oriented policies; in turn, the regional system needs to remain accessible to integrating economies.

The principal groups of the current framework range widely in scope, from subregional organizations that encompass parts of a few countries to APEC and the Asia-Europe Meeting (ASEM), which span continents (Figure 10). This diversity is consistent with, and necessary for, achieving the region’s multiple policy objectives. Developing infrastructure to connect nearby communities through transport and energy links, for example, requires limited, focused subregional cooperation. At the same time, ensuring that markets in Asia, Europe, North America, and other parts of the world remain open to each other requires dialogue in APEC, ASEM, and of course global institutions. The challenge is to maintain effective and flexible groups while ensuring the coherence of their different policy directions. Some institutional consolidation can be valuable in this process—as this study recommends, for example, in the area of macroeconomic surveillance. Yet overlap and competition among groups is not necessarily bad; it opens multiple options for addressing a problem and stimulates forums to become more effective.

Because the structure of regional cooperation in Asia remains very fluid, proposing firm assignments of institutional functions is premature. Nevertheless, as the detailed arguments of this study

**Figure 10. Economic architecture: regional and transregional forums**



APEC = Asia-Pacific Economic Cooperation; ASEAN+3 = ASEAN plus three countries, as shown; ASEAN = Association of Southeast Asian Nations; ASEM = Asia-Europe Meeting; EAS = East Asia Summit; CAREC = Central Asia Regional Economic Cooperation; FSU = Federated States of Micronesia; Lao PDR = Lao People's Democratic Republic; PIF = Pacific Islands Forum; PRC = People's Republic of China; SAARC = South Asian Association for Regional Cooperation.

**Notes:**

ASEM includes also the European Commission as a member.

For CAREC, the PRC's membership is focused on the Xinjiang Uygur Autonomous Region.

Source: ADB.

suggest, ASEAN+3 frequently emerges as an especially useful coordinating forum. It is organized around ASEAN, which has the most experience with cooperation and operates the most developed regional institutions. It also incorporates the region's three large economies (the PRC, Japan, and the Republic of Korea), and is generally closely integrated. But processes coordinated by ASEAN+3 need not be limited to its membership. For example, functions that require wider participation—such as the Asian Financial Stability Dialogue proposed in this study—could also build on EAS membership.



Although the process of cooperation may begin with an ASEAN+3 structure, it should not end there. It should involve strong complementary relationships with other regional forums whose unique histories and memberships provide expertise for addressing different aspects of cooperation. This argues for maintaining multiple regional arrangements and good connections among them. For example, ASEAN will be an especially effective proving ground for more advanced forms of regional cooperation. It will become an increasingly effective hub as it pursues deeper integration itself, following the recently adopted ASEAN Economic Community Blueprint (Kawai 2007). The Greater Mekong Subregion framework—a subregional group—provides an ideal laboratory for coordinated infrastructure development as well as for targeted new initiatives in areas such as fighting poverty. The EAS may prove to be the most effective forum for addressing climate change and other environmental challenges from Asian perspectives. And given its membership, APEC can be effective in trade facilitation. APEC and ASEM could also have useful roles in policy dialogue on domestic regulatory policies and in ensuring that the region's expanding global role is effectively managed (Table 8).

A flexible, multitrack architecture also responds to the challenges of the region's exceptional political, economic, and cultural diversity. Asia's economics and politics are not always aligned, but they are interdependent. Economic interests shape political positions, much as political will affects economic outcomes. Closer economic cooperation within Asia will provide a stronger framework for managing the economic adjustments ahead, both within the region and with the world. Foremost among these is the rise of the PRC and India, which will affect regional and global markets in far-reaching ways.

As long as the economic benefits of regional integration are substantial, political compromises are possible. A survey for this study confirms that the region's opinion leaders welcome regional engagement and are optimistic that political hurdles can be overcome (Capannelli 2008). Asia's approach emanates from—and neatly accommodates—its diversity. The approach allows countries to retain a great deal of independence and control over their internal affairs, yet fosters a sense of community—in essence, mutual trust and confidence.

## Leadership

Gradual, bottom-up cooperation has economic and political advantages; it also has risks, including possible inconsistencies among initiatives, and slower progress than might be possible with a top-down approach. What forces will generate momentum and pressure for deep and ambitious integration?

At the highest levels of government, the importance of regional cooperation is well accepted—Asian leaders have repeatedly and eloquently confirmed their commitment to work together.<sup>15</sup> But they will need effective mechanisms to translate this intent into pragmatic results. Asia’s regional institutions are not strong enough to take a

**Table 8. Major economic cooperation groups in Asia and the Pacific**

Name, Year established	Membership
Asia Cooperation Dialogue (ACD) 2002	Bahrain, Bangladesh, Brunei Darussalam, Bhutan, Cambodia, People’s Republic of China (PRC), India, Indonesia, Iran, Japan, Kazakhstan, Republic of Korea, Kuwait, Lao People’s Democratic Republic (Lao PDR), Malaysia, Mongolia, Myanmar, Oman, Pakistan, Philippines, Qatar, Russian Federation, Saudi Arabia, Singapore, Sri Lanka, Tajikistan, Thailand, United Arab Emirates, Uzbekistan, and Viet Nam.
Asia Pacific Economic Cooperation (APEC) 1989	Australia; Brunei Darussalam; Canada; Chile; PRC; Hong Kong, China; Indonesia; Japan; Malaysia; Mexico; New Zealand; Papua New Guinea; Peru; Philippines; Republic of Korea; Russian Federation; Singapore; Taipei,China; Thailand; United States; and Viet Nam.
Asia-Europe Meeting (ASEM) 1996	Members of the Association of Southeast Asian Nations (ASEAN), European Union, and European Commission plus PRC, India, Japan, Republic of Korea, Mongolia, and Pakistan.
Association of Southeast Asian Nations (ASEAN) 1967	Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Thailand, Singapore, and Viet Nam.
ASEAN Plus Three (ASEAN+3) 1997	ASEAN members plus PRC, Japan, and Republic of Korea.

<sup>15</sup> The reports of the East Asia Vision Group (2001) and the East Asia Study Group (2002), commissioned by the leaders, offer an excellent summary of potential regional cooperation efforts and provided guidance for this study.

leadership role yet; many operate with very limited resources and often with staff members on short, temporary assignments. In this context, knowledge-generating institutions outside the official sphere play an especially important role. Ideas matter, and the region’s think tanks and universities have the structure and time to focus on long-term issues and to offer objective advice.

In the longer run, civil society will provide the most important source of support. The survey for this study found that a wide range of Asian opinion leaders welcomes international cooperation. All nationalities and groups seem to share this perspective, including business executives; professionals; journalists; experts in universities, laboratories, and research institutes; and political and economic

Area of focus	Major initiatives
<ul style="list-style-type: none"> <li>• Technology</li> <li>• Tourism</li> <li>• Trade and investment</li> <li>• Money and finance</li> <li>• Energy</li> <li>• Health and education</li> <li>• Politics</li> <li>• Agriculture</li> </ul>	<ul style="list-style-type: none"> <li>• Annual ministerial meetings</li> <li>• Projects in 19 areas involving cooperation between various members</li> <li>• Think tank (symposium and network) to support ACD projects</li> </ul>
<ul style="list-style-type: none"> <li>• Business facilitation</li> <li>• Economic and technical cooperation</li> <li>• Trade and investment liberalization</li> </ul>	<ul style="list-style-type: none"> <li>• Bogor goals of “free and open trade and investment”</li> <li>• APEC Business Travel Card</li> <li>• Best practices for regional trade agreements and free trade agreements,</li> <li>• Declaration on Climate Change, Energy Security and Clean Development</li> </ul>
<ul style="list-style-type: none"> <li>• Cultural and intellectual issues</li> <li>• Financial and social reform</li> <li>• Political issues</li> <li>• Trade and investment barriers</li> </ul>	<ul style="list-style-type: none"> <li>• Asia-Europe Cooperation Framework</li> <li>• Asia-Europe Foundation</li> <li>• Trans-Eurasian Information Network</li> </ul>
<ul style="list-style-type: none"> <li>• Economic cooperation</li> <li>• Trade and investment</li> <li>• Regional security</li> <li>• Sociocultural exchange</li> </ul>	<ul style="list-style-type: none"> <li>• Treaty of Amity and Cooperation in Southeast Asia</li> <li>• ASEAN Free Trade Area</li> <li>• ASEAN Economic Community</li> <li>• ASEAN Security Community</li> <li>• ASEAN Social and Cultural Community</li> </ul>
<ul style="list-style-type: none"> <li>• Finance</li> <li>• Macroeconomics</li> </ul>	<ul style="list-style-type: none"> <li>• Economic Review and Policy Dialogue</li> <li>• Chiang Mai Initiative</li> <li>• Asian Bond Markets Initiative</li> <li>• Research Group</li> </ul>

continued

analysts. They welcome an Asian identity, and increasingly interact with regional colleagues in professional, educational, and official networks. Their collaboration and friendships can inform regional strategies and provide foundations for future cooperation.

**Table 8. Major economic cooperation groups in Asia and the Pacific** (continued)

Name, Year established	Membership	
Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC) 1997	Bangladesh, Bhutan, India, Myanmar, Nepal, Sri Lanka, and Thailand.	
Brunei Darussalam-Indonesia-Malaysia-Philippines East ASEAN Growth Area (BIMP-EAGA) 1994	Brunei Darussalam plus provinces of Indonesia, Malaysia, and the Philippines.	
Central Asia Regional Economic Cooperation (CAREC) 1997	Afghanistan, Azerbaijan, PRC provinces, Kazakhstan, Kyrgyz Republic, Mongolia, Tajikistan, and Uzbekistan.	
East Asia Summit (EAS) 2005	ASEAN members, Australia, PRC, India, Japan, Republic of Korea, and New Zealand.	
Greater Mekong Subregion (GMS) 1992	Cambodia, two provinces of PRC, Lao PDR, Myanmar, Thailand, and Viet Nam.	
Indonesia-Malaysia-Thailand Growth Triangle (IMT-GT) 1993	Provinces in Indonesia, Malaysia, and Thailand.	
Pacific Islands Forum (PIF) 1971	Australia, Cook Islands, Federated States of Micronesia, Fiji Islands, Kiribati, Nauru, New Zealand, Niue, Palau, Papua New Guinea, Marshall Islands, Samoa, Solomon Islands, Tonga, Tuvalu, and Vanuatu.	
Shanghai Cooperation Organization (SCO) 2001	PRC, Kazakhstan, Kyrgyz Republic, Russian Federation, Tajikistan, and Uzbekistan.	
South Asian Association for Regional Cooperation (SAARC) 1985	Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka.	

In short, Asian regionalism will need sophisticated official leadership as well as individual champions. It will need the support of many visionary and determined people—including political, business, and civic leaders; academic experts; and intellectuals—people from

Area of focus	Major initiatives
<ul style="list-style-type: none"> <li>• Transport</li> <li>• Tourism</li> <li>• Trade and investment</li> <li>• Energy</li> <li>• Health</li> <li>• Agriculture</li> </ul>	<ul style="list-style-type: none"> <li>• Link South and Southeast Asia</li> <li>• Commitment to liberalize trade by 2012 (3 members)</li> <li>• Plan for free trade pact by 2017</li> </ul>
<ul style="list-style-type: none"> <li>• Agro-industry</li> <li>• Environment</li> <li>• Tourism</li> <li>• Transportation</li> </ul>	<ul style="list-style-type: none"> <li>• Roadmap to Development (2006–2010)</li> <li>• Agreements on air transport, other transport, trade facilitation, and tourism</li> </ul>
<ul style="list-style-type: none"> <li>• Energy</li> <li>• Trade facilitation</li> <li>• Trade policy</li> <li>• Transport</li> </ul>	<ul style="list-style-type: none"> <li>• Comprehensive Action Plan (CAP 2006)</li> <li>• Transport and Trade Facilitation Strategy</li> <li>• CAREC Institute</li> </ul>
<ul style="list-style-type: none"> <li>• Economic community</li> <li>• Energy and environment</li> <li>• Trade and finance</li> </ul>	<ul style="list-style-type: none"> <li>• Declaration on Climate Change, Energy and the Environment</li> <li>• Declaration on East Asian Energy Security</li> </ul>
<ul style="list-style-type: none"> <li>• Agriculture</li> <li>• Environment</li> <li>• Human resource development</li> <li>• Tourism</li> <li>• Trade and investment</li> <li>• Transport, energy, telecommunications</li> </ul>	<ul style="list-style-type: none"> <li>• East-West Economic Corridor</li> <li>• Ten-Year Strategic Framework</li> </ul>
<ul style="list-style-type: none"> <li>• Agriculture and fisheries</li> <li>• Environment</li> <li>• Human resources development</li> <li>• Tourism</li> <li>• Trade and investment</li> <li>• Infrastructure</li> </ul>	<ul style="list-style-type: none"> <li>• IMT-GT Roadmap to promote trade and investments, agriculture, agro-industry, tourism, infrastructure, human resource development, mobility of labor, and natural resource management</li> <li>• Joint tourism promotion</li> </ul>
<ul style="list-style-type: none"> <li>• Energy</li> <li>• Information and communications technology</li> <li>• Transport</li> </ul>	<ul style="list-style-type: none"> <li>• Pacific Agreement on Closer Economic Relations</li> <li>• Pacific Aviation and Safety Office</li> <li>• Pacific Island Countries Trade Agreement</li> </ul>
<ul style="list-style-type: none"> <li>• Political issues</li> <li>• Culture and education</li> <li>• Energy and transport</li> <li>• Environment protection</li> <li>• Science and technology</li> <li>• Trade and economy</li> </ul>	<ul style="list-style-type: none"> <li>• Action plan on implementation of the program for multilateral trade and economic cooperation</li> <li>• Regional Antiterrorist Structure</li> <li>• SCO Business Council and Interbank Consortium</li> </ul>
<ul style="list-style-type: none"> <li>• Agriculture and rural development</li> <li>• Environment and forestry</li> <li>• Health and population</li> <li>• Human resources development</li> <li>• Science, technology, and meteorology</li> <li>• Transport</li> <li>• Women, youth, and children</li> </ul>	<ul style="list-style-type: none"> <li>• SAARC Development Fund</li> <li>• South Asian Free Trade Area</li> </ul>

all walks of life and representing the region's great cultural diversity. The challenge for governments is to embrace this broad coalition, to provide forums where its voice can be heard, and to make sure that its impact is felt.

## A partnership for shared prosperity

It is easier, in some ways, to envision an integrated Asia many decades hence than to describe the detailed goals that could be achieved by 2020. In the longer run, Asia is likely to have a single market subject to common regulations, a common currency, and substantial freedom of movement for workers—in other words, an environment similar to that of the EU today. An integrated Asia will reap enormous benefits from the great diversity of its economies and peoples; its deep cultural heritage; the vast scale of its financial, technical, and other resources; and its joint ability to manage economic, social, environmental, and other threats. It will offer unrivaled opportunities for innovation, entrepreneurship, and commerce. And it will help subdue the political rivalries that could otherwise threaten stability.

Such a vision can provide inspiration and offers guidance on long-term directions. But to inform immediate policy, it must be translated into steps that can—and should—be achieved in the intermediate term. The vision that motivates these steps has to be pragmatic. It must consist of realistic initiatives that show early, step-by-step results. This report has identified important options. By pursuing some of these, by 2020 Asia could have

- an integrated market free of restrictions on regional flows of goods, services, and capital;
- deep and liquid financial markets open to cross-border financial flows and services, with high standards of oversight and strong protection to national and foreign investors;
- effective frameworks to coordinate macroeconomic and exchange rate policies, taking into account global challenges and differing national circumstances;
- collective efforts to address vital social issues, such as poverty, exclusion, income insecurity, migration, ageing, health, and environmental threats;
- a consistent voice to project the concerns of Asian economies in global policy forums and enhance responsible global governance; and

- vital institutions, adequately and highly professionally staffed, to provide first-rate analytical and logistical support for these efforts.

The goals are challenging but achievable. Some should receive earlier attention than others; cooperation to ensure financial stability and the smooth adjustment to global imbalances are especially urgent.

Each step toward regional integration will require innovation, leadership, and support from major economies. Asia is poised to take these steps: its economies are sound and enjoy good relations with each other and other global centers. Appropriately, Asian regionalism is becoming more confident in its potential to contribute to both Asian and global welfare. All of this favors the emergence of a strong, prosperous, outward-looking Asian economic community, regionally integrated yet connected with global markets, and with responsibility and influence to match its economic weight. In short, emerging Asian regionalism is a partnership that can ensure the region's continued, peaceful progress, and help power globally and regionally shared prosperity.

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