REGIONAL INTEGRATION: A BALANCED VIEW

Introduction

The Asian Development Bank's (ADB) *Strategy 2020* has three distinct but complementary development agendas for Asia and the Pacific: (i) inclusive economic growth, (ii) environmentally sustainable growth, and (iii) regional cooperation and integration (RCI). ADB has been supporting RCI initiatives since the late 1980s. Early efforts came in the form of facilitating knowledge sharing. Starting in the mid-1990s, ADB began supporting concrete projects in regional integration in the Greater Mekong Subregion and subsequently in all other subregions—Central Asia, East Asia, South Asia, Southeast Asia, and the Pacific and Oceania. In parallel, ADB also adopted an internal institutional architecture to adequately support RCI efforts in all subregions. It established the Office of Regional Economic Integration (OREI) in 2005 to help coordinate knowledge generation, research, and advisory work on RCI. The achievements made under those initiatives formed the basis for the adoption of *Strategy 2020*, with RCI as one key pillar.

The ongoing eurozone crisis has indeed raised a range of questions about RCI. Concerns over RCI, particularly relating to integration, have begun to be debated in Asia as well. This is healthy. While there are concerns, there are fundamental differences between the Asian and European approaches to regional integration. The Asian RCI model, in comparison with the European model, has been more bottom-up, market-driven and institution-light, with continuous efforts to foster strong cooperation across countries and subregions.

The eurozone crisis should not detract policymakers in the various subregions from cooperating closely. As yet, there is no need for a fundamental shift in the RCI model per se, given the difference in approach. In one sense, a strategic one at that, the eurozone crisis has raised the importance of enhanced Asian regionalism even more. Although these crises did not originate in Asia, its economies were seriously hit by the downturn in export demand from advanced markets (the United States and Europe), and volatility in financial markets. At present Asian economies continue to rely on advanced markets as the destination for their final exports. The advanced economies are likely to experience a lengthy period of slow growth, which will in turn mean there will be reduced demand for Asia's exports. In order to reduce vulnerabilities arising from external shocks, Asian economies will likely rebalance their sources of growth by strengthening domestic and regional demand. Continuous effort will be needed to sustain regional cooperation.

In this context, this special chapter takes a balanced look at various facets of regional integration. Its main premise is that both benefits and costs should be gauged carefully in evaluating proposals for regional integration. The overall aim of RCI, like any development agenda, is to boost prosperity and reduce poverty and inequality. Small and large economies alike should benefit from any regional integration agenda in a sustainable and equitable manner.

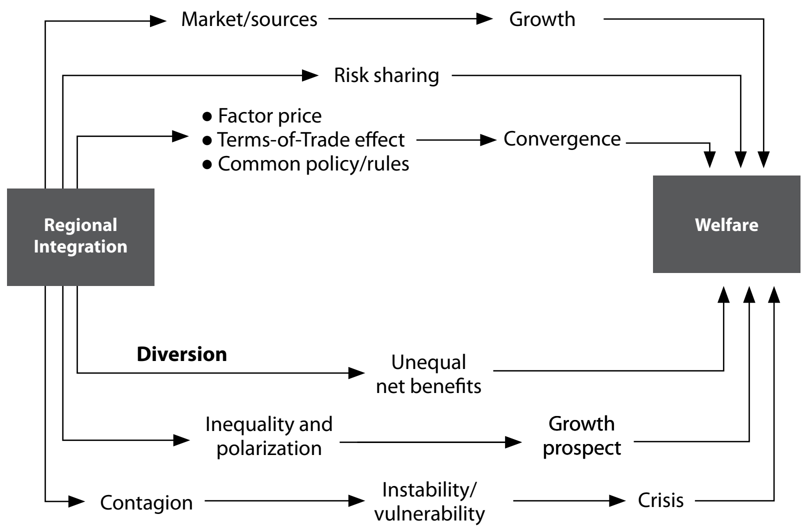
Benefits and Opportunities of Integration

Regional integration expands markets and input sources, better allocating resources across the region and accelerating economic growth.

Regional economic integration is one way countries achieve national interests—only in concert with others. It expands national markets to the region. Like globalization, it can be thought of as an alternative to international embeddedness—or how one relates to the rest of the world. But unlike globalization, regional integration is geographical, and in some cases political. It is stronger institutionally than globalization, as rules tend to be tighter and peer pressure can be more intense.

Expanding markets and input sources beyond national boundaries is one of the most compelling arguments for integration. With an expanded market for goods and services, for both outputs and inputs, higher economic growth and improved welfare can be expected **(Figure 46)**. Integration helps more efficient resource allocation across the region (or globally) in line with the principle of comparative advantage. By enhancing productivity growth, regional integration can accelerate economic growth and increase employment. But integration is not the same for all. Whether in trade, finance, or infrastructure, integration benefits some more than others. And when one measures the effects

Figure 46: Impact of Integration



Source: Office of Regional Economic Integration, ADB.

that go beyond the original purpose of integrating, some countries can even lose.[52] Thus, there could be negative net effect on welfare. So how the benefits of regional integration are distributed matters a great deal.

Regional integration appears to reduce income inequality between countries.

Based on Europe's experience, most studies indicate that regional integration coincides with a substantial decrease in income inequality between countries.[53] While economic factors are important, it is political integration that appears to drive this convergence. It suggests that institutional forces outweigh market forces in bringing national economies closer together.[54] Economic arguments show freer trade and factor mobility from integration allow less-developed members to grow faster than more-developed ones. Factor price equalization further supports the convergence hypothesis.[55] In a two-country resource-rich/resource-poor model, lowering tariffs has a negative effect on real wages in the resource-rich country (most gains accrue to resource rent), while the resource-poor country benefits through terms-of-trade (TOT). This also supports the convergence hypothesis.

An institutionalist economic explanation, however, emphasizes more the formal structure and the role actors play in integration initiatives. It suggests that as economic actors follow common rules in a more integrated system, and markets increase in size and complexity, convergence will likely result. It also stresses the importance of institutions politically established. Thus, to analyze convergence, political relations matter more than regional markets or the process of economic development. Convergence can come from the diffusion of common development policies and the diffusion of common rules and market regulations.

[52] Venables argued that the gains from integration are unevenly distributed (see A. Venables. 2009. Economic Integration in Remote Resource-Rich Regions. *OxCarre Working Papers*. No. 022. Oxford: Oxford Centre for the Analysis of Resource Rich Economies.) He also showed the conditions under which some countries will lose from integration. In particular, the effects of preferential liberalization in regional integration will only benefit resource-poor countries, whereas non-preferential liberalization tends to benefit only resource-rich countries.

[53] See R. Leonardi. 1995. *Convergence, Cohesion, and Integration in the European Union.* New York: St. Martin's Press; H.W. Armstrong. 1995. An Appraisal of the Evidence from Cross-Sectional Analysis of the Regional Growth Process within the European Union. In H.W. Armstrong and R.W. Vickerman, eds. *Convergence and Divergence among European Regions*. London: Pion; and D. Ben-David. 2001. Trade Liberalization and Income Convergence: A Comment. *Journal of International Economics*. 55. pp. 229–234. Some, however, found a pattern of divergence (see M. Slaughter. 2001. Trade Liberalization and Per Capita Income Convergence: A Difference-in-Differences Analysis. *Journal of International Economics*. 55. pp. 203–228; and P. Arestis and E. Paliginis. 1995. Divergence and Peripheral Fordism in the European Union. *Review of Social Economy*. pp. 261–283). Part of the explanation rests on the interpretation of σ- and β-convergence, where σ-convergence is a decrease in GDP dispersion, hence showing how the distribution of income evolves, and β-convergence points to a negative relationship between growth and initial level of GDP (see X. Sala-i-Martin. 1996. Regional Cohesion: Evidence and Theories of Regional Growth and Convergence. *European Economic Review*. 40. pp. 1325–1352).

[54] J. Beckfield. 2009. Remapping Inequality in Europe: The Net Effect of Regional Integration on Total Income Inequality in the European Union. *International Journal of Comparative Sociology*. 50 (5-6). pp. 486–509.

[55] W. Stolper and P. Samuelson. 1941. Protection and Real Wages. *Review of Economic Studies.* 9 (1). pp. 58–73.

In Asia, inequality between countries has been declining (see Figure 36). Whether this convergence is due to regional integration or other more forceful factors—or both—requires more research. Regardless, forces explained by theoretical arguments are likely part of the reason inequality between countries is narrowing.

Risk sharing is another possible benefit of integration; unfortunately, there is little empirical evidence that it happens.

Intuitively, more risk sharing through integration makes sense. But many empirical studies show the degree of risk sharing following integration has been limited. Since the work of Backus, Kehoe, and Kydland,[56] several studies have examined the presence of full risk sharing using cross-country income and consumption correlations. Most of them found that perfect risk sharing does not happen. Asia is no exception. Given an idiosyncratic shock, risk sharing in Asia was not strong, nor did it improve.

What causes this mismatch? Based on numerous studies across many countries, the mismatch could come from several factors, ranging from using domestic equity markets as a major source of finance,[57] time horizon and measurement errors,[58] consumption endowment uncertainty,[59] to the limited size of capital flows and higher sovereign default.[60]

Financial integration in Asia remains limited; but it is increasing, especially after the 2008/09 global financial crisis. The effect of financial integration on economic growth has been well documented—more so than the effect of integration on international risk sharing.[61] Theoretically, the consumption growth rate in integrating countries will be cross-sectionally independent of idiosyncratic variables as financial integration increases.[62] The key factor is greater insurance. If inter-regional or international capital markets are well-integrated, countries can insure against idiosyncratic shocks. Individuals will invest more in high-risk and high-return assets if the risk can be shared or diversified.[63]

Examining the impact of financial integration on macroeconomic volatility (one indicator of risk sharing), Prasad, Rogoff, Wei, and Kose argued that for more financially-integrated developing countries, the consumption volatility relative to the volatility of gross domestic product (GDP) increases.[64] Another study tested seven countries in East Asia for Granger-causality between growth rates in consumption, investment and GDP between countries. Despite evidence of common trends and factors, the patterns of commonality differ between these variables. The results do not rule out the possibility that there is no causality between growth rates of those variables across pairs of countries. Thus, there is little evidence of an East Asian business cycle.

Since the hypothesis of perfect risk sharing is mostly rejected, some have studied the extent of consumption smoothing as a reason for the incompleteness of risk sharing. The results show there is no consumption smoothing in the case of Asia—the coefficients either have a wrong sign or are insignificant. When the period is split into before and after the 1997/98 Asian financial crisis, the results are generally the same—no evidence of consumption smoothing, even when there is a greater synchronization of business cycles among countries (especially after the Asian financial crisis).

All in all, while the level of Asia's financial integration may have increased, its benefits in terms of consumption and investment risk sharing have been limited.

If business cycles are more synchronized, one might expect greater resilience to external shocks. But this does not appear to happen either. Although the concept of integration-driven risk sharing is ideal and conceptually

[56]D. Backus, P. Kehoe, and F. Kydland. 1992. International Real Business Cycles. *Journal of Political Economy.* 100 (4). pp. 745–775.

[57]K.R. French and J.M. Poterba. 1991. Investor Diversification and International Equity Markets. *American Economic Review Papers and Proceedings*. 81. pp. 222–226.

[58]F. Canova and M. Ravn. 1996. International Consumption Risk Sharing. *International Economic Review.* 37 (3).

[59]See M. Obstfeld. 1994. Risk-Taking, Global Diversification, and Growth. *American Economic Review.* 84. pp. 1310–1329; and E. Mendoza. 1995. The Terms of Trade, the Real Exchange Rate and Economic Fluctuations. *International Economic Review.* 36. pp. 101–137.

[60]Y. Bai and J. Zhang. 2012. Financial Integration and International Risk Sharing. *Journal of International Economics.* 86 (1). pp. 17-32.

[61]See, for example, R. Levine. 2001. International Financial Liberalization and Economic Growth. *Review of International Economics.* 9 (4). pp. 668–702.

[62]J. Cochrane. 1991. A Simple Test of Consumption Insurance. *Journal of Political Economy*. 99 (5). pp. 957–976.

[63]M. Obstfeld. 1994. Risk-Taking, Global Diversification, and Growth. *American Economic Review.* 84. pp. 1310–1329.

[64]E. Prasad, K. Rogoff, S. Wei, and M. Kose. 2003. Financial Globalization on Developing Countries: Some Empirical Evidence. *IMF Working Paper*. Washington DC.

sound,[65] the impact of regional integration must be predicated not on an ideal world, but on the world as it is **(Box 3)**.

Costs and Risks of Integration

People talk more frequently about the benefits of integration, especially when new regional cooperation initiatives are launched to strengthen integration—for example, initiatives to share risk, joint commitments on domestic reform, positive spillover effects, liberalizing markets, and division of labor.[66] Much less is heard about the risks of integration.

The cascading effect of the ongoing eurozone crisis is a vivid reminder of the contagion risk of highly integrated systems.

The main argument against excessive integration is that it exacerbates contagion in times of crisis. Examples abound of financial crises rapidly spreading from one country to another, especially when integration is deeper due to either geographical proximity or a regional arrangement.

While a shock may originate in the financial sector of one country, it can rapidly infect others across a region—affecting entire economies and damaging people's welfare. For Asia, the damage caused by the 1997/98 Asian financial crisis is a powerful reminder of the danger of contagion. An idiosyncratic shock occurring elsewhere can leap across boundaries, devastating another's economy. And yet the scale of integration in Asia at the time was more limited than now, despite some policy convergence. One can only imagine how bad the crisis would have been had intra-Asian cross-border financial holdings been larger than they were.

[65]Under certain circumstances, full integration leading to risk sharing can be less desirable than generally thought. While the more integrated the regional economy the better risks can be dispersed, risk sharing can lower expected utility. In particular, this is true when technologies are not convex (see J. Stiglitz. 2010. Risk and Global Economic Architecture: Why Full Financial Integration May Be Undesirable. *NBER Working Paper*. No. 15718. Massachusetts: NBER. Following this dictum, and given the fact that things like information, externalities, learning processes, and bankruptcy give rise to a natural set of non-convexities, the intuition that integration should be always desirable is wrong.

[66]In some cases, cooperation and integration are promoted for political reasons and to build trust. Even if that is the case, the political windfall that follows can also lead to significant economic benefits.

Box 3: Measuring Welfare Gains

With evidence showing limited risk sharing, alternative measures of welfare gains have been developed. One uses the permanent percentage increase in expected consumption by using information about the mismatch factors mentioned earlier, degree of risk aversion, and the elasticity of substitution between traded and non-traded goods.[1] Assuming that preferences are additively separable in tradables and non-tradables, and risk sharing with respect to non-tradables is not possible, the welfare gains from risk sharing can be measured by considering the following expected utility:

$$U = \mathrm{E}\int_0^h e^{-\alpha . t}\frac{(c_{it}^T)^{1-\delta}}{1-\delta}dt$$

where δ is the rate of risk-aversion, c_{it}^T is the consumption of tradables by residents of country *i* at time *t*, and *h* is the time horizon. Since risk sharing with respect to the non-tradables is not possible, the utility from non-tradables is not included. Assuming consumption endowment of tradables, y_{it} follows a random walk, if there is no risk sharing $c_{it}^T = y_{it}^T$, the expected utility would be

$$U = \frac{(y_{i0}^T)^{1-\delta}}{1-\delta}\cdot\frac{1-e^{-[(\alpha+(\delta-1)(\rho-0.5\delta\sigma_T^2)]T}}{\alpha+(\delta-1)(\rho-0.5\delta\sigma_T^2)}$$

With risk sharing, each country's tradables consumption is equal to y_t^{TR} which is the per-capita endowment in region *R*; hence $c_{it}^T = y_t^{TR} = \sum_j^J y_{jt}^T / J$, where subscript *j* denotes country. With this specification, the welfare gain that reflects the permanent percentage increase in the expected level of tradables consumption yielding an equivalent improvement in welfare is:

$$-[1-h(r-\bar{\rho})\frac{e^{-(r-\bar{\rho})h}}{1-e^{-(r-\bar{\rho})h}}]\frac{0.5\delta d\sigma_T^2}{r-\bar{\rho}}$$

where $\bar{\rho}$ is the risk-adjusted growth rate of consumption, which is equal to (r – 0.5 $\delta\sigma_T^2$), *r* is the risk-free adjusted interest rate, hence (r-$\bar{\rho}$) is the discount rate. σ_T^2 is the variance of consumption growth. Applied to some Asian countries, the welfare gain using this measure turns out to be also limited. The gain will be greater only when the time horizon is longer and when some variables change over time (endogenous).

[1]E. van Wincoop. 1999. How Big Are Potential Welfare Gains From International Risk Sharing? *Journal of International Economics*. 47. pp. 109–135.

In a currency union, the risks of integration cannot be overemphasized. Many studies prior to the formation of the euro emphasized the benefits and opportunities of having a single currency. This could be true for Asia as well. But when the costs and risks are taken into account—some of which are intangible—a single currency remains a long-term prospect. Even after running some sensitivity tests, the result is the same.[67] Clearly, neglecting the risks and costs of having a single currency to promote regional integration could be counterproductive.

Trade diversion is another potential risk from regional integration that can damage people's welfare.

Trade diversion—as opposed to trade creation—is another classic risk of integration debated among academics and policymakers alike.[68] In Asia, the South Asian Free Trade Area (SAFTA) is a notable example. Given relatively high levels of protection in the region, many predicted that the risk of trade diversion is rather high.[69] This could be minimized, however, when regional integration is pursued along with unilateral and multilateral liberalization. The trade-off between trade creation and trade diversion is often used to back North-South—rather than South-South—free trade agreements, as South-South arrangements are prone to trade diversion (sectors that develop have comparative advantage relative to partner countries, not globally). When geographical agglomeration effects are also at work, regional integration produces unequal net benefits; development takes place in a few rather than in all.

If not well managed, integration can increase inequality within countries.

In a report by the Commission on the Measurement of Economic Performance and Social Progress, Nobel laureates Joseph Stiglitz and Amartya Sen, along with Jean-Paul Fitoussi viewed inequalities as the first cross-cutting challenge for quality-of-life indicators. They argued that inequalities should be assessed comprehensively by examining differences in quality of life—across people, groups and generations.[70]

Unlike the relation between regional integration and income inequality between member countries, the relation between regional integration and income inequality within countries is based on the idea that market competition and the labor/capital balance of power is a key determinant of income inequality. Unfortunately, empirical studies on this are scant, most of them done in relation to European integration. They argue that economic integration tends to create a larger labor market and increase wage competition between workers.[71] With workers exposed to competition beyond national boundaries, their bargaining power weakens—either through unions losing influence or by other means. In this case, further integration is expected to increase inequality internally.[72]

So what is the difference between the impact of globalization and that of regional integration, as both give rise to increased market competition? Labor markets expand more readily and labor is more competitive within regions than between regions. Consequently, firms can more easily exercise control over subsidiaries within than between regions. Also, political institutions are more similar within than between regions. So one can hypothesize that regional integration is likely to exert a larger effect on labor unions, and thus have a more pronounced effect on income inequality.

When integration leads to lower inequality, the welfare system plays a major role.

In some cases more developed institutions (like in Western Europe) can insulate workers from the pressures of international competition.[73] Strong welfare states with generous unemployment benefits and training programs can help stabilize the national economy against the vicissitudes of international markets, such that worsening inequality can be averted when regional integration increases.

[67] I. Azis. 2009. Regional Financial Arrangement. In I. Azis. *Crisis, Complexity and Conflict*. London: Emerald.

[68] A customs union is a form of regional integration that is likely to cause the largest trade diversion where the effect is distributed unequally.

[69] T. Baysan, A. Panagariya, and N. Pitigala. 2006. Preferential Trading in South Asia. *World Bank Policy Research Working Papers*. No. 3813. Washington, DC: World Bank.

[70] J. Stiglitz, A. Sen, and J-P. Fitoussi. 2010. *Mis-Measuring Our Lives: Why GDP Doesn't Add Up/The Report by the Commission on the Measurement of Economic Performance and Social Progress*. New York: The New Press.

[71] B. Western. 1997. *Between Class and Market: Postwar Unionization in Capitalist Democracies.* Princeton, NJ: Princeton University Press.

[72] A. Alderson and F. Nielsen. 2002. Globalization and the Great U-Turn: Income Inequality Trends in 16 OECD Countries. *American Journal of Sociology.* 107. pp. 1244–99.

[73] D. Cameron. 1978. The Expansion of the Public Economy: A Comparative Analysis. *American Political Science Review.* 72. pp. 1243–61; and P. Katzenstein. 1985. *Small States in World Markets*. Ithaca, NY: Cornell University Press.

Again, most empirical evidence on this is based on Europe's integration experience. The welfare state shapes stratification directly through income transfers—and it can reduce inequality and poverty.[74] But European integration is also associated with retrenchment of Western European welfare states through spending limits imposed by the "convergence criteria" of the 1992 Maastricht treaty.[75] A more limited national autonomy due to regional integration also contributes to the shrinking of the welfare state, one consequence being worsening income inequality.

Inequality within most Asian countries has been worsening.[76] This occurred even with economic integration rising, though still limited. The simultaneous occurrence of two events does not imply causality, however. With limited integration, it is hard to draw any accurate conclusion on the link between regional integration and rising inequality within Asian countries. Current efforts—in ASEAN+3 in particular—to intensify regional cooperation to remove barriers to trade and finance, and to further market deregulation ("negative integration") may produce forces that can surpass those caused by regulations to correct market failures ("positive integration"). This happened in Europe.[77] There is no reason it cannot happen in Asia as well. When it does, domestic inequality and polarization may worsen.

Unlike in the past, it is now widely acknowledged that income and wealth inequality has a clear negative impact on future growth. Inequality is often associated with the insecurity of property rights, which will lower investment. This is a common knowledge. But the uncertainty created by the diffusion of political and social instability—caused by inequality—also tends to raise rent-seeking and dampens investment; all of which challenge the standard argument for Kuznets' U-hypothesis. Thus, if regional integration leads to greater inequality within a country, growth and the prospect of improved welfare will be affected adversely.

[74]See footnote 72 and D. Brady. 2003. The Politics of Poverty: Left Political Institutions, the Welfare State and Poverty. *Social Forces*. 82.

[75]W. Korpi. 2003. Welfare-State Regress in Western Europe: Politics, Institutions, Globalization, and Europeanization. *Annual Review of Sociology.* 29. pp. 589–609.

[76]ADB. 2012. *Asian Development Bank Outlook 2012: Confronting Rising Inequality in Asia.* Manila.

[77]The convergence effect of regionalization on between-country income inequality in Europe outweighs the polarizing effect of regionalization on within-country inequality, such that the net total income inequality has declined. In other words, regional integration has a positive net effect on reducing total income inequality. See F. Scharpf. 1997. Economic Integration, Democracy, and the Welfare State. *Journal of European Public Policy.* 4. pp.18–36.

Welfare as the Ultimate Goal

Like any policy and strategy, the goal of integration must be an improvement in welfare and quality-of-life—especially for the largest segment of society.

Indeed, welfare measures must go beyond just consumption-based utility, as in the van Wincoop formula (see Box 3). Take the case of trade integration. To evaluate whether or not a regional trade agreement will help, the volume and composition of trade are standard indicators measured. This, however, is just part of the story. How much those indicators change will either improve or weaken several socio-economic indicators as well. While these may not be on the trade arrangement agenda, they need to be taken into account from the overall development perspective. Ignoring them could make the policy and strategy unsustainable. Worse, it could lead to misguided policy.

The policy response to a crisis caused by an integration-driven contagion can damage welfare, especially when governments are belt-tightening.

As integration makes contagion easier to occur, it raises the probability of a crisis, the policy response to which is often belt-tightening. While some argue that this is needed to restore confidence in a crisis, they neglect to count the irreversible impact from wage cuts, tax increases, benefit reductions, and reduced subsidies that largely affect the most vulnerable in low-income nations. There is an estimated one billion undernourished people worldwide, 60% of whom are women. And close to 180 million children under five have stunted growth as a result of lack of food—exacerbated by rising prices of basic commodities resulting from fiscal restraints.

According to one Organisation for Economic Co-operation and Development (OECD) report, some 20 million jobs in both developed and developing countries disappeared since the 2008/09 global financial crisis and 21 million jobs must be generated in G20 countries just to match the pre-crisis employment rate.[78] The report also says this is impossible in the near term. If anything, there is a risk the unemployment rate could increase.

[78]OECD and International Labour Organization (ILO). 2012. Joint statement by ILO Director-General Juan Somavia and OECD Secretary-General Angel Gurría on the occasion of the G20 Labour and Employment Ministers' Meeting. Guadalajara, Mexico. 17 May.

The United Nations Children's Fund (UNICEF) reports that, between 2010 and 2012, one-fourth of developing nations were excessively belt-tightening, with spending below 2007 levels.[79] The study noted that "[i]n the wake of the food, fuel and financial shocks, a fourth wave of the global economic crisis began to sweep across developing countries in 2010: fiscal austerity." Indeed, even with fiscal stimulus to mitigate the impact of the global financial crisis, belt-tightening became widespread beginning in 2010. Based on information from 128 countries, the study found governments basically relied on five ways to save cash—(i) cutting or capping wages (56 countries); (ii) phasing out or removing subsidies, mainly for fuel but also electricity and food (56 countries); (iii) rationalizing or means-testing social programs (34 countries); (iv) reforming pensions (28 countries); and (v) raising consumption taxes on basic goods (53 countries). In Asia, even without the crisis and austerity measures, several critical Millennium Development Goals (MDGs) will not meet their 2015 targets—such as maternal mortality rates, number of underweight children, and access to improved sanitation.

Thus, while it is bad enough to have a crippled financial sector in a crisis, nothing is more serious than the true crisis costs to welfare when speaking about the risk of integration.

The environmental impact of a contagion-driven crisis poses another serious welfare risk.

While a crisis can reduce pollution and resource consumption through reduced economic activity, the bad effects on the environment are more obvious. A weakened economy tends to reduce environmental priorities. Working toward a quick recovery, promotion of environmentally-damaging enterprises could harm those living nearby and worsen the national environment. It is easy to let the environment take a back seat to recovery. Some pro-environment policies are also likely shelved as cost and regulatory oversight tends to weaken during a crisis.

The list is almost endless, but the bottom line is that, when regional integration raises the probability of contagion, the resulting crisis goes well beyond trade, finance and macroeconomics; it hits the heart of what the central focus of all policies and strategies—including regional integration—is about: improving welfare.

Integration and Unilateral Policies

While collective regional policies have their merit, unilateral policies can benefit both individual countries and the region.

Another important assessment is whether countries are better off with regional integration as collective regional policies are superior to unilateral national policies. While that may be true, it does not mean that unilateral policies will not have any benefit for the region. The East Asia Miracle of the 1980s and early 1990s is testament to the value of unilateral liberalization. To say that without integration something bad will happen is erroneous. To argue that only by joining a regional integration initiative or agreeing on some regional agenda will the entire region benefit is farfetched. Even without the risks of integration discussed earlier, this is the wrong way to think. Countries commit to a regional agenda because it is to their advantage, provides new opportunities, and allows them to allocate their own resources more efficiently. If they fail to see this and decide not to participate, there is no disastrous result. This is very different than a global commons like climate change.

If unilateral policies improve a country's economic performance, it is not difficult to imagine there will be some positive spillover effects on the regional economy. In trade and financial integration, for example, if countries adopt policies that are good for themselves even without signing up for a regional initiative, their economic growth could become more robust and stable, which by itself also helps the region.

It is important to use national policies to maintain the integrity of domestic institutions.

Even in today's more globalized world, nation states remain dominant, and democratic deliberation remains largely organized around it. Each country has the right to protect its own regulatory arrangements and institutions. In view of regional integration, it is important to provide national or domestic policy space

[79] I. Ortiz, J. Chai, and M. Cummins. 2011. Austerity Measures Threaten Children and Poor Households: Recent Evidence in Public Expenditures from 128 Developing Countries. *Social and Economic Policy Working Paper.* UNICEF.

to maintain the integrity of domestic institutions.[80] Filled in with the right measures, policy space can positively contribute to the regional economy. The key principle is to be clear and transparent that the unilateral policy and national deliberation are based on facts and evidence for improving welfare. The cooperation agenda for regional integration can then focus on the rules and monitoring that will ensure more effective implementation while minimizing negative spillover (as a safeguard). This approach may also improve the quality of national deliberation, making it more effective in reaching its goal of welfare improvement.

Cross-border holdings of financial assets is a case in point. Cross-border capital flows within Asia—especially in its bond markets—remain relatively small (see Figure 29). But individual markets have grown significantly, providing the necessary investment alternatives and ways to raise long-term funds. More importantly, this can avoid potential maturity mismatches. And because the growing market is in local currency, it will also avoid currency mismatches—the "double mismatch" problem played a central role in creating the 1997/98 Asian financial crisis. And that came largely from domestic national policies. While a strong fixed income market in individual economies is welfare-improving, it also helps regional bond markets and the regional economy.

Associating regional integration with regional/global commons is a less-explored frontier, but critical if one is to be more realistic about the concept of regional integration, development and governance, and to focus more on welfare improvement.

Conclusion

Globalization and regionalization are facts of life. Goods and services are traded and increasingly produced globally; labor and capital are becoming more mobile, both globally and regionally. It is clear that regional integration is progressing in Asia (see *Progress in Regional Cooperation and Integration*, page 11). So there is a great need to better and carefully manage the market process of integration to reap its benefits while minimizing potential costs. In many cases, Asia needs to cooperate more and better—in trade, finance, macroeconomic policy, infrastructure (including energy), and on the environment. In some of these areas, greater cooperation does not necessarily lead to greater integration. Cooperation in providing financial safety nets is a clear example; it can mitigate the risks of contagion-driven crises. Unlike home-grown crises, contagion-driven crises are more likely to happen with greater regional integration.

With the current uncertainty over the global economy, any country is vulnerable to a contagion-driven crisis through financial channels, even if the crisis occurs elsewhere. While domestic macroeconomic policy can help mitigate the impact, sufficient foreign exchange reserves are usually the first line of defense to financial contagion. Yet a domestic safety net alone may be inadequate, even for a resilient Asia. If contagion effects are severe, markets may react indiscriminately. To the extent an interconnected financial system raises the probability of spillover effects—and that the global nature of most crises calls for a coordinated policy response—a regional safety net can complement the domestic and global financial reforms needed to respond to systemic shocks. An effective financial safety net is thus necessary. It is no exception for Asia. The Chiang Mai Initiative Multilateralisation (CMIM) is a notable example of a regional financial safety net for ASEAN+3 (see *Regional Financial Safety Nets*, page 49).

The urgency of preparing regional safety nets is indisputable—as the next crisis could alas be rooted in new vulnerabilities and transmitted through different channels. Some can or cannot be detected (contagion channels do not mirror past events). Even in an economy with relatively robust macroeconomic and financial systems, domestic safety nets alone may be inadequate to handle new vulnerabilities. Closer cooperation for an effective regional safety net is needed, as a collective regional initiative can often collide with flagging domestic political will. A fully-functioning regional financial safety net—supported by an effective surveillance system—can help member countries minimize the risk of contagion.[81]

Countries in Asia have made impressive progress in regional economic integration and cooperation. The Asian Development Bank has helped and continues to help facilitate this process. The region's diversity, development pattern and global links have generated a unique Asian model of regionalism—dynamic,

[80] D. Rodrik proposed a similar principle applied to the concept of globalization. See D. Rodrik. 2011. The Globalization Paradox. *Making It*. 24 August. See also I. Azis. 2011. Assessing Asian Economic Integration With Cautionary Notes. *Journal of Northeast Asia Development*. 13. pp. 17-42.

[81] M. Kawai, P. J. Morgan, and S. Takagi, eds. 2012. *Monetary and Currency Policy Management in Asia.* London: Edward Elgar. See also I. Azis. 2012. Asian Regional Financial Safety Nets? Don't Hold Your Breath. *Public Policy Review.* 8 (3).

open, multi-track, and multi-speed—which enhances prosperity not only in the region but also in the rest of the world. Asia's open regionalism underscores the importance of strengthening trade, investment, and capital flows within the region while maintaining strong ties with and remaining open to the rest of the world. It aims to build a regionally integrated and globally connected Asia.