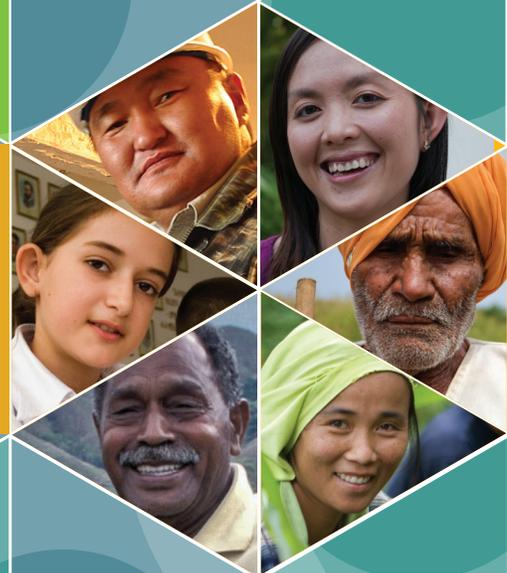


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Asian Economic Integration Monitor

OCTOBER 2013



Asian Development Bank



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Abbreviations and Acronyms

ACIA	ASEAN Comprehensive Investment Agreement	HP filter	Hodrick-Prescott filter
ADB	Asian Development Bank	IAI	Initiative for ASEAN Integration
AEC	ASEAN Economic Community	IHR	International Health Regulations
AEIM	Asian Economic Integration Monitor	IMT-GT	Indonesia–Malaysia–Thailand Growth Triangle
AFAS	ASEAN Framework Agreement on Services	IPR	intellectual property rights
AFTA	ASEAN Free Trade Agreement	ISEAS	Institute of Southeast Asian Studies
AI	avian influenza	Lao PDR	Lao People's Democratic Republic
APTA	ASEAN Preferential Trading Agreement	LDCs	least developed countries
ARIC	Asia Regional Integration Center	LHS	left-hand scale
ASEAN	Association of Southeast Asian Nations (Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Viet Nam)	MFN	most favored nation
ASEAN+3	ASEAN plus the People's Republic of China, Japan, and the Republic of Korea	MRAs	Mutual Recognition Agreements
ASEAN-4	Indonesia, Malaysia, the Philippines, and Thailand	NAFTA	North American Free Trade Agreement
ASEAN-5	Indonesia, Malaysia, the Philippines, Thailand, and Viet Nam	NBER	National Bureau of Economic Research
ASW	ASEAN single window	NIEs	Newly industrialized economies (Hong Kong, China; the Republic of Korea; Singapore; and Taipei, China)
ATIGA	ASEAN Trade in Goods Agreement	NSWs	national single windows
BIMP-EAGA	Brunei Darussalam–Indonesia–Malaysia–Philippines East ASEAN Growth Area	NTBs/NTMs	non-tariff barriers/non-tariff measures
CARI	CIMB ASEAN Research Institute	OECD	Organisation for Economic Co-operation and Development
CAREC	Central Asia Regional Economic Cooperation	PPP	purchasing power parity
CEPT	common effective preferential tariff	PRC	People's Republic of China
CLM	Cambodia, the Lao People's Democratic Republic, Myanmar	QE	Quantitative Easing
CLMV	Cambodia, the Lao People's Democratic Republic, Myanmar, Viet Nam	q-o-q	quarter-on-quarter
DSU	dispute settlement understanding	RCEP	Regional Comprehensive Economic Partnership
EA-9	Emerging Asia-9 (ASEAN-4, NIEs, India)	RCI	regional cooperation and integration
EDSM	Enhanced Dispute Settlement Mechanism	RHS	right-hand scale
ERIA	Economic Research Institute for ASEAN and East Asia	RIETI	Research Institute of Economy, Trade, and Industry
EU	European Union	RTA	Regional Trade Agreement
FDI	foreign direct investment	saar	seasonally adjusted annualized rate
FTA	free trade agreement	SARS	Severe Acute Respiratory Syndrome
FY	fiscal year	SASEC	South Asia Subregional Economic Cooperation
GATS	General Agreement on Trade in Services	SDT	special and differential treatment
GATT	General Agreement on Tariffs and Trade	TA	trade assistance
GDP	gross domestic product	TPP	Trans-Pacific Partnership
GFC	global financial crisis	UNCTAD	United Nations Conference on Trade and Development
GMS	Greater Mekong Subregion	UNESCAP	United Nations Economic and Social Commission for Asia and the Pacific
G3	eurozone, Japan, and the United States	US	United States
G7	Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States	US Fed	US Federal Reserve
G20	Group of Twenty (Argentina, Australia, Brazil, Canada, the People's Republic of China, France, Germany, India, Indonesia, Italy, Japan, the Republic of Korea, Mexico, Russian Federation, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States, and the European Union)	WTO	World Trade Organization
		y-o-y	year-on-year

HIGHLIGHTS

Regional Economic Update

- The gradual, plodding economic recovery in the G3 has begun to strengthen.
- Despite the slightly more positive external environment, developing Asia's growth will likely slow slightly this year before picking up next year.
- The economic outlook for developing Asia is subject to three major risks: (i) increased volatility in global and regional financial markets—in particular due to uncertainties over monetary and fiscal policies in advanced economies; (ii) a more pronounced slowdown in major regional economies than expected—such as the PRC, India, or Indonesia—which will affect other economies within the region; and (iii) a disruption in the G3 recovery.
- Short-term responses are needed to bolster the foundations of financial stability and avoid deterioration in market confidence; and the recent financial turmoil is a timely reminder of the need for continued structural reform.

Regional Cooperation and Integration

- Five years after the global financial crisis, the world economy remains in transition; policy responses in advanced economies have been unpredictable, adding to market uncertainty, fueling volatility, and threatening economic stability.
- Market uncertainty increases vulnerability to shocks, particularly in emerging economies; thus, strengthening regional dialogue, cooperation, and integration is critical to sustain growth.
- While there is mixed progress in regional cooperation and integration in Asia—uneven across subregions—most subregions show growing intra-Asian links in trade, finance, and tourism.
- Although national measures continue to protect domestic markets from external competition, regional dialogue and cooperation is increasingly important to craft regional solutions to the key challenges facing the region.

- Compared with other regions, services trade in Asia is strong relative to trade in goods—in intraregional trade share and trade intensity.
- Recent capital flow volatility in response to US monetary policy announcements underscores emerging Asia's high degree of interdependence with the world economy—a lingering effect of the 2008/09 global financial crisis on Asia's financial integration.
- Growing human and animal mobility across a more integrated Asia has made the prevention of disease transmission an increasingly important regional public good.
- More correlated business cycles between the PRC and the rest of emerging Asia indicate rising macroeconomic interdependence; nonetheless, co-movements with Japan remain strong and the region appears more “coupled” today with the US economy than before 2003.
- Migrant workers continue to make substantial contributions to Asian economies, even if growth in remittances has generally slowed this year; the expanding movement of workers across borders makes the need for regional talks on labor mobility more urgent.

Theme Chapter I: Toward an ASEAN Economic Community—and Beyond

- ASEAN seeks to create an ASEAN Economic Community (AEC) by 31 December 2015; although it is unlikely to meet all of its targets by the deadline, it nonetheless has come a long way in the process of establishing an AEC.
- Overall, the AEC Scorecard shows that, since 2008, ASEAN has made slow but steady progress (68% by 2011) in reaching AEC targets.
- Even if reform proceeds apace, the real test for the AEC will lie in the years beyond 2015—in trade facilitation, liberalization of services, investment, labor mobility and competition policy, among others, and how all of these are implemented.

Theme Chapter II: World Trade Facilitation Negotiations—Asian Perspectives

- Trade facilitation is important to ensure equal access to the potential benefits of trade and regional integration—the WTO's December Ministerial Conference in Bali will try to approve a multilateral trade facilitation framework.
- The open framework would bring efficiency gains for non-members' future negotiations and augment resources through special and differential treatment for more challenged states.
- Over the long run, preferential regional trade facilitation measures—as with FTAs in general—should be multilateralized on a de facto basis to reduce the administrative burden.

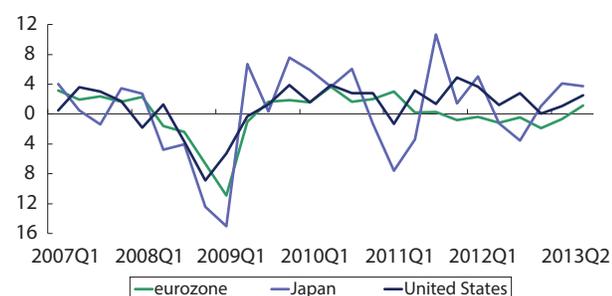
REGIONAL ECONOMIC UPDATE

External Economic Environment

The gradual, plodding economic recovery in the G3 has begun to strengthen.

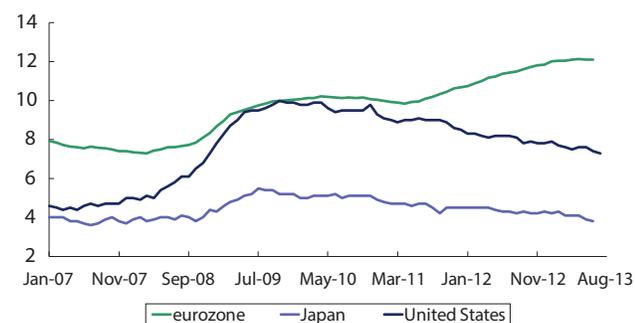
Growth in the real economies of the G3—the eurozone, Japan, and United States (US)—has shown signs of strengthening so far this year (**Figure 1**). Unemployment rates for the US and Japan continue to decline, and has stopped rising in the eurozone (**Figure 2**). In the US, the recovery has led to a discussion on the timing of when to begin the tapering of quantitative easing (QE), with global and regional financial markets fluctuating in response (**Figure 3**). However, with G3 imports from Asia still weak, the solidifying of the G3 recovery may not immediately translate into greater growth prospects for Asia's emerging economies (**Figure 4**).

Figure 1: GDP Growth—G3 (saar, q-o-q, %)



q-o-q = quarter-on-quarter; saar = seasonally adjusted annualized rate.
Source: ADB calculations using data from CEIC and national sources.

Figure 2: Unemployment Rate—G3 (seasonally adjusted, % of labor force)



Note: Data for eurozone and Japan until Jul 2013.
Source: US Bureau of Labor Statistics, European Central Bank, and CEIC.

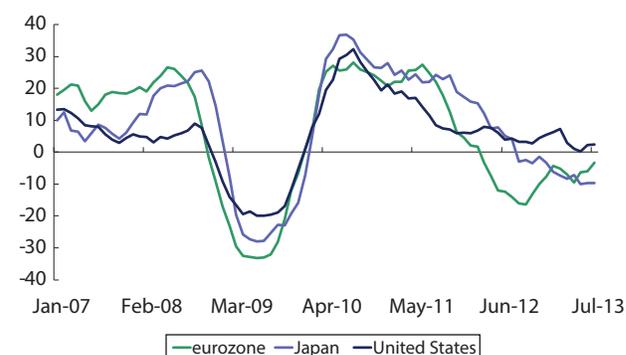
The US economy will continue its modest recovery through the rest of 2013 and in 2014. GDP growth improved to 2.5% (seasonally adjusted annualized rate [saar]) in the second quarter, up from 1.1% in the first quarter, with higher contributions from both private consumption and investment. The unemployment rate and industrial production also improved steadily so far this year. However, the recovery has not yet fully taken hold. While consumer confidence is high, retail and whole sales growth slowed month-on-month during the third quarter. Sales of existing homes continue to rise, but permits for housing starts and new house sales are slowing. In addition, the 16-day partial US government shutdown likely hurt the economy, and to some extent damaged confidence in US Treasuries.

Figure 3: Composite Stock Price Indexes—Asia subregions, PRC, India, and United States (2 Jan 2012 = 100)



PRC= People's Republic of China.
Note: For subregions, index refers to the main stock price index for each economy weighted by market capitalization in US dollars. East Asia includes Hong Kong, China; the Republic of Korea; and Taipei, China. Southeast Asia includes Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam. For the PRC, index refers to the combined Shanghai and Shenzhen composites weighted by market capitalization; India refers to the Bombay Stock Exchange 100; and for the United States the Dow Jones Industrial Average. Data as of 14 October 2013.
Source: ADB calculations using data from Bloomberg.

Figure 4: Growth of Imports from Asia—G3 (y-o-y, %)



Note: Based on 3-month moving average of commodity imports.
Source: ADB calculations using data from CEIC.

The fiscal impasse, though postponed from a mid-October to a mid-December deadline, may continue to threaten the modest recovery. The US economy is forecast to grow 1.7% in 2013 and pick up to 2.4% in 2014.

Japan's new troika of economic "arrows" or Abenomics, has given the economy a boost. But the recovery's sustainability depends much on the so-called "third arrow" of deep structural reforms. Supported by monetary and fiscal stimulus, Japan's growth jumped from 1.1% (saar) in the fourth quarter of 2012 to 4.1% and 3.8% in the first and second quarters of 2013, respectively. Second quarter growth was broad-based, with contributions from private and government consumption, investment, and net exports. The stubborn deflation of recent decades started to turn the corner in April with some inflation taking hold. Thus far, Abenomics has been largely successful. Yet, the positive momentum has been largely due to the Bank of Japan's radical quantitative easing, which led to significant currency depreciation and increased confidence. This has allowed the government to push through with the planned increase in the consumption tax in April 2014. Inflation has been driven mainly by a rise in fuel and food prices, which is related to yen depreciation. Critically, the sustainability of these policy effects depends on the success of the deep-seated structural reforms needed to boost productivity and potential growth. Japan is expected to grow 1.9% in 2013, moderating to 1.4% in 2014.

The eurozone may be exiting the recession, with growth returning in 2014. GDP returned to growth in the second quarter of 2013 (1.1%, saar) for the first time since the third quarter of 2011. While growth appears to be broad-based—supported by a recovery in consumption, fixed capital investment, and net exports—it is rebounding from last year's low base. With unemployment no longer rising, consumption could recover further. Yet, industrial production plunged in July and building permits and housing prices continue to decline. The hope now is that second half growth will mark the turning point for the eurozone economy. To address both fiscal vulnerabilities and record unemployment, the recovery would need to reach key economies still in recession. Eurozone GDP is expected to contract 0.5% in 2013, but grow 1.2% in 2014.

Regional Economic Outlook

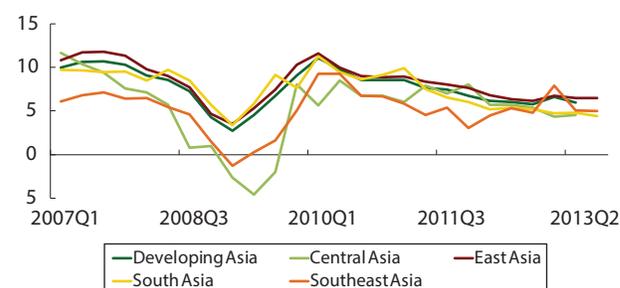
Despite the slightly more positive external environment, developing Asia's growth will likely slow slightly this year before picking up next year.

Developing Asia is forecast to grow 6.0% in 2013, slightly below the 6.1% growth in 2012, recovering to 6.2% in 2014 (**Table 1, Figure 5**). This largely reflects the slowdown in the People's Republic of China (PRC), India, and Southeast Asia—all for different reasons. The PRC is using slower growth to adjust its economic structure and ensure its medium-to-long term growth is sustainable. India may continue to suffer from the slow pace of the structural reforms needed to return the economy to the higher growth of the mid-2000s. Slower growth in Southeast Asia can be attributed to moderation from the above-potential growth in 2012. Central Asia and the Pacific are also expected to see growth slow, with the moderation this year and next hopefully helping sustain growth in the long term.

PRC growth may continue to moderate, reflecting weak external demand and government efforts to sustain growth over the medium to long term.

PRC's GDP growth slowed from 7.9% in the fourth quarter of 2012 to 7.7% the first quarter and 7.5% the second quarter of 2013. With year-on-year quarterly growth below 8.0% since the second quarter of 2012, the economy seems to be entering a lower growth trajectory than earlier believed, mainly because domestic demand has waned. Growth in exports decelerated significantly

Figure 5: GDP Growth—Asia (y-o-y, %)



Note: Developing Asia includes Central Asia, East Asia, South Asia, and Southeast Asia. Pacific is excluded as quarterly data unavailable. Central Asia includes Armenia, Georgia, and Kazakhstan. East Asia includes the People's Republic of China; Hong Kong, China; the Republic of Korea; Mongolia; and Taipei, China. Southeast Asia includes Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam. South Asia includes India and Sri Lanka. Data for Developing Asia and Central Asia until 2013Q1. Source: ADB calculations using data from CEIC.

Table 1: Regional GDP Growth¹ (y-o-y, %)

	2009	2010	2011	2012	Forecast ⁸	
					2013	2014
Developing Asia²	6.1	9.2	7.3	6.1	6.0	6.2
Central Asia³	3.2	6.8	6.8	5.6	5.4	6.0
East Asia⁴	6.8	9.8	8.2	6.5	6.6	6.6
People's Republic of China	9.2	10.4	9.3	7.7	7.6	7.4
South Asia⁵	7.7	8.4	6.0	5.1	4.7	5.5
India	8.6	9.3	6.2	5.0	4.7	5.7
Southeast Asia⁶	1.4	7.9	4.7	5.6	4.9	5.3
The Pacific⁷	4.3	5.5	8.3	7.5	5.2	5.5
Major Industrialized Economies						
eurozone	-4.4	2.0	1.5	-0.6	-0.5	1.2
Japan	-5.5	4.7	-0.6	2.0	1.9	1.4
United States	-3.1	2.4	1.8	2.8	1.7	2.4

¹Aggregates weighted by gross national income levels (Atlas method, current \$) from *World Development Indicators*, World Bank.

²Refers to ADB's 45 developing member economies.

³Includes Armenia, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.

⁴Includes the People's Republic of China; Hong Kong, China; the Republic of Korea; Mongolia; and Taipei, China.

⁵Includes Afghanistan, Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan, and Sri Lanka. Data for Bangladesh, India, and Pakistan are fiscal-year. For India, fiscal year is from April of the specified year through the following March. For Bangladesh and Pakistan, fiscal year is from the previous year's July through June of the specified year.

⁶Includes Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam. Excludes Myanmar as weights unavailable.

⁷Includes the Cook Islands, Fiji, Kiribati, the Marshall Islands, the Federated States of Micronesia, Palau, Papua New Guinea, Samoa, Solomon Islands, Timor-Leste, Tonga, Tuvalu, and Vanuatu. Excludes Nauru as weights unavailable.

⁸ADB forecasts from *Asian Development Outlook Update*, October 2013.

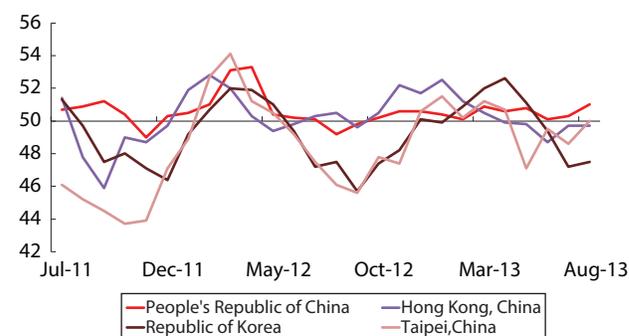
Source: ADB calculations using data from various issues of the *Asian Development Outlook*, Asian Development Bank; and CEIC.

in the second quarter of 2013, largely due to weakened global demand, some friction with major trading partners, and rising export prices. PRC authorities seek to engineer a strategic shift away from growth led by exports and investment toward more balanced growth. The shift is most evident in recent efforts to wrestle down credit bubbles and come to grips with the burgeoning shadow banking system. GDP growth is forecast to slow slightly from 7.7% last year to 7.6% in 2013 and to 7.4% in 2014.

As the recovery in major advanced economies firms up, growth in the highly-open East Asian economies will likely stabilize in 2013 and 2014.

Helped by improving external demand, the highly-open East Asian economies of the Republic of Korea and Hong Kong, China picked up in the first half of 2013. In the same period, however, growth in Taipei, China was below that of the previous 6 months. Slower PRC growth also weighed in as purchasing managers' indexes (PMI) fell (**Figure 6**). Mongolia endured a sharp drop in coal exports and in commodity prices in the first quarter, but received a boost from increased public expenditure in the second quarter. In general, East Asia is expected to

Figure 6: Manufacturing Purchasing Managers' Index (PMI)—East Asia



Note: A reading above 50 indicates an expansion in the manufacturing sector, while below 50 indicates a contraction. Composite PMI for Hong Kong, China.

Source: Markit Economics and National Bureau of Statistics of China.

maintain stable growth in 2013 and 2014. GDP growth is projected to remain at 6.6% for both years (see Table 1). Despite the downward revisions to growth projections, East Asia still outpaces other Asian subregions—as high PRC growth dominates the subregional average. As in the past year, growth rates will vary substantially across the East Asian subregion.

India's growth outlook continues to be hampered by challenges in both policy and execution.

India's economic growth rate has been slowing—from 9.9% in the March quarter of 2011 to 4.4% in the June quarter of 2013. Annual growth for the fiscal year (FY) ending March 2013 (FY2012) was 5.0%, the lowest since 2002. While last year's slowdown partially reflects the bad monsoon, structural issues—including a poor investment climate and high fiscal deficit—have contributed to the lower growth. Subsidies have driven fiscal deficits higher, resulting in excess demand, rising inflation, and higher trade and current account deficits. Policies adopted—along with the US Federal Reserve's (US Fed) September decision to retain QE levels—stanching portfolio outflows and stopped currency depreciation. However, tight monetary policy targeting price stability, along with limited fiscal headroom for stimulating growth, will constrain economic activity in the near term. While a favorable monsoon is expected to help agriculture, economic growth may remain subdued as structural reform continues to be implemented slowly (**Figure 7**). India's economy is expected to grow 4.7% in 2013 before picking up to 5.7% in 2014.

The prospects for other major South Asian economies remain mixed.

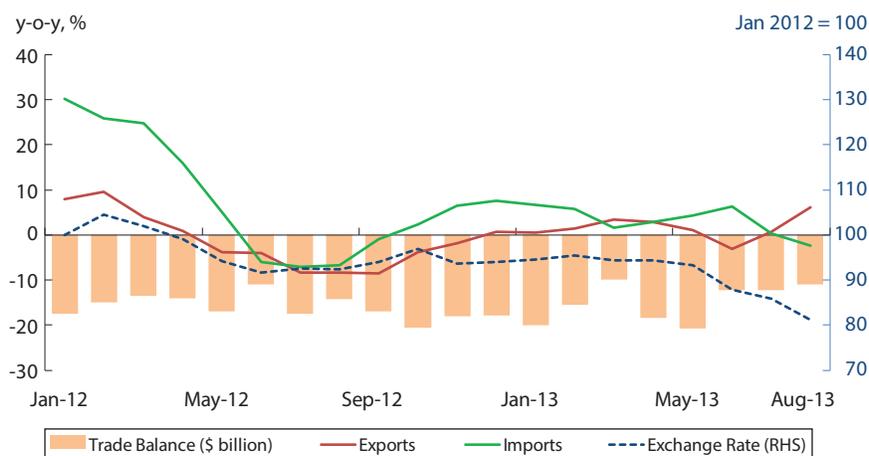
With a current account surplus fuelled by remittance inflows, the Bangladesh currency held steady despite the mid-year talk of QE tapering. However, output growth

for FY2013—ending June—marginally slowed to 6.0% as domestic demand weakened due to poor agricultural output. As remittance inflows are slowing, output growth is expected to further ease in FY2014. Worsening fundamentals in Pakistan's economy led the newly elected government to undergo some needed structural reforms in hopes of regaining healthy fundamentals. These structural reforms are expected to slow economic growth in the short run, with GDP growth expected to be 3.0% in FY2014 (ending in June 2014), down from 3.6% in FY2013. While Sri Lanka is also suffering from a current account deficit and currency depreciation, robust domestic demand to support the recovery from domestic civil strife is expected to underpin a growth of close to 7%, up from 6.4% in 2012. Combined, growth in South Asia is likely to slow to 4.7% in 2013 before rising to 5.5% in 2014.

Growth in Southeast Asia is moderating, crimped by weakness in its three biggest economies.

Lackluster export markets and moderating investment weighed on growth in Indonesia, Thailand, and Malaysia (**Figure 8**). By contrast, the Philippines is performing strongly, with growth higher than expected over the past few quarters. While inflation is more subdued in Southeast Asia generally, it has accelerated sharply in Indonesia since June, when the government lowered fuel subsidies. Inflation remains moderate in the Philippines, but rapid money supply growth and an increase in the share of real estate lending signal the

Figure 7: Trade Balance, Merchandise Trade Growth, and Exchange Rate Index—India

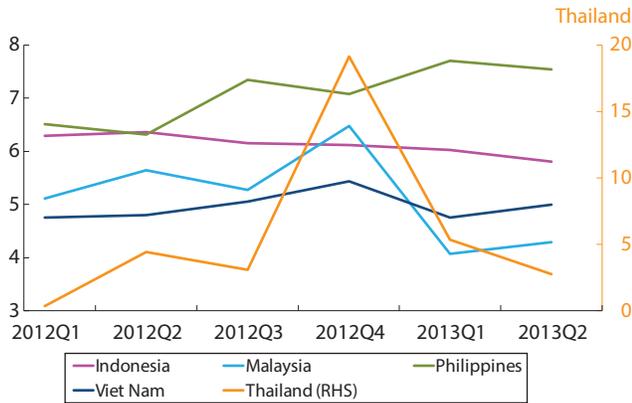


RHS = right-hand scale.

Note: Trade growth based on 3-month moving average. For exchange rate, an increase means appreciation while decrease means depreciation.

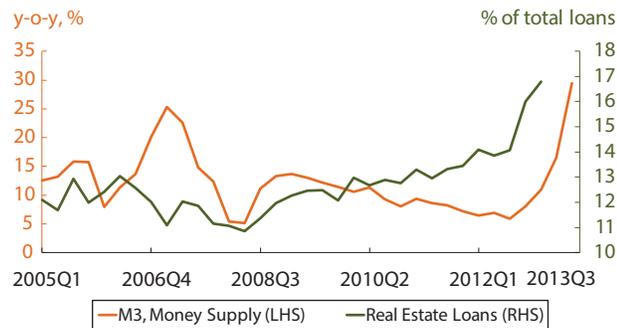
Source: ADB calculations using data from CEIC.

Figure 8: GDP Growth—ASEAN-4 and Viet Nam (y-o-y, %)



RHS = right-hand scale.
Source: ADB calculations using data from CEIC and national sources.

Figure 9: Money Supply Growth and Real Estate Loans—Philippines



LHS = left-hand scale, RHS = right-hand scale.
Note: Data for M3 (broad money liabilities) for 2013Q3 refer to July/August average. Real estate loans refer to the sum of loans by universal and commercial banks and thrift banks, data up to 2013Q1.
Source: ADB calculations using data from CEIC and Datastream.

possibility of overheating (**Figure 9**). The Southeast Asia subregion is forecast to grow 4.9%, this year from 5.6% in 2012. In 2014, growth should quicken to 5.3%, as investment recovers and exports benefit from improved global trade and recent currency depreciations in several economies.

Central Asia’s growth will slow marginally in 2013 before recovering in 2014.

Slower growth is expected in Central Asia—except in Azerbaijan, where domestic demand remains strong, and the Kyrgyz Republic, where gold production is recovering from last year’s plunge due to technical problems. The reasons for slower growth vary among countries. For instance, Kazakhstan’s sluggish performance in industry and exports can be linked to lower demand from partners—including the Russian

Federation and the PRC, while Georgia’s slowdown in the first 7 months reflects investors’ caution linked to the political transition, delays in public infrastructure projects, and weak domestic demand. As slower growth in the other countries outweighs the higher growth in Azerbaijan and the Kyrgyz Republic, Central Asia’s growth as a subregion is expected to slow marginally to 5.4% in 2013 from 5.6% in 2012, before recovering to 6% in 2014.

Growth in the Pacific may moderate in 2013 and 2014.

While a few economies may perform better in 2013 and 2014, most are likely to see slower growth. Papua New Guinea, the largest developing member economy in the Pacific, may see growth slow in 2013 and 2014 while waiting for the completion of work on the new 850 km liquefied natural gas pipeline. Public expenditure in Timor-Leste was lower than budgeted, and Solomon Islands’ production in gold mining, logging, and agriculture fell short of expectations. While improving consumption and investment in Fiji and unexpectedly large increases in tourism arrivals in the Cook Islands may marginally offset negative factors, the Pacific is expected to grow 5.2% in 2013 and 5.5% in 2014, significantly below the 7.5% growth in 2012.

Risk to the Outlook and Policy Issues

The economic outlook for developing Asia is subject to three major risks: (i) increased volatility in global and regional financial markets—in particular due to uncertainties over monetary and fiscal policies in advanced economies; (ii) a more pronounced slowdown in major regional economies than expected—such as the PRC, India, or Indonesia—which will affect other economies within the region; and (iii) a disruption in the G3 recovery.

While the recent decision by the US Fed to wait before beginning to unwind quantitative easing—and the fiscal compromise reached in mid-October—have given developing Asia some short-term reprieve, the level of uncertainty among investors over the direction of monetary and fiscal policy in major advanced economies is startling. Any volatile market reactions

could undermine developing Asia's outlook, even if high levels of reserves and current account surpluses continue throughout much of the region. Financial stress may also increase the possibility of policy errors—as policy makers could be forced to adopt inconsistent policies, aggravating financial volatility. The second risk is that growth in the PRC, India, or Indonesia slows too fast due to rising financial stress and existing structural imbalances, subsequently affecting others in the region through more integrated trade and financial channels. The third risk is that policy missteps, such as another fiscal impasse in the US, new financial stress or sovereign risks in eurozone, or delayed structural reforms in Japan, could reverse the fragile recovery in the G3, damaging developing Asia's economic prospects.

Authorities in developing Asia need to respond promptly, decisively, and collectively should downside risks from financial market volatility escalate dramatically.

In general, developing Asia now has more flexible exchange rates, much higher foreign exchange reserves, healthier current account balances, better financial regulation, increased macroeconomic transparency, and better structured foreign debt than before the 1997 Asian financial crisis. Had financial turbulence escalated into financial crisis, the most immediate challenge would relate to pressures on foreign currency liquidity and the risk of spillovers into the region's financial systems. Slowing growth could also expose new financial vulnerabilities, and contingency plans are needed to safeguard financial stability. Preemptive and proactive policies may help, thus breaking a potentially vicious loop between financial weakness and the real economy.

Short-term responses are needed to bolster the foundations of financial stability and avoid deterioration in market confidence.

Confidence rests on authorities continuing to pursue sound macroeconomic policies. Recent financial crises—from the 1997 Asian financial crisis to the 2008/09 global financial crisis to the ongoing eurozone sovereign debt crisis—offer valuable lessons for developing Asia in its quest for financial stability. Policymakers can increase resilience to potential shocks by strengthening economic fundamentals in four ways. First, prudential policies can be strengthened to ensure cross-border capital flows do not undermine banking soundness.

Bank regulations must also be tightened to help banks cope with volatile capital flows and protect bank integrity. Second, the region needs to better monitor asset markets and help shield the financial system from asset price trend reversals. Third, maintaining sufficient foreign reserves can enable authorities to use them as a buffer to smooth increasingly volatile capital flow and exchange rate movements. And fourth, the region should also strengthen its regional financial safety nets through bilateral and multilateral swap agreements to counter regional contagion.

The recent financial turmoil is a timely reminder of the need for continued structural reform.

The market impact on India, Indonesia, and others in developing Asia underscored the urgency of structural reforms to keep economic growth strong and sustainable. Developing Asia has the opportunity to reinforce growth prospects by working on “hard” infrastructure investment and structural “software” reforms supported by regional cooperation. In themselves these policies can have a stabilizing market impact. High priorities include reforms that encourage foreign direct investment, diversify the industrial base, close gaps in infrastructure and human capital, consolidate fiscal positions by cutting inefficient subsidies, and strengthen social protection, among other constraints to long-term growth.

Easing supply-side bottlenecks can reduce the cost of doing business, encouraging investment and spurring further growth. As most economies in the region still suffer large infrastructure gaps, expanding and improving infrastructure can pay large dividends in productivity and growth. Efficient “software” must complement good hardware. Many Asian economies could reduce excessive regulation and red tape to reduce business costs, unleash innovation, greater competition and entrepreneurship, and encourage more foreign direct investment.

REGIONAL COOPERATION AND INTEGRATION

Progress and Issues

Five years after the global financial crisis, the world economy is in transition; many uncertainties are keeping markets volatile, potentially threatening economic stability.

Since the 2008/09 global financial crisis, economic growth in advanced economies continues to be anemic and below trend. While the recovery there has been largely L-shaped, emerging economies—particularly those in Asia—showed a relatively rapid V-shaped return to growth. This year, however, these roles have begun to reverse. The long recovery in advanced economies is strengthening, while growth in emerging economies has started to moderate. Merely the announcement that the United States Federal Reserve (US Fed) might soon begin tapering its quantitative easing (QE) program destabilized financial markets across emerging economies—in particular, India and Indonesia. And, while the US Fed's September decision to wait before starting the unwinding process gave Asia some short-term reprieve, the October US government shutdown, if protracted, could threaten its own recovery and threaten economic growth globally.

Regardless, the level of uncertainty increases as the global economy begins to navigate its transition phase. And as a result, volatility—particularly in emerging financial markets—will increase as varied and conflicting responses interact. Significant and persistent market volatility hampers the real economy, deterring consumption and investment, threatening economic stability, and damaging growth.

One immediate uncertainty is the evolution of monetary and fiscal policy in advanced economies and its impact on the global economy. While the eurozone is emerging out of recession and the US continues its plodding recovery—despite the unprecedented policy support—when and how to ease that support and normalize policy will have a highly uncertain impact on the global economy. The recent financial turmoil and market volatility surrounding the US Fed's decision *not* to begin unwinding in mid-September was a clear demonstration of its uncertain impact globally. Add to this continued fiscal uncertainty in the US and the (however remote) risk of a US public debt crisis disrupting global markets. And to round it off, it remains uncertain that Japan will

adopt policies that make its fiscal path and public debt dynamics sustainable over the medium term.

Another uncertainty is how global markets—and economies in general—react to an increasingly multi-polar world. The global economy, while still influenced by its dominant players, no longer relies on a single driving force. Globalization is undergoing significant structural change. And its major players—the US, European Union (EU), the People's Republic of China (PRC), Japan, and emerging economies collectively—are all amid major structural adjustments 5 years after the global financial crisis. The impact of these structural adjustments on themselves—and particularly on each other—is also uncertain.

The third uncertainty comes from the evolving development paradigm—the relationship between growth and welfare. Asia continues to see rapid and, increasingly, resilient growth. But emerging Asia's growth has come with growing inequality—both by income and non-income measures. And it brought with it resource depletion and environmental degradation. Asia is in search of a new development paradigm, one that balances growth with welfare and the environment. The uncertainty is whether Asia can find a properly balanced development paradigm—and then work out ways to achieve it.

To sustain growth in these uncertain and volatile times, strengthening regional cooperation and integration is critical.

While some uncertainties are policy related, they are mostly structural and probably long-lasting. Uncertainties and resulting market volatilities could leave Asia more vulnerable to external shocks now more than ever. Uncertain macroeconomic policies in advanced economies will complicate macroeconomic management and undermine economic stability in emerging economies. A global economy undergoing significant structural change will challenge every economy to adapt and adjust. And any policy misstep could have unintended consequences—on itself and others. Therefore, strengthening cooperation globally and regionally is paramount—to maximize the

benefits of integration and minimize its costs and risks.¹ Maintaining open regionalism is essential. It has served the region well in the past, and will likely continue to do so.

Global and regional integration can promote economic growth by allocating resources more efficiently and effectively. By expanding markets and the sources of inputs, regional integration can also increase economies of scale and might also increase returns to scale—thus raising productivity. Several recent studies show human exchange and communication is one of the deepest roots of mankind’s historical development.² Asia needs continued support from partners in other regions to tackle its development challenges. With various subregions working together, more can be done toward creating a truly integrated Asia. And cooperation is central in tackling global uncertainties and negative spillovers from national policies. History also shows that crises and uncertainties have been the driving force behind rising integration in Asia—a catalyst for regional cooperation. Behind-the-border reforms, enhanced information and knowledge-sharing, and seeking consensus on key policies can help prepare for and address increased financial market volatilities in the region.

Evolving macroeconomic policies, particularly monetary policy, and structural adjustment in major economies could shape the progress of cooperation and integration in the region.

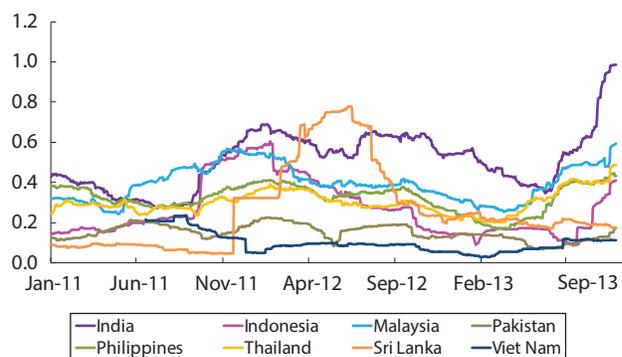
Notwithstanding growing uncertainties, major advanced economies will sooner or later have to normalize unconventional macroeconomic policy. Globally, this could be a game changer, and there are numerous variables at play, making the dynamics of this transition complicated. A high degree of co-movement in Japanese and US business cycles in recent years suggests that emerging Asian economies will likely feel the impact of macroeconomic policy changes in major economies (see *Macroeconomic Interdependence*, page 26).

As mentioned, the expectation of the US Fed tapering QE has already spurred financial market volatility. The May 2013 ‘tapering’ announcement triggered a massive selloff of emerging market equities, bonds, and

¹For an analysis of the costs and benefits of integration, see ADB. 2012. *Asian Economic Integration Monitor July 2012*. Manila, pp. 59–62.

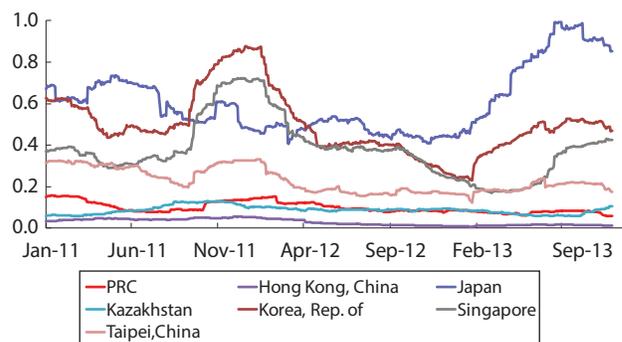
²See for example, E. Spolaore and R. Wacziarg. 2013. How Deep Are the Roots of Economic Development?. *Journal of Economic Literature*. 51(2), pp. 1–45.

Figure 10: Standard Deviation of Exchange Rates—South and Southeast Asia



Note: Based on 3-month rolling standard deviation of daily percentage change of currency against \$. Data up to 30 September 2013.
Source: ADB calculations using data from Bloomberg.

Figure 11: Standard Deviation of Exchange Rates—PRC, Japan, Kazakhstan, and NIEs

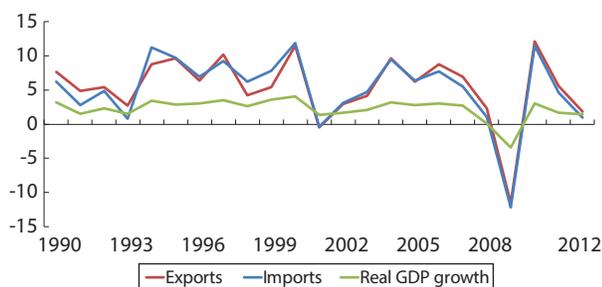


PRC = People’s Republic of China, NIE = newly industrialized economy.
Note: Based on 3-month rolling standard deviation of daily percentage change of currency against \$. Data up to 30 September 2013.
Source: ADB calculations using data from Bloomberg.

currencies—raising exchange rate movements across the region (**Figures 10, 11**). As a result, macroeconomic management in Asia has become more difficult, with policymakers more inwardly focused, trying to manage flow-on effects of potential policy unwinding. Financial market and exchange rate volatility could further weaken financial—and even trade—flows. And that would weaken market integration (see *Financial Integration*, page 17).

Despite the strengthening recovery in major advanced economies, thus far it has not led to a revival in export orders from Asia. Advanced economies’ growth in import volumes of goods and services has been below growth in gross domestic product (GDP) during the past year (**Figure 12**). The US has improved its current account deficit—from 3.2% of GDP in mid-2011 to 2.4% by mid-2013. In contrast, the PRC’s current account surplus as a share of GDP fell from 10.2% in 2007 to

Figure 12: Growth in Trade Volume of Goods and Services—Advanced Economies (y-o-y, %)



Note: Advanced economies include Australia; Austria; Belgium; Canada; Cyprus; Czech Republic; Denmark; Estonia; Finland; France; Germany; Greece; Hong Kong, China; Iceland; Ireland; Israel; Italy; Japan; the Republic of Korea; Luxembourg; Malta; the Netherlands; New Zealand; Norway; Portugal; San Marino; Singapore; Slovak Republic; Slovenia; Spain; Sweden; Switzerland; Taipei, China; the United Kingdom; and the United States.
Source: *World Economic Outlook 2013*, International Monetary Fund.

2.5% in early 2013. These unwinding global imbalances suggest substantial structural transformation has begun in major economies as well as the global economy in general. As external demand is expected to remain weak despite some improvement, domestic and regional demand must strengthen to sustain growth in the region. The economic structure of the region needs to transform to increase productivity and efficiency, allowing households more income to boost consumption. To date, the share of consumption to output in Asia declined from a peak of 69.1% in 2001 to 59.9% in 2012 (Figure 13). The drop in consumption share occurred across all subregions—most pronounced in East Asia, where it fell from 67.9% to 56.5% during the same period.

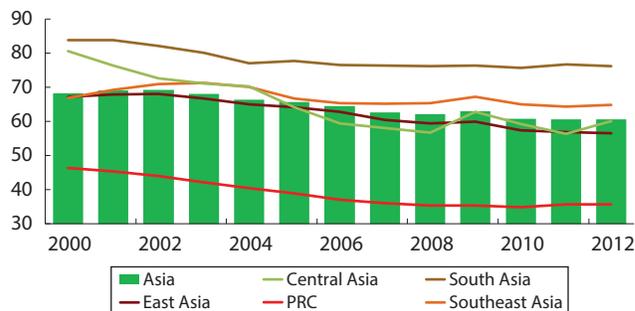
As the economic and financial landscape shifts, progress in regional cooperation and integration in Asia has been mixed.

Progress in Asia's regional cooperation and integration (RCI) has shown strengths and weaknesses. Rising from 45% in 1990 to 55% in 2012, intra-Asian trade has clearly increased. In recent years, however, cross-border trade and equity flows have slowed modestly since 2010 despite growing intraregional foreign direct investment (FDI), bond holdings, and tourism (Figure 14).³

There was a slight easing in intraregional trade during 2012, partly reflecting weaker global trade growth and

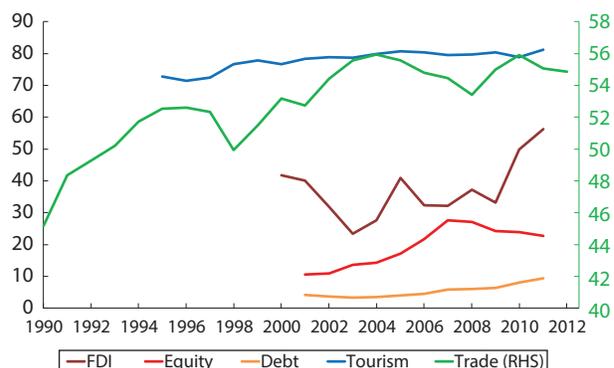
³Due to lack of complete data, intraregional FDI only covers the 10 Association of Southeast Asian Nations (ASEAN) economies (Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Viet Nam); Australia; the PRC; Hong Kong, China; India; Japan; Pakistan; the Republic of Korea; and New Zealand. This is a smaller set compared with those covered in previous issues of the Asian Economic Integration Monitor.

Figure 13: Consumption—Asia (% of GDP)



PRC = People's Republic of China.
Note: Asia excludes the Pacific as data unavailable. Data for the PRC refer to final household consumption expenditure. Central Asia excludes Afghanistan, Tajikistan, Turkmenistan, and Uzbekistan as data unavailable. South Asia excludes Bhutan and the Maldives as data unavailable; data starts in 2002 for Sri Lanka and 2005 for Pakistan; Bangladesh and Pakistan refers to fiscal year data ending June, India ending March, and Nepal ending July. Southeast Asia excludes Myanmar as data unavailable; data for Malaysia starts 2005.
Source: ADB calculations using data from CEIC and national sources.

Figure 14: Progress of Integration—Regional Indicators (intraregional as % of total)



FDI = foreign direct investment.
Notes:
FDI—includes ASEAN; Australia; the People's Republic of China; Hong Kong, China; India; Japan; Pakistan; the Republic of Korea; and New Zealand. Data for Australia and New Zealand start from 2001.
Trade—national data unavailable for Bhutan, Kiribati, Nauru, Palau, Timor-Leste, and Tuvalu; no data available on the Cook Islands, the Marshall Islands, and the Federated States of Micronesia.
Equity holdings—based on investments from Hong Kong, China; India; Indonesia; Japan; Kazakhstan; the Republic of Korea; Malaysia; Pakistan; the Philippines; Singapore; Thailand; and Vanuatu. Excludes Oceania. Recipient data unavailable for Azerbaijan, Bhutan, the Federated States of Micronesia, Palau, Samoa, Tonga, Turkmenistan, and Tuvalu. Data from 2001 to 2011.
Bond holdings—based on investments from Hong Kong, China; India; Indonesia; Japan; Kazakhstan; the Republic of Korea; Malaysia; Pakistan; the Philippines; Singapore; Thailand; and Vanuatu. Excludes Oceania. Recipient data unavailable for Azerbaijan, Bhutan, the Federated States of Micronesia, Palau, Samoa, Tonga, Turkmenistan, and Tuvalu. Data from 2001 to 2011.
Tourism—does not include Oceania. Data until 2011.
Source: ADB calculations using data from Bloomberg; CEIC; Asia Regional Integration Center; ADB; *Coordinated Portfolio Investment Survey*, International Monetary Fund; *Direction of Trade Statistics*, International Monetary Fund; *World Economic Outlook Database October 2013*, International Monetary Fund; and United Nations World Tourism Organization.

slowing Asian trade with the US and EU. In turn, this affected parts and components trade within Asia—seen by the marked decline of PRC and Japanese trade with key regional suppliers. The slowdown in PRC economic growth may have also led to the easing in intraregional trade.

Cross-border equity flows also slowed slightly and equity returns in the region have moved less synchronously thus far in 2013. While Japan's equity markets were strong as the positive effects of Abenomics began to affect the real economy, equity markets in most newly industrialized economies (NIEs) contracted in step with the growth slowdown in the PRC and weak subregional trade. PRC stock indexes also fell following weaker manufacturing and export growth, along with tightened liquidity. Combined, cross-border equity flows were weak in East Asia, setting the pace for equity flows in the region generally. Growth in remittance inflows also slowed, particularly to South Asian economies, though remittance inflows to some other countries (such as the Philippines) continue to show solid growth (see *Labor Mobility*, page 31).

Interestingly, intraregional FDI, and bond markets and tourism flows within Asia have shown greater resilience. Intraregional FDI flows for emerging East Asian economies increased significantly in 2010 and 2011, due to strong growth prospects in emerging markets and rising FDI outflows from Japan, the PRC, and the Republic of Korea. The region's large domestic markets and key role as export base also helped boost intraregional FDI. Bond markets in emerging East Asia also expanded rapidly. Through March 2013, emerging East Asia's local currency bond markets expanded 12.1% year-on-year to \$6.7 trillion, with corporate bonds rising faster (19.5%) year-on-year. Bond market growth is driven primarily by East Asian bonds—which are generally perceived as more stable.⁴ Local currency bond markets also benefitted from the ASEAN+3 Asia Bond Markets Initiative (ABMI).⁵ In addition, intraregional bank credit flows have risen significantly after the global financial crisis, particularly from Japan and Australia to other emerging Asian economies (see *Asia's Rising Exposure to Intraregional Bank Lending*, page 21). This not only deepened financial linkages in the region, but also increased the risk of contagion through financial channels.

Regional tourism also rebounded strongly with a global recovery in tourist arrivals. Improvements in intraregional tourism reflected robust income growth in the region as well as policies that foster greater intraregional cooperation and coordination in tourism.

While progress in RCI is uneven across subregions, linkages between them are growing stronger, with most showing growing trade, financial, and tourism links with the rest of Asia.

Among subregions, East Asia and Southeast Asia show a higher degree of cross-border flows relative to the other subregions.⁶ For instance, 35.9% of East Asia's trade and 24.5% of Southeast Asia's trade was within itself, as opposed to single-digit shares in Central Asia, South Asia, and the Pacific and Oceania. Also, 16.6% of East Asia's equity flows were within itself (6.8% for Southeast Asia), with hardly any in Central Asia and South Asia (**Table 2**).

Despite the uneven picture, links across subregions are strong. For instance, trade flows from the Pacific and Oceania, Southeast Asia, South Asia, and Central Asia to Asia remain sizeable, accounting for 61.9%, 42.5%, 30.2%, and 22.8% of each subregion's trade, respectively. Equity holdings in Asia from Southeast Asia (39.3%), South Asia (19.9%) and Central Asia (12.0%) are significant. Also, 5.7% of South Asia's external bond holdings are Asian. Tourism between subregions is also significant in South Asia (34.5%), Southeast Asia (20.9%), the Pacific and Oceania (12.1%), and in Central Asia (5.4%).

In response to the global financial crisis, many countries worldwide resorted to trade restrictions to protect domestic markets from external competition.

For instance, among the Group of 20 (G20), some 100 trade-restrictive measures were put in place just in the past 7 months—in addition to many introduced over the past few years (**Table 3**).⁷ The measures this year alone affected 0.5% of G20 merchandise imports and 0.4% of total world imports. These included trade remedy actions and tariff increases. While affecting only a small proportion of global trade, it is clear increasing protectionism only slows the expansion of world trade—essential for the global recovery. If at all, reforming behind-the-border restrictions and increasing trade facilitation are central to increasing goods and services trade in the region (see *World Trade Facilitation Negotiations: Asian Perspectives*, page 47).

⁴See ADB. 2013. *Asia Bond Monitor September 2013*. Manila.

⁵For details of the ABMI, see ADB. 2012. *Asian Economic Integration Monitor July 2012*. Manila.

⁶See ADB. 2012. *Asian Economic Integration Monitor July 2012*. Manila.

⁷G20 includes Argentina, Australia, Brazil, Canada, the PRC, France, Germany, India, Indonesia, Italy, Japan, the Republic of Korea, Mexico, Russian Federation, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States, and the European Union.

Table 2: Progress in Regional Integration (2008–2012)

Subregions	Production Networks and Trade		Capital Markets		Macroeconomic Links		Migration	
	Intra-subregional FDI (%)	Intra-subregional Trade (%)	Intra-subregional Equity Holdings (%)	Intra-subregional Bond Holdings (%)	Intra-subregional Output Correlations	Intra-subregional Tourism (%)	Migrant to Population Ratio (%)	
Central Asia	–	5.89 ▼	0.40 ▲	–	0.28 ▲	28.13 ▲	1.56 ▼	
East Asia	56.73 ▲	35.93 ▼	16.60 ▲	3.41 ▲	0.63 ▲	74.28 ▲	0.26 ▲	
South Asia	– ▲	4.43 ▼	0.54 ▼	14.99 ▼	0.24 ▲	12.04 ▼	0.47 ▼	
Southeast Asia	16.60	24.52 ▲	6.76 ▼	8.35	0.52 ▲	69.73 ▲	0.66 ▲	
The Pacific and Oceania	0.32	7.94 ▼	–	–	0.13 ▲	3.51 ▼	0.09 ▼	

Subregions	Inter-subregional FDI (%)	Inter-subregional Trade (%)	Inter-subregional Equity Holdings (%)	Inter-subregional Bond Holdings (%)	Inter-subregional Output Correlations	Inter-subregional Tourism (%)	Migrant to Population Ratio (%)
	Central Asia	–	22.77 ▲	12.01 ▼	– ▲	0.30 ▲	5.36 ▲
East Asia	6.03	17.25 ▲	4.43 ▲	6.07 ▲	0.40 ▲	9.76 ▲	–
South Asia	21.31	30.24 ▲	19.92 ▲	5.65 ▲	0.31 ▲	34.54 ▲	–
Southeast Asia	46.64	42.46 ▲	39.29 ▲	32.08 ▲	0.39 ▲	20.93 ▲	–
The Pacific and Oceania	13.58	61.95 ▲	–	–	0.21 ▲	12.10 ▲	–

TOTAL	FDI (%)	Trade (%)	Equity Holdings (%)	Bond Holdings (%)	Output Correlations	Tourism (%)	Migrant to Population Ratio (%)
Asia	45.60 ▲	54.85 ▲	25.84 ▲	12.29 ▲	0.33 ▲	80.03 ▲	0.51 ▼
Central Asia	–	28.66 ▲	12.41 ▼	–	0.30 ▲	33.50 ▲	–
East Asia	62.75 ▲	53.17 ▼	21.03 ▲	9.47 ▲	0.44 ▲	84.04 ▲	–
South Asia	21.31 ▲	34.66 ▲	20.46 ▲	20.64 ▼	0.30 ▲	46.58 ▲	–
Southeast Asia	63.24	66.97 ▲	46.05 ▲	40.43 ▲	0.42 ▲	90.66 ▲	–
The Pacific and Oceania	13.90	69.89 ▲	–	–	0.19 ▲	15.61 ▲	–

▲ = increase from 2000–2007 average; ▼ = decrease from 2000–2007 average; – = data unavailable.

FDI = foreign direct investment.

Note: Data calculated for Asia unless otherwise noted. Total Asia equals total intra-Asian using intraregional data.

†Total Asia equals total intra-Asian (using intraregional data).

FDI—includes ASEAN; Australia; the People's Republic of China; Hong Kong, China; India; Japan; Pakistan; the Republic of Korea; and New Zealand. Data for Australia and New Zealand start from 2001.

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

Equity holdings—based on investments from Hong Kong, China; India; Indonesia; Japan; Kazakhstan; the Republic of Korea; Malaysia; Pakistan; the Philippines; Singapore; Thailand; and Vanuatu. Excludes Oceania. Recipient data unavailable for Azerbaijan, Bhutan, the Federated States of Micronesia, Palau, Samoa, Tonga, Turkmenistan, and Tuvalu. Data from 2001 to 2011.

Bond holdings—based on investments from Hong Kong, China; India; Indonesia; Japan; Kazakhstan; the Republic of Korea; Malaysia; Pakistan; the Philippines; Singapore; Thailand; and Vanuatu. Excludes Oceania. Recipient data unavailable for Azerbaijan, Bhutan, the Federated States of Micronesia, Palau, Samoa, Tonga, Turkmenistan, and Tuvalu. Data from 2001 to 2011.

Output correlations—based on simple averages of 3-year rolling bilateral correlations of annual growth rates (difference of natural logarithms) of detrended gross domestic product series (2005 base year). Data unavailable for Afghanistan, the Cook Islands, the Marshall Islands, the Federated States of Micronesia, Myanmar, Nauru, Palau, Timor-Leste, and Tuvalu.

Tourism—does not include Oceania. Data until 2011.

Migrant to population ratio—share of migrant stock to population in 2010 (compared with 2000 estimate). Does not include Oceania. Data unavailable for Afghanistan and Pakistan.

Source: ADB calculations using data from Bloomberg; CEIC; *Asia Regional Integration Center*, ADB; *Coordinated Portfolio Investment Survey*, International Monetary Fund; *Direction of Trade Statistics*, International Monetary Fund; *World Economic Outlook Database October 2013*, International Monetary Fund; *Bilateral Migration Database 1990–2000*, World Bank; *Bilateral Migration Matrix 2010*, World Bank; United Nations Conference on Trade and Development; and United Nations World Tourism Organization.

Table 3: Number of Measures Restricting Trade—G20

Type of Measure	Mid-May to mid-Oct 2010	Mid-Oct 2010 to mid-Apr 2011	May to mid-Oct 2011	Mid-Oct 2011 to mid-May 2012	Mid-May to mid-Oct 2012	Mid-Oct 2012 to mid-May 2013
Trade remedy	33	53	44	66	46	67
Import	14	52	36	39	20	29
Export	4	11	19	11	4	7
Other	3	6	9	8	1	6
Total	54	122	108	124	71	109
Average per month	10.8	20.3	18	17.7	14.2	15.6

G20 = Group of 20.

Source: WTO–OECD–UNCTAD, 2013. *9th Report on G20 Trade and Investment Measures June 2013*. Geneva.

History clearly shows that crises promote regionalism, which in turn builds greater resilience against future crises.

While no one wants financial crises, they tend to accelerate the impetus for greater RCI. For instance, during the 1997/98 Asian financial crisis, government cooperation in monitoring the crisis impact and in building financial safety nets supported market-led integration. After the 2008/09 global financial crisis and 2011 eurozone debt crisis, the proliferation of free trade agreements and expansion of regional safety nets in Asia also helped build resilience to future shocks.⁸

Various forms of regionalism also deliver huge benefits. This is a key lesson learned from the various subregional groupings—which have emerged to promote more closely identified common interests. For instance, ASEAN has shown that deeper trade, better developed and integrated financial markets, and seamless logistics and infrastructure provide a solid foundation for new, sustainable and inclusive growth. The Greater Mekong Subregion (GMS) has also shown the importance of building economic corridors to link less-developed and landlocked countries with high-growth economies and foster more inclusive growth and greater convergence in development. ASEAN is also poised to benefit from the freer movement of goods and services, investment, skilled labor, and capital, even if it must overcome many challenges to reach the milestone of an ASEAN Economic Community (AEC) by end-2015. The recent financial turmoil could offer a new boost to strengthen integration—as crises have in the past—even as it looks beyond 2015 (see *Toward an ASEAN Economic Community—and Beyond*, page 34).

National and global approaches are no longer sufficient to address key challenges facing the region, and regional cooperation is an important means to craft regional solutions.

Traditional growth models must change, and globalization is undergoing significant structural change—with emerging markets and developing economies expected to remain the engine of global growth. Also, uncertainties and volatilities have immense global and regional dimensions with national policies insufficient to cope with shocks or mitigate their effects. There are also several transboundary issues—ranging

from climate change, transboundary haze, health risks and territorial disputes—which are beyond the scope of national or bilateral actions (see *Regional Public Goods*, page 23).

Regional cooperation remains a key strategy to find solutions to regional issues. RCI can also deliver new sources of growth that are more sustainable and inclusive. In the coming years, key RCI priorities could include

- promoting greater policy dialogue;
- nurturing stronger regional institutions;
- developing deeper and more inclusive regional capital/financial markets;
- strengthening regional financial safety nets; and
- developing greater cross-border connectivity to link East and Southeast Asia with South Asia and Central Asia.

The succeeding sections will discuss the progress and issues affecting RCI across its many dimensions.

Intraregional Trade in Services

Services has become an important aspect of trade integration in Asia—it is now as important as Asia's trade in goods; and, more importantly, its structure is very different from goods trade.

There is very limited research on services trade in Asia, partly because data are scarce. This is particularly true when it comes to regional trade integration. While much has been written on the subject, nearly all research focuses exclusively on goods trade. A few studies mention services trade integration, but to date no substantial analysis of trade in services in Asia exists.⁹ Naturally, this makes it difficult to understand and track the progress of Asia's trade integration in services.

However, enough data are available—for the PRC; Hong Kong, China; Japan; the Republic of Korea; and Singapore—to attempt an analysis in comparison with

⁸See ADB. 2013. *Asian Economic Integration Monitor March 2013*. Manila.

⁹ADB's 2010 publication, *Institutions for Regional Integration*, argues that regional integration in services trade is insignificant compared with goods trade, though its empirical analysis on services trade remains preliminary. See ADB. 2010. *Institutions for Regional Integration*. Manila.

Box 1: Intraregional Trade Share and Intraregional Trade Intensity

The formulae to compute intraregional trade share and intraregional trade intensity are given below:

$$\text{Intraregional Trade Share} = T_{ii}/T_i$$

$$\text{Intraregional Trade Intensity} = (T_{ii}/T_i)/(T_i/T_w)$$

where

T_{ii} ≡ exports of region i to region i plus imports of region i from region i

T_i ≡ total exports of region i to the world plus total imports of region i from the world

T_w ≡ total world exports plus imports

Intraregional trade share measures the amount of the region's members' trade with each other to their total trade worldwide. In certain cases, however, it is inappropriate for cross-regional comparisons. First, the share can rise when more countries are included in the group even if, in fact, there is no regional trade bias among its members. Second, the share can increase substantially when a large trading nation is included in the group even without any regional trade bias.¹

¹See M. Plummer, D. Cheong, and S. Hamanaka. 2010. *Methodology for Impact Assessment of Free Trade Agreements*. Manila: ADB; World Trade Organization. 2010. *Measuring Trade in Services (Training Module)*. Geneva.

Intraregional trade intensity is a better measure of regional bias because it takes into account the region's weight in total world trade. To compute intraregional trade intensity, the intraregional trade share is divided by the region's total trade share in world trade. If the intensity indicator is more or less than 1.0, then the region's trade has accordingly a positive or negative regional bias toward itself.² For instance, if a region's share of world trade is 10% and its intraregional trade share is 10%, the resulting intensity becomes 1.0 (neutral regional bias), because the likelihood of trading within or outside the region is the same—10%. If a region's share in world trade is 10% and its intraregional trade share is 20%, the resulting intensity of 2.0 implies the region's trade has a strong positive bias, because its intraregional intensity is twice as much as it is globally. The reverse also holds when the intraregional share is below the region's share of world trade—for example, a 5% intraregional trade share in a region with 10% of world trade, a 0.5 intensity which implies a negative bias.

²It must be noted though that the indicator only takes into consideration internal bias and not external bias. A regional trade introversion index is more suitable to measure trade interdependence as it considers both intraregional and external trade bias.

Europe and North America.¹⁰ Does Asia's services trade have a positive regional bias? If so, is it greater or less than that of goods trade? And is the regional bias of services trade in Asia greater or less than that in Europe and North America?

There are two main indexes used to assess the level of trade interdependence within a region: (i) intraregional trade share and (ii) intraregional trade intensity. Intraregional trade share is widely used and easy to calculate, providing a snapshot of trade interdependence in a particular region. However, it does

¹⁰Four Asian economies—Hong Kong, China; Japan; the Republic of Korea; and Singapore—publish relatively comprehensive services trade statistics. Given the increasing significance of the PRC in services trade, it has been included using mirror statistics from services trading partners. For Europe, France, Germany, Italy, the Netherlands, Spain, and the United Kingdom (UK) are included—as these six dominate European services trade and publish relatively comprehensive sets of statistics. For North America, the three members of the North America Free Trade Agreement (NAFTA)—Canada, Mexico, and the United States (US)—are included. Mexico does not have comprehensive services trade so mirror data are used.

not measure trade bias, as it is not regionally weighted against world trade. A more suitable indicator for comparing regional bias across regions is intraregional trade intensity, which accounts for the weight of the region in the world trade (**Box 1**).

For the services trade analysis, the United Nations (UN) Service Trade Statistics database is used. It is based on the International Monetary Fund's (IMF) Balance of Payments Manual 5, which covers 11 sectors: (i) transport; (ii) travel; (iii) communications services; (iv) construction services; (v) insurance services; (vi) financial services; (vii) computer and information services; (viii) royalties and license fees; (ix) other business services; (x) personal, cultural, and recreational services; and (xi) government services.¹¹ The three major sectors for intraregional services trade in Asia are transport (36.5%), travel (29.9%), and other business

¹¹For the further discussions on services trade classifications, see ADB. 2013. Trade Integration. *Asian Economic Integration Monitor March 2013*. Manila.

services (16.1%). However, capturing the trade amount beyond these three sectors is difficult for statistics agencies, and regarding them as “minor” sectors would be misleading. They may appear “minor” partly because transactions are not fully captured by statistics.¹² While international services trade is classified into four modes of supply in trade liberalization negotiations, UN Service Trade Statistics mainly cover Mode 1 (cross-border transactions).^{13, 14}

Intraregional trade intensity—better than trade share when comparing regional bias across regions—shows Asia as the only region globally where services and goods trade intensity are at almost the same level.

The difference between goods and services trade is significant for Asia and North America (in particular, North America’s intraregional trade share in services is half that of its share in goods trade) (Figure 15). In absolute terms, while Asia’s intraregional trade share is the lowest among the three in the case of goods, its intraregional trade share in services is higher than North America, but lower than Europe. However, as mentioned, intraregional trade share is difficult to compare between regions.

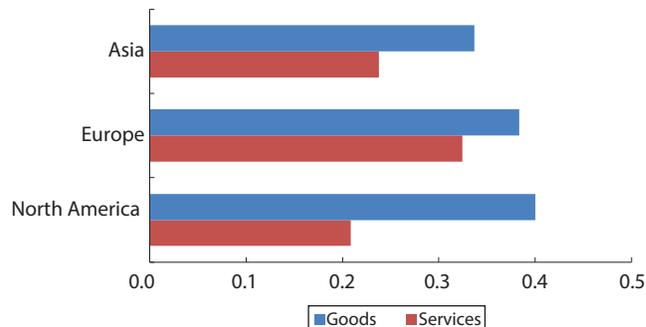
A clearer understanding of the level of services trade integration comes from analyzing the intraregional trade intensity index (Figure 16). In Asia’s case, trade intensity of services and goods is almost the same—Asia is the only region that has a comparative level of services trade intensity to goods trade intensity. Asia’s intraregional trade share in services is lower than goods because Asian countries are still relatively small services trade players (not because of the level of regional services trade bias).

¹²In fact, the sum of sectors is usually smaller than total services trade. In addition, mirror statistics (import versus export) at the sectoral level differ significantly.

¹³Mode 1 is “cross-border” services transactions, where both services suppliers and consumers remain in their respective countries as the services cross borders. Mode 2 is “consumption abroad”, where consumers move across the border to consume services. Mode 3 is “trade through a commercial presence”. Here, corporate services suppliers, such as foreign banks, move across borders to supply services in foreign markets. Mode 4 is the “movement of natural persons”, in which individual services suppliers, such as engineers, move across borders to supply services.

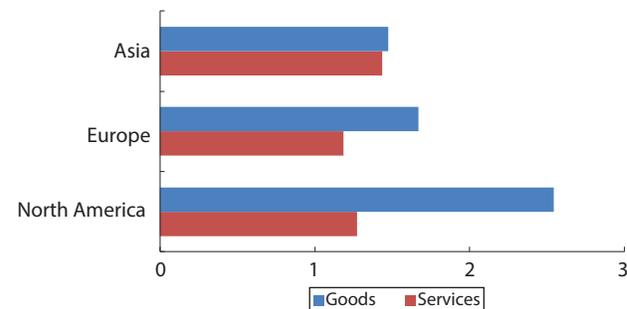
¹⁴Services trade statistics include some services trade other than Mode 1 because services are usually transacted under a combination of supply modes. For example, computer and information, other business services and personal, cultural, and recreational services are delivered through Modes 1 and 4. In the case of construction, Modes 3 and 4 may be involved. Travel is services consumption by travelers, and therefore falls under Mode 2. For details, see A. Maurer et al. 2008. *Measuring Trade in Services*. In A. Mattoo, R. Stern and G. Zanini (eds). *A Handbook of International Trade in Services*. Oxford: Oxford University Press.

Figure 15: Intraregional Trade Share, 2010



Note: Asia refers to the People’s Republic of China; Hong Kong, China; Japan; the Republic of Korea; and Singapore. Europe refers to France, Germany, Italy, the Netherlands, Spain, and the United Kingdom. North America refers to Canada, Mexico, and the United States. Source: ADB calculations using data from *Direction of Trade Statistics*, International Monetary Fund (for goods) and *Service Trade Statistics*, United Nations (for services).

Figure 16: Intraregional Trade Intensity, 2010



Note: Asia refers to the People’s Republic of China; Hong Kong, China; Japan; the Republic of Korea; and Singapore. Europe refers to France, Germany, Italy, the Netherlands, Spain, and the United Kingdom. North America refers to Canada, Mexico, and the United States. Source: ADB calculations using data from *Direction of Trade Statistics*, International Monetary Fund (for goods) and *Service Trade Statistics*, United Nations (for services).

In fact, the PRC is the second largest goods trader, while only the fourth largest services trader. Likewise, Japan is the fourth largest goods trader, but the sixth largest services trader.

In the case of North America, services trade intensity is significantly below that of goods trade; services about half that of goods, the same as its intraregional services trade share. In other words, North America’s lower intraregional services trade share is due to a regional bias factor, not a weight factor. This also consistent with common understanding of US trade: it is a global services trader, while a regional goods trader. In the case of Europe, intraregional trade intensity of services is slightly below that in goods, just as in the case of intraregional trade share. Thus, again, Europe’s slightly lower intraregional services trade share than in goods is due to a regional bias factor, not weight.

Thus, it can be said that while Asian countries trade services with each other intensively, their weight in the

Table 4: The Status of Determinants of Services Trade

	Common Language	Archipelagic Nature	Services RTA Networks
Asia	High	High	Low
Europe	Low	Low	High
North America	High	Very Low	High

RTA = regional trade agreement.

Notes: Asia refers to the People's Republic of China; Hong Kong, China; Japan; the Republic of Korea; and Singapore. Europe refers to France, Germany, Italy, the Netherlands, Spain, and the United Kingdom. North America refers to Canada, Mexico, and the United States.

"High" status leads to higher regional bias in services than goods. For example, higher level of archipelagic nature leads to more trade in services than goods, because the lack of land border creates unfavorable condition to goods trade rather than services trade.

Source: S. Hamanaka. 2013. Cross-regional comparison of trade integration: The Case of Services. *ADB Working Paper Series on Regional Economic Integration*, No. 108. Manila: ADB.

global services trade has been relatively insignificant. It is wrong to argue that intraregional services trade in Asia is insignificant just because its intraregional services trade share is low. In absolute terms, Asian countries do trade heavily with non-Asians, but relatively, they also trade a great deal within the region. Also interesting is that Asia's regional bias in services trade is higher in absolute terms than in either North America or Europe. For the intensity of goods trade, however, Asia is lowest among the three regions. In short, Asia is the only region where regional services trade intensity is comparable to its goods trade bias, and the lower intraregional services trade share compared with its goods trade is because of weight, not regional bias.

Asia's relatively high regional bias in services trade can be explained by two determinants (Table 4).¹⁵ The first is the common language factor. There seems to be a consensus that the common language factor affects services trade much more than in goods trade.¹⁶ If two countries share the same language, the likelihood of deepening services trade rather than goods trade increases. This is understandable because language is crucial in supplying services. In fact, Asia has a relatively high-level of a shared language (Chinese); again, more essential to services trade than goods trade. The second determinant is the archipelagic nature of the region. Many studies show that a common land border affects

¹⁵For the review of determinant factors of goods and services trade, see S. Hamanaka. 2013. Cross-Regional Comparison of Trade Integration: The Case of Services. *ADB Working Paper Series on Regional Economic Integration*. No. 108. Manila: ADB.

¹⁶F. Kimura and H-H. Lee. 2006. The Gravity Equation in International Trade in Services. *Review of World Economics*. Weltwirtschaftliches Archiv. 142 (1). pp. 92–121; A. Lejour and J.W. de Paiva Verheijden. 2004. Services Trade within Canada and the European Union: What do They Have in Common? *CPB Discussion Paper*. No. 42; C. Lennon. 2009. Trade in Services and Trade in Goods: Differences and Complementarities. *WiiW Working Papers*. No. 53. Vienna: The Vienna Institute for International Economic Studies; K. Head, T. Mayer, and J. Ries. 2009. How Remote is the Offshoring Threat? *European Economic Review*. 53 (4). pp. 429–444.

goods trade more than services trade.¹⁷ A common land border has a larger positive impact on goods rather than on services trade between two countries. This is also understandable given the types of goods that can be easily delivered via land transportation. However, most Asian nations are separated by water—no common land borders—which favors services trade over goods trade.

The explanatory power of joining regional trade agreements (RTAs) is ambiguous when comparing goods and services trade. But this is partly because most studies compare the impact of a goods agreement on both goods and services trade, not the impact of a services agreement on services trade. However, recent studies find that a goods agreement has a small positive impact on services trade, while a services agreement has a larger positive impact on services trade.¹⁸ Thus, RTAs seem to have a larger impact on services than goods if they include a substantial services component (or chapter). Supposing that RTAs covering services have a larger impact on services than goods, one could argue that the poor status of services agreement networks in Asia would have a negative impact on the regional bias in services trade relative to goods.

In order to further integrate Asia's services trade, effective regional services agreements would be necessary. The poor status of services RTA networks in Asia creates unfavorable conditions for regional bias in services trade relative to goods trade. In contrast, both Europe and North America have region-wide services agreements. If there were effective services agreement networks in Asia—or even a regional services agreement—the regional bias (regional integration) in services would have been much higher than that in goods.

Updates on Financial Integration

The impact of the 2008/09 global financial crisis continues to affect financial integration in Asia due to the region's high degree of interdependence with the world economy.

In response to the crisis, advanced economies, particularly the US, used QE—large-scale purchases of government securities and other securities—to

¹⁷See footnote 16.

¹⁸I. Park and S. Park. 2011. Regional Liberalisation of Trade in Services. *World Economy*. No. 34. pp. 725–740.

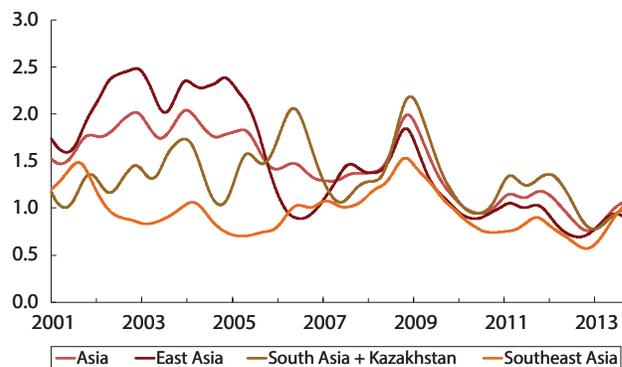
prevent their economies from falling into recession, and in so doing helped stabilize global economic conditions. The effect on Asia was felt more on financial markets than on the real economy. In advanced economies, the availability of this new liquidity also helped improve market confidence and spurred economic activity, facilitating the start of the recovery. However, the massive injection of money also had an unintended effect of encouraging large capital inflows into developing Asia's financial markets as investors searched for higher yields. When announced in April 2013, Japan's qualitative and quantitative easing also triggered volatility in Asian equity, bond, and currency markets. And when the US Fed announced in May its plans to taper quantitative easing as the US economy strengthened, foreign capital began flowing out of the region.

While price co-movements among Asian equities increased in 2009 and 2012 in response to the global shock and eurozone crisis, daily equity returns were less synchronous in 2013, with increased dispersion observed across all subregions.

The combined impact of (i) expectations of unwinding easy monetary policy worldwide, (ii) the slowdown of economic growth in the PRC, (iii) political tensions in the Middle East, and (iv) a variety of domestic risks, created a trend of increased dispersion among Asia's financial markets (**Figure 17**). In East Asia, Japan's stock markets surged while others in the subregion were more subdued (**Figure 18**). Japan's equity market showed strong growth as Abenomics began to boost the real economy.¹⁹ In contrast, equity markets in the NIEs fell as exports and economic growth eased in H12013—in response to slower growth in the PRC. Stock indexes in the PRC continued to drop amid weaker manufacturing and export growth, along with tightened liquidity as authorities slowed credit expansion—particularly in the “shadow” banking system. In Southeast Asia, equity markets were mixed. They rose early in the year as strong domestic demand insulated the subregion from global weakness—boosting market confidence—but declined beginning in June as the US Fed's statement of impending tapering of quantitative easing spread fears of capital flow reversals. Equity markets in South Asia and Kazakhstan also showed diverging trends with most

¹⁹Abenomics refers to “three arrows” or policy measures introduced by Prime Minister Shinzo Abe shortly after his reelection in December 2012. The three arrows comprise of massive fiscal stimulus, aggressive monetary easing, and structural reform to enhance the country's competitiveness.

Figure 17: Cross-Market Dispersion of Equity Returns (%)



Note: Cross-market standard deviation of daily stock market returns, detrended using Hodrick-Prescott (HP) filter. Asia includes East Asia, South Asia plus Kazakhstan, and Southeast Asia. East Asia includes the People's Republic of China; Hong Kong, China; Japan; the Republic of Korea; Mongolia; and Taipei, China. South Asia includes Bangladesh, India, Pakistan, and Sri Lanka. Southeast Asia includes Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam. Data until 16 September 2013. Source: ADB calculations using data from Bloomberg.

markets stabilizing, except for Pakistan's bullish market, which rose strongly on the back of rising banking and construction stocks.

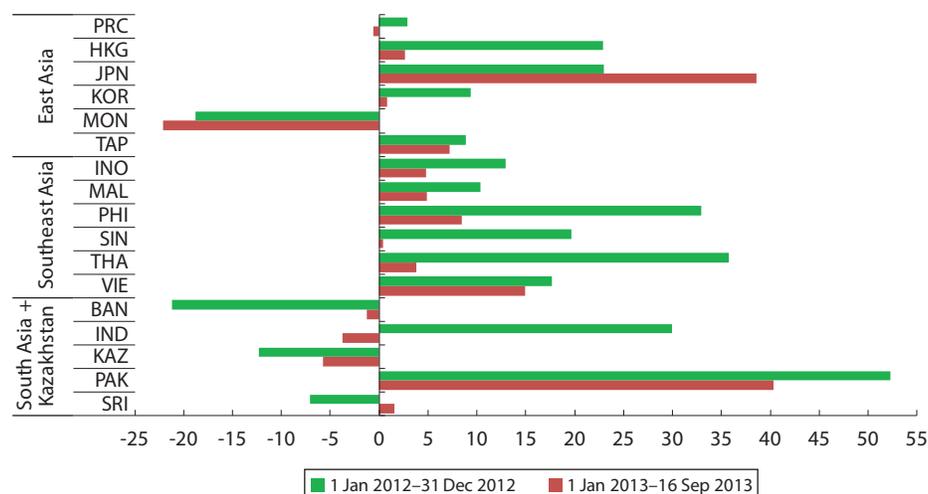
The movements of Asian bond yields continue to be less synchronous, as the selloff by foreign investors affected economies perceived to be more vulnerable.

The coefficient of variation of 10-year bond yield spreads for Southeast Asian economies has increased, largely driven by an increase in Indonesian bond yields (**Figure 19**). These reflect deteriorating current account conditions and rising inflation. Bond yields in Thailand also increased in July as its fiscal position, current account position, and growth prospects weakened. However, bond yields in Malaysia and the Philippines have remained relatively stable as they continue to run current account surpluses. In East Asia, bond yields have generally been unaffected by capital outflows as these economies are perceived to be more stable. Meanwhile, 10-year bond yields for South Asia closely follow India and have shown very limited movement over time.

Despite the significant selloff of Asian equities and bonds, foreign direct investment inflows have become more stable, due to the region's large domestic markets and key role as an export base.

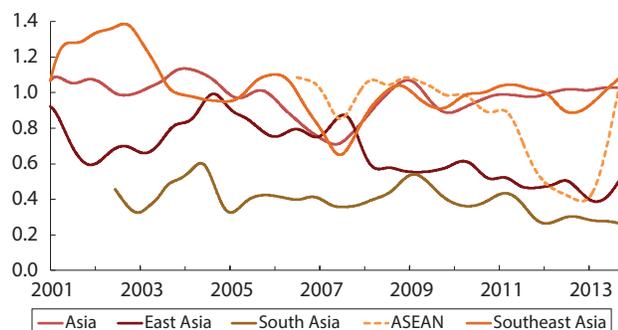
In 2011, total FDI inflows to the ASEAN; Australia; the PRC; Japan; the Republic of Korea; Hong Kong, China; India; Pakistan; and New Zealand topped \$251 billion,

Figure 18: Growth of Stock Price Indexes—Asia (%)



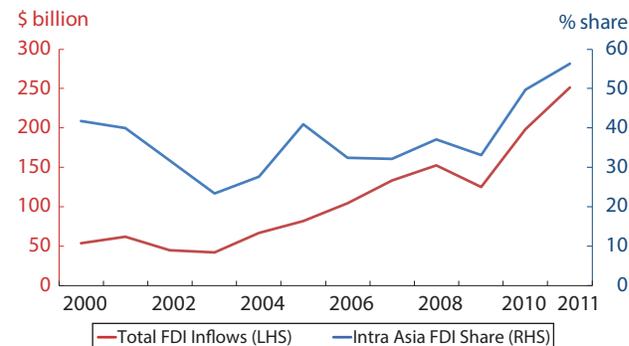
BAN = Bangladesh; PRC = People's Republic of China; HKG = Hong Kong, China; IND = India; INO = Indonesia; JPN = Japan; KAZ = Kazakhstan; KOR = Republic of Korea; MAL = Malaysia; MON = Mongolia; PAK = Pakistan; PHI = Philippines; SIN = Singapore; SRI = Sri Lanka; TAP = Taipei, China; THA = Thailand; VIE = Viet Nam.
 Notes: Data refer to the main index in each economy. For the PRC, daily stock price indexes of combined Shanghai and Shenzhen composites, weighted by their respective market capitalization. For India, Bombay Stock Exchange 100.
 Source: ADB calculations using data from Bloomberg.

Figure 19: Coefficient of Variation of 10-Year Bond Yield Spreads



Note: Coefficient of variation of 10-year government bond yield spreads over benchmark United States Treasuries, detrended using Hodrick-Prescott (HP) Filter. Asia includes East Asia, South Asia, and Southeast Asia. East Asia includes the People's Republic of China; Hong Kong, China; Japan; the Republic of Korea; and Taipei, China. South Asia includes India, Pakistan, and Sri Lanka. ASEAN-4 includes Indonesia, Malaysia, the Philippines, and Thailand. Southeast Asia includes ASEAN-4 plus Singapore and Viet Nam. Data until 16 September 2013.
 Source: ADB calculations using data from Bloomberg.

Figure 20: FDI Inflows and Intra-regional FDI Share—Asia



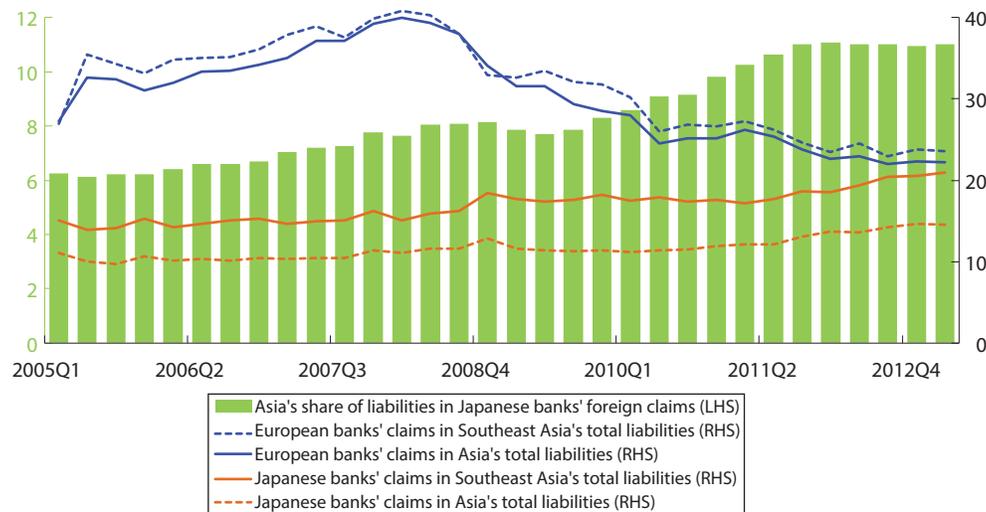
FDI = foreign direct investment, LHS = left-hand scale, RHS = right-hand scale.
 Note: Asia includes ASEAN; Australia; the People's Republic of China; Hong Kong, China; India; Japan; Pakistan; the Republic of Korea; and New Zealand. Data for Australia and New Zealand start from 2001.
 Source: ADB calculations using data from ASEAN Secretariat, and national sources.

\$99 billion more than the levels during the 2008/09 global financial crisis (Figure 20). During the same period, the share of intraregional FDI to total inflows also increased from 37.1% in 2008 to 49.8% in 2010 and to 56.3% in 2011. Part of the reason for increasing intraregional FDI shares is the increased outward orientation of FDI from the PRC, Japan, and the Republic of Korea. By country, the PRC and Japan continue to dominate FDI inflows although the PRC's share may fall as labor costs rise and the economy diversifies and shifts some manufacturing to other parts of the region. Among economies receiving sizeable FDI inflows are Hong Kong, China; Singapore; the Republic of Korea; Malaysia; India; Thailand; and Indonesia.

Japanese bank lending in the region continues to rise, offsetting some of the retrenchment by European banks after the 2008/09 global financial crisis.

The share of Asian international borrowing from Japanese banks remained slightly above 10% in the last quarter of 2012, continuing the buffer against declining European exposure (Figure 21). Japanese bank claims on Asian liabilities to foreign banks increased from 11.1% in the first quarter of 2005 to 14.5% in the fourth quarter of 2012; and on Southeast Asia's liabilities from 15.1% to 20.9% during the same period. European bank lending

Figure 21: Japanese and European Banks' Foreign Claims in Asia (% share of total claims)



LHS = left-hand scale, RHS = right-hand scale.

Notes: European banks (excluding United Kingdom banks) based on Bank for International Settlements (BIS) definition.

Asia excludes Australia, Japan, and New Zealand due to differences in the structure of their economies with the rest of Asia.

Total foreign claims of banks from 22 BIS reporting economies.

Source: ADB calculations using data from Bank for International Settlements (Table 9D). Data accessed 11 July 2013.

decreased from 27.2% to 22.2%, and 26.9% to 23.6% in Asia and Southeast Asia, respectively (**Box 2**).

Going forward, the progress of financial integration in the region will largely reflect how recent financial market volatility plays out.

Three plausible scenarios can illustrate some of the likely impact and mitigation measures that could be taken in response to changing conditions:

Early in the year, a key scenario is a full blown crisis—similar to the 1996/97 Asian financial crisis—arising from a disorderly tapering of quantitative easing in the US. The likelihood of this scenario has now ebbed with the US Fed postponing its plan for an early exit. More so, it is important to stress that developing Asia is now in a much stronger position to weather any storm than it was in 1997. Most economies retain current account surpluses, lower levels of external debt, and much higher levels of foreign reserves. Since 1997, the region has also made significant progress in putting in place sound macroeconomic management, financial regulation and supervision, and corporate governance.

Thus, a more plausible scenario is a temporary increase in capital outflows with moderate effects on production and economic growth. Under this scenario, capital flow volatility will likely ease as the US recovery strengthens. Only countries displaying weak fundamentals (in economic growth, fiscal and current account balances, and outstanding foreign debt, among others) will be hard hit, while others will weather any storm. Natural financial stabilizers will manage the effect, with asset prices and exchange rates adjusting gradually. Growth would only slow for key economies with large external and fiscal imbalances. But currency depreciation, for example, will make exports more competitive, helping the external balance. This scenario could worsen if countries try to inappropriately defend currencies, protect domestic markets, and support business through subsidies. Then cross-border capital flow volatility will be prolonged, hurting output, employment, and prospects for financial integration. To mitigate these risks, it may be useful for authorities to directly address the source of imbalances, adopt measures that improve the credibility of government policy and work to further boost economic competitiveness.

Another scenario is a new bubble emerging from the slower pace of US QE tapering and renewed dynamism in the PRC, which could bring back capital flows and appreciating Asian currencies. Under this condition, financial markets (equities, bonds, and currencies) would further strengthen and drive the economic recovery and

Box 2: Asia's Rising Exposure to Intraregional Bank Lending¹

Since the 2008/09 global financial crisis (GFC), Asia's regional economic and financial integration has been strengthening. One area where this has become apparent is Asia's rapidly rising exposure to intraregional bank lending, particular since 2010. Aside from the increased portfolio investment contributing to deepening regional financial integration, intraregional bank lending is becoming an emerging new source of economic growth—and financial volatility—in Asia.

Since the GFC, Asia's exposure to European bank lending decreased as a percent of borrowers' total outstanding domestic credit. This was due to European bank deleveraging in the region, precipitated by the eurozone sovereign debt crisis. European bank exposure in Asia fell from 12.1% in 2007 to 7.5% in 2012, but it was uneven across subregions. In fact, South Asia, including India, increased its exposure to European banks—from 13.3% in 2007 to 17.5% in 2012.

Similar to the effect of European deleveraging, Asia also saw a decrease in exposure to US banks—from 3.1% in 2007 to 2.5% in 2012. The exception was Asia's newly industrialized economies (NIEs)—Hong Kong, China; the Republic of Korea; Singapore; and Taipei, China—which increased their US bank lending exposure from 7.6% in 2007 to 8.9% in 2012.

Notable features of Asia's exposure to regional bank credit flows

Despite data limitations, Asia's exposure to intraregional bank lending has several notable features that warrant further study and may hold policy implications.

First, with European banks already deleveraged and new US liquidity expected to taper, Asia's appetite for intraregional bank credit flows has been on the rise. In 2010, when the impact of the eurozone sovereign debt crisis was strongest—and European banks were pulling back from the region—intraregional bank lending rose significantly.

In particular, Asia's exposure to Japanese bank lending more than doubled between 1997 and 2012—to about \$511 billion, well beyond the \$208 billion 1997 and \$274 billion pre-crisis 2008 levels (**Box figure 1**).

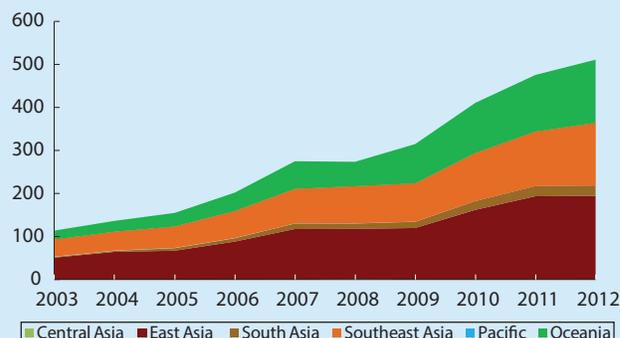
Second, by subregion, the NIEs, ASEAN-5, and South Asia all substantially increased their exposure to Japanese bank credit flows as a percent of borrower's domestic credit.² The NIEs rose from 5.2% in 2010 to 6.2% in 2012, ASEAN-5 from 4.3% to 4.8%, and South Asia from 2.0% to 2.5%.

Third, since the start of 2010, Asia's higher exposure to Japanese bank lending was accompanied by significantly more exposure to Australian banks in terms of the size of bank credit flows (**Box figure 2**).

¹Asia here includes Oceania and the Pacific in describing financial links and channels.

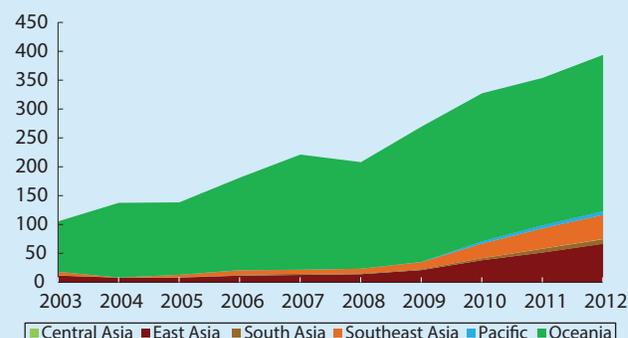
²ASEAN-5 includes Indonesia, Malaysia, the Philippines, Thailand, Viet Nam.

1: Lending to Asia—Japanese Banks (\$ billion)



Source: ADB calculations using data from Table 9B (Consolidated foreign claims of reporting banks—immediate borrower basis), Bank for International Settlements.

2: Lending to Asia—Australian Banks (\$ billion)



Source: ADB calculations using data from Table 9B (Consolidated foreign claims of reporting banks—immediate borrower basis), Bank for International Settlements.

In particular, Australian bank-lending within the region rose steeply from 2009, reaching \$393.8 billion in December 2012—almost double its size of its bank credit flows in December 2006.

Behavior of bank credit flows

In practice, a sizable portion of cross-border flows are intermediated by Asia's banks. Cross-border bank credit flows continue to account for a substantial proportion of total cross-border flows in developing Asia (**Box table**).

From 2008Q2 to 2009Q2, emerging economies saw three important shifts: (i) capital flows were more volatile than changes in the real economy; (ii) banking sector credit flows were highly volatile; and (iii) bank credit flows reacted differently from other types of capital flows—foreign direct investment (FDI) flows remained steady, even given the heightened crisis; equity and bond portfolios rapidly reversed, but quickly recovered; while bank lending withdrew sharply (**Box figure 3**). The lesson is that banking sector

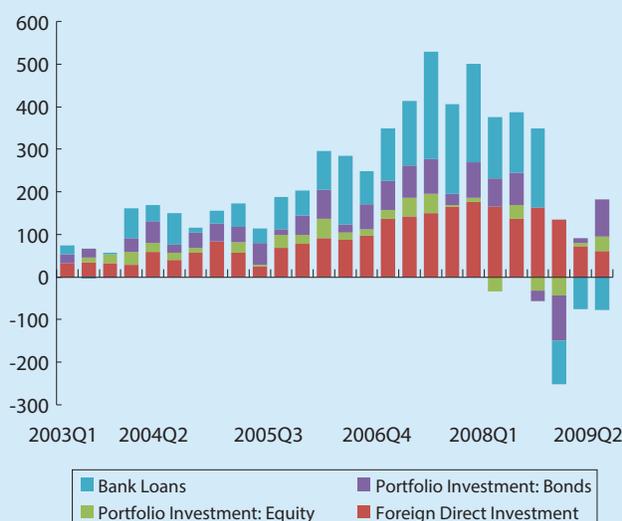
Table: Developing Asia's Private External Financing (% of total)

	2006	2007	2008	2009	2010	2011	2012
Bonds	12.9	9.1	8.3	15	18.7	30.1	36.6
Equities	50.2	47.1	23.1	51.1	49.2	24.6	30.5
Loans	36.9	43.8	68.6	34	32.1	45.2	32.9

Note: Developing Asia refers to: a) Bonds- the People's Republic of China, Fiji, India, Indonesia, Malaysia, the Philippines, Sri Lanka, Thailand, and Viet Nam; b) Equities- Bangladesh, Cambodia, the People's Republic of China, Fiji, India, Indonesia, Lao PDR, Malaysia Maldives, the Philippines, Sri Lanka, Thailand, and Viet Nam; c) Loans- Bangladesh, Bhutan, Brunei Darussalam, Cambodia, the People's Republic of China, India, Indonesia, Lao PDR, Malaysia, Maldives, Marshall Islands, Myanmar, Pakistan, Papua New Guinea, the Philippines, Sri Lanka, Thailand, and Viet Nam.

Source: *Global Financial Stability Report*, various issues, International Monetary Fund.

3: Composition of Capital Inflows (\$ billion)



Source: Directly culled out from Figure 4.3: Liquidity-Receiving Economies: Composition of Capital Inflows, *Global Financial Stability Report April 2010*, International Monetary Fund.

credit flows appear to be procyclical and volatile, potentially exacerbating the immediate effects of short-term capital flow reversals on financial stability in times of crisis.

Preparing policy options ahead of time

Whether Asia's recently rising intraregional bank exposure is structural or temporary remains a question. But the behavior of the region's bank credit flows show (i) a steep increase in intraregional exposure, particularly to Japanese and Australian banks; and (ii) since 2002, there have been highly correlated movements in regional and global liquidity, specifically between Japanese and Australian bank and US bank credit flows (**Box figure 4**).

4: Bank Credit Flows to Asia—Co-movement of Japan plus Australia and the United States (\$ billion)



Note: Developing Asia includes Asia less Australia, Japan, and New Zealand. Source: ADB calculations using data from Table 9B (Consolidated foreign claims of reporting banks—immediate borrower basis), Bank for International Settlements.

Japanese and Australian bank credit flows to the region together totaled \$904.8 billion in December 2012, almost close to the level of US bank credit flows to the region (\$942 billion). And it appears to continue its upward trend—though there remains the possibility of a sudden reversal should a shock like the 1997/98 Asian financial crisis hit the region. As the US Federal Reserve gradually enters its tapering phase, Asia needs to closely monitor financial conditions and the nature of its regional bank credit flows—in addition to its portfolio investment flows.

While crises tend to drive Asia toward greater financial integration and cooperation, they also deepen the risk of contagion by increasing the exposure to regional bank credit flows through financial channels. Research shows that cross-border bank flows mushroomed over the past decade.³ Bruno and Shin (2013) also suggest the leverage cycle of global banks as being a prime determinant of contagion across borders.⁴

A notable caveat is that bank lending is highly procyclical, rising significantly in good times and draining rapidly during bad—whether it is caused by weak fundamentals or deteriorating macroeconomic and financial prospects. Given the financial turmoil in Asia from May to early September this year, Asia's increasing appetite for regional bank credit flows may require Asian policymakers to analyze its policy implications, and boost dialogue through regional forums to enhance financial coordination and cooperation to preserve and strengthen regional financial stability.

³See G. Hoggarth, L. Mahadeva, and J. Martin. 2010. Understanding International Bank Capital Flows During the Recent Financial Crisis. *Bank of England Financial Stability Paper*. No.8. London: Bank of England.

⁴V. Bruno and H.S. Shin. 2013. Capital Flows, Cross-border Banking and Global Liquidity. *NBER Working Paper* No. 19038. Cambridge, MA: National Bureau of Economic Research.

cross-border flows in the region. Consequently, countries could afford to ignore their structural imbalances in the short term, which could lay the foundation for a more difficult adjustment in the future. As in the scenario above, direct action to address the source of the imbalance and enhance competitiveness are more sustainable. Regional action to strengthen regional integration through a more harmonized regional regulatory framework and settlement mechanism could be in order, in addition to enforcing stricter regulation on short-term capital inflows into the region.

Regional Public Goods

Regional public goods—generally defined as a public good shared by two or more countries in a specified region—offer solutions to problems that individual countries cannot correct alone.

Public goods vary in terms of their “publicness”, depending on how they are produced. Some require equal contributions or “weight” from participating members or countries, while others are critically dependent on the most powerful member (“best shot”), while others may depend on the actions of the weakest member. In general, however, regional goods cannot be supplied by normal market mechanisms, as potential suppliers are deterred by the knowledge they will be unable to reap the full benefits of their efforts. In addition to this “non-excludability”, regional public goods also have a “non-rivalry” character, whereby use of public goods by some does not reduce the supply for others. The two characteristics together limit the supply of goods from a single private supplier, or as in the case of regional goods, from one country.

Economic integration and transmission of disease

Increased cross-border transmission of disease—through increased human and animal mobility—is one of the most serious costs of cooperation and integration.

Regional cooperation and integration generates both costs and benefits. Successful cooperation programs therefore strive to maximize the net benefits of cooperation and minimize risks. Unfortunately, increased cross-border transmission of diseases through better human and animal transportation can have serious deleterious effects as recent history shows. The increased speed and volume of cross-border trade from increasing economic and social integration in Asia and the Pacific has broadened the risk and spread of communicable diseases. The 2002–2003 Severe Acute Respiratory Syndrome (SARS) epidemic in Asia clearly demonstrated the significant regional social and economic impact of better regional connectivity. Ultimately the epidemic was controlled, but only through drastic and costly reductions in travel and human interaction. Aside from the human cost—nearly 800 died out of over 8,000 infected—economies suffered as well from the severe impact on business travel, Asian tourism, and air transport.

Likewise, the H5N1 avian influenza (AI) epidemic caused significant loss of life and economic consequences, particularly severe on the livelihoods of the poor—often the most at risk—in infected areas. The epidemic was controlled only after the culling of millions of chickens. The spread of drug-resistant malaria and dengue fever can also be associated with increased cross-border migration. Of over 2.5 billion people living in the tropics and subtropics at risk to dengue and dengue hemorrhagic fever, nearly 70% live in Asia and the Pacific. Dengue fever alone is estimated to cost Asian countries \$950 million a year, with Indonesia, Thailand, and the Philippines being particularly affected. The current situation of malaria in the Greater Mekong Subregion, with the emergence of resistance to artemisinin—the most effective antimalarial drug available—raises particular public health concerns, not only for border areas but through the region.

What to do: The public goods response

Dealing effectively with cross-border health problems—some new diseases and others re-emerging—requires strong country-level intervention and improvements in health systems at national, state or provincial, and local levels.

Given the cross-country spread of new, mutated, and traditional diseases, national efforts must be complemented by international and regional collaborative efforts.

Sustainable regional economic cooperation in Asia requires complementary mechanisms that improve disease control and emergency response capabilities. Improving the cross-border flow of information on communicable diseases—and strengthening regional surveillance and response capabilities—are central for a public goods response. Multilateral development agencies have a major role to play in helping provide the technical, economic, social, and political means of controlling cross-border disease transmission. Over the past decade, ADB, for example, has provided substantial assistance at both the regional and country levels for interventions against SARS, AI, malaria, and dengue, as well as for broader programs on communicable disease control and transboundary animal disease. This experience suggests several ways global and regional public goods can minimize and mitigate the unintended consequences of closer regional cooperation and integration.

International norms and standards for dealing with communicable diseases have to be established and/or strengthened.

The International Health Regulations (IHR 2005)—adopted by all World Health Organization (WHO) member countries and entered into force in June 2007—provides a legal framework for identifying public health threats, assessing their risks, and putting in place effective public health responses. As well as providing a set of standards and a legal framework for information sharing, IHR 2005 requires each state to establish a national focal point to ensure adherence to reporting and verification requirements and strengthen response capabilities in surveillance. IHR 2005 is much broader than its predecessor, which focused only on cholera, plague, and yellow fever, and placed a heavier burden on signatory nations.

Effective partnerships between many different groups and sectors are needed.

Asia's development experience has showed that effective prevention and control of cross-border disease depends on multisectoral collaboration and multi-dimensional approaches. Coordination between health authorities of neighboring countries is obvious—as most times complementary and simultaneous interventions are needed on both sides of a border. It is critical that countries understand the health policies of neighbors and that health agencies from neighboring countries cooperate at the local level. Less obvious but equally important is the need for cooperation between health authorities and those in charge of external trade, transport networks, and customs, whose primary concerns do not necessarily cover the health sector. A holistic approach to healthy borders—which ensures that investment in regional cooperation projects does not unintentionally increase cross-border health hazards—is required. Coordination between authorities responsible for human health and those overseeing animal health is also essential at both regional and national levels.

Regional and national public health care systems to detect disease outbreak, channel interventions, and monitor and report progress on communicable disease control are needed.

Health infrastructure is a central requirement for prevention, diagnosis, and treatment of communicable disease. Local level infrastructure such as primary health care centers need to be established near international entry points in or nearby regional economic and transport corridors. Access to these physical facilities—and effective distribution of medicines—also need to be available and purpose-built social programs for mobile populations and ethnic groups may be required.

Health interventions must focus more on border areas. Health systems in border areas may require special attention in terms of financial outlays as well as the type of interventions. Health systems may be particularly weak in more isolated border areas due to physical remoteness, while being subjected to complex problems created by cross-border movements. Migrants, legal or illegal, may have even less access to health services and thereby be at great risk to communicable diseases—while at the same time stigmatized as a source of disease. The problem for Asian countries with many

different ethnic minorities who are residing on or near international political borders may complicate disease dynamics and intervention further.

Disease surveillance and reporting capabilities need to be improved for rapid response and effective treatment. The capacities of individual health workers, including their ability to function effectively in multi-country settings, are needed. Their capacity to cooperate should also be augmented by better laboratory diagnostic facilities and drug quality certification as well as by the establishment of effective institutions for cross-border and regional collaboration.

Research and knowledge transfer about diseases in poorer countries should be increased. Scientific knowledge, particularly about region-specific issues, is essential. Global and regional efforts to reduce the so-called “10/90 gap”—where some 10% of global health resources are spent on diseases that affect 90% of the world—are needed. Two approaches can be used to address this gap. First, research and development can be promoted either by establishing research facilities specializing in these neglected diseases by the public sector, or through providing incentives for public-private partnerships. A second approach would be to adopt the use of advance market commitments at the country or regional level to create a market and offer incentives to stimulate commercial development and rapid introduction of new and affordable vaccines and medicines.

How does one finance regional public health goods?

Financing regional public health goods is subject to three challenges. First, despite the increase in funding over the past 20 years from new sources—such as the Gates Foundation—requirements outstrip needs. Second, financing has to be long-term with minimum volatility, which would interrupt health services and interfere with effective planning. Since the non-exclusive nature of regional public goods can reduce their attractiveness to donor agencies, as well as countries and private sector entities, securing adequate investment in regional public health goods requires innovative financing. Several innovations have been attempted in Asia and could be expanded. Tapping private sector resources from philanthropies and businesses with strong interest in corporate social responsibility (CSR) may be a useful approach. Establishing public-private partnerships—especially where there is some prospect for longer term private sector profitability—may also

be a source of investment. Financing from either multilateral or bilateral development agencies through a multi-country health fund may also play a key role in making available critical investments.

Designing a multi-country health fund

The theory of public goods—along with ADB’s own experience in regional cooperation over the past two decades—provides several possible insights on how an effective regional health fund could pool resources and could be structured.

The fund should have minimal transaction costs. The number of actors carrying out essential functions in global health has increased dramatically since 1993, which in some cases have led to overlapping of functions and inefficiency, duplication, policy confusion, and undermining accountability. Regional cooperation is not a costless activity and consumes valuable technical and financial resources of developing countries. One way in which these problems can be minimized is to use existing regional cooperation institutions and networks, build on hard earned trust, and modify existing institutions to address new tasks rather than creating new ones.

Economies of scope and scale need to be carefully considered in the design of the fund. Strict subsidiary principles may reduce transactions costs of negotiating and supervising regional public goods. But an overly strict approach may be counterproductive when goods have important economies of scale in their production and distribution—for example, the procurement of pharmaceuticals. In such cases it may be more efficient to search for institutions with large jurisdictions. Similarly, if goods have broad economies of scope, the subsidiary approach will have to be modified and it may be more efficient to integrate different activities under the same institutional structure to take advantage of existing links.

The rationale for cooperation on regional health goods must be made clear early on. The costs and benefits of noncooperation as well as the expected benefits of cooperation to each member of a cooperative effort must be made, in particular to the government ministries in charge of overall national development and the financial purse strings.

The needs and capabilities of the weakest member of the group need to be effectively addressed for two reasons. First, the weak link needs to be provided with a rationale and the resources needed for its sustained commitment to cooperation. Second, failure in the weakest partner may derail progress of the entire initiative, for example, poor surveillance in one country may adversely affect otherwise effective interventions in other countries. Ensuring that recipients have a voice in priority setting that is at least as equal as that of donors will be critical.

The fund should have an open architecture. A strong foundational core which ensures efficient management and financial sustainability is critical. At the same time, it should be expandable and capable of handling emerging needs, new technological advances, and the participation of new partners, donors, as well as fund recipients.

Business Cycle Synchronization

There was a sharp rise in the degree of output correlation within Asia during the global financial crisis; afterward, it eased somewhat, yet remained at historic highs.

Macroeconomic interdependence is the degree to which individual economies interact with one another. One frequently used measure is the correlation between national output and prices. When economies share similar industries and face common shocks, output and prices are expected to move more closely with each other. While common shocks—particularly originating in global financial markets—may remain an important driving force behind these correlations, the close co-movements could also be the result of closer trade and financial links within Asia. Well-developed production networks—which rely on intra-industry trade in parts and components—increase the synchronization of output movements.²⁰

This section analyzes business cycle co-movements differently from previous issues of the *Asian Economic Integration Monitor*. The first difference is that deviation cycles from the trends in output are examined instead of simple output growth. The second difference is that the co-movements in business cycles of Asia's emerging economies are assessed against those of three major world economies—the PRC, Japan, and the US—rather

than pair-wise correlations between all economies in the region. These two differences offer a different perspective on business cycle co-movements in Asia to deepen understanding of Asia's business cycles in general.

In a classical cycle—as defined by the US National Bureau of Economic Research (NBER)—a recession (or economic contraction) is a period (between peak and trough) of declining economic activity spread across an economy, usually lasting for a minimum of two consecutive quarters. The trough marks the end of the downward phase and the start of the upward phase of the business cycle.²¹ However, in many emerging economies—even during economic downturns—the level of real GDP does not fall. Therefore, the business cycle in emerging economies does not fit the classical cycle. To compensate, economists often study deviation cycles—deviations of actual output from its trend component—that exhibit similar patterns to those of classical cycles in advanced economies.

Deviation cycles and their correlations are useful when analyzing business cycle co-movements between emerging Asian economies and major world economies.

The Hodrick-Prescott filter is used to detrend real GDP data and extract their deviation cycles. To be consistent, the US business cycle studied here is also based on its deviation cycle, which is more or less similar to that defined by NBER (except a minor cycle between 1994 and 1996). Official seasonally adjusted quarterly GDP data from 1993 were used wherever possible. The nine emerging Asian economies (EA-9) covered include the NIEs (Hong Kong, China; the Republic of Korea; Singapore; and Taipei, China), ASEAN-4 (Indonesia, Malaysia, the Philippines, and Thailand), and India (**Table 5**).

Group correlation coefficients are the means of the respective bilateral correlation coefficients included in the group. To calculate these mean correlation coefficients, the usual bilateral Pearson's product-moment correlation coefficients first had to be transformed into Fisher's z correlation coefficients, averaged and subsequently converted back into

²⁰ADB. 2012. Macroeconomic Interdependence. *Asian Economic Integration Monitor* July 2012. Manila.

²¹NBER. 2013. *US Business Cycle Expansions and Contractions*. <http://www.nber.org/cycles/cyclesmain.html>

Table 5: Business Cycle Correlation Coefficients (Hodrick-Prescott Filter Deviation Cycles)

	1993Q1–2013Q2	1993Q1–2003Q1	2003Q2–2013Q2
PRC–Emerging Asia-9	0.42 [0.22,0.58]	0.40 [0.11,0.63]	0.50 [0.22,0.70]
PRC–NIEs	0.48 [0.30,0.63]	0.31 [0.00,0.57]	0.62 [0.39,0.78]
PRC–ASEAN-4	0.36 [0.15,0.53]	0.54 [0.27,0.72]	0.32 [0.01,0.57]
PRC–India	0.55 [0.36,0.70]	0.10 [-0.28,0.46]	0.72* [0.53,0.85]
PRC–United States	0.17 [-0.05,0.37]	-0.12 [-0.41,0.19]	0.34* [0.04,0.59]
Japan–Emerging Asia-9	0.64 [0.48,0.75]	0.63 [0.41,0.79]	0.72 [0.53,0.85]
Japan–NIEs	0.67 [0.53,0.78]	0.64 [0.41,0.79]	0.76 [0.58,0.86]
Japan–ASEAN-4	0.64 [0.49,0.75]	0.78 [0.63,0.88]	0.74 [0.55,0.85]
Japan–India	0.43 [0.21,0.61]	0.06 [-0.32,0.42]	0.57* [0.32,0.75]
Japan–United States	0.59 [0.42,0.71]	-0.03 [-0.33,0.28]	0.85* [0.73,0.92]
Japan–PRC	0.46 [0.27,0.61]	0.50 [0.22,0.70]	0.45 [0.17,0.67]
United States–Emerging Asia-9	0.36 [0.16,0.54]	0.12 [-0.20,0.41]	0.66* [0.45,0.81]
United States–NIEs	0.49 [0.31,0.64]	0.29 [-0.01,0.55]	0.68* [0.48,0.82]
United States–ASEAN-4	0.18 [-0.04,0.38]	-0.18 [-0.46,0.13]	0.69* [0.48,0.82]
United States–India	0.50 [0.30,0.66]	0.66 [0.38,0.83]	0.43 [0.14,0.66]

ASEAN-4 = Indonesia, Malaysia, the Philippines, and Thailand. PRC = People's Republic of China. NIEs = Hong Kong, China; the Republic of Korea; Singapore; and Taipei, China.

Note: Emerging Asia-9 includes ASEAN-4, India, and NIEs. 95% confidence intervals are reported in square brackets.

* indicates that the statistic is significantly higher than 1993Q1–2003Q1.

Source: ADB calculations using data from Haver Analytics.

weighted correlation coefficients.²² To see whether business cycle co-movements might have changed over time, the group correlation coefficients in the first half of the sample period (from 1993Q1 to 2003Q1) are compared with the correlations calculated for the second half of the sample period (from 2003Q2 to 2013Q2).

Among the three major economies examined, Japan's business cycle was more synchronized over the past two decades with the US business cycle than with the PRC's, with the correlation between the PRC and US cycles insignificant over the full sample period.

However, both the PRC and Japan's economies appeared "decoupled" from the US economy during the first 10 years with correlation coefficients insignificant, and became "coupled" in the next 10 years. Moreover, from 2003Q2 to 2013Q2, the correlation coefficient between Japan and the US business cycles is significantly much higher than the one between the PRC and the US, indicating the global financial crisis brought these two economies much closer together than before. The co-movement in business cycles between the PRC and Japan remained steady over the past 20 years, with the correlation coefficients more or less at 0.5.

While business cycles in emerging Asian economies began to correlate more with the PRC's over the past two decades, the degree of output co-movements remained strong between emerging Asian economies and Japan, and significantly higher than that with the PRC and US; they grew more "coupled" with the US economy from 2003Q2 to 2013Q2 after "decoupling" from 1993Q1 to 2003Q1.

While the mean correlation coefficient between the EA-9 and the PRC is 0.42 for the whole sample period, it was 0.40 in the first half of the sample period and 0.50 in the second half. The degree of co-movement between India and the PRC has increased most significantly—from 0.10 to 0.72—while that between NIEs and the PRC also rose from 0.31 in the first half to 0.62 in the second half. However, the mean correlation coefficient between the deviation cycles of ASEAN-4 and the PRC has fallen

from 0.54 in the first half of the sample period to 0.32 in the second half. This is because after 2003, particularly after the global financial crisis, ASEAN-4 economies maintained robust growth or even accelerated (in the Philippines), while the PRC economy gradually slowed.

The degree of co-movement in business cycles between the EA-9 and Japan remained strong over the past two decades, with a mean correlation coefficient of 0.64 in the whole sample, rising from 0.63 in the first half to 0.72 in the second half. Japan had been the largest economy in the region for many years and a major investor throughout the region, while trade and financial links between Asian economies and Japan remain strong—which underlie the close co-movements in their business cycles. The business cycles in the NIEs and ASEAN-4 are closely correlated with Japan's, as the mean correlation coefficients are above 0.60 over the whole period and its sub-samples. India's business cycle has also become more correlated with Japan's, with the correlation coefficient increasing from 0.06 to 0.57.

The degree of business cycle co-movements between emerging Asian economies and the US has changed significantly over the past two decades. While the mean correlation coefficient is 0.36 for the whole sample, it rose from 0.12 in the first half of the sample to 0.66 in the second half. The simultaneous rise and fall in economic growth before and after the global financial crisis have contributed to the significant rise in business cycle synchronization. Both the NIEs and ASEAN-4 have become more synchronized with the US, with the mean correlation coefficient between the NIEs and US rising significantly—from 0.29 in the first half of the sample to 0.68 in the second half—and that between ASEAN-4 and the US reversing from -0.18 to 0.69. This is possibly because both groups globalized more in the past 10 years than the previous decade—which was also affected by the Asian financial crisis. The reverse occurred in India, whose business cycle was less synchronized with that of the US in the most recent 10 years—with the correlation coefficient declining from 0.66 to 0.43. This indicates that India's business cycle may be driven more recently by idiosyncratic factors.

The correlation analysis also shows that the EA-9 are more correlated with Japan than with either the PRC or the US, as the mean correlation coefficient between the EA-9 and Japan is significantly higher than those for the PRC and the US. The correlation with Japan was also higher in the first 10 years, but in the decade from 2003, the mean correlation between the NIEs and the three major economies are not statistically different from each other—though the mean correlation with

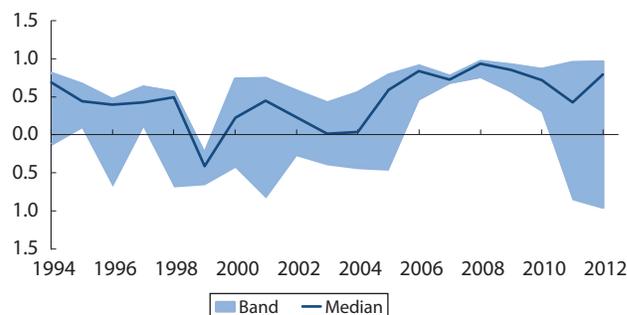
²²P. G. Hoel. 1947. *Introduction to Mathematical Statistics*. New York: Wiley; A.J. Faller. 1981. Notes: An Average Correlation Coefficient. *Journal of Applied Meteorology*, 20. pp. 203–205.

Japan is slightly higher than those with the PRC and US. The correlation between ASEAN-4 and Japan is higher, but not statistically different from that with US—yet it is statistically higher than that with the PRC. In contrast, India's business cycle was more correlated with the US in the 10 years from 1993, but became significantly more correlated with the PRC the following decade.

Business cycles in emerging Asian economies, the NIEs in particular, appear increasingly correlated with those in the PRC, possibly due to increasing trade and financial linkages between them.

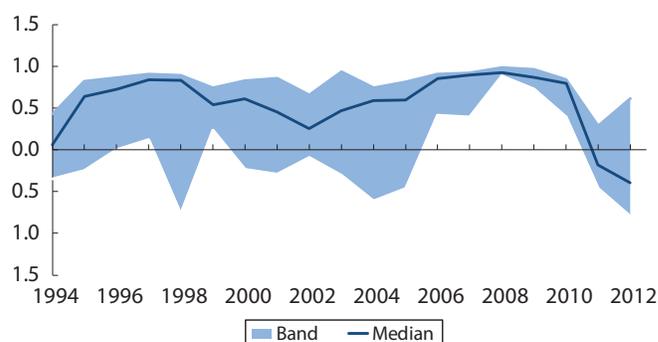
To provide a better view of the dynamics of business cycle co-movements, 3-year rolling correlation coefficients were calculated for the EA-9 with the three major economies (Figures 22, 23, 24). Constructed by the maximums and minimums of rolling correlation coefficients, the wide bands around the median correlation coefficients indicate large variations in business cycle correlations between the EA-9 and the PRC, Japan, and the US. Yet, the degree of business cycle synchronization between EA-9 and the PRC—despite a dip during the Asian financial crisis—gradually rose over the past two decades, with the median correlation remaining high even after the global financial crisis. On the other hand, the median correlations between the EA-9 and Japan or the US were high before 2008, but fell to negative after the global financial crisis. By looking at the different groupings, it is clear the NIEs became much more synchronized with the PRC in recent years, indicated by rising median correlations and narrowing bands, which drive the rise in the median correlation between the EA-9 and the PRC (Figures 25, 26, 27). The ASEAN-4, however, appear more correlated with Japan and the US, with the median correlations not falling much during the global financial crisis and rising afterward (Figures 28, 29, 30).

Figure 22: EA-9 Business Cycle Correlation—People's Republic of China



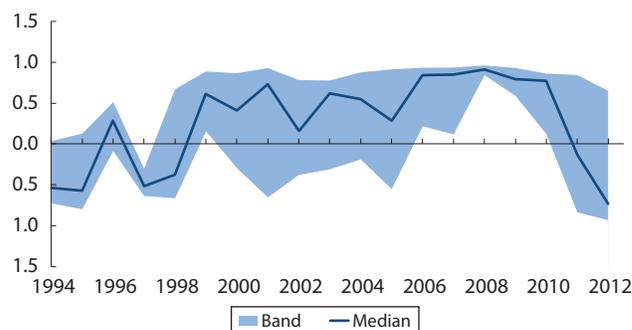
Note: Emerging Asia-9 (EA-9) includes Hong Kong, China; India; Indonesia; the Republic of Korea; Malaysia; the Philippines; Singapore; Taipei, China; and Thailand. Correlation based on cyclical Hodrick-Prescott (HP) filtered gross domestic product. Source: ADB calculations using data from Haver Analytics.

Figure 23: EA-9 Business Cycle Correlation—Japan



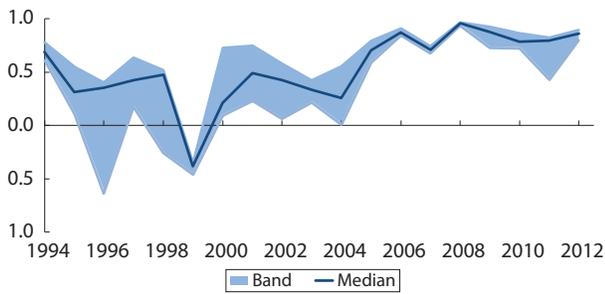
Note: Emerging Asia-9 (EA-9) includes Hong Kong, China; India; Indonesia; the Republic of Korea; Malaysia; the Philippines; Singapore; Taipei, China; and Thailand. Correlation based on cyclical Hodrick-Prescott (HP) filtered gross domestic product. Source: ADB calculations using data from Haver Analytics.

Figure 24: EA-9 Business Cycle Correlation—United States



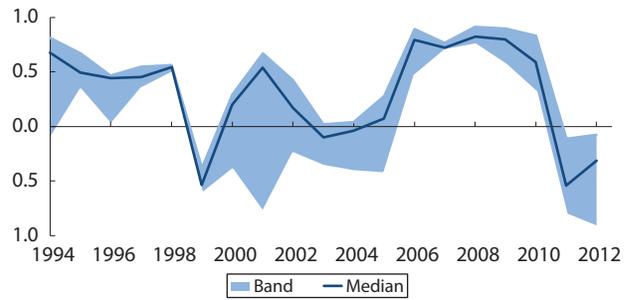
Note: Emerging Asia-9 (EA-9) includes Hong Kong, China; India; Indonesia; the Republic of Korea; Malaysia; the Philippines; Singapore; Taipei, China; and Thailand. Correlation based on cyclical Hodrick-Prescott (HP) filtered gross domestic product. Source: ADB calculations using data from Haver Analytics.

**Figure 25: NIEs Business Cycle Correlation—
People's Republic of China**



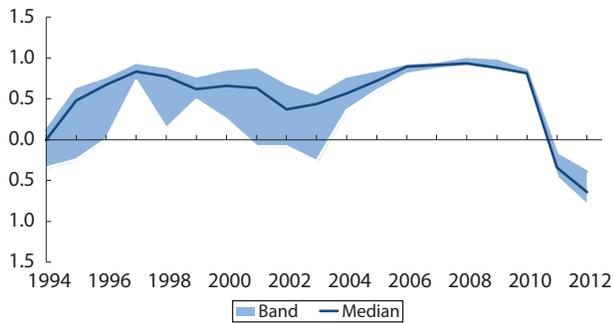
NIEs = Hong Kong, China; the Republic of Korea; Singapore; and Taipei, China.
Note: Correlation based on cyclical Hodrick-Prescott (HP) filtered gross domestic product.
Source: ADB calculations using data from Haver Analytics.

**Figure 28: ASEAN-4 Business Cycle Correlation—
People's Republic of China**



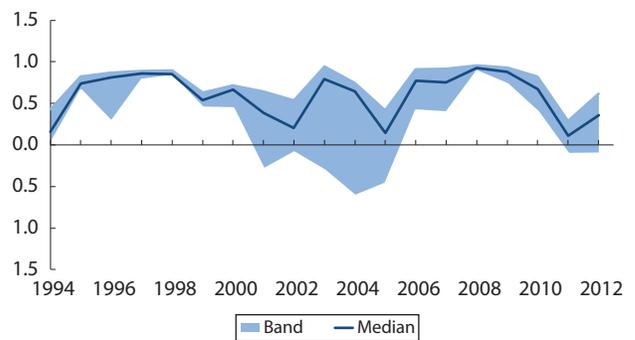
ASEAN-4 = Indonesia, Malaysia, the Philippines, and Thailand.
Note: Correlation based on cyclical Hodrick-Prescott (HP) filtered gross domestic product.
Source: ADB calculations using data from Haver Analytics.

Figure 26: NIEs Business Cycle Correlation—Japan



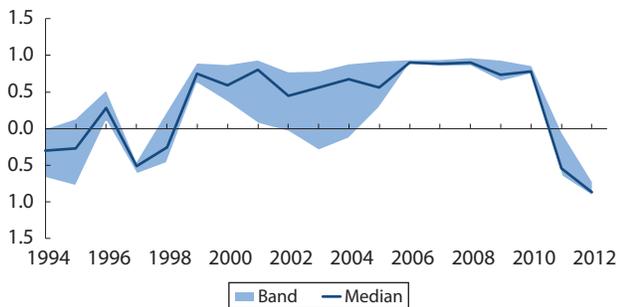
NIEs = Hong Kong, China; the Republic of Korea; Singapore; and Taipei, China.
Note: Correlation based on cyclical Hodrick-Prescott (HP) filtered gross domestic product.
Source: ADB calculations using data from Haver Analytics.

Figure 29: ASEAN-4 Business Cycle Correlation—Japan



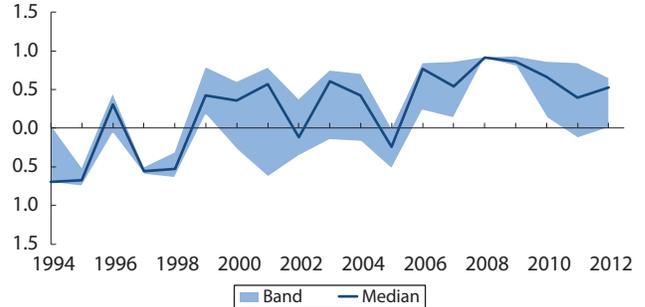
ASEAN-4 = Indonesia, Malaysia, the Philippines, and Thailand.
Note: Correlation based on cyclical Hodrick-Prescott (HP) filtered gross domestic product.
Source: ADB calculations using data from Haver Analytics.

Figure 27: NIEs Business Cycle Correlation—United States



NIEs = Hong Kong, China; the Republic of Korea; Singapore; and Taipei, China.
Note: Correlation based on cyclical Hodrick-Prescott (HP) filtered gross domestic product.
Source: ADB calculations using data from Haver Analytics.

Figure 30: ASEAN-4 Business Cycle Correlation—United States



ASEAN-4 = Indonesia, Malaysia, the Philippines, and Thailand.
Note: Correlation based on cyclical Hodrick-Prescott (HP) filtered gross domestic product.
Source: ADB calculations using data from Haver Analytics.

This suggests that a global business cycle surrounding the 2008/09 global financial crisis originated in the US. However, while the impact of recent expectations of a US tapering of quantitative easing on emerging economies indicates that emerging economies' growth may begin to diverge from the growth in the US, it remains to be seen whether this global cycle is in fact ending. There is also evidence that emerging Asian economies, particularly the NIEs, are becoming more correlated with the PRC. The expected structural adjustment in the PRC economy might also slow growth in Asia's other emerging economies because of increasing trade and financial linkages and rising macroeconomic interdependence.

Updates on Labor Mobility and Remittances

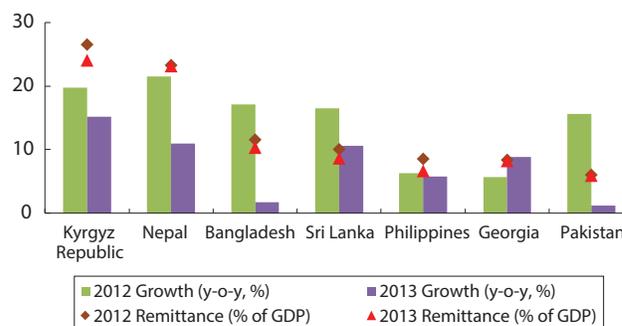
Migrant workers continue to make substantial contributions to Asia's economies, even if growth in remittances has generally slowed this year.²³

Recent remittance data show the importance of migrant workers to Asian economies, even if remittance growth slowed in most countries. The ratio of remittance inflows to GDP in 2013 (based on latest available data) is slightly lower compared with 2012 (**Figure 31**). Growth in remittances has been slowing, particularly in South Asia, which saw especially slow remittance growth from the Middle East. Remittance growth in Nepal could be hit more by India's economic slowdown. The Philippines' slight reduction in remittance growth was due almost exclusively to a depreciated yen, which reduced the value of remittances from Japan by over 30%.

This issue examines the underlying factors for the slowdown in remittance growth in South Asia. In particular, the discussion focuses on Bangladesh and Pakistan, which—among South Asian countries—have relatively complete monthly remittance data.

²³This report uses remittances as a rough proxy for labor mobility—as data are more frequently available than migrant stock data. Though remittance flows are affected by factors other than the number of migrant workers outside a source country—such as the economic conditions in source and recipient countries (including wage levels)—it is generally consistent with migrant data (see ADB. 2012. International and Regional Transmigration. *Asian Economic Integration Monitor July 2012*. Manila). Data are available for most countries on an annual basis, with some countries providing monthly or quarterly data. This report utilizes monthly and quarterly data to project flows for 2013. Countries are selected based on data availability.

Figure 31: Remittances Growth and Ratio to GDP—Selected Asian Countries



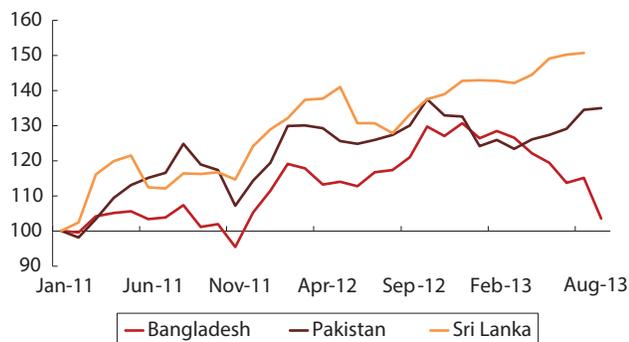
Note: Remittance growth based on average annual growth rate using monthly data except for Nepal (quarterly data). Share of GDP based on average monthly remittance flows divided by average monthly GDP. Data for 2013 until June for the Kyrgyz Republic and Nepal; July for the Philippines and Sri Lanka; and August for Bangladesh, Pakistan, and Georgia. GDP data for 2013 are WEO estimates. Source: ADB calculations using data from CEIC; *World Economic Outlook (WEO) Database April 2013*, International Monetary Fund; and national sources.

Migrant workers remain vulnerable to changes in host country conditions; remittance inflows to South Asia, a rough proxy for labor mobility, nearly stagnated early this year.

Remittance inflows to South Asia, which grew strongly even after the 2008/09 global financial crisis, began slowing late last year. Inflows to Bangladesh peaked in October 2012 and continued to decline until August this year; while those to Pakistan stagnated after robust growth following the 2008/09 global financial crisis (**Figure 32**). The critical factor appears to be remittances from the Middle East, the dominant destination for South Asia's migrant workers. The rise or fall in remittances appears to run in tandem with labor conditions and policies in the host country, and workers are essentially subject to the changes in conditions.

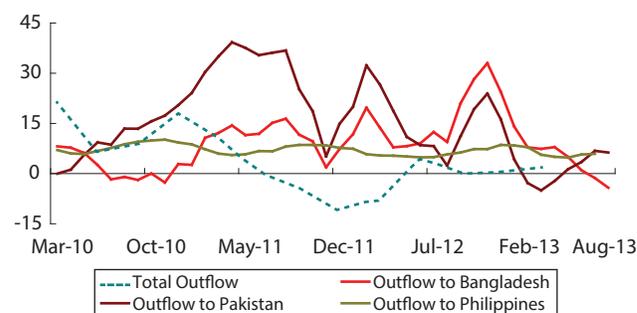
For example, the recent slowdown in remittances from the Middle East can be tied to a major change in Saudi Arabia's labor policy and weak economic outlook due to stagnated oil prices. Saudi authorities strengthened implementation of its "Nitaqat" program, which promotes employment of Saudi nationals in an economy where foreign workers comprise more than half the labor force. The program requires each company to fill a specified quota for Saudi employment as a ratio to a firm's total workforce. The required ratio varies depending on firm size and industry category. The Ministry of Labor examined Saudi employment for each private firm and categorized them into four categories to differentiate the treatment among firms in visa and employment process. A company ranking lowest, for

Figure 32: Remittance Inflows—South Asia (Jan 2011=100)



Note: Remittance inflows based on 3-month moving average of seasonally adjusted series. Data for Sri Lanka until July 2013. Source: ADB calculations using data from CEIC.

Figure 33: Growth Rate of Outward Remittances—Saudi Arabia (y-o-y, %)



Note: Growth rate based on 3-month moving average. Data for the Philippines until July 2013; quarterly data for total outflow from Saudi Arabia, until 2013Q1. Source: ADB calculations using data from Haver Analytics.

instance, cannot renew foreign worker visas, while those in the highest category can hire foreign workers from companies ranked lower in employment of Saudi nationals and obtain visas for them. The effect of the new policy is that foreign workers employed by a company with a low score should move to a company with a high score to remain in Saudi Arabia to work. The result has been a strong crackdown on illegal workers since early this year. Authorities later offered an amnesty period to correct migrant workers' status—to moderate the impact on the economy.

The program was designed to promote local employment rather than squeeze out foreign workers. But the impact on foreign workers and Saudi labor markets was significant, judging from remittance data. Growth in remittance outflows from Saudi Arabia—proxied by compensation of employees in balance of payments data—plunged in the latter half of 2011, and remained subdued until the first quarter of 2013. Accordingly, remittance growth rates to Pakistan and Bangladesh declined, particularly since late 2012 as the new policy was implemented (Figure 33). News sources report that a significant number of foreign workers categorized as “illegal” under the new policy has left Saudi Arabia and that foreign worker wages have risen in response to lower migrant labor supply. Aiming to ease the impact on Saudi Arabia's economy, the legalization of a significant number of illegal workers is said to be done, at least through the middle of this year. Given the likely adjustment process toward a new labor market equilibrium resulting from the policy, the recent shocks can be temporary, but the outlook remains uncertain, requiring close monitoring at least for the next several months.

Relatively stable remittance inflows from Saudi Arabia to the Philippines show Filipino workers have adjusted to the new policy relatively smoothly; skill development and pre-departure training are proving to be critical factors for source country workers.

Interestingly, despite the change in Saudi's labor policy, the growth rate of remittance flows from Saudi Arabia to the Philippines remained steady in late 2012 and early 2013. This is in contrast with the dramatic slowdown of remittance growth from Saudi Arabia to Bangladesh and Pakistan (see Figure 33). The steady remittance growth to the Philippines implies that its workers adapted to the new rules better than South Asian migrant workers (although it may also reflect an increase in remittance per worker).

The reasons for the difference between the Philippines and South Asian countries may be difficult to identify. However, one reason could be the difference in the skill composition of Filipino migrant workers. While the lack of comparable cross-country data only allows for a very indicative and rough comparison, the skill composition of Filipino workers in Saudi Arabia appears to be higher than workers from South Asian countries. Given that skilled workers are generally more resilient to host country conditions and can acquire legal status more easily, the difference in skill composition may have possibly contributed to the better adjustment of Filipino workers to the new labor environment. Another possible explanation may be the higher compliance of Filipino workers to Saudi laws due to better pre-departure preparation and training.

Having a diversified spectrum of recipient countries can reduce the impact of shocks to labor mobility.

Economic conditions in recipient countries affect labor mobility—as several events following the 2008/09 global financial crisis show. All major source countries were affected by either the economic slowdown or policy changes in major recipient economies—the US, Europe, Russia, and the Middle East. One way to reduce remittance flow volatility would be to actively try to diversify the destinations of migrant workers.

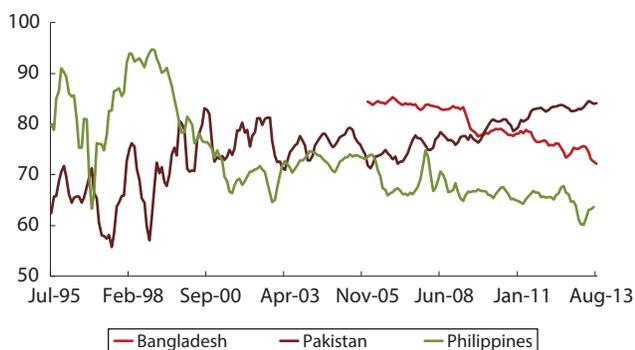
For example, host countries of Filipino workers are far more diversified than those from Pakistan and Bangladesh. Taking the share of remittances from the top five host countries to total remittances (the “top five share”) as a proxy for diversity, the Philippines shows 65% of its total remittances coming from the top five share, while it is 74% for Bangladesh and 85% for Pakistan (**Figure 34**). This greater diversity in the number of countries hosting Filipino workers reflects the change following the 1997/98 Asian financial crisis. In the mid-1990s, the top five share for the Philippines was roughly 90%, but the US share continuously declined as demand for Filipino workers elsewhere grew. The Philippines’ top five share fell to 65% and has remained steady since 2008. Upgrading migrant worker skills also contributed to the diversification. While the top five share of Bangladesh is higher than that of the Philippines, Bangladesh diversified following the 2008/09 global financial crisis by responding to the increased demand from Southeast Asia.²⁴ In contrast, Pakistan increased its reliance on Middle East jobs after the 2008/09 global financial crisis, becoming less diversified.

To smoothen the adjustment process to changes in policy, increased cooperation between source and host countries is essential.

Regional cooperation is critically important when dealing with labor mobility—close communication between host and source countries and among source countries can help smooth the effects of worker flows in a new environment. For instance, countries can work together to foster greater predictability for both migrant workers and employers by providing timely information. They can also cooperate to improve pre-departure training for migrant workers to avoid unnecessary conflicts with host country citizens and ensure compliance to rules and laws. Source countries may share experience and knowledge on labor mobility issues, and work together in smoothing relations with host countries. Establishing regular regional dialogue between source and recipient countries can be an early option. Given that intra-Asia labor mobility is increasing, the need for regional talks on labor mobility issues is also increasing.

Summing up, the recent slowdown in remittance from the Middle East highlights the importance of (i) closer communication among host and source countries to minimize the adjustment costs to a new environment, of (ii) upgrading skills of migrant workers to increase resilience to shocks, and of (iii) diversifying migrant destinations to reduce the impact of shocks in a source country. Setting up of regular regional talks on labor mobility may help both host and source countries to benefit more from labor mobility.

Figure 34: Share of Top Five Sources of Remittances—Bangladesh, Pakistan, and Philippines (% of total)



Notes: Growth rate based on 3-month moving average. Data for the Philippines until July 2013. Source: ADB calculations using data from CEIC.

²⁴ADB. 2013. International and Regional Transmigration. *Asian Economic Integration Monitor March 2013*. Manila.

TOWARD AN ASEAN ECONOMIC COMMUNITY— AND BEYOND²⁵

Introduction

The Association of Southeast Asian Nations (ASEAN) is arguably the most durable and successful regional association in the developing world.

The push toward regional economic integration was not a major part of the ASEAN agenda during its first decade. Between its establishment in 1967 up until the mid-1970s, ASEAN's primary focus was on creating harmony and cohesion within the region. Tentative steps toward economic cooperation only began in earnest in 1976, with the launch of the ASEAN Preferential Trading Agreement (APTA)—the first major attempt to promote intra-ASEAN trade through institutional integration and regional trade preferences. Over the succeeding decades, pursuing regional economic integration has gained prominence in ASEAN affairs. From the initial focus on trade liberalization—through APTA and eventually the ASEAN Free Trade Agreement (AFTA)—ASEAN's regional economic integration agenda has broadened to include services trade, investment, labor migration, and even macroeconomic policy, although progress in these new areas has been mixed (Hill and Menon 2012).

ASEAN's regional economic integration will reach an important milestone by end-2015 with the creation of an ASEAN Economic Community.

As part of ASEAN's Vision 2020, one of the three pillars of the ASEAN Community is the establishment of an ASEAN Economic Community (AEC)—the other two are a Security Community and Socio-Cultural Community. ASEAN leaders had originally intended to create the AEC by 2020, but in early 2007 they advanced the deadline to 2015. Three factors prompted the shift to an earlier date. First was the need to maintain the centrality of

ASEAN's role in the face of proliferation of free trade agreements (FTAs) between ASEAN and its dialogue partner countries. Many of ASEAN's FTAs aim to be completed by 2015 or earlier—if the ASEAN market is not fully integrated before its FTAs are in place, its role as an integration hub in Asia could erode. Second was the desire of ASEAN leaders to expedite ASEAN economic integration and take it to the next level. And third was the growing concern over the erosion of ASEAN competitiveness vis-à-vis key competitors—such as the People's Republic of China (PRC) and India.

At the 13th ASEAN Summit held in Singapore on 20 November 2007, the ASEAN leaders adopted the ASEAN Economic Blueprint for an AEC. It defines four pillars of the AEC, contains 17 'core elements', and 176 priority actions to serve as a guide. It also contains agreed goals and specific commitments to be carried out within definite timelines, with a "Strategic Schedule" in the form of a matrix specifying "Priority Actions" to be undertaken over four 2-year periods from 2008 to 2015.

Progress is measured through an AEC Scorecard mechanism, established in 2008. The AEC Scorecard is a self-assessment tool that monitors the achievement of milestones indicated in the Economic Blueprint's Strategic Schedule. It also tracks specific actions that must be undertaken by ASEAN member states, both individually and collectively, to establish the AEC (Das 2012).

Fulfilling these commitments would promote predictability in ASEAN, as well as strengthen its credibility. But with only 2 years remaining before the 31 December 2015 deadline, many are still wondering—will the AEC become a reality in 2015, or will it remain essentially a vision statement? Or will former ASEAN secretary general Rodolfo Severino's warning apply to the AEC, that "regional economic integration ... [becomes] stuck in framework agreements, work programs and master plans", with little real movement on the ground? (Severino 2006).

²⁵Parts of this chapter draw upon material from *The ASEAN Economic Community: A Work in Progress*, particularly the Overview Chapter prepared by Rodolfo Severino and Jayant Menon. The study is a joint publication of ADB and the Institute of Southeast Asian Studies (ISEAS).

Measuring Progress: The AEC Scorecard

ASEAN's biggest strides in achieving an AEC have been in Pillar 4—integrating into the global economy.

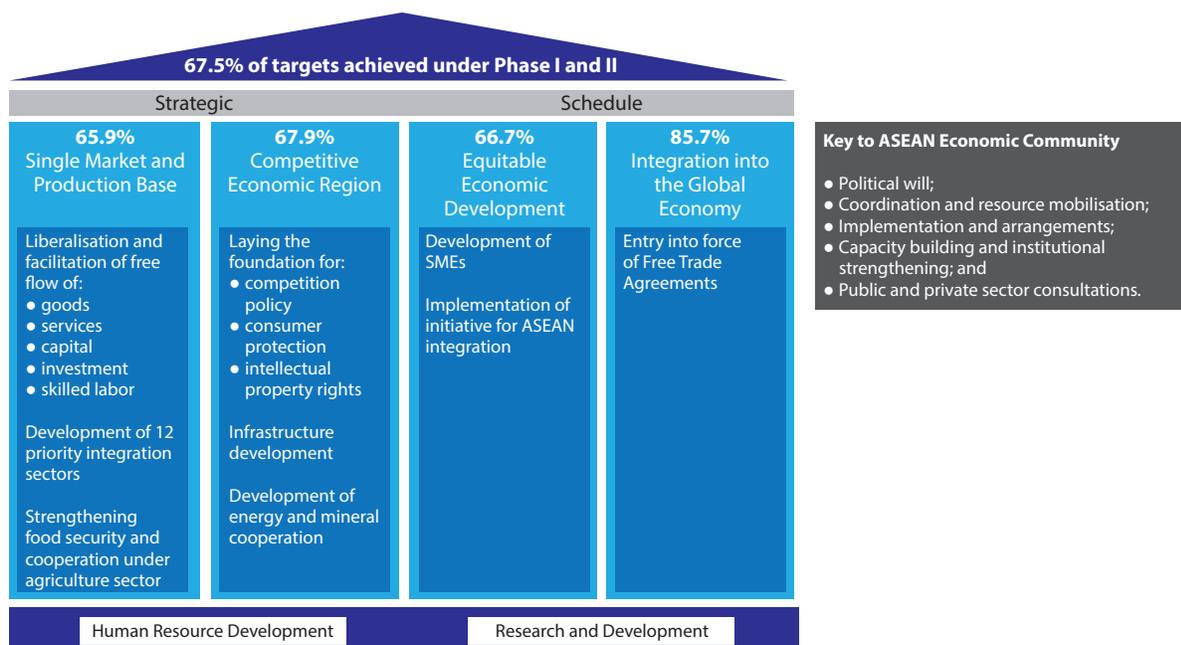
The ASEAN Secretariat has published two AEC Scorecards to date. The latest AEC Scorecard released in March 2012 shows progress toward the AEC reached about 68% of the targets between 2008 and 2011 (Figure 35). The biggest strides have been made in integrating into the world economy (Pillar 4, 86%). This is hardly surprising, given that ASEAN economies trade mostly with the rest of the world. Since 1970, intraregional trade has generally been between 15% and 30% of total ASEAN trade, and although this share has been trending upward, it remains low relative to the shares of ASEAN's external trading partners, particularly the European Union (EU) (Hill and Menon 2013).

In contrast to Pillar 4, progress in other areas of the AEC has been less stellar, with ASEAN as a whole achieving just a little over two-thirds of its targets in the other three pillars.

In particular, the score for Pillar 1 (creating a single market and production base) hints at the various obstacles to deepening economic integration within the region. Many of the achievements reported in Pillar 1 relate to tariff liberalization and other “low hanging fruit” reforms. ASEAN has removed customs duties on most intra-ASEAN trade, but this was mainly through AFTA.

There are positive developments worth highlighting. ASEAN members have formally adopted a Customs Code of Contact, national and regional “Single Window” systems, the ASEAN Harmonized Tariff Nomenclatures, and the World Trade Organization’s (WTO) mode of customs valuation. They have concluded “framework” agreements on liberalizing trade in services, investment, goods in transit, multi-modal and inter-state transport, and information and communications technology. They have also agreed on mutual recognition agreements (MRAs) or their equivalent for three types of goods and seven professions, as well as concluding a “framework agreement” on MRAs (Severino and Menon 2013).

Figure 35: Implementation of AEC Scorecard under Phase I and II



Note: As of December 2011, the implementation rates under Phase I and Phase II are 86.7% and 55.8%, respectively.
Source: ASEAN. 2012. *ASEAN Economic Community Scorecard 2012*. Jakarta.

Overall, the AEC Scorecard shows that, since 2008, ASEAN has made slow but steady progress in reaching AEC goals.

Scorecard results, however, need to be taken with a grain of salt for several reasons. First, one must bear in mind that the AEC Scorecard is a compliance tool that relies on self-assessment. While ASEAN member states may be willing to give a fair and balanced view of their progress, the need to meet the 2015 deadline could understandably lead countries to overestimate compliance and achievement.

Second, the AEC Scorecard measures aggregate progress, thereby glossing over significant challenges to implementation within individual countries. Given the ASEAN's diversity—and sensitivities on different issues and sectors—members agreed that liberalization of goods, capital, and (skilled) labor flows would proceed at different speeds, according to each country's readiness. Thus, the "Strategic Schedule" remains saddled with loopholes and "flexibility" hedges, full of words and phrases like "minimal", "where appropriate and possible", "establish good practices", and "possibly" (Severino and Menon 2013). The Scorecard, however, fails to fully capture these differences. Although Annex 2 of the 2012 AEC Scorecard differentiates implementation of AEC targets by country, the information provided is still too general to give a country-specific picture of where the true bottlenecks lie (Table 6).

The third and perhaps biggest shortcoming of the AEC Scorecard is that it does not try to analyze or explain the results. In the case of achievements, progress toward realizing the AEC involve significant amounts of double counting, whereby reforms undertaken under different initiatives and before the AEC proposal was launched are still being added to the tally. In the case of shortfalls or delays in implementation, the Scorecard falls short of examining the reasons for these delays and suggesting ways to improve implementation (Das 2012).

Realizing the AEC: Obstacles, Challenges, and Possible Solutions

Given Scorecard limitations and doubts surrounding its ability to provide an objective assessment of implementation, the question remains—how far has ASEAN gone in carrying out the more significant commitments under the AEC Economic Blueprint? And why has ASEAN or its members succeeded or failed in achieving them? A joint Asian Development Bank (ADB) and Institute of Southeast Asian Studies (ISEAS) study (Das et al. 2013) examines this and offers recommendations on what needs to be done to realize the AEC. More specifically, the study examines a number of core elements under the AEC's four

Table 6: Implementation of AEC Scorecard by ASEAN Member States

	Free Flow of Goods	Free Flow of Services	Free Flow of Investment	Free Flow of Capital	Free Flow of Skilled Labor	Priority Integration Sectors	Food, Agriculture and Forestry	Competition Policy	Consumer Protection	Intellectual Property Rights	Transport	Energy	Mineral
Brunei Darussalam	●	●	●	●	●	●	●	●	●	●	●	●	●
Cambodia	●	●	●	●	●	●	●	●	●	●	●	●	●
Indonesia	●	●	●	●	●	●	●	●	●	●	●	●	●
Lao PDR	●	●	●	●	●	●	●	●	●	●	●	●	●
Malaysia	●	●	●	●	●	●	●	●	●	●	●	●	●
Myanmar	●	●	●	●	●	●	●	●	●	●	●	●	●
Philippines	●	●	●	●	●	●	●	●	●	●	●	●	●
Singapore	●	●	●	●	●	●	●	●	●	●	●	●	●
Thailand	●	●	●	●	●	●	●	●	●	●	●	●	●
Viet Nam	●	●	●	●	●	●	●	●	●	●	●	●	●
ASEAN	●	●	●	●	●	●	●	●	●	●	●	●	●

● All measures targeted in this area were implemented
 ● More than half of measures targeted in this area are implemented
 ● Less than half of measures targeted in this area were implemented.

Lao PDR = Lao People's Democratic Republic.

Source: ASEAN. 2012. *ASEAN Economic Community Scorecard 2012*. Jakarta.

Effectively reducing NTBs will require several measures, such as giving NTBs a common definition; involving the private sector in identifying NTBs; subjecting all non-tariff measures to a compliance review to ensure that they are transparent and nondiscriminatory; and maximizing use of information and communications technology (ICT) for reporting, monitoring, and eliminating NTBs (Austria 2013). NTBs are not only wide-ranging, they can evolve over time, often in response to efforts to curtail them, and therefore present a formidable challenge to countries pursuing reform.

With more than 70% of intra-ASEAN trade tariff-free, and less than 5% subject to tariffs above 10%, the role of trade facilitation in reducing trade costs further is critical.

As a result of unilateral and multilateral efforts, as well as AFTA, tariffs in ASEAN are already very low. These achievements highlight the importance of trade facilitation in bringing down trade costs further. The Economic Blueprint covers several aspects of trade facilitation, including the harmonization and standardization of trade and customs procedures; customs modernization; integration of national single windows (NSWs) into an ASEAN single window (ASW); and harmonization of standards, technical regulations, and conformity assessment procedures. ATIGA also addresses trade facilitation challenges by including the ASEAN Framework on Trade Facilitation. This subsequently led to the adoption of the Trade Facilitation Work Program for 2009–2015. A number of agreements on transport facilitation and connectivity complement these initiatives, such as the ASEAN Framework Agreement on the Facilitation of Inter-State Transport, the ASEAN Framework Agreement on Multimodal Transport, and the Master Plan on ASEAN Connectivity.

While these recent initiatives have helped trade facilitation reforms move forward, data on trade costs and logistics continue to show considerable variation in trade facilitation and logistical performance across ASEAN members (Menon 2012). Private sector feedback from several members continue to cite excessive and time-consuming documentation requirements, as well as irregular and arbitrary payments for expediting customs procedures. There have also been delays and unevenness in implementing key reforms such as integrating NSWs into the ASW—with Cambodia, the Lao PDR, and Myanmar (CLM) lagging behind, and the rest in various stages of implementation (ERIA 2012). These challenges, coupled with the nonbinding

nature of certain commitments—such as those under the 2005 Agreement and 2006 Protocol on the ASW (Dosch 2013)—make it unlikely the deadlines under the AEC will be met. For ASEAN to meet its AEC trade facilitation objectives, members will have to expedite the harmonization of business processes and data elements as well as address legal issues. Adopting clear timelines and trade facilitation performance targets to measure progress will also be helpful (Pellan and Wong 2012).

With services growing in significance as a share of GDP and employment, liberalization of this difficult sector is gaining importance.

The services sector is becoming increasingly important as a driver of growth in the region, both as a share of GDP, and of employment. Given difficulties with measurement, there is increasing recognition that its share in GDP and trade is probably much higher than reported. In principle, the liberalization of services under the ASEAN Framework Agreement on Services (AFAS) and the Economic Blueprint should have been significantly bolder than under the WTO's General Agreement on Trade in Services (GATS). In reality, however, ASEAN service liberalization has been slow. Existing commitments are insufficient. Nevertheless, AFAS commitments have improved over time, and now there are significant GATS-plus elements that have been adopted (Hamanaka 2013).

Liberalization—particularly in banking and financial services—has been hampered by built-in flexibilities introduced under the “ASEAN-X” formula, which allows member states to liberalize according to each country's readiness. In financial services, therefore, the scope of liberalization is not specified, and member countries are allowed to carve out subsectors that they are not ready to liberalize (Nikomborirak and Jitdumrong 2013).

In addition to these flexibilities, statutory or constitutional limitations on foreign equity, restrictions on land ownership, and impediments to professional or labor mobility across national boundaries also continue to work against fulfilling services liberalization commitments (Severino and Menon 2013). These problems have been compounded by the global tendency to liberalize services last (Hill and Menon 2013).

Nevertheless, liberalizing services trade could be improved by concentrating on groups of services rather than focusing on isolated individual sectors; prescribing standard rules governing licensing and other regulatory

regimes; and replacing built-in flexibilities under the ASEAN-X formula with specified dates for compliance (Nikomborirak and Jitdumrong 2013).

As with trade in goods and services, unilateral policies have been more significant in liberalizing investment.

A key objective of AFTA was to remove barriers to trade in order to further promote foreign direct investment (FDI) in regional production networks. Prior to the adoption of the ASEAN Comprehensive Investment Agreement (ACIA) in 2008, the scope of the ASEAN Investment Area had placed too much emphasis on intraregional FDI—prioritizing investment facilitation and provision of national treatment among ASEAN partners. This strategy made very little sense, given that the bulk of FDI in the region comes from non-ASEAN economies like the US, Japan, EU, and increasingly the PRC and the Republic of Korea. ACIA and the Economic Blueprint seem to have gone some ways toward fixing this by covering a wider range of provisions on investment liberalization, MFN and national treatment, investment protection, facilitation and cooperation, and promotion and awareness (Aldaba and Yap 2009). Nonetheless, as with trade in goods as well as in services, unilateral policy initiatives seem to have played the more significant role with investment liberalization. Key challenges also remain, foremost being the removal of domestic hurdles that continue to hamper ASEAN integration. To increase investments, priority must be given to improving the business climate and reducing the cost of doing business in each country (Bhaskaran 2013). The real impact of the AEC on FDI will depend on the extent to which it succeeds in presenting the region to potential investors as a single market and production base.

Attempts to liberalize skilled labor within ASEAN could be positive if it results in greater mobility of professionals within the region, reducing skill gaps.

Unlike reforms relating to trade and investment, policies relating to labor flows remain piecemeal. Although ASEAN labor markets are becoming increasingly integrated, policies relating to cross-border movement of people continue to lag behind. The policy gaps relating to labor flows exist in both sending and receiving countries, and both must be addressed. Therefore, the policy challenges relate to the governance of labor mobility, the protection of migrant workers, and harnessing labor migration for economic development.

Although ASEAN has signed several formal accords since 2000—including the January 2007 ASEAN Declaration on the Protection and Promotion of the Rights of Migrant Workers—implementation has been lackluster (Hill and Menon 2012). However, intra-ASEAN labor flows occur independently of these arrangements and are largely market-driven—dictated by large inter-country differences in labor supply and demand, wage differentials, and porous borders.

The overwhelming share of both recorded and unrecorded labor flows within ASEAN is in low- and semi-skilled labor. This extends from domestic helpers in Malaysia and Singapore (from the Philippines and Indonesia), to agricultural labor in Malaysia (from Indonesia) and Thailand (from CLM countries) to various service sectors such as construction in Malaysia and Singapore and food processing in Thailand. It is unclear what impact the AEC will have on overall flows as it only deals with movement of skilled labor. There are clear difficulties and sensitivities in liberalizing unskilled labor flows given the diversity within ASEAN. But it remains an open question as to how an economic community, however defined—or a single market and production base—can be achieved when the majority share of labor is excluded.

Nevertheless, the attempt to liberalize skilled labor within ASEAN could be a positive move if it results in great mobility of professionals within the region that reduce skill gaps. This is being pursued by negotiating ASEAN Mutual Recognition Arrangements (MRAs) in seven occupational groups—engineering, nursing, architecture, surveying, medical practice, dental practice, and accountancy. The approach being taken has generally been bilateral, given the complexities involved. Although MRAs underscore ASEAN's commitment to the principle of regional economic integration, most are riddled with loopholes under the general cover of “flexibility,” and some of them have not been ratified by all ASEAN member states (Severino and Menon 2013). Furthermore, an MRA does not provide for unrestricted free flow of foreign professionals, because relevant domestic regulations and market demand conditions still apply. It remains to be seen how much these MRAs will add to skilled labor movements that were already taking place bilaterally.

As ASEAN members prefer to run disputes through the WTO rather than ASEAN's Enhanced Dispute Settlement Mechanism (EDSM), the mechanism must be strengthened while dispelling perceptions its decisions are not rules-based.

The principles for dispute settlement are set out in the 2004 ASEAN Protocol on EDSM and the 1996 ASEAN Protocol on Dispute Settlement Mechanism—patterned after the WTO Understanding on Dispute Settlement. To date, however, ASEAN members have yet to activate the protocol. This failure is due to many factors. For one, not all unresolved disputes as defined in the Protocol adopted in 2010 are “referable” to the ASEAN Summit, and ASEAN’s EDSM is currently plagued by weak financial and institutional support. Not surprisingly then, ASEAN members would rather refer their trade and investment disputes to the WTO than to ASEAN bodies provided for in the ASEAN Charter and other agreed ASEAN instruments like the EDSM. In addition, the traditional ASEAN non-confrontational way of settling disputes has allowed the rare intra-ASEAN trade dispute to be settled amicably, without proceeding to formal panel hearings (Hsu 2013).

To encourage its use, ASEAN must first and foremost strengthen the EDSM and dispel the notion that its decisions are not rules-based. There is also a need to provide assistance to members requiring help so that they are well-equipped to effectively use the EDSM (Hsu 2013). This is a major challenge given ASEAN’s penchant to settle disputes in the non-confrontational “ASEAN way.”

Pillar 2: Competitive economic region

Competition policy and intellectual property rights (IPR) protection are difficult areas of reform, and questions remain as to what extent a regional approach, as opposed to a national or multilateral one, can be more effective.

Two of the key components of the AEC’s second pillar are competition policy and intellectual property rights (IPR) protection, both of which aim to improve a country’s business environment. Both promote price, product and production-process competition, thus lowering production and transaction costs, and encouraging more efficient allocation of resources and improved consumer

welfare. Effective IPR protection also helps foster competition among firms, leading to greater product and process innovation, making consumers better off. They are also designed to better the business climate in attracting FDI inflows (Severino and Menon 2013).

These are difficult areas of reform, and questions remain as to whether a regional approach is better than a national or multilateral one. Take the case of IPR. Removing barriers generally occurs under the presumption that liberalization is mutually beneficial. But in the case of intellectual property, countries that do not innovate but adapt or even copy innovations elsewhere without offering at least some compensation to the originator could end up worse off—as a result of rules that protect IPR (Bhagwati 1994; Lawrence 1996). Given the lack of direct incentives, the multilateral approach has one key advantage over the regional one—the ability to trade concessions across disparate interests. A multilateral approach can weigh up the costs to non-innovating countries (such as most ASEAN members) of conceding on IPR protection, against the benefits from increased market access in areas that benefit them—such as in agriculture, textiles, and apparel (Maskus 1997).

Nevertheless, there are potentially considerable benefits regionally from the harmonization of standards, particularly in developing a regional market.

Harmonizing standards has one major problem—implementation and enforcement. For a long time, enforcing intellectual property rules, in particular, has been a major concern with respect to developing countries (Konan et al. 1995). Although the AEC Economic Blueprint bears the commitment to integrate the regional economy, both competition policy and IPR protection are essentially national in application. In light of widely different levels of development among ASEAN members and their often clashing national interests, cooperation and coordination—rather than uniformity in competition and IPR rules—are likely to be more achievable as goals. Even these, however, will likely take considerable time (Lall and Ian McEwin 2013).

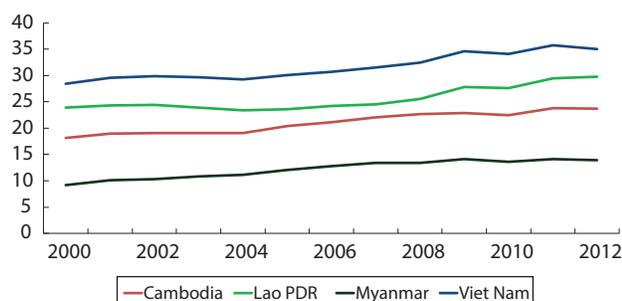
Pillar 3: Equitable economic development

Notwithstanding recent achievements, there is a long way to go before the development gap within ASEAN narrows substantially.

The third pillar of the AEC Economic Blueprint is Equitable Economic Development, which aims to address the development divide and accelerate integration of CLM within ASEAN. There is evidence that the process of convergence has begun as newer members begin to catch up to the economic conditions in the original, higher-income ASEAN states. Strong rates of economic growth since the 1990s—driven by trade, investment, and other market reforms—have reduced differences in per capita incomes (Figure 36). This rapid growth has also been associated with dramatic reductions in poverty. Still, much more needs to be done before the development divide is substantially narrowed (Menon 2012).

Under the AEC Blueprint, subregional arrangements such as the Initiative for ASEAN Integration (IAI) have been identified as key components supporting the third pillar. The lack of disaggregated data makes it difficult to discern how much success or failure can be attributed solely to subregional initiatives. But an assessment of the IAI and four subregional zones (SRZs)—the Singapore–Johor–Riau (SIJORI) zone, the Greater Mekong Subregion (GMS), the Indonesia–Malaysia–Thailand Growth Triangle (IMT-GT), and the Brunei Darussalam–Indonesia–Malaysia–Philippines East ASEAN Growth Area (BIMP-EAGA)—affirms that subregional zones can potentially help reduce development gaps and improve connectivity across national boundaries. To fully harness

Figure 36: GDP per capita of the CLMV as a share of Thailand's GDP per capita (PPP, current international \$)



Lao PDR = Lao People's Democratic Republic, PPP = purchasing power parity.
Source: ADB calculations using data from *World Economic Outlook April 2013*, International Monetary Fund.

the potential of these initiatives, emphasis should be placed on developing the newer and less-developed ASEAN members with innovative ways of financing, such as public-private partnerships (Pomfret and Das 2013).

Nonetheless, the reality is that neither the IAI nor other subregional initiatives will have the resources, or the ability, to fully address the development divide. While these can play a part, the solution must come from broader economic reforms. This will necessarily involve adoption of policies that promote rapid economic development and economic convergence. Among other things, investing in social infrastructure, especially in education and health—to produce a more productive workforce, to increase capital inflows and labor absorption using comparative advantage, and to redress asset inequality and enhance incentives for productivity in agriculture—are all necessary conditions. They need to be complemented with the other elements of an inclusive growth strategy in order to ensure convergence (Menon 2013b).

Pillar 4: Integration into the global economy

Throughout the 1980s and 1990s, ASEAN members embarked on a combination of multilateral and unilateral measures to reduce barriers to trade in goods, services, and investments. Since 2000, however, there has been less progress on multilateral liberalization, and domestic reform has slowed significantly as a result. One partial response has been the proliferation of ASEAN FTAs (ADB 2013).

ASEAN FTAs have done little to promote regional economic integration or integration with the wider Asian or the global economy.

A closer look at ASEAN FTAs leads to several conclusions. One is that the shift from unilateral liberalization to preferential liberalization has not led to further external opening or domestic reform (WTO 2011). Another is that the FTAs are “weak” and “trade-light.” In other words, while the agreements commit the parties to eliminating tariffs on trade between themselves, they do not effectively address regulatory barriers and other NTBs, like product standards and MRAs, services, investment, intellectual property rights, government procurement, or the movement of business people—which are all more important than tariffs for regional economic integration.

Thus, the FTAs that ASEAN has concluded hardly promote regional economic integration or ASEAN's integration with the wider Asia or the global economy (Sally 2013; Hamanaka 2012).

These findings are significant, particularly in light of two major FTAs in the offing: the Trans-Pacific Partnership (TPP) and the Regional Comprehensive Economic Partnership (RCEP).

Although the TPP's agenda is ambitious and wide ranging, it remains to be seen what can be agreed on, given the diversity of its membership.

The TPP involves four ASEAN members—Brunei Darussalam, Malaysia, Singapore, and Viet Nam—and features an agenda that is wide-ranging and demanding, more so than the RCEP or other FTAs. It excludes most ASEAN members as well as the PRC and the Republic of Korea, and a significant increase in Asian membership is needed before it could be considered a serious alternative to the RCEP. More generally, without participation of these economically important countries, there is serious concern that the current TPP membership satisfies the critical mass criterion. The same concern applies to the current makeup of RCEP.

The need to provide exemptions, or “carve outs,” to avoid a collapse in negotiations also raises concerns over the final form the TPP will take. The secrecy surrounding the negotiations makes it difficult to assess progress, but— from what is known—there is the risk of degenerating into a series of loosely tied bilateral deals. Indications are that the two largest TPP members—the US and Japan—are proceeding along bilateral lines, threatening the demanding single-undertaking approach the TPP is supposed to adopt.

Although the number of countries involved in these negotiations is much lower than at the WTO, for instance, it does not translate to a commensurate reduction in diversity in terms of disparate interests. These interests often conflict, especially in a context where the agenda is far more ambitious than any other proposed thus far. The recent round of negotiations that took place in Brunei Darussalam in August 2013 was reported to have made very little progress, highlighting the difficulties being faced as the TPP moves toward finding common ground on the more difficult issues.

With RCEP, there is a real risk of a “race to the bottom”, where the lowest common denominator prevails in order to secure consensus.

Although RCEP membership is supposed to be based on open accession, it starts with the ASEAN members and the “Plus Six”, all of whom have bilateral FTAs with ASEAN (the ASEAN+1 FTAs).²⁷ Although the ASEAN Framework on the RCEP was formally endorsed in November 2011, negotiations began only in May 2013. Now underway, no new members will be allowed until negotiations are completed. Details remain sparse, but from the RCEP's Guiding Principles it is clear that it will add to, rather than replace, existing FTAs. Again, the target completion date is 2015. But this is highly unlikely given the difficulties noted earlier of folding multiple, disparate agreements into one that is region-wide.

RCEP's Guiding Principles also includes a “flexibility” clause, stating that it “will include appropriate forms of flexibility including provision for special and differential treatment (SDT), plus additional flexibility to the least-developed ASEAN member states. . .” As already seen, flexibility can both be a boon and bane. While it can help break deadlocks and protect disparate self-interests, it can also limit change or curtail progress in achieving greater liberalization. With RCEP, there is also the real risk of a “race to the bottom”, where the least common denominator prevails to secure consensus (Menon 2013b). Were this to occur, RCEP would simply add to the tangled regional trade landscape.

Between Now and 2015: Pursuing Reform in an Era of Rising Uncertainty

The deadline for realizing the AEC is December 2015. Merely 2 years away—and given all the remaining obstacles and challenges—fully achieving the AEC by the end of 2015 seems highly improbable. On top of this, a new challenge has appeared as a result of recent events. The financial turmoil that affected several ASEAN countries (and beyond)—following capital outflows in anticipation of the US Federal Reserve's tapering of quantitative easing—poses a new challenge to meeting the AEC timetable. Within ASEAN, Indonesia was most

²⁷The “Plus Six” refers to Australia, the PRC, India, Japan, the Republic of Korea, and New Zealand.

directly affected (as of September 2013), with significant currency depreciation and a decline in stock market prices. Other ASEAN countries have not been immune—with Thailand and Malaysia also affected. Both, like Indonesia, have significant and deteriorating fiscal deficits. Malaysia's current account surplus has narrowed significantly, while the deficits in Indonesia and Thailand have widened.

Progress in the reforms needed for regional integration are usually hampered during periods of heightened risk and uncertainty, as preserving employment and short-term growth can override longer term objectives.

Apart from slowing the pace of reform, market uncertainties can wind back the process if countries opt for increasing restrictions in the short term. This was played out to varying degrees across ASEAN in the immediate aftermath of the 2008/09 global financial crisis. A joint WTO–Organisation for Economic Co-operation and Development–United Nations Conference on Trade and Development (WTO–OECD–UNCTAD 2013) assessment to the G20 and by the European Commission (2013) both point to a rise in various forms of trade restrictions together with a slowdown in liberalization. Both reports cite several countries—particularly Indonesia and Brazil—as continuing to shield some domestic industries from foreign competition, to the disadvantage of their consumers and other industry sectors. The report to the G20 cites an increase in the number of trade restrictive measures from 71 during May–October 2012 to 109 during October 2012–May 2103, with Indonesia in the top 4 countries accounting for the increase (see Table 3). This jives with a longer term trend of a rise in non-tariff protectionist measures, which the Global Trade Alert database reports rose gradually from 105 in 2009 to 330 in 2012.²⁸ It should be noted, however, that these assessments precede the recent market turmoil in Indonesia, which happened after May 2013.

While a protectionist backlash may be the first response to rising uncertainties, the aftermath of the 1997/98 Asian financial crisis suggests that turmoil can boost regional integration in the medium to longer term.

The challenge lies with containing any short-term knee-jerk reaction, before a more thought out response kicks in after the dust settles. Should economic conditions deteriorate further, it is likely that progress toward realizing the AEC will slow. This will mean even less of the 2015 AEC targets will be met. But if recent experience is any guide, the prospects for the AEC beyond 2015 may even be enhanced, if again regional turmoil leads to increased efforts to bolster reforms and strengthen regional cooperation and integration.

AEC 2015 and Beyond: Reconsidering “Business as Usual”

With the prospects for completing the AEC by 2015 highly unlikely, it would be best to view 2015 as a milestone rather than a “must-do” target.

In light of the many obstacles and challenges that remain—compounded by recent events that increase financial risk and uncertainty—it is unlikely to meet all of its targets by the end of 2015. Therefore, it is best to view 2015 as an important milestone, and just one—but major—step in establishing an integrated ASEAN economic community. The commitments to an AEC should continue to denote ASEAN members' political conviction that regional economic integration will help improve the lives of its citizens. And it should continue to signal to the international community that ASEAN is open for business—profitable for trade and investment—and a market that intends to compete globally. However, making it happen means not only strengthening implementation to close remaining gaps, but even more important, it will mean reconsidering existing institutional mechanisms for creating an AEC.

²⁸Global Trade Alert. <http://www.globaltradealert.org/>

The success or failure of the AEC ultimately lies in the hands of national decision-makers in charge of implementation.

Although often constrained by powerful domestic political and economic lobbies, ASEAN's leaders need to ensure those in charge of implementing AEC commitments have the power to do so. As Bhaskaran (2013) argues, ASEAN "must be realistic in appreciating that the political obstacles towards full-blown integration will take time to dissipate." Toward this end, there may be merit in focusing on "bite-sized" subregional integration, such as the GMS Program, for possible expansion or replication.

The flexibility engrained in ASEAN cooperation and institutional arrangements should not become a pretext for non-compliance, undermining the predictability that investors look for in any country or region.

At present, there are no means to compel compliance with AEC commitments. There are a number of ways this weakness can be addressed. One is to reduce "ambiguities" through realistic time-bound commitments, while maintaining the flexibility and consensus decision-making that protects the sovereignty and autonomy ASEAN members insist upon. Another is to improve the effectiveness of existing monitoring and feedback mechanisms through independent and better information. The ASEAN Secretariat will also have to be strengthened and streamlined (Nesadurai 2013).

Giving AEC commitments more teeth is important. But ASEAN also must face the reality that liberalization thus far has been driven more by market forces than by regional agreements. As Sally (2013) correctly argues, the first priority should be the "revival of the unilateral liberalization of trade and FDI and behind-the-border reforms, which would be a more realistic step than ambitious new initiatives and grand designs for regional integration, which invariably promise much but deliver little." This observation should give ASEAN pause as it heads deeper into, for example, RCEP negotiations.

Conclusion

ASEAN seeks to create an ASEAN Economic Community or AEC by 31 December 2015. Although it has come a long way toward meeting its own targets, it is likely to fall short by the deadline. How close it gets to these targets will depend on the progress of reforms in the next 2 years. Given ASEAN's diversity, how much is achieved will also vary greatly across member countries. The recent financial turmoil affecting the region presents a new challenge to all members—ASEAN must avoid succumbing to protectionist pressures that arise during periods of uncertainty. If history is any guide, it is likely that reform momentum could slow, at least in the short term. But beyond that, the turmoil could offer a new boost to strengthen integration—as crises have in the past—even as it moves beyond its self-imposed 2015 deadline.

Even if reform proceeds apace toward the deadline, the real test for the AEC will lie in the years beyond. It is one thing to sign agreements, and quite another to implement and enforce them. The success or failure of the AEC ultimately lies in the hands of the national decision- and policymakers who make it happen, and who have the political backing to overcome vested domestic interests that stand to lose from liberalization. Several other factors could complicate the process. Some reforms may require domestic laws to be revamped, while others may require constitutional amendments. The flexibility that characterizes ASEAN cooperation and institutional arrangements could give member states a pretext for non-compliance—and there are enforcement issues. This is the key challenge to be overcome in realizing the AEC as more than a political exercise in solidarity.

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WORLD TRADE FACILITATION NEGOTIATIONS: ASIAN PERSPECTIVES

The World Trade Organization (WTO) will hold its 9th Ministerial Conference in Bali, Indonesia on 3–6 December 2013. This will be the seventh ministerial meeting since the Doha Development Round began in 2001. And, for once, members are optimistic about the outcome.

Negotiators will be holding discussions on three topics—development, agriculture, and trade facilitation. Of these, trade facilitation will be watched most closely. It is key to any successful conclusion. This theme chapter examines the recent structure and progress on trade facilitation measures in Asia and the Pacific to better understand how Asia fits in the global multilateral negotiating process.²⁷

The Scope of Trade Facilitation

Trade facilitation ranges from narrow measures aimed solely at easing border restrictions to a much broader set of policies that span the spectrum from increasing customs efficiency to complex institutional and regulatory reforms.

In general, trade facilitation measures include policies intended to simplify international trade procedures. The definition we follow in this chapter comes from the International Chamber of Commerce (ICC), which describes it as “improvement of the efficiency of the trade process.”²⁸

Over the past decade, trade facilitation has attracted increasing attention in Asia and the Pacific. While traditional aspects—such as customs cooperation—are deeply embedded in regional agreements (such as in

the Association of South East Asian Nations [ASEAN]), recent progress is largely tied to the proliferation of free trade agreements (FTAs) and production fragmentation. The motivation is to address both the various stages of development within the region and to more effectively reduce trade costs where average tariff barriers are already below 5%.

Low existing tariffs underscore the need for a wider understanding of how to address other barriers to trade. This is particularly true in Asia where, while average tariff rates have fallen, tariff peaks remain and progress on removing nontariff barriers has been limited (Shepherd 2010). Nontariff barriers and the lack of trade-supporting mechanisms—such as trade finance—are difficult to quantify. In terms of international assistance, Staiger (2011) differentiates these two needs as nontariff barriers and nontariff measures. Nontariff measures are not necessarily barriers to trade, but affect trade. For example, the establishment of a trade finance institution is a nontariff measure which promotes trade but does not directly remove nontariff barriers.

The WTO process also exposes another facet of trade facilitation measures—implementation costs. While savings from implementing trade facilitation measures are expected to outweigh setup and operations costs, initial expenditures may be too high for some countries. To compensate, the draft WTO Trade Facilitation Agreement includes Special and Differential Treatment (SDT) as a separate section—recognizing that those least able to benefit from trade liberalization are those which need the most assistance in trade facilitation.

Multilateral Trade Facilitation

Given the potential for discrimination in regional measures, a multilateral trade facilitation agreement will greatly benefit Asia by strengthening the already vibrant regional trade environment.

Asia has participated in WTO trade facilitation discussions since the issue was first raised at the 1996 Singapore Ministerial Conference. Trade has been a

²⁷This theme chapter does not detail or describe ADB's long work in trade facilitation. For more detailed discussion see, for example, ADB-UNESCAP. 2013. *Designing and Implementing Trade Facilitation in Asia and the Pacific*. Manila.

²⁸International agencies use different definitions of trade facilitation. The WTO defines trade facilitation as “the simplification of international trade procedures.” Alternatively, the Organisation for Economic Co-operation and Development (OECD) defines trade facilitation as “the simplification and standardization of procedures and associated information flows.” For the details of various definitions of trade facilitation used, see ADB-UNESCAP. 2013. p. 4.

major driver of growth in the region, and as such, trade facilitation has been a priority.

Trade facilitation in the WTO

The history of multilateral discussion on trade facilitation is relatively recent. Trade facilitation is mentioned in General Agreement on Tariffs and Trade (GATT) 1947. However, prior to 1996 most work was undertaken by the World Customs Organization and UNCTAD. Since then, multilateral discussions on trade facilitation were one of the few topics that have moved forward. At the 1996 Singapore Ministerial Conference, ministers agreed to initiate “exploratory” work on four issues—investment, competition policy, transparency of government procurement, and trade facilitation. However, officials decided at the 2003 Cancun Ministerial Conference to exclude the four issues from the Doha Development Agenda.

Trade facilitation was reintroduced by the WTO General Council in 2004 in response to continued advocacy over the issue.²⁹ It was agreed that separate treatment for trade facilitation be explored, and formal trade facilitation negotiations were launched—the so-called “July Package.”

The current trade facilitation negotiations are limited in scope. The modalities of these negotiations are provided in Annex D of the July Package, which specifically says that “negotiations shall aim to clarify and improve relevant aspects of Article V, VIII, and X of the GATT 1994.”³⁰ Annex D also emphasizes the importance of technical assistance and capacity building in the field of trade facilitation.

²⁹The “Colorado group” of economies have been strong proponents of WTO trade facilitation negotiations. The group includes Australia; Canada; Chile; Columbia; Costa Rica; the European Union; Hong Kong, China; Hungary; Japan; the Republic of Korea; Morocco; New Zealand; Norway; Paraguay; Singapore; Switzerland; and the United States (see I. Fergusson et al. 2005. *The Doha Development Agenda: The WTO Framework Agreement. Congressional Research Service Report for Congress.* p. 17).

³⁰Article V is “Freedom of Transit”; Article VIII is “Fees and Formalities connected with Importation and Exportation”; and Article X is “Publication and Administration of Trade Regulations.”

Technical Assistance

As technical assistance will be a significant part of any trade facilitation agreement that comes out of the Bali Ministerial meeting, it is useful to examine how it is treated in existing WTO Agreements. While there are many assistance provisions throughout the WTO agreements, the level of discipline varies (**Table 7**).

There are three main types of technical assistance in the WTO. The first type includes measures where all WTO Members are expected to provide technical assistance (Technical Barriers to Trade [TBT], Sanitary and Phytosanitary Measures [SPS]). In this case, all members can be recipients, but special emphasis is placed on developing countries. In the second type, only developed country members are required to provide technical assistance and only developing country members can receive it (Customs Valuation Agreement [CVA], Trade Related Intellectual Property Rights [TRIPS], Government Procurement Agreement [GPA]). In the third type, the Secretariat provides the assistance and only developing country members can be recipients (General Agreement on Trade in Services [GATS], Dispute Settlement Understanding [DSU], and Trade Policy Reviews Mechanism [TPR]).³¹

The level of specificity of technical assistance obligations and how binding they are depends on who is the expected provider. When assistance is provided by the Secretariat, the obligations are binding and softening language is not used. Moreover, required actions by the Secretariat can be very specific as in the case of the DSU, which requires the Secretariat to organize special training courses on dispute settlement. However, when technical assistance obligations fall on WTO members, a strong term such as “shall provide technical assistance” is usually accompanied by softening language (“on mutually agreed terms and conditions”) and the obligations become less binding. There are some agreements that include technical assistance obligations without softening language. However, in these cases the technical assistance obligations are not required at the outset and the scope is limited to the provision of advice and consideration (for example, terms such as “shall advise,” “shall consider,” or “agree to facilitate” are used).

On the specificity of obligations, the specific form of technical assistance is always mentioned if the expected providers are developed countries (CVA and TRIPS). In contrast, the specific forms of technical assistance

³¹In the case of the DSU, all members can be beneficiaries.

Table 7: WTO Technical Assistance Obligations—Implications for a Trade Facilitation Agreement

	Trade Assistance Obligations			Concerned Parties	
	Required Actions	“On mutually agreed terms”	Specific form of Trade Assistance	Provider	Recipient
Technical Barriers to Trade	Shall advise	Not used	No further explanation on advise	All members	All members, especially developing member
	Shall grant technical assistance	Used	Not mentioned	All members	All members, especially developing members
Sanitary and Phytosanitary Measures	Agree to facilitate the provision of technical assistance	Not used	May take the form of advice, credits, donations, and grants for the purpose of training personnel	All members	All members, especially developing members
	Shall consider providing technical assistance	Not used	Not mentioned	Importing members	Exporting developing members
Customs Valuation Agreement	Shall furnish and draw up programs of technical assistance	Used	May include training personnel	Developed members	Developing members
Preshipment Inspection	Shall offer to provide technical assistance	Used	Not mentioned	Exporting members	User members
General Agreement on Trade in Services	Shall provide technical assistance	Not used	Not mentioned	Secretariat	Developing members
Trade Related Intellectual Property Rights	Shall provide technical and financial assistance	Used	Shall include training personnel	Developed members	Developing members
Dispute Settlement Understanding	Shall make available a qualified legal expert	Not used	The obligations in the left column are already specific	Secretariat	Developing members
	Shall conduct special training courses	Not used	The obligations in the left column are already specific	Secretariat	All members
Trade Policy Reviews	Shall make available technical assistance	Not used	Not mentioned	Secretariat	Developing members
Government Procurement Agreement	Shall provide all technical assistance	Not used	Translation of qualification documents and tenders	Developed parties	Developing parties

Source: S Hamanaka. 2011. Comparative Analysis of Technical Assistance Obligations under WTO and FTAs: The Missing Perspective of the Regionalism-Multilateralism Debate. *Legal Issues of Economic Integration*. 38 (4). pp. 341-388.

are usually not mentioned if the expected providers of technical assistance are all WTO members (TBT). Thus, the TRIPS Agreement is the only agreement that has binding and specific obligations on developed countries—a combination of a nonbinding and nonspecific obligation with a binding and specific obligation (although it mentions only training as a specific type of technical assistance).

Progress of Multilateral Negotiations

While the majority of WTO members agree on the significance of trade facilitation, there are various views over the treatment of trade facilitation in the Doha Development Agenda and on its technical details.

Some developing countries are skeptical about the benefits of a new trade facilitation agreement on their economies. These countries do not support de-linking trade facilitation from other items on the grounds that

there are many other important outstanding issues to be tackled (“external” balance of trade facilitation negotiations). There is also a widely shared view among developing countries that strong technical assistance and capacity building—including special and differential treatment—must be included in a new agreement. The latest negotiation text is Version 17, released 29 July 2013 (**Box 3**).³² While there has been significant progress from the initial version, the text still includes more than 400 brackets left to be negotiated. These are expected to be significantly reduced through technical negotiations, so an objective decision can be reached at the Bali Ministerial Conference in December.

Successfully concluding WTO negotiations would amplify the benefits of Asia’s existing regional trade facilitation measures by introducing global coverage of some issues.

Both governments and the private sector will benefit from a better trade reform structure and greater assistance. However, it remains to be seen if the many conflicting interests can coalesce around a mutually beneficial agreement.

Box 3: Contents of the Proposed World Trade Organization Trade Facilitation Agreement

Section I

- 1.1 Publication and Availability of Information
- 1.2 Prior Publication and Consultation
- 1.3 Advance Rulings
- 1.4 Appeal or Review Procedures
- 1.5 Other Measures to Enhance Impartiality, Non-Discrimination and Transparency
- 1.6 Disciplines on Fees and Charges Imposed on or in Connection with Importation and Exportation
- 1.7 Release and Clearance of Goods
- 1.8 Consularization
- 1.9 Border Agency Cooperation
- 1.10 Formalities Connected with Importation and Exportation and Transit
- 1.11 Freedom of Transit
- 1.12 Customs Cooperation
- 1.13 Institutional Arrangements
- 1.14 National Committee on Trade Facilitation
- 1.15 Preamble/ Cross-Cutting Matters

Section II: Special and Differential Treatment Provisions for Developing Country Members and LDC Members

- 2.1 General provisions and Basic Principles
- 2.2 Definitions of Categories of Commitments
- 2.3 Notification and Implementation of Category A Provisions
- 2.4 Notification and Implementation of Category B and C Commitments
- 2.5 Early Warning Mechanism: Extension of Implementation Dates of Provisions under Categories B and C
- 2.6 Shifting between Categories B and C
- 2.7 Grace Period for the Application of the Understanding on Rules and Procedures Governing the Settlement of Disputes
- 2.8 Provision of Technical Assistance and Capacity Building
- 2.9 Information on Assistance to be Submitted to the Committee

LDC = least developed country.

Source: World Trade Organization. 2013. *Draft Consolidated Negotiating Text*. Document No. TN/TF/W/165/Rev.17.

³²See World Trade Organization. 2013. *Draft Consolidated Negotiating Text*. Document No. TN/TF/W/165/Rev.17.

Trade Facilitation in Asia and the Pacific

Countries in Asia and the Pacific have shown progress on many of the indicators that describe the trade environment. Overall, the region is close to the G7 average in terms of World Bank's *Doing Business* indicators (ADB-UNESCAP 2013). Over the past 5 years, most countries have reduced the costs of exporting and the time needed to ship. This suggests that trade facilitation measures in the region are working. Between 2006 and 2013, almost all subregions saw a reduction in export processing times. However, more work remains to be done. For example, while Central Asian countries have reduced time to export by 15% since 2006, the subregional average is 54 days compared with Southeast Asia, where time to export is only 17 days (Table 8).

Asia and the Pacific also does well in assessments of how selected trade facilitation measures are implemented (Figure 37). The OECD produces trade facilitation indicators that assess the status of trade facilitation measures as stipulated in GATT Article V, VIII, and X. Asia

Table 8: Time to Export (regional averages)

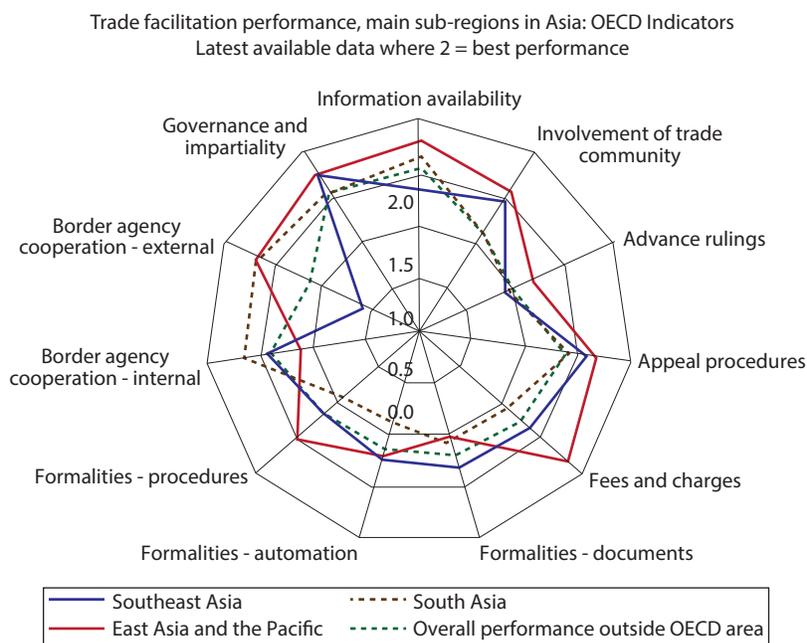
	2006	2009	2012	2013
Southeast Asia	25	30	18	17
Northeast Asia	19	19	18	18
Central Asia	64	59	53	54
South Asia	31	27	26	26
Pacific Islands	24	24	24	24
All economies	29	26	25	24
G7	11	10	9	9

G7 = Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.
 Note: Country groupings based on ADB-UNESCAP (2013).
 Source: ADB-UNESCAP. 2013. *Designing and Implementing Trade Facilitation in Asia and the Pacific*. Manila.

performs above average on governance and impartiality, involvement of the trade community, the appeals procedure, and fees and charges. However, progress by subregion is more mixed.

South Asia, for example, performs poorly in external border agency cooperation. East Asia and the Pacific perform better than the regional average in most areas, but internal border agency cooperation and the simplification and harmonization of documents needs work.³³

Figure 37: OECD Indicators on Selected Trade Facilitation Measures (2012)



OECD = Organisation for Economic Co-operation and Development.
 Note: Country groupings based on OECD (2013).
 Source: Based on Trade Facilitation Indicators as constructed in OECD. 2013. *Trade Facilitation Indicators: The Potential Impact of Trade Facilitation on Developing Countries' Trade*. *OECD Trade Policy Paper* No. 144. Data as of January 2013 for 107 countries outside the OECD area.

³³OECD. 2013. *Trade Facilitation Indicators: The Potential Impact of Trade Facilitation on Developing Countries' Trade*. *OECD Trade Policy Paper*. No. 144.

While indicators paint a relatively positive picture of trade facilitation progress in Asia, a closer look at how measures are implemented reveals a potential source of trade diversion stemming from the very measures intended to improve trade flows. The potential for exclusivity that accompanies certain regional measures needs to be examined.

Potential Benefits from Trade Facilitation

Trade costs are a key determinant of a country's ability to participate in global production networks.

The factors that affect trade costs include everything from tariffs to quality of infrastructure to availability of trade finance.³⁴ While regional trade costs have fallen across Asia, they remain high in comparison to the European Union (ADB-UNESCAP 2013). This underlines the importance of trade facilitation measures to reduce these costs.

Projected benefits of improved trade facilitation are often large.³⁵ The OECD calculates that each 1% saving in trade-related transaction costs saves \$43 billion (OECD 2003).³⁶ Former WTO director-general Pascal Lamy often said a trade facilitation agreement could give a \$1 trillion boost to the world economy (Lamy 2013).³⁷

Within Asia, a World Bank study estimates intraregional trade could increase by over \$250 billion (Wilson, Mann, and Otsuki 2003). This rests on the assumption that trade facilitation reforms in port and customs efficiency, domestic regulations, and e-business can draw countries with below-average performance closer to the regional average.

³⁴In fact, Saslavsky and Shepherd (2012) find that intra-production network trade is more sensitive to trade costs than final goods trade. See D. Saslavsky and B. Shepherd. 2012. Facilitating International Production Networks: The Role of Trade Logistics. *Policy Research Working Papers*. No. 6224. Washington, DC: World Bank.

³⁵It is, however, too early to accurately predict the exact impact of trade facilitation agreement at this stage, because it mainly depends on the level of ambition that WTO members agree on with regard to the new text. In fact, the consequence of trade facilitation agreements significantly differ if provisions use "shall" or "should" or "may" and if softening terms such as "to the extent possible" is included or not.

³⁶OECD. 2003. Quantitative Assessment of the Benefits of Trade Facilitation. *TD/TC/WP(2003)31/FINAL*. Paris.

³⁷P. Lamy. 2013. Speech to the Chittagong Chamber of Commerce, Bangladesh. 1 February. http://www.wto.org/english/news_e/sppl_e/sppl265_e.htm

Table 9: Benefits of Trade Facilitation

Benefits to Government	Benefits to Firms
Increase effectiveness of control methods	Lower costs and reduced delays
More efficient deployment of resources	Faster customs clearance and release
Correct revenue yields	Simplified commercial framework for trade
Improved compliance from traders	Enhanced competitiveness
Encouragement of foreign investment	
Accelerated economic development	

Source: UNECE. 2002. *Trade Facilitation: An Introduction to the Basics Concepts and Benefits*. Geneva.

Econometric studies concretely show the potential impact of trade facilitation reform in various fields. According to Anderson and van Wincoop (2004), even a relatively minor area of trade facilitation reform—such as the information and language barrier (which is covered under the transparency concept of trade facilitation negotiations) would have an impact equivalent to a 13% tariff reduction. The same study suggests that cost of transit is equivalent to 9% of tariffs and administrative burden of trade procedures is equivalent to 8% of tariffs. Thus, a successful conclusion of a WTO trade facilitation agreement—including strong capacity building elements and trade facilitation reform triggered by the agreement—would have a significant impact on trade. Sometimes overlooked is the obvious—that the benefits of trade facilitation accrue not only to governments, but to the private sector as well (**Table 9**). When trade costs fall, entrepreneurs, employees, and consumers all gain from the more competitive business environment.

Global resources devoted to trade facilitation are significant. In particular, lending has increased due to the Aid for Trade initiative introduced by the WTO in 2005. A recent joint statement signed by many of the world's multilateral lenders cited the funding commitment for trade facilitation in 2011 at more than \$381 million—an increase of 365% (in real terms) of official development assistance to trade facilitation compared with the 2002–2005 average.³⁸

³⁸WTO. 2013. Joint Statement on Trade Facilitation during the 4th Global Review of Aid for Trade Meeting. <http://www.nzembassy.com/switzerland/events-and-news-zealand-statements/world-trade-organisation-wto/joint-statement-%E2%80%93-trade-f>

Free Trade Agreements: The Potential for Exclusivity

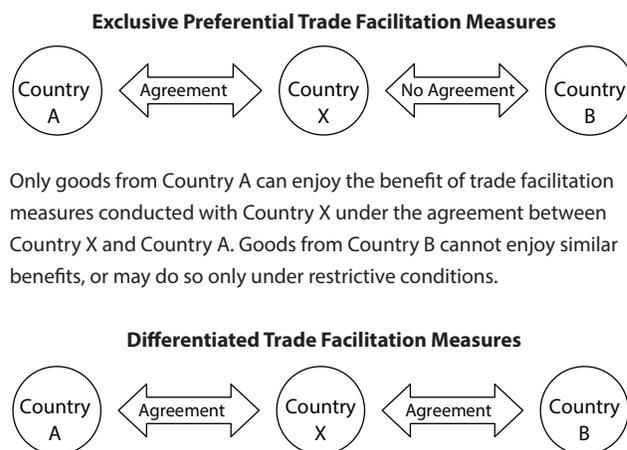
Trade facilitation measures are not only being pursued multilaterally, but they also feature in regional initiatives.

According to UNESCAP (2011), 91% of recently signed FTAs in the region include some element of trade facilitation. There are also many regional or subregional economic cooperation programs—such as Central Asia Regional Economic Cooperation (CAREC), the Greater Mekong Subregion (GMS), South Asia Subregional Economic Cooperation (SASEC), and the Brunei Darussalam-Indonesia-Malaysia-Philippines East ASEAN Growth Area (BIMP-EAGA)—that include some trade facilitation. Some subregional projects resulted in the signing of cross-border transport agreements (CBTAs) emphasizing trade facilitation.³⁹

Regional trade facilitation initiatives include a wider set of measures than those being negotiated at the WTO—and they also raise a different set of issues. Unlike multilateral initiatives, regional trade facilitation measures hold the potential to facilitate members' trade at the expense of multilateral trade, for example. It is widely assumed that nonexclusive regional trade facilitation measures pave the way for "open" regionalism. For example, simplifying customs procedures regionally facilitates both intraregional and inter-regional trade (Moisé 2002). However, there are some measures that give preferential treatment to a limited number of countries. In fact, some trade facilitation measures—such as concessionary customs fees only applicable to members, and mutual recognition among members—can have discriminatory effects (Maur 2008; OECD 2005).⁴⁰

There are two types of discrimination that can arise from bilateral trade facilitation measures. The first is exclusive preferential trade facilitation measures. If an agreement gives preferential treatment to partners only, treatment varies between members and nonmembers (**Figure 38**). It is possible to determine whether an agreement creates

Figure 38: Two Types of Discriminatory Treatment



Only goods from Country A can enjoy the benefit of trade facilitation measures conducted with Country X under the agreement between Country X and Country A. Goods from Country B cannot enjoy similar benefits, or may do so only under restrictive conditions.

Country X renders different trade facilitation treatment to goods from Country A and Country B, even if both have an agreement with Country X.

Source: S. Hamanaka. 2013a. *Asian Free Trade Agreements and WTO Compatibility: Goods, Services, Trade Facilitation and Economic Cooperation*. Singapore: World Scientific.

legal preferential treatment exclusively to goods from a partner country (Country A), and how the agreement between Country X and Country A stipulates the trade facilitation merit for the goods from Country B to Country X.

The second type of discrimination is differentiated trade facilitation measures. Preferential trade facilitation treatment stipulated in FTAs is not homogenous across agreements. For example, Country X, a common partner, may render much better treatment in terms of trade facilitation of goods from Country A than goods from Country B, even if both Country A and Country B have an agreement with Country X.

One example of a discriminatory measure is the simplification of customs procedures. Most FTA provisions related to simplifying customs procedures apply to FTA partners only. There are many FTAs that give preferential customs procedures exclusively to FTA partners. Most FTA provisions on customs procedures state that they should be simplified for goods traded between contracting parties, rather than encompassing "all goods or shipments." Provisions on express shipments are a typical example of discriminatory treatment. Usually, only goods traded between FTA partners can use express shipment facilities. Moreover, when express shipment is covered by FTAs, the prescribed speed applicable to goods traded between members becomes the question. Differentiated treatment in terms of the speed of customs clearance

³⁹Discussion on subregional cooperation programs in ASEAN can be found in *Toward the ASEAN Economic Community—and Beyond*, page 34. ADB provides details on current work in ASEAN and other subregions (see www.adb.org).

⁴⁰Mutual recognition of standards among members may bring exclusive effects to nonmembers. However, there is also a possibility that nonmembers can enjoy benefits (See K. Nicolaidis. 2000. Non-Discriminatory Mutual Recognition: An Oxymoron in the New WTO Lexicon? In T. Cottier, P.C. Mavroidis, and P. Blatter, eds. *Regulatory Barriers and the Principle of Non-Discrimination in World Trade Law: Past, Present, and Future*. Michigan: University of Michigan Press).

across FTAs can become an issue due to different stipulated time limitations prescribed for different FTA partners. For example, the US-Singapore FTA requests that express shipments should be released within 6 hours, while the US-(Republic of) Korea FTA requests they should be released within 4 hours.^{41, 42}

There are many types of trade facilitation measures that are exclusive under FTAs. In addition, these FTA measures are diverse in terms of their discriminatory and exclusive elements and that differentiated treatment across FTA partners under different FTAs is common. This underscores the potential importance of a multilateral agreement on trade facilitation. While trade facilitation measures are well integrated into regional trade arrangements, they may not be accessible to all countries. A multilateral agreement on trade facilitation will not constrain the continued inclusion of trade facilitation in regional agreements, and to the extent that it promotes broader cooperation and technical assistance, it may highlight the benefits of a more open approach.

Conclusions and Policy Implications

Trade facilitation measures can play an important part in ensuring all countries have access to the potential benefits of trade and regional integration.

This assurance is true both for developing countries with limited resources and for small- and medium-sized firms in high- and middle-income countries. December's Bali Ministerial Conference is the first time a trade facilitation framework has reached the highest multilateral levels. Countries in Asia and the Pacific have an opportunity to engage in the process to ensure it reflects both the realities and capacity of the region.

There are three main advantages to actively participating in a successful multilateral process. First, while progress through FTAs has been good, it can be made even more efficient by extending preferential trade facilitation measures to nonmembers (ADB 2013). The WTO process is a limited, but important, first step in this direction. Second, Asia can benefit from a multilateral agreement as it simplifies the process of future trade facilitation negotiations. By establishing a multilateral framework,

both public and private sectors will be working from the same text. While private sector growth has been central to Asia's dynamic growth, too often the private sector is not brought in as a policy partner. Yet, in identifying facilitation gaps, the private sector has been most effective. Many WTO measures—such as enquiry points, the establishment of national committees on trade facilitation and opportunities to comment on rules—will effectively draw in the private sector.

A third gain is the additional resources through special and differential treatment for more challenged states. These countries have the furthest to go to meet their trade facilitation obligations, but also the most to gain. In the multilateral process, least developed countries in particular have been vocal in their views on the SDT section of the trade facilitation agreement. While trade facilitation benefits all, some measures are resource-intensive and inaccessible to countries with limited means. These countries will gain both from SDT and from the establishment of a Committee on Trade Facilitation—which would be open to all WTO members.

In addition to the benefits from multilateralization, the WTO process raises the profile of trade facilitation measures at all levels. This attention may enable countries to better address the challenges of FTA trade facilitation measures. Where preferential trade facilitation measures vary across FTAs, governments accrue costs. Take, for example, the situation where the stipulated time limit for express shipments varies across FTAs. While different time requirements for express shipments do not seem a large problem for the US—as mentioned, 6 hours for imports from Singapore and 4 hours for imports from the Republic of Korea—for less developed countries it is more efficient to adhere to a single expedited amount of time to avoid maintaining regular lanes, express lanes, and super-express lanes—which add administrative costs. The differentiated preferential trade facilitation measures would simply increase the administrative burden.

There are many discriminatory trade facilitation measures in the region. Regional preferential trade facilitation measures are not ideal because they are opaque and often complex—they should be multilateralized on a de facto basis in the long run to reduce the administrative burden.

⁴¹US-Singapore FTA. Chapter 4, Article 4.10.

⁴²US-(Republic of) Korea FTA. Chapter 7. Article 7.7.

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