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An Overview of Economic Cooperation and Integration in Asia

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Regionalism has existed for so many years in various parts of the world, but it has never risen as rapidly as it had in the last decade. Presently, practically all countries are members of at least one regional bloc. It is therefore important to understand why countries, particularly in Asia, have resorted to regionalism against the backdrop of an increasingly globalizing economy; examine the various forms of regionalism that have emerged in Asia; and assess their roles in advancing economic integration.

As part of its overall program to support regional economic cooperation in Asia, the Asian Development Bank (ADB) held the High-Level Conference on Asia's Economic Cooperation and Integration on 1–2 July 2004 at ADB headquarters in Manila, Philippines. The various papers discussed during the conference are presented as chapters of this book. This overview chapter largely draws on materials presented in the various papers.

This chapter is organized as follows: the first section presents definitions of major concepts that are frequently mentioned in the various chapters and discusses the three waves of regionalism. The second section briefly discusses Asia's place in the world economy in the past, today, and in the future and presents an overview of regional economic cooperation and integration initiatives in Asia. The next three sections examine the roles and modalities of regional economic cooperation and integration in Asia in three broad areas, namely, trade and investment, monetary and financial integration, and infrastructure and associated software. The last section discusses Asia's prospects for deepening regional integration and the challenges it will address to deepen integration.

Conceptual Definitions and Waves of Regionalism

Conceptual Definitions

It is important to distinguish regional cooperation from regional integration. Regional cooperation refers to policy measures jointly undertaken by a group of countries typically located within a geographic area, to achieve a level of welfare that is higher than what is possible when compared to pursuing such a goal unilaterally. Some regional initiatives are intended to facilitate or enhance economic integration, while others are not. Regional integration, on the other hand, is *de facto* integration of economies within a geographic region. It may be market-driven integration, that is, there is no explicit agreement or coordinated action among countries within a region to integrate their economies; or policy-induced integration, that is, one that results from regional cooperation. Regional integration can vary in intensity. Full economic integration occurs when goods, services, and factors of production can flow freely and financial markets are unified among countries within a region.

It is also important to distinguish regionalization from regionalism. Regionalization is market-driven integration, spurred by unilateral reforms in individual economies within a particular region. In the area of trade and investment, for instance, a favorable trade and investment regime combined with other factors, such as geographical proximity and social and cultural factors, may encourage multinational enterprises (MNEs) to establish factories in different countries within a region for specialized production of specific components of finished goods. This is exemplified by the "flying geese" pattern of relocating production processes to cheaper areas abroad as domestic costs rise (Kumar 2001). This process gives rise to regional production networks characterized by increased international specialization, interdependence, and integration (Moon and Roehrl, this volume). Regionalism, on the other hand, refers to formal economic cooperation and economic arrangements of a group of countries aimed at facilitating or enhancing regional integration. For instance, a group of countries enter into a regional trade agreement (RTA) to facilitate economic integration.

RTAs can take various forms indicating various levels of regional integration. A description of the various types of RTAs is presented in Box 1.1.

Waves of Regionalism

Bonapace (this volume) has identified three waves of regionalism in postwar history. The first wave occurred in the 1960s and is known as closed regionalism because the regional economic cooperation forged by participating countries was aimed mainly at determining which import-substituting industries are to be developed and where to locate them, and securing raw materials for such industries from member countries. The import-substituting industries were financed mainly by borrowing from abroad and were protected against imports through high external tariffs and nontariff

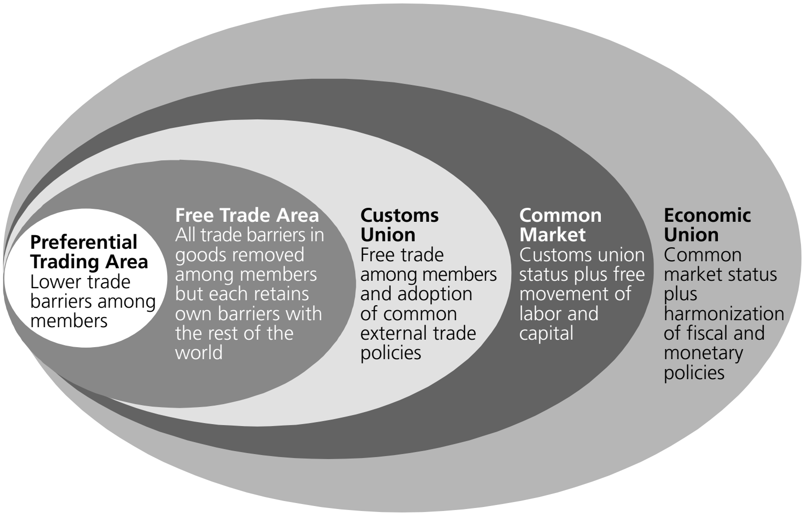
BOX 1.1

Evolution of Economic Integration

Regional trade agreements (RTAs) can take various forms: preferential trade area, free trade area, customs union, common market, or economic union. In a preferential trade area, trading partners grant partial preferential tariff reductions to each other. In a free trade area, members eliminate all tariffs and nontariff barriers among themselves, but each member can set its own tariff rates on nonmembers. A customs union is a free trade area, but members adopt a common external tariff on nonmembers. A common market goes beyond a customs union by allowing free movements of factors of production. Finally, economic union involves integrating national economic policies, like fiscal and monetary policies.

RTAs differ in configuration; they may be bilateral (agreement between two parties) or plurilateral (agreement among three or more parties). More complex agreements occur when one (or more) of the parties is an RTA itself or all parties are themselves distinct RTAs.

RTAs also differ in scope. The simplest form takes the exchange of preferences on a number of limited products among the parties. The more complex ones go beyond tariff elimination to include services, investment, competition policy, government procurement, intellectual property rights, etc.



Sources: Low (2000) and Das (2001) as cited in Austria (2003).

barriers. The results of closed regionalism that began to appear in the 1970s were generally disappointing. More specifically, it contributed marginally to the economic development of participating countries and caused them external debt problems.

Many developing countries then shifted from an inward-looking to an outward-looking development strategy by liberalizing trade and investment to enhance their export competitiveness. The number of countries embracing multilateralism increased rapidly as indicated in the list of member countries of the General Agreement on Tariffs and Trade/World Trade Organization (GATT/WTO) system.[1] Some countries have decided to fast-track trade liberalization through a regional route. This regionalism has put emphasis on open regionalism, an example of which is the formation of the Asia-Pacific Economic Cooperation (APEC) that espouses nondiscriminatory liberalization; that is, the best tariff preferences that one APEC member accords to APEC members are also extended to other non-APEC trading partners.[2] Thus, multilateralism and regionalism were considered to be reinforcing each other.

The third wave of regionalism emerged after the 1997 East Asian financial crisis. By then, the APEC process virtually halted after the largest trading nations, led by the United States (US) and Japan, expressed their willingness to liberalize only within the context of the negotiated reciprocity under WTO. Progress in multilateral trade and investment liberalization also slowed. Thus, some countries started to explore alternative routes to achieving trade and investment liberalization by entering into RTAs with neighboring countries or countries in other regions of the world seeking the same objectives. The new RTAs are more comprehensive in scope than the traditional RTAs. They gave birth to a new kind of regionalism whose growth has been phenomenal in the last 5 years. Today, virtually all countries are members of at least one bloc, and many belong to more than one or are still negotiating with potential partners (De, this volume).

Regional Cooperation and Asia's Place in the World Economy

Asia has an important place in the world economy. It provides a base for the production of certain commodities and a large market for goods and services. Its progress therefore will contribute significantly to the growth of the world economy.

In 1820, Asia accounted for 68% of the world's population and 59% of the world's income valued in terms of 1990 purchasing power parity (Agarwala, this volume). In 1950, these shares went down significantly to 55% and 18%, respectively. By 1995, however, its share in world income rose markedly to 34% while its share in world population had remained almost the same as the 1950 level. Conservative

[1] As of October 2004, 148 economies have already acceded to WTO, up from 77 in January 1995.

[2] The APEC member countries are Australia; Brunei Darussalam; Canada; Chile; People's Republic of China (PRC); Hong Kong, China; Indonesia; Japan; Republic of Korea (Korea); Malaysia; Mexico; New Zealand; Papua New Guinea; Peru; Philippines; Russia; Singapore; Taipei,China; Thailand; United States; and Viet Nam.

estimates suggest that Asia will reclaim its place in the world economy by 2030 and, with import shares of more than 50%, will become a dominant market in the world economy. It will likely become a dominant producer/consumer of certain agricultural commodities (e.g., cereals, pulses, oil crops, cotton lint, tobacco, and fishery), raw materials (e.g., coal, steel, cement, and fertilizer), and even higher income commodities (e.g., passenger cars, air travel, consumer durables, personal computer, and mobile phones).

How can Asia be sure that it can reclaim its place in the world economy by 2030? What will be the main stimulus for Asia's growth in the future?

The respectable growth realized by most Asian countries in the past two decades was fueled to a large extent by rapid expansion in trade and foreign direct investment (FDI), which in turn were stimulated by both domestic factors—as trade and investment liberalization, favorable macroeconomic environment, and abundant supply of well-educated, low-wage labor—and external factors—realignment of exchange rates and remarkable progress in information and communication technology (ICT) (Kawai, this volume). With significant improvements in economic efficiency realized from trade and investment liberalization, Asia has become a dominant exporter to developed economies, especially the US. However, this trend may not continue in the future due to certain factors. One is that the US, to correct its unfavorable trade balance with Asia, may resort to trade restrictions and pressure the People's Republic of China (PRC) to move to floating exchange rate and capital account convertibility, which may hurt growth prospects of Asia and bring exchange rate instability to the region (Agarwala, this volume). Another factor is the formation of regional trading blocs in other parts of the world. To address these threats, it may be well for Asia to accelerate the pace of trade liberalization to promote intraregional trade and increased imports from the US and develop alternative reserve assets in the region so that an increasing proportion of Asia's surpluses, which have been used to finance the US current account deficit, can be invested in those assets. All this, however, requires regional economic cooperation.

One threat to Asia's growth prospects may come from within individual countries' borders. Despite high growth rates achieved in the past two decades, many Asian countries still face rising income inequality and high unemployment rates, which in the near future may reach a point where they can undermine political and social stability, a factor which is crucial in sustaining a country's growth. Interestingly, a high incidence of poverty occurs in border areas within Asia where infrastructure is poor and opportunities for increasing residents' incomes are limited. Regional cooperation aimed at improving infrastructure and promoting trade and investment in these border areas can help broaden the opportunities for increasing incomes of residents there, and thus reduce income inequality.

In sum, the stimulus for Asia's growth in the future will have to increasingly come from within. This makes regional economic cooperation all the more important to Asia's future growth prospects.

Currently, there are several subregional groupings in Asia that have regional economic cooperation initiatives. In Southeast Asia, the Association of Southeast Asian Nations (ASEAN)—which includes Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic (Lao PDR), Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam—has an ASEAN Free Trade Area (AFTA) agreement. In South Asia, the South Asia Association for Regional Cooperation (SAARC)—which includes Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka—has a South Asian Free Trade Agreement (SAFTA). Some members of these subregional groupings have bilateral RTAs with other countries within and outside Asia. Recently, ASEAN agreed to the creation of an ASEAN Economic Community (ASEAN-EC) by 2020 to achieve greater economic integration of the region as stipulated in the ASEAN Vision 2020.[3]

While ASEAN has already started to lay the foundation for building an ASEAN Economic Community, the East Asia Vision Group (EAVG) has proposed the formation of an East Asian Economic Community (EAEC) that will include the 10 ASEAN member countries, Japan, Republic of Korea (Korea), and PRC. Indeed, the recent decision of the 13 leaders of Southeast and Northeast Asian states during the 10th ASEAN Summit held in the Lao PDR to step up regional integration by transforming the ASEAN+3 Summit into the East Asia Summit (EAS) has boosted the EAVG's proposal. Observers have taken this shift as a sign that ASEAN has come to realize that its economy is too small to have a global impact and that a strong regional grouping that includes large economies in the region is needed to enhance the benefits that can be derived from economic cooperation and integration.

Another proposal is to form an Asian Economic Community (AEC), which is broader in coverage than any of the existing subregional integration arrangements and the proposed EAEC (Kumar, this volume). Substantial complementarities that exist between Asian economies have yet to be exploited. In the ICT industry, for instance, East Asia has huge hardware capacity, and some countries like India and the Philippines have the software capacity. Japanese and Korean construction and engineering industries have underutilized capacities that could be used to meet the demand of other Asian countries for services from such industries. Aside from complementarities in production, the Asian region includes the fastest growing economies in the world that provide a huge market for goods and services. Pan-Asian economic cooperation can facilitate the exploitation of such complementarities and market opportunities. Cooperation may not be limited only to regional trading arrangements and financial and monetary cooperation, but will also cover other areas, such as intraregional FDI and transfers of technology and skills, energy community cooperation, transport infrastructure and connectivity cooperation, and cooperation in core technologies for addressing the digital divide and nutritional and health-related issues.

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[3] Press statement by the Chairperson of the 9th ASEAN Summit and the 7th ASEAN+3 Summit held in Bali, Indonesia (7 October 2003). ASEAN+3 includes the 10 members of ASEAN plus the People's Republic of China (PRC), Japan, and Republic of Korea (Korea).

Regional Cooperation and Integration in Asia: Trade and Investment

Extent of Trade and Investment Integration

The extent of trade and investment integration in Asia may be measured in terms of actual trade and investment flows among Asian countries. Aside from actual trade flows, intraregional trade share and a trade intensity index may be used to ascertain the extent of trade integration. Such measures are typically applied to merchandise trade due to unavailability of reliable data on services trade.

The past two decades saw increasing shares of intraregional trade and investment in Asia. However, this was largely between North Asia led by Japan, and the rest of Asia (Agarwala 2002). After the East Asian financial crisis, the shares of intraregional trade and investments declined, while those of Asia's trading partners outside the region rose. While this demonstrates Asian economies' openness to the rest of the world, nevertheless it suggests that Pan-Asian integration is not yet deeply rooted in the region. What has emerged so far is increasing subregional integration, and the East Asian region appears to be more integrated than other subregional configurations in Asia.

EAST ASIA

East Asia includes the 10 ASEAN member countries; PRC; Japan; Korea; Hong Kong, China; and Taipei,China.[4] Although ASEAN-10's intraregional trade share rose from 18% in 1980 to 24% in 2002, it is still indicative of the low level of integration occurring in this subregion despite efforts to promote intraregional trade.[5] However, taking the 15 East Asian economies together (East Asia-15), the intraregional trade share appears remarkably high, rising from 35% to 57% during the period 1980–2002. The recent intra-East Asian trade share is slightly lower than that of the European Union (EU)-15 (62%), but significantly higher than that of the North American Free Trade Area or NAFTA (48%).[6] Meanwhile, the intraregional trade intensity index of East Asia-15 remained stable[7] (2.4-2.5%) during the period 1980–2002, and is comparable to that of NAFTA (2.0-2.4%), but significantly higher than that of EU-15 (1.4–1.7%). More importantly, the growing intra-East Asian regional trade occurred, but not at the expense of the region's trade with other countries.

As regards FDI, firms from industrialized countries are the main investors in East Asia. However, Japan appears to be the largest investor in middle-income ASEAN countries, particularly Thailand and Indonesia. Interestingly, the share of Asia's newly

[4] In some chapters of this book, Hong Kong, China, and Taipei,China are not included in the analysis.
[5] ASEAN's regional economic initiatives are discussed later.
[6] EU-15 includes Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and United Kingdom. NAFTA includes Canada, Mexico, and United States.
[7] The Asian NIEs are Hong Kong, China; Korea; Singapore; and Taipei,China.

industrializing economies (NIEs) in total FDI inflows in ASEAN has been increasing, and recent data show that it has already reached 33%. In the PRC, the largest investor is Hong Kong, China.[8]

The link between trade and FDI is not straightforward. FDI may be a complement (trade-creating) or substitute (trade-reducing) for trade depending on the type of FDI and the underlying motives for trade. Resource-extracting, production-fragmenting, and differentiated product-delivering FDIs tend to create more trade, whereas market-seeking FDI tends to reduce trade. Labor-seeking FDI is a substitute for trade if its purpose is to invest in a labor-abundant economy because of low wages; but it creates trade if its purpose is to use labor-abundant economies as an export platform. Kawai (this volume) reported that applying an expanded gravity model—which includes FDI as one of the explanatory variables—to Japanese data yields results that support the proposition that Japanese FDI promotes exports in sectors such as food, general machinery, chemical products, electrical machinery, and textiles. These are sectors where Japanese MNEs' vertical intra-industry trade is actively developed. A closer look at the behavior of Japanese MNEs in East Asia shows that 96% of the exports of Japanese MNEs' affiliates to Japan were destined for their parents, while 83% of their imports from Japan came from their parents. Intrafirm trade between Japanese multinationals' affiliates in East Asia accounted for 59% of their total trade within the region. Many corporations of Asian NIEs are setting up similar production networks in the PRC and ASEAN countries, thereby contributing to the growing intraregional trade and investment.

It is to be noted that East Asia's increasing trade and investment integration is mainly market-driven rather than a result of regionalism. In the 1980s and 1990s, many emerging East Asian economies embarked on liberalization of trade and FDI regimes and deregulation in domestic activities as part of more comprehensive structural reform policies (Kawai, this volume).

SOUTH ASIA

In South Asia, which includes Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka, intraregional trade as a proportion of total trade is low, around 4%.[9] However, since the early 1990s when almost all countries in South Asia initiated major policy reforms with respect to the external sector, intraregional trade has been increasing. The value of regional trade increased fourfold during the period 1990–2000 (Mohanty 2003). South Asian countries with smaller economies are more dependent on intraregional trade than those with larger economies, and thus can benefit more from trade liberalization. It should be pointed out, however, that India, the largest economy in the region, has maintained a favorable trade balance with the

[8] A significant portion of this is due to "round-tripping"; that is, Chinese investments are channeled through Hong Kong, China and return to the mainland as FDI to secure the greater privileges and security accorded to foreign investors (Hill 2004).

[9] This share easily doubles if informal intraregional trade is taken into account (RIS 2002). However, it is still low even when compared with that of intra-ASEAN trade.

whole of South Asia throughout 1990–2000. Its exports to South Asia constitute 3-6% of its global exports. Being a large economy, India has more diversified export and import baskets compared with those of its neighboring countries.

Intraregional FDI flows in South Asia are much more limited than intraregional trade. As noted earlier, Japan's and NIEs' MNEs in East Asia have played a big role in increasing intraregional FDI flows by setting up production networks in other countries in the region. Such pattern is also emerging in South Asia, though not on the same scale as that in East Asia. For instance, the bilateral trade agreement between India and Nepal had encouraged some Indian enterprises to locate their production base in Nepal (RIS 2004). Indeed, some Indian companies are already in a position to play the same role played by Japan's and NIEs' MNEs for East Asia because India's intra-industry trade with neighboring countries is already high in several industries. Examples of high intra-industry trade between India and its neighboring countries follow—Bangladesh: manufacturing units relating to shirts not hand printed, sacks and bags or other plastics; India/Bhutan: sweetened flavored water, tubes, and pipes; India/Maldives: air conditioning machines, water pumps; Nepal: manufacture of toothpaste, household and laundry soaps; Pakistan: cane sugar, some chemical products; and Sri Lanka: manufacture of printing and writing papers not elsewhere classified, soap cutting and moulding machinery.[10] Indian companies in these industries could move to neighboring countries either as joint ventures or as wholly owned subsidiaries to exploit cost advantages, thereby enhancing their competitiveness. Such complementarities can be exploited if South Asian countries deepen further their regional cooperation in trade and investment.

ASEAN'S TRADE LINKAGES WITH THE PRC

The economic landscape of Asia has changed markedly with the emergence of the PRC as a major economic power. Since it started to liberalize its economy in 1979, the PRC has attracted FDI from industrialized economies and NIEs. In fact, in recent years the PRC has become the largest recipient of FDI among developing countries. Between 1990 and 2000, its economy grew on average by 8.5% annually and exports expanded on average by 15% annually. Indeed, PRC's phenomenal economic performance in the last decade has posed some challenges to ASEAN countries, particularly middle-income ASEAN countries. Some FDI that otherwise would have gone to these countries went to the PRC, thereby enhancing PRC's position as an export platform. Moreover, middle-income ASEAN countries and the PRC appear to have significant similarities in trade structure (Kawai, this volume). PRC's accession to WTO in December 2001 has further improved its investment environment, and has added more competitive pressure on middle-income ASEAN countries. However, this situation has also offered both ASEAN and the PRC some opportunities for increasing substantially their bilateral trade in goods and services.

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[10] See Mukherji (2004) for a comprehensive list of product lines.

Since 1991, bilateral merchandise trade between ASEAN-5 and the PRC grew at an annual average of 20%, reaching $39.5 billion in 2002.[11] The PRC had maintained a favorable trade balance during this period. As of 2001, it became the fifth largest trading partner of ASEAN-5, accounting for 6–7% of ASEAN-5's total trade. Between 1993 and 2001, the composition of ASEAN's exports to the PRC had shifted from primary products to manufactured products, such as electrical and electronic machinery and mechanical appliances. Interestingly, these products accounted for more than half of ASEAN-5's imports by the PRC. This could be an indication that there is increasing intra-industry trade in manufactured products between ASEAN-5 and the PRC. Increasing intra-industry trade coupled with PRC's accession to WTO gives ASEAN ample opportunities for expanding trade with the PRC.

Opportunities for expanding trade in services between ASEAN and the PRC also exist, especially since liberalization in trade in services is an important dimension of PRC's accession to WTO. One of the services sectors where there are more opportunities for increasing trade between ASEAN-5 and the PRC is travel and tourism. ASEAN-5 countries enjoy a comparative advantage in travel and tourism, and the PRC is the fastest growing market for tourism. Two-way flows of tourists between ASEAN-5 and the PRC have risen rapidly in recent years. The number of ASEAN's tourists visiting the PRC rose from 1.1 million in 1995 to 1.8 million in 2000, while the number of tourist arrivals from the PRC to ASEAN-5 increased from 0.8 million to 2.3 million during the same period.

ASEAN'S TRADE LINKAGES WITH INDIA

In the early years of the 1990s, India initiated major economic reforms covering trade, industrial, and exchange rate policy regimes (RIS 2004). Since then, it has become a favored destination for FDI in South Asia, particularly relating to business processing operations. India's FDI inflows averaged $1.1 billion annually during 1991–1996, and rose to an average of $2.4 billion annually during 1997–2002. Indeed, India is one of the fastest growing economies in Asia. Between 1995 and 2001, the Indian economy's growth averaged 6.4% annually. It dipped to 5% annually in 2002 and 2003 due to the slowdown of the US economy that adversely affected the demand for exports of its ICT industry, poor monsoons, rising oil prices, and the Afghan War. However, the economy is expected to rebound quickly and is projected to grow by more than 7% in 2004 and 2005. India is projected to emerge as the third largest economy in 2003 US dollars by the year 2050, behind the PRC and the US. As such, it will become a very important trading partner of ASEAN.

Presently, trade linkages between ASEAN and India are still weak. However, recent trends indicate that such linkages are going to strengthen in the near future. Between 1993 and 2001, ASEAN's exports to India rose from $1.5 billion to $6.2 billion, while its imports from India increased from $1.4 billion to $3.7 billion (Rajan and Sen,

[11] Rajan and Sen, this volume. ASEAN-5 comprises Indonesia, Malaysia, Philippines, Singapore, and Thailand.

this volume). During the same period, the composition of ASEAN-5's exports to and imports from India shifted markedly from primary to manufactured products, such as electrical and electronic machinery and mechanical appliances. This could be an indication that there is increasing intra-industry trade between ASEAN-5 and India.

India has a competitive advantage as a business outsourcing hub. While many US, British, and other MNEs have been outsourcing a number of their services activities to India for several years now, ASEAN enterprises are rather slow in following that pattern, thereby forgoing the potential competitive advantage by not locating some parts of the value-chain in India. Tourism is another sector where potentials for increased trade between ASEAN and India have remained largely untapped. Between 1992 and 2002, the number of visitor arrivals from India to ASEAN increased from about 420,000 to over 880,000. In contrast, the number of ASEAN tourists visiting India in 2001 was only 140,000.

Existing and Proposed RTAs in Asia

As of 2003, there were already 184 RTAs notified to WTO. Because of its long-standing policy of pursuing trade liberalization only under a multilateral framework, Asia appears to be the least regionalized in terms of RTAs notified to WTO. However, this status is changing rapidly in recent years as many governments in Asia have started to promote regional and bilateral trade and investment arrangements. These initiatives have emerged due to several factors.[12] First, the formation of RTAs is a defensive response to the rise of regionalism in Europe, North America, and Latin America that has threatened the competitiveness of Asian economies. Thus, regional economic integration is adopted as a strategy for development and strengthening external competitiveness by countries. Second, the slow progress in trade liberalization under the WTO framework has raised concerns over market access of Asia's rapidly growing export-oriented industries. Thus, developing a larger regional market through regional integration initiatives and at the same time increasing market access in economies outside the region through RTA is a strategic fallback position. Third, with the liberalization of trade and investment regime undertaken by many countries around the world, the competition for FDI has become more intense. Asian economies will be vulnerable to such development especially since they have been relying considerably on FDI for industrial upgrading and increased productivity. Fourth, there is a concern that the proliferation of overlapping bilateral agreements can lead to a number of "hub-and-spokes" type of trade arrangement.[13] Such an arrangement tends to favor the hub because of its stronger bargaining position and greater attractiveness of its central location to investors (Medalla

[12] See Kawai (this volume), Rajan and Sen (this volume), and Yue (1995).

[13] In a "hub-and-spokes" arrangement, one country becomes a "hub" by establishing different bilateral RTAs with a number of countries ("spokes") while these countries retain their most favored nation (MFN) barriers on each other's goods.

and Lazaro 2004). Thus, countries are rushing the formation of FTAs to establish dominance as a hub. Fifth, countries found the need to institutionalize the *de facto* integration process because of increased interaction through trade and investment. Such institutionalization will make it clear to all parties involved that the integration process cannot be reversed.

REGIONAL TRADE AND INVESTMENT COOPERATION

The Bangkok Agreement established in 1976 under the United Nations Economic and Social Commission for Asia and the Pacific (UN-ESCAP) initiative is an attempt at regional economic cooperation between five countries in Asia, namely, Bangladesh, India, Lao PDR, Korea, and Sri Lanka. The PRC joined the Agreement in 2000. The Agreement covers exchange of tariff concessions among member countries. So far, the achievement of this Agreement in terms of increasing trade among participating countries has been minimal due to its limited coverage of membership and products, preference margins that are not deep enough, and its scope that does not extend to nontariff barriers (Kumar, this volume).

Ten years after its formation in 1967, ASEAN introduced the ASEAN Preferential Trading Arrangement (PTA) to promote intraregional trade through preferences in the form of lower tariff rates, lower nontariff barriers, long-term quantity contracts, preferential financing, and preferential procurement by government agencies.[14] The PTA had negligible impact in promoting intra-ASEAN trade due to the inclusion of products that were not significant to intra-ASEAN trade, exclusion of products that were significant to intra-ASEAN trade, and time-consuming bureaucratic procedures to establish ASEAN content to qualify for tariff preferences, among others (Yue 1997). The refinements made to the PTA in 1987 still did not improve its utilization rate and contributions to intra-ASEAN trade.

To deepen regional economic integration, ASEAN decided in 1992 to set up an ASEAN Free Trade Area (AFTA), which is to be achieved at the end of a 15-year program of eliminating tariffs and nontariff barriers.[15] Under AFTA's Common Effective Preferential Tariff (CEPT) scheme, tariff levels of most goods that meet the 40% content requirement would have reached the target 0-5% by 2008.[16] In 1994, ASEAN agreed to shorten the time frame for regional liberalization to 10 years so that regional free trade would be achieved by 2003 instead of 2008. More than 99% of the products in the CEPT Inclusion List (IL) of ASEAN-6, comprising Brunei Darussalam, Indonesia, Malaysia, Philippines, Singapore, and Thailand, have already

[14] It is to be noted that the formation of ASEAN was motivated more by political than economic considerations.

[15] According to Yue (1997), "For the first 25 years of ASEAN's existence, official documents avoided the term 'integration' and emphasized only 'cooperation,' as ASEAN policymakers were not prepared to consider either a free trade area or a customs union as they pursued national import substitution strategies."

[16] The tariff lines have been classified into four categories: (i) inclusion list; (ii) temporary exclusion list; (iii) sensitive list which constitutes 0.6% of total ASEAN tariff lines and will not be included in AFTA until 2010; and (iv) general exclusion list, which comprises 1.3% of total ASEAN tariff lines.

exceeded their commitment to eliminate tariffs on 60% of their products in the IL by the year 2003. Meanwhile, the new members of ASEAN have committed themselves to eliminating import duties in a later period: Viet Nam, 2006; Lao PDR and Myanmar, 2008; and Cambodia, 2010. Almost 80% of their products have already been moved to their respective CEPT IL. Of these items, about 66% already have tariffs within the 0-5% tariff band. The completion of AFTA can stimulate more intra-industry trade (see Box 1.2).

Some analysts are of the view that AFTA can have only marginal impact in promoting intra-ASEAN trade. One reason is that ASEAN member countries seem to be still reluctant to liberalize trade and instead want to continue protecting some of their domestic industries. This can be seen from the numerous exceptions allowed from the CEPT scheme and backsliding in commitments by some member countries (e.g., Malaysia in the case of motor vehicles and parts, Indonesia in agricultural products, and the Philippines in the case of petrochemical products) and the marginal difference between CEPT rates and MFN rates for several products that can hardly outweigh the cost of accessing the preferential rate under the CEPT scheme (Rajan, this volume). Consequently, only a small proportion of intra-ASEAN trade was done under the CEPT scheme. Another reason is that ASEAN lacks economic complementarity (Yue 1997).

AFTA has two complementary programs, namely, ASEAN Investment Area (AIA) and ASEAN Industrial Cooperation (AICO) scheme.[17] AIA aims to make ASEAN a competitive, conducive and liberal area through some measures, such as, implementing coordinated ASEAN investment cooperation and facilitation programs; opening up all industries for investment—with some exceptions specified in the Temporary List and Sensitive List—to ASEAN investors by 2010 and to all investors by 2020; promoting freer flows of capital, skilled labor, professional expertise and technology among the member countries; removing investment barriers and liberalizing investment rules and policies in the sectors covered by the Agreement. So far, AIA has not made any significant progress. The AICO scheme, on the other hand, is ASEAN's industrial cooperation program to promote joint manufacturing industrial activities between ASEAN-based companies.[18] The major privilege of the new scheme is that AICO products, upon their approval, shall immediately enjoy preferential tariff rates of 0–5%. So far, 126 AICOs have been approved, which are expected to generate $1.4 billion transactions a year.[19]

The recent decision of ASEAN to create an ASEAN Economic Community (ASEAN-EC) by 2020 is perhaps the strongest indication of its member countries' desire to deepen regional integration further. ASEAN-EC is envisaged as a single market and production base with free flow of goods, services, investment, skilled labor, and freer flow of capital. More recently, ASEAN leaders signed the Framework Agreement

[17] http://www.adb.org.

[18] AICO replaces the ASEAN Industrial Joint Venture and Brand-to-Brand Complementation schemes, which were ineffective due to a lot of shortcomings.

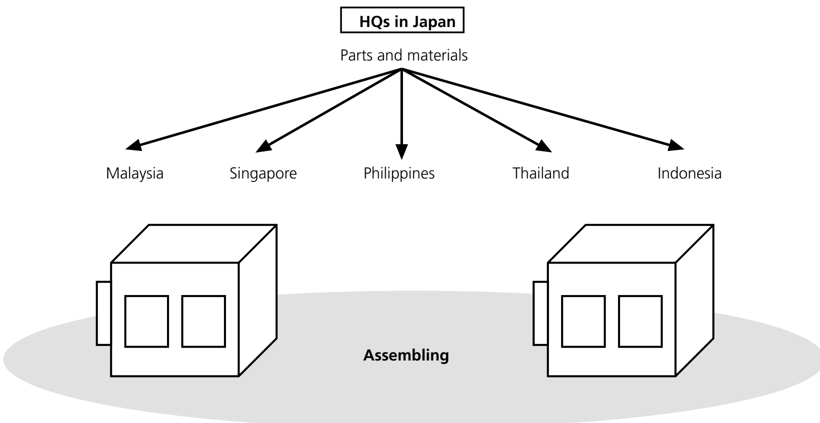
[19] Thirty-Sixth ASEAN Economic Ministers Meeting, Joint Media Statement, Jakarta, 3 September 2004.

BOX 1.2
Impact of AFTA on Trade and Investment

With the completion of AFTA, the intra-ASEAN trade, especially among the original six ASEAN members, will be exempted from these tariffs. It will certainly encourage local and foreign firms operating within ASEAN to become more active in their business across borders.

As a matter of fact, Japanese firms have already started moving in that direction in anticipation of the completion of AFTA. Box Figures 1.1 and 1.2 illustrate this move. Box Figure 1.1 depicts conventional bilateral business between a parent company in Japan and its subsidiary firms in individual ASEAN economies. All parts and materials

BOX FIGURE 1.1
Traditional Procurement System



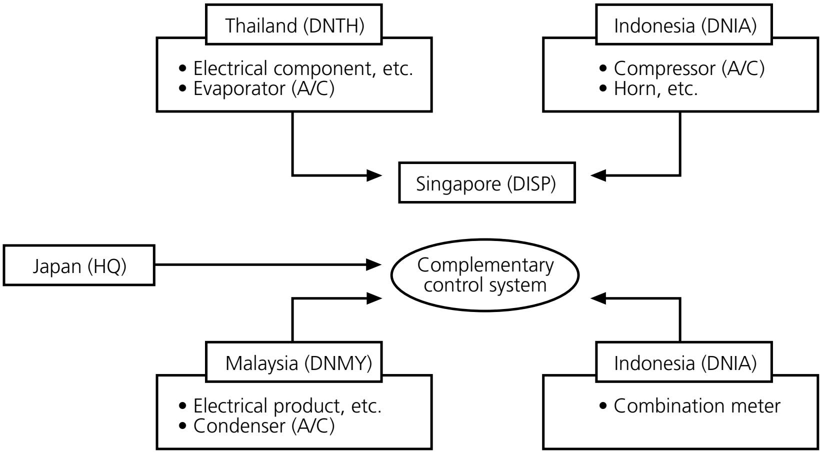
for the Integration of Priority Sectors that aims to accelerate the integration of 11 priority sectors, namely, electronics, e-ASEAN, health care, wood-based products, automotives, rubber-based products, textiles and apparels, agro-based products, fisheries, air travel, and tourism.[20]

ASEAN's counterpart in South Asia is the South Asian Association for Regional Cooperation (SAARC), which came into existence in 1985 and comprises Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka. SAARC established the SAARC Preferential Trading Arrangement (SAPTA) in December 1995. Under the

[20] Chairman's Statement at the 10th ASEAN Summit held in Vientiane, Laos (29 November 2004).

are produced in Japan and shipped to the ASEAN subsidiaries for assembly and sale in local markets. Their sales across borders are constrained by high tariffs, as mentioned earlier. In contrast, Box Figure 1.2 depicts an ASEAN-wide business network, in which the parent company allocates its production of various parts among individual ASEAN members, gathers them in Singapore, and makes a complete kit to be distributed to individual countries for assembly, enabling greater economy of scale in parts production. This requires frequent flows of parts across borders and was not viable in the days of high tariffs.

BOX FIGURE 1.2
Complementary System–Denso Thailand Co., Ltd.



A/C=aircon, DISP=Denso International Singapore, DNIA=Denso Indonesia, DNMY=Denso Malaysia, DNTH=Denso Thailand.
Source: Yamazawa (2003).

SAPTA, three rounds of trade negotiations have already been completed: SAPTA I covers 226 commodities; SAPTA II covers 1,868 products; and SAPTA III covers 3,456 commodities (Agarwala 2002). The depth of the tariff cuts for these products vary from 5% to 100% (Mukherji 2004).

SAPTA has been criticized for producing negligible gains in intra-SAARC trade. It is to be noted, however, that under SAPTA smaller countries such as Bangladesh and Maldives have made some gains as import liberalization from India has stimulated preferential imports from these countries (RIS 2004).

In January 2004, SAARC agreed to establish a South Asian Free Trade Area (SAFTA) that will supersede SAPTA. The agreement on SAFTA will take effect in January 2006.

Under SAFTA, more developed countries in the region are expected to bring down their tariffs to 0–5% in 7 years while less developed countries are required to do the same in 10 years.

With the initiative of Thailand and support from ADB and United Nations Economic and Social Commission for Asia and the Pacific, a regional economic forum was formed in 1997. The Bay of Bengal Initiative for Multisectoral Technical and Economic Cooperation (BIMSTEC) includes Bangladesh, Bhutan, India, Myanmar, Nepal, Sri Lanka, and Thailand. The member countries signed in January 2004 an agreement to establish an RTA.

Intraregional trade has gradually developed among Central Asian countries in the decade of independence. However, unlike Southeast Asia and South Asia, Central Asia does not have a formal regional body that promotes regional integration. ADB initiated its Central Asia Regional Economic Cooperation (CAREC) Program in 1997 to deepen and accelerate economic integration in the region. Participants in this Program include Azerbaijan, PRC, Kazakhstan, Kyrgyz Republic, Mongolia, Tajikistan, and Uzbekistan. The operational strategy of the Program is to finance infrastructure projects and improve the policy environment for promoting cross-border activities in the areas of transport, trade, and energy. ADB is currently undertaking Regional Trade and Trade Review Country Studies.[21] Whether in the future CAREC will evolve into a regional institution similar to ASEAN or SAARC that will promote deeper regional integration will be an interesting development to watch.

BILATERAL TRADE AND INVESTMENT COOPERATION

In East Asia, there are already 11 bilateral free trade agreements/economic partnership agreements (FTAs/EPAs) in effect, of which two involve countries within East Asian countries, viz., Lao PDR-Thailand FTA and Japan-Singapore EPA. The rest are bilateral agreements between an East Asian country and a country or RTA outside the region. Eighteen bilateral FTAs/EPAs are in various stages of negotiations, of which six involve countries within East Asia, viz., Japan-Korea, Japan-Thailand, Japan-Philippines, Japan-Malaysia, Korea-Singapore, and PRC-ASEAN FTAs/EPAs. ASEAN is currently negotiating an FTA with India, while Singapore and Thailand are doing the same separately with India. Thirteen FTAs/EPAs are under study, including Japan-ASEAN, Japan-Indonesia, Korea-ASEAN and Singapore-Taipei,China FTAs/EPAs. PRC, Japan, and Korea are currently having consultations for a possible FTA/EPA in Northeast Asia.

In South Asia, there are three existing bilateral FTA initiatives, all involving countries within the region. These are India-Bhutan, India-Nepal, and India-Sri Lanka FTAs. Currently, six bilateral FTAs all involving countries within the region are in various stages of development. These proposed bilateral agreements have been initiated

[21] http://www.adb.org.

by countries within the region in response to the slow progress of SAPTA in tariff liberalization compared with progress made under the three existing bilateral FTAs (RIS 2004).

Some Central Asian countries are engaged in bilateral FTAs with countries within and outside the region. The Kyrgyz Republic appears to be the most aggressive among Central Asian countries in terms of trade liberalization. It has an FTA with Armenia, Kazakhstan, Moldova, Russian Federation, Ukraine, and Uzbekistan. Aside from the Kyrgyz Republic, Kazakhstan has an FTA with Georgia. Azerbaijan has an FTA with Georgia.

Key Features of RTAs

RTAs in Asia have special features that make the recent wave of regionalism different from previous ones (Rajan and Sen, this volume). First, the new ones are more comprehensive than the traditional FTAs in that they include, not only merchandise trade liberalization but also liberalization of services and other trade facilitation measures, such as investment protection and liberalization, harmonization and mutual recognition of standards and certification, streamlining and harmonization of customs procedures, opening of government procurement markets, etc. Thus, these agreements potentially allow for deeper integration and greater efficiency gains than simply removing tariffs (Bonapace, this volume). Because of their comprehensiveness, these agreements are sometimes referred to as EPAs to distinguish them from RTAs that focus only on trade agreement. Second, the RTAs are not restricted to just the immediate countries within a region. This is an indication that these countries wish to maintain open trading relations with other parts of the world rather than be inward-looking (Kawai, this volume). Third, because of the depth of the issue coverage, the initial membership tends to be smaller than that of traditional RTAs. In fact, many of the recent RTAs are bilateral agreements to fast-track the negotiations and implementation of the agreements. Interestingly, ASEAN as a whole is negotiating an FTA with countries within and outside Asia. However, because of the slowness of this process, some ASEAN member countries are negotiating separately with the same countries.

Impact Assessment

Countries adopt an RTA with the expectation that it will yield more economic benefits to them than if they pursue the same goal individually. In reality, however, it is difficult to predict with a high degree of reliability the impact of RTAs. Existing literature distinguishes two types of impacts from RTAs: static and dynamic. Static effects emphasize an RTA's efficiency effects, taking into account the trade creation effect, i.e., intraregional expansion of trade due to the removal of trade barriers, and the trade diversion effect, i.e., imports of efficient production from outside the region would be replaced by imports from inside the region. On the other hand, dynamic effects consider gains arising from economies of scale, increased competition, or increased domestic and foreign investments. Thus, dynamic effects are much more difficult to quantify than static effects.

Quantitative results of the economic impact of RTAs invariably show that participating countries gain from trade liberalization, although the magnitude of the gains varies among them. Results of simulation analysis using a general equilibrium trade model that examines only static effects of integration suggest that an East Asian RTA (i.e., JACK [Japan, ASEAN, PRC, Korea]) can yield benefits to all participants, most especially ASEAN members.[22] In South Asia, results with the gravity model indicate that elimination of tariffs under SAFTA may increase intraregional trade by 1.6 times the existing level (RIS 2004). For JACIK (Japan, ASEAN, PRC, India, Korea), the gains from integration can be more than 3% of the combined GDP of JACIK economies if RTA is combined with investment liberalization and mobility of skilled manpower (Kumar, this volume).

Major Issues

Notwithstanding the potential gains from RTAs, the proliferation of RTAs has raised some concerns (Rajan and Sen, Bonapace, this volume). First, overlapping RTAs with different rules of origin applied to trading partners can reduce transparency in trading rules and can unnecessarily raise the cost of implementing them, and thus impede cross-border economic activity, which is the primary aim of RTAs. They can increase the risk of inconsistencies in trading rules among RTAs, which in turn can cause systemic risk on the functioning of WTO by making it difficult, if not impossible, to develop consistent multilateral rules in the future. Thus, RTAs can become stumbling blocks, rather than building blocks, to the rules-based multilateral trading system under WTO. This issue has been debated at length in the literature for years without coming to a closure. Second, asymmetry in political power and economic resources between contracting countries may result in an agreement grossly disadvantageous to low-income contracting countries. This is specially so since low-income countries lack the technocratic and institutional capacity to negotiate RTAs. Third, and which is closely related to the second, upper- and middle-income countries that are "like-minded" and have the technocratic and institutional capacity can negotiate and implement RTAs among themselves more quickly than when other contracting parties involve low-income countries.[23] Considering the potential gains from trade accruing to members of RTAs, this situation can further widen the divide between rich and poor countries.

[22] Kawai (this volume). Kawasaki (2003) showed similar results even if Korea is dropped from the East Asian RTA.

[23] High-income countries will have no motivation to enter into a legally binding agreement with low-income countries if the latter do not have the capacity to implement existing laws.

Regional Cooperation and Monetary and Financial Integration

The 1997 financial crisis has put East Asia in the limelight of policy research, and since then several papers have been written to determine the degree of financial and monetary integration in the region and to recommend proposals to deepen such integration. This section will focus mainly on issues on financial integration in East Asia. The same issues are relevant to other subregions in Asia.

Financial Integration

EXTENT OF FINANCIAL INTEGRATION

Financial integration implies an increase in capital flows and a tendency for the prices and returns on traded financial assets in different countries to equalize on a common-currency basis (De Brouwer, this volume). The increase in capital flows between countries can happen in the absence of artificial barriers, such as capital controls. Since the 1980s, many East Asian countries have been gradually deregulating their financial systems, opening financial services to foreign investors, and liberalizing capital accounts to improve the efficiency of their financial markets and attract foreign capital. Park (2002) observed that although East Asian countries were slow in liberalizing capital account transactions and stock markets, their overall degree of domestic financial liberalization had reached on average the European level by 1995.[24] Such measures could have led to deeper integration of financial markets in East Asia, and at least part of the contagion of the currency crisis in 1997 reflected such linkages within the region (Kawai, this volume).

Measuring the degree of regional financial integration is a difficult and complex exercise. There is yet no universally accepted method for measuring the degree of financial integration. There are rough and incomplete measures of regional financial integration, which can be classified into three categories: price-based measures, such as interest parity conditions; quantity-based measures, such as gross capital flows; and regulatory and institutional measures, such as restraints on capital flows (Rajan, this volume). Each measure has certain limitations. For instance, data on gross capital flows and intraregional flows in East Asia are incomplete, while the use of interest rate parity conditions encounters some difficulties in modeling expectations in a way that is consistent with observed facts (De Brouwer, this volume). Notwithstanding these limitations, results of such measures can paint a broad picture of the degree of financial integration.

Available data suggest that although the largest share of financial flows in the region came from the US and Europe, a significant portion of such flows came from Japan and Asian NIEs. For instance, 36% of Korea's outstanding FDI as of 2001 went

[24] For this index, the East Asian economies included are Hong Kong, China; Indonesia; Korea; Malaysia; Philippines; Taipei,China; and Thailand.

to East Asian economies, while Singapore's top eight investment destinations included PRC; Hong Kong, China; Indonesia; and Malaysia.[25] It is to be noted that intraregional financial flows had declined after the 1997–1998 financial crisis, as Japanese banks reduced their lending and Japan's and NIEs' MNEs decreased their FDIs.

Using annual data from 1980 to 2002, Kawai and Motonishi (this volume) found that real stock prices are strongly positively correlated across East Asia. The exception is the PRC. The limited openness of PRC's financial market and capital account could have acted as barriers to the integration of its financial market with the rest of the East Asian economies.

Except for Japanese banks, East Asian banks had hardly any presence in neighboring countries until recently. Singapore banks appear to be most aggressive in that they have either branches or subsidiaries recently opened in most East Asian economies. After the Philippines opened its banking sector to foreign banks in the mid-1990s, several branches and subsidiaries of banks from neighboring countries, such as PRC, Indonesia, Korea, Malaysia, Singapore, and Taipei,China were established in the country. One of the major businesses of these banks is to provide trade financing for import and export between the Philippines and their home countries.

EXISTING REGIONAL FINANCIAL COOPERATION

East Asian economies have liberalized their financial systems to integrate them with the global financial system so that they can have better access to capital markets, especially those of developed economies, and at the same time enhance portfolio diversification. This raises a fundamental issue: what incentives do East Asian countries have to promote regional integration? At least five incentives can be identified (Kawai and Motonishi, this volume). The first is that there is a need to formalize the de facto financial integration through the establishment of a formal cooperative framework to internalize externalities and spillover effects. Intraregional trade has been increasing rapidly in recent years, signifying that macroeconomic and financial sector policies can have progressively larger economic spillovers within the region (Montiel 2004). Second, many have been dissatisfied with the way the International Monetary Fund (IMF) and the international community handled the 1997 financial crisis. One of the lessons learned from this experience is the realization that a regional "self-help" mechanism is needed for the effective prevention, management, and resolution of financial crises and contagion. Third, regional commitments can motivate domestic reforms and overcome antireform constituencies. Fourth, given the disproportionate share in the power of East Asia in IMF, regional cooperation in financial markets that strengthen these markets can be important in providing the region with a stronger voice in global forums and institutions. Fifth, cooperation to harmonize "soft infrastructure," such as payments and settlements systems, accounting system, regulatory frameworks, and standards can facilitate integration of financial markets, thereby enhancing

[25] Data are based on Tables 8 and 10 of Park (2002).

the funding base of East Asian firms and households and at the same time offering investors within and outside the region a large market for financial instruments.

Regional financial cooperation can take various forms, which can be viewed in terms of gradation of policy measures and the required institutional mechanisms (Montiel 2004). The weakest form of regional financial cooperation involves information sharing and peer pressure to strengthen domestic financial systems. Above it is a form of regional cooperation aimed at developing effective mechanisms for regulation and supervision of financial institutions. The highest form of regional cooperation in the financial sector involves regional harmonization of regulations of financial systems to achieve full unification of regional financial markets. The less integrated the financial markets in the region are, the more difficult and costly would it be to cooperate in other areas, such as the development of the Asian bond market discussed later.

Since the 1997 financial crisis, there have been several initiatives in monetary and financial cooperation. These can be grouped into four areas: policy dialogue and surveillance mechanism, liquidity support facility, financial system strengthening, and Asian bond market development.

Policy dialogue and surveillance

Several mechanisms are involved in policy dialogue and surveillance. The ASEAN Surveillance Process (ASP) was established in October 1998 to strengthen the capacity of policy making within ASEAN on the principles of peer review and mutual interest among ASEAN member countries. It has two mechanisms: the monitoring mechanism that allows early detection of problems that might affect the economy in general, and the financial sector in particular; and a peer review mechanism that focuses on the policy measures needed to quickly address the issues identified in the monitoring exercises. Finance and central bank officials of ASEAN provide information on the latest economic and financial developments in their respective countries to the ASEAN Surveillance Coordinating Unit (ASCU), which in turn conducts analysis using such information and information about recent global developments. ADB through its Regional Economic Monitoring Unit (REMU)[26] supports the ASP by making available its quarterly Asia economic monitor report and by conducting special studies requested by ASEAN. The ASEAN finance ministers meet once a year for policy coordination under the ASP.

With the formation of ASEAN+3 in 1999, the ASP has been expanded to include PRC, Japan, and Korea. Like the ASP, the ASEAN+3 Economic Review and Policy Dialogue (ERPD) process provides a forum for policy dialogue and aims to strengthen policy coordination and collaboration in the region. Finance ministers of this group meet once a year and their deputies meet semi-annually. The first peer review conducted under this process was held in 2000. ADB's REMU provides inputs to the ASEAN+3 economic monitoring and surveillance process. In 2001, the ASEAN+3

[26] REMU was replaced by the Office of Regional Economic Integration (OREI), effective 1 April 2005.

created a Study Group to examine ways of enhancing the effectiveness of economic reviews and policy dialogues. It recommended that the surveillance process at the ASEAN+3 Finance and Central Bank Deputies (AFDM+3) meetings be undertaken at two levels: (i) discussion of current economic conditions and issues, and (ii) selection of a topic of interest/concern to the region for more in-depth discussion. With regard to the latter, the process could take the following form: (i) the AFDM+3 is to identify specific economic and financial issues of concern to the region or, when deemed necessary, direct that a third-party assessment of regional issues be undertaken to complement the assessments made by IMF and other financial institutions; (ii) the host country will prepare the background paper on the selected topic(s) either individually or jointly and, in the latter case, the host country with another ASEAN or +3 country, as the case may be; and (iii) any member country may also volunteer to prepare the background paper on any of the selected topics with the consent of the host country. In their meeting held in August 2003, the ASEAN+3 finance ministers agreed to implement the recommendations made by the Study Group.

The Manila Framework Group (MFG) was another mechanism for surveillance. Before its dissolution in November 2004, deputy finance ministers and central bank governors from member countries held meetings twice a year with the participation of IMF, World Bank, ADB, and Bank for International Settlements (BIS). The presence of these four institutions in the meetings provided a high-level and more intensive discussion of recent economic performance of member countries as well as regional and global developments.

To a lesser extent, other regional bodies, such as APEC and the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP), are involved in reviewing recent economic and financial developments in the member economies during their finance ministers' or central bank governors' regular meetings.

There are criticisms against the existing surveillance mechanisms in the region. Henning (2002) has argued that the multiplicity and overlap of these mechanisms have already reached the point of diminishing returns and suggested that they be streamlined to better allocate resources. Others find all of these mechanisms ineffective in attaining their objectives. There is no clear linkage between surveillance and the Chiang Mai Initiative (CMI) and there is no independent, professional organization that prepares comprehensive analyses or identifies issues for discussion (Kawai and Motonishi, this volume). Even the MFG surveillance mechanism, which was expected by many to carry out a more effective dialogue than other forums in the region, appeared to have had very limited success (Bergsten and Park 2002).

Liquidity support facility

The contagious regional financial crisis has made East Asian countries realize that IMF's role in helping countries prevent and manage any crisis that might originate in one country and quickly spread to the rest of the region is fairly limited. Failing to establish the Asian Monetary Fund proposed by Japan, ASEAN+3 formulated in 2000 the so-called Chiang Mai Initiative (CMI), which is a regionwide defense against future crises and complements IMF's role in averting financial crisis. It has two components. The first component is the expanded ASEAN swap arrangement (ASA), which expanded the coverage of the original ASA to all ASEAN members and increased the total amount from $200 million to $1 billion. Currencies available under this arrangement include the US dollar, euro, and yen. The second component is the set of bilateral swap arrangements (BSAs) among ASEAN+3 members. The BSA is designed to complement IMF's assistance to a country suffering liquidity crisis. Automatic disbursement from this facility is allowed only up to 10% of the facility. Any drawings beyond this limit require linkage with an IMF program or conditionality. As of December 2003, 16 BSAs had already been concluded, amounting to $36.5 billion.

The CMI is an important step toward building strong regional monetary cooperation in East Asia, for any higher form of monetary cooperation requires a liquidity mechanism. There are now discussions on how to improve the CMI, focusing on three major issues (De Brouwer, this volume). The first relates to the need for the CMI to reduce its reliance on IMF conditionality and formulate its own conditionality. Whatever is the shape of such conditionality, it must have strong surveillance capability, an effective mechanism for enforcing conditionality, and clear linkages with IMF, which is responsible for protecting the global system by preventing and resolving financial crises. The second issue relates to the need to increase the resources of the BSA. The third issue is the possibility of transforming the BSA into a multilaterally administered arrangement. So far, ASEAN+3 has not yet reached a common view on these issues.

Financial system strengthening

Since the 1997–1998 crisis, most regional institutions have placed greater emphasis on the need to strengthen domestic institutions and markets to restore investor confidence and diversify sources of corporate funding so that economic recovery can be sustained. While this responsibility largely rests on the shoulders of individual countries, countries in the region have begun to recognize the need for regional cooperation in this area to ensure that the reform package will take into account special characteristics of East Asian institutions and markets, the reform measures are harmonized at this early stage to facilitate regional integration later, and there is a coordinated approach to implementing the reforms while giving countries flexibility in implementation in terms of timing and phasing. In its Hanoi Plan of Action, ASEAN has laid down specific areas of cooperation to strengthen the region's financial system with a specific time line for implementation for some cases. For example, ASEAN member countries had agreed to adopt and implement sound international financial practices and standards by 2003 and establish a set of minimum standards for listing rules, procedures, and requirements also by 2003.

For its part, APEC issued in 1997 voluntary principles for promoting financial and capital market development in member economies. The principles include, among others, encouraging member economies to adopt high standards in information disclosure and accounting, and ensure that information is available in a timely manner; to develop effective, credible, and independent rating agencies and, as appropriate, promote the greater use of ratings; and to consider efforts to make the legal and regulatory systems consistent with capital market development.

The effectiveness and sustainability of these initiatives are less clear. Thus, an alternative is to put up a formal structure dedicated to achieve specific objectives. In this regard, Eichengreen (2001) has proposed the creation of an Asian Financial Institute (AFI) whose role is to coordinate financial sector reform and development within Asia. One of its tasks is to develop common regional prudential measures for financial systems in Asia.

Asian bond market

There is great interest in developing the region's capital market to avoid the double mismatch that largely underpinned the recent regional crisis and to exploit the huge savings available in the region.[27] The regional bond market can be developed in parallel with the development of the domestic bond market of East Asian economies to exploit economies of scale. There are several Asian bond market initiatives that have been discussed in several forums in the last 3 years (Yoshikuni 2003). Accordingly, both the ASEAN+3 Asian Bond Market Initiative (ABMI) and the APEC regional bond initiative are supposed to examine *supply side issues*, such as new debt instrument offerings, debt instrument rating and enhancements, infrastructure improvement, etc. To support the ASEAN+3 ABMI, separate working groups have been created to examine new securitized debt instruments, credit guarantee mechanisms, foreign exchange transactions and settlement system, issuance of bonds denominated in local currencies by multilateral development banks (MDBs), and local and regional rating agencies. The sixth group is the technical assistance coordination group. These groups have met to consider various proposals to develop the regional bond market.

The Asian Bond Fund (ABF) initiative under the EMEAP will deal with *demand side issues*. On 2 June 2003, the EMEAP Group announced the launch of ABF-1, which amounted to $1 billion. Managed by the BIS, the ABF will be invested in a basket of dollar-denominated bonds issued by EMEAP economies' sovereign and quasi-sovereign issuers, except Japan, Australia, and New Zealand. On 16 December 2004, EMEAP announced the launch of ABF-2. EMEAP members' investment in ABF-2 would be around $2 billion. Under this program, local-currency bonds issued by sovereign and quasi-sovereign issuers in selected EMEAP economies will be pooled and passively managed against a set of predetermined benchmarks in two forms: Pan-Asian Bond Index Fund, which will be a single bond fund index investing in local currency bonds of EMEAP and Fund of Bond Funds, which allows investors to enter a parent fund and select particular countries' bonds in the combination that they want.

[27] Many have observed that East Asian countries continue to export "safe capital" and import "risk capital" after the financial crisis (e.g., Yoshikuni 2003).

For its part, the Asia Cooperation Dialogue (ACD) is mandated to improve *public awareness* of the various bond market initiatives to secure political support for such initiatives.

Recently, Japan's Ministry of Finance and Korea's Ministry of Finance and Economy agreed to issue bonds totaling up to ¥10 billion over a 3-year period starting in late 2004 (De Brouwer 2004). The purpose is to allow Korean small and medium-size firms to gain access to the Japanese capital market. Both governments provide credit enhancement to make these bonds attractive to investors. Other proposals to develop the Asian bond market are worth considering by governments in the region. For instance, Ito (2003) proposes Asian Basket Currency (ABC) bonds that have two mechanisms, one for sovereign bonds that will serve as benchmark bonds and another one for corporate bonds. Under the first mechanism, the ABC Bond Corporation that will be formed by participating governments will issue an ABC bond backed up by local currency-denominated government bonds of the same participating governments. The same system is utilized under the second mechanism except that corporate bonds denominated in the issuers' currency serve as the underlying assets. For the ABC corporate bond market to prosper, Ito proposes a partial credit guarantee to corporate issuers, but only during the initial phase of the development of this market. A regional guarantee facility set up by participating governments, Japan Bank for International Cooperation (JBIC), or multilateral institutions could provide such a guarantee.

Monetary Integration

EXTENT OF MONETARY INTEGRATION

Monetary integration refers to cooperative arrangements in exchange rates and/ or monetary policy (De Brouwer, this volume). Empirical analyses on the extent of monetary integration have attempted to answer the question of whether a group of countries has satisfied the optimum currency area (OCA) criteria. If so, then establishing a common monetary arrangement will have potentially high social benefits. That is, the loss of macroeconomic instruments for stabilization will be more than compensated by microeconomic benefits to be gained from having a common monetary arrangement.

Several studies have already empirically verified whether East Asia has satisfied the OCA criteria. Using 1990 data, Goto and Hamada (1994) analyzed an extensive set of economic variables such as money, interest rates, price levels, real GDP, investment, trade intensity, trade dependence, labor mobility, and FDI. They found that the degree of interdependence among East Asian countries was substantial, with some integration indicators showing higher integration than that in Europe.

Based on econometric estimates, the empirical results of Bayoumi et al (2000) established three important and significant conclusions: first, demand and supply side disturbances are highly and positively correlated for most countries in East Asia similar to what is observed in the EU. Second, the disturbances are larger in East Asia than in the EU. Third, the speed of adjustment is much faster in Asia, specifically in ASEAN, which presumably reflects the region's more flexible labor markets. Goto and Hamada (1994) noted that migration between less- and more-developed East Asian economies was significant, suggesting that labor force in this region had been quite responsive to changing economic conditions.

Kawai and Motonishi (this volume) revisited these issues and found that macroeconomic conditions of the East Asian economies are generally highly synchronized with each other, with the exception of the PRC. They also found that deep real economic interdependence that exists among the economies of East Asia is largely due to strong correlations of supply shocks.

Several studies have claimed and established that Europe, that is, the EU, was not an OCA when political leaders decided to form a monetary union. Neither was the US (another classic example of a working and operational single currency regime) when it decided to establish a monetary union way back in 1785.[28] However, that did not deter them from creating a monetary union.[29] This is an important point to ponder because Frankel and Rose (1997) found that some OCA criteria are endogenous. More specifically, they found strong positive relationship between the degree of bilateral trade intensity and the cross-country bilateral correlation of business cycle activity. This relationship was confirmed by the finding of Bayoumi et al (1999) that OCA indices indicate that European countries became better candidates for a monetary union after 1987. This finding underlies the importance of a strong political commitment for advancing regional economic integration, which is a big challenge to East Asia.

Notwithstanding the generally consistent results obtained by various studies that examined the degree of economic interdependence among East Asian countries, much more empirical analyses are needed to better understand the types of shocks common to countries in the region; the extent of labor mobility in East Asia, which is a sensitive issue for policy dialogue and cooperation in the region, and the endogeneity of the optimal currency criteria for East Asia (De Brouwer, this volume).

REGIONAL MONETARY COOPERATION

This is one area where there is no clear regional initiative at the moment beyond conducting studies on the feasibility of having a common monetary policy and exchange rate system for East Asia. Currently, there is a diversity of exchange rate

[28] Actually, the US entered into an arrangement similar to the EMU when President Woodrow Wilson signed the Federal Reserve Act 88 years ago.

[29] In a recent study using data for the period 1969:Q1 to 1998:Q3, Kouparitsas (1999) produced empirical results confirming that the US satisfies the four OCA criteria: (i) regions are exposed to similar sources of economic disturbances (common shocks); (ii) the relative importance of these shocks across regions is similar (symmetric shocks); (iii) regions have similar responses to common shocks (symmetric responses); and (iv) if regions are subject to region-specific economic disturbances (idiosyncratic shocks), they are capable of quick adjustment.

regimes in East Asia, ranging from hard peg to floating rate, and countries do not seem to have an interest in altering their exchange rate regimes in the near future.[30]

Every country puts stable macroeconomic growth high in the agenda of economic policy. In most East Asian economies, both real output growth and price inflation were found to be sensitive to the real effective exchange rate (Kawai and Motonishi, this volume). With the rising degree of economic interdependence among East Asian economies through trade, investment, and financial flows, maintaining exchange rate stability in the region through closer policy coordination has become more important. Policy coordination may evolve in three stages:

(i) loose policy coordination: information coordination, initial institutional coordination, and resource coordination;
(ii) tight policy coordination: macroeconomic and exchange rate policy coordination for intraregional exchange rate stabilization; and
(iii) complete policy coordination: economic and monetary union with a single currency.

Should East Asia aim for a monetary union in the future, it must hurdle certain preconditions along the way. Given the lessons that can be drawn from Europe's experience with monetary union, Eichengreen (this volume) has distinguished preconditions from pseudo preconditions, i.e., superfluous or counterproductive, to a monetary union. The preconditions include the capacity to delegate monetary policy to an international institution, a culture of monetary policy transparency, open capital accounts, and a common transmission mechanism. The pseudo preconditions, on the other hand, include fiscal transfers between member states, deficit ceilings, sanctions and fines, and numerical convergence criteria. Making such distinctions is useful in that some preconditions that have been emphasized by the EU turn out to be unnecessary for a successful monetary union. For example, the deficit ceiling is not grounded in theory, and hence difficult to enforce. Such lessons can offer some guidance to East Asia on what preconditions to focus on so as to reduce its workload and to avoid counterproductive preconditions should it decide to work for the creation of a monetary union.

Monetary union is not always a necessary companion to deeper regional economic integration. Eichengreen (this volume) has pointed out that in the case of NAFTA, where there is a high degree of economic and financial integration, currencies of member countries float against each other. Canada and Mexico are formal inflation targeters, while the US is a de facto inflation targeter. Fluctuation of their exchange rate is not insignificant, yet it did not hamper the integration of their economies. Thus, instead of pursuing monetary union, an alternative would be for East Asian countries

[30] For more than 5 years now, the PRC has been pressured by the US to abandon its fixed exchange rate system and to switch to a floating exchange rate regime, but so far the PRC has not made any move to do so.

to adopt a managed floating exchange rate regime backed up by inflation targeting. Among East Asian countries, four—Indonesia, Korea, Philippines, and Thailand—are already formal inflation targeters. Interestingly, some of the preconditions for a monetary union, such as a culture of transparency, are also preconditions for a successful inflation targeting framework.

Regional Cooperation and Integration in Infrastructure and Associated Software

If two or more countries with common language and borders impose no tariffs and nontariff barriers on each others' export of goods and services and yet hardly trade with each other, one can think of many causes, but on top of the list would naturally be poor infrastructure that denies connectivity to these countries. Within a country's border, lack or absence of infrastructure can segment population and markets, and often the poor living in hinterlands and the country's border areas do not get a fair share of government's infrastructure spending, and are therefore left out of the infrastructure dividend. As Moon and Roehrl (this volume) emphasized, regional economic cooperation in infrastructure offers a way forward for countries in the region to address issues such as market access, economic growth, marginalization, and poverty reduction.

Infrastructure, Transaction Cost, and Regional Integration

Infrastructure may be divided into four broad categories, namely: agriculture infrastructure (access to fertilizer consumption, irrigated land, and agricultural machinery); economic infrastructure (access to electricity, telephones, personal computer, banking facility, and Internet); social infrastructure (access to health facility, media, education, and drinking water); and transport infrastructure (access to roadways, railways, airways, and ports) (De, this volume). East Asian countries vary greatly in terms of these indices. High-income economies in Asia—Hong Kong, China; Japan; Korea; and Singapore—consistently rank high in all these indices, while low-income countries consistently rank low, indicating severe imbalance in infrastructure in this region.[31] Economies that have better infrastructure are found to have benefited more from the expanding export market.

Using an extended gravity model, De (this volume) analyzed the impact of infrastructure—specifically transport infrastructure, transaction costs, and other variables—on the bilateral trade of Asian economies. Results show that the higher the transaction cost between each pair of partners, the less they trade; and that an

[31] Asian countries include Bangladesh; Brunei; Cambodia; PRC; Hong Kong, China; India; Indonesia; Japan; Lao PDR; Malaysia; Myanmar; Pakistan; Philippines; Singapore; Korea; Sri Lanka; Thailand; and Viet Nam.

exporting country's infrastructure produces a significant positive effect on bilateral trade. Economies that have common borders tend to have higher trading activity due to geographical advantage that could be further enhanced through improved cross-border transport infrastructure and lower transaction costs. All this suggests that any plan for Pan-Asian integration will have to address the inadequacy of infrastructure and high transaction costs, particularly in low-income economies in the region, so that all parties can extract more benefits from such integration in a more equitable manner.

Existing Regional Cooperation in Infrastructure

Regional cooperation in infrastructure in Asia can be classified into six types. These are (i) global UN conventions (of a general nature and in a specific sector); (ii) intergovernmental agreements/organizations addressing regional cooperation (in general and in a specific sector); (iii) intergovernmental agreements/organizations addressing subregional cooperation (in general and in a specific sector); (iv) programs addressing regional or subregional cooperation (in general and in a specific sector; (v) frameworks for agreements; and (vi) guidelines for legislation.

The number of intergovernmental agreements/organizations on regional cooperation in the transport and communications sectors has been increasing in recent years. Examples are the Asia-Pacific Telecommunity (APT); Intergovernmental Commission-Transport Corridor Europe-Caucasus-Asia (IGC-TRACECA); International North-South Transport Corridor (INSTC); Intergovernmental Agreement on the Asian Highway (AH); and the Intergovernmental Consultative Committee on the Regional Space Applications Program for Sustainable Development in Asia and the Pacific (ICC-RESAP).

There are several regional or subregional programs on cooperation of a general nature supported by multilateral organizations. Examples are CIS-7, ADB/Central Asia Regional Economic Cooperation Program (CAREC), ADB/Greater Mekong Subregion (GMS), ADB/Central and South Asia Transport and Trade Forum (CSATTF), United Nations Development Programme (UNDP)/Tumen River Area Development Program, ADB/South Asia Subregional Economic Cooperation (SASEC), United Nations Special Program for the Economies of Central Asia (SPECA), and Mekong-Ganga Cooperation (MGC). Programs addressing subregional or regional cooperation in a specific sector include the ESCAP Asia Land Transport Development (ALTID) Project and the UNDP Silk Road Area Development Program.

It is worth noting that some of the regional initiatives mentioned above focus or include the "software" aspect of infrastructure development that can facilitate interconnectivity. For example, the APT has been facilitating the adoption of regional ICT standards. Another example is the AH Network, which covers issues related to routes, including their numbering, classification, design standards, and signage in highways.

Infrastructure Development and Regional Economic Cooperation and Integration

In Asia, most of the poor live in remote or isolated areas, especially in regions close to their borders (Hong, this volume). They need to be linked to commercial and industrial centers within their borders as well as to those of other countries in the region and beyond through highways, railways, telecommunications, etc. While low-income countries in the Asian region attempt to catch up with high-income countries in infrastructure development by raising investment in domestic infrastructure projects perhaps through a combination of internal and external financing with private sector participation, there is also a need to pay attention to the development of cross-border infrastructure among geographically contiguous areas of neighboring countries to facilitate cross-border movements of goods and factors of production, thereby enhancing economic integration. However, unlike investment in domestic infrastructure projects, investment in cross-border infrastructure presents an additional problem because some countries may make large investments for small gains, while others may realize large benefits from small investments. This makes regional cooperation very important in cross-border infrastructure development.

There are two models of cross-border infrastructure development, namely, the "bottom-up approach" and the "regional public goods approach." The first includes infrastructure projects in a geographic area that aims at reducing poverty directly—examples are regional and subregional projects funded by multilateral organizations—or indirectly by supporting national economic development. The second approach can be implemented in two ways. One way is to choose specific projects, such as transportation infrastructure and prevention or mitigation of natural disasters, that can be implemented through regional cooperation. The other is to establish RTAs among countries and use them as a platform for regional infrastructure development. A case in point is the Greater Mekong Subregion project in which PRC's Yunnan Province participated on a project-specific basis. After putting in place the ASEAN-PRC FTA in November 2002, the GMS project has become one of the top 16 projects of this RTA. However, it is to be noted that it takes more time to arrive at a regional integration agreement than to agree on specific projects.

Private and social benefits from cross-border infrastructure development in Asia can diverge especially in the short term, and such divergence can lead to under-provision of cross-border infrastructure. There are several reasons why private and social benefits from such cross-border investment can diverge at least in the short-term. First, the present trade intensity among countries in a regional bloc may be low and the degree of the openness of their economy to the outside world may be much higher than that among countries in the regional bloc. Thus, it will take a long time before an investment in cross-border infrastructure that is aimed at increasing regional integration can become commercially viable. BIMSTEC can be cited as an example. Second, cross-border infrastructure development projects in Asia are aimed at directly or indirectly reducing poverty, especially in areas along common borders. Although such projects have large social benefits, they have however low profitability, and hence cannot attract private sector investment. Third, cross-border infrastructure projects aimed at regional poverty reduction require supporting and related investments to make them effective, thereby making the total required investment relatively large. This lengthens the time for transforming poverty reduction types of projects into private business investment projects. Fourth, Asian countries generally have underdeveloped capital markets and face very high barriers in accessing capital from international markets.

Major issues need to be addressed to improve cross-border infrastructure development. They include the weak potential for regional and subregional cooperation due to poor economic attractiveness of cross-border infrastructure projects; low private sector involvement owing to low profitability of such projects; lack of long-term commitments, given the time required to recoup the investment; difficulty in packaging a large infrastructure investment that includes several components; and lack of financing structure for regional and subregional infrastructure projects. To address these issues in the short term, multilateral financial organizations have to balance their investment portfolio to include both highly profitable and less profitable projects and deepen their cooperation with regional institutions promoting regional integration, such as APEC, ASEAN+3, etc. In the medium term, some specific regional financial institutions could be set up to take care of the demand for specific cross-border infrastructure in different regions or subregions in Asia. In the long term, strong local government commitments to infrastructure development are needed, while the private sector can play supplementary roles.

Prospects and Challenges

The preceding discussion suggests that prospects for Asia to regain its dominance in the world economy in the near future are bright, but that it will have to increasingly rely on its potentially large internal market for growth through closer economic cooperation to deepen integration. However, an integration process among different economies in Asia must not only allow each member to grow faster, but also reduce disparity among its members over time and space. Thus, Asia needs to carefully craft and manage the integration process.

This last section discusses prospects for deeper regional integration, the challenges Asia has to address to achieve such an objective in the future, and the possible role multilateral organizations can take on to support Asia's drive toward greater economic integration.

Prospects

The building blocks for deeper regional integration in Asia are already in place. In East Asia, ASEAN is trying to move its integration process one step forward by creating an ASEAN Economic Community in Southeast Asia. The recent decision of ASEAN and the three Northeast Asian countries, namely, PRC, Japan, and Korea, to transform ASEAN+3 into an East Asian Summit can facilitate the building of an East Asian Community especially since ASEAN has already started the process of forming separately an RTA with PRC, Japan, and Korea, while the three are also doing the same among themselves.

In South Asia, the decision of SAARC to form SAFTA, a higher level of regionalism than the current SAPTA, moves the integration process in the region one step forward. In Central Asia, the ADB-initiated CAREC program can serve as a stimulus for building an economic bloc in Central Asia similar to SAARC or ASEAN.

Several initiatives can provide bridges between subregional economic blocs in Asia. BIMSTEC, which includes five South Asian countries and two Southeast Asian countries, will soon be implementing an RTA, while India is currently negotiating an RTA with ASEAN.

The various economic cooperation initiatives that have emerged in Asia are not limited to the formation of RTAs, but also include regional cooperation on infrastructure development that can support regional integration. Moreover, regional cooperation in Asia has already spilled over to the financial sector, and here East Asia is leading the way, with India being gradually drawn in with its participation in the Asian Bond Fund.

Will Asia's regionalism give rise to a "fortress Asia" mentality? This is unlikely to happen because the formation of RTAs in the region has been led by some of the more open economies in Asia (De Brouwer, Rajan and Sen, this volume). Note that the integration process that occurred in the region was mainly market-driven, and the formation of RTAs is a means to formalize and accelerate the integration process.

The emergence of the PRC as an economic power or a "factory" of the world, which can be boosted further by its recent accession to WTO, has posed a serious challenge to most Asian economies, particularly middle-income economies. However, trade and investment liberalization among ASEAN+3, i.e., formation of an East Asian RTA, can help spread PRC's gains from liberalization to a wider set of economies (Kawai, this volume).

Challenges

Economic progress through deeper integration will not easily come to Asia. The region will face many challenges along the way, and any misstep can easily lead Asia to a situation where it cannot fully realize the potential gains from integration. The major challenges that Asia must address to move the process of integration forward are discussed next.

THE VISION

What is Asia's vision for the region? This is an issue that leaders in Asia must address. Presently, there are three competing visions for Asia today, namely, the ASEAN Economic Community, the East Asian Economic Community (EAEC), and the Asian Economic Community. Confining the East Asian Economic Community only to East Asian countries may not bring comfort to other countries in the region. It may be well for Asian countries to subscribe to a common vision for the region, but at the same time recognize the possibility that some countries may not be able to join the economic bloc initially due to their stage of development and lack of institutional capacity to implement commitments. What is important though is that they know that they are part of a larger community right from the beginning and are welcome to join the economic bloc when they are ready. This is important in designing Asia's regionalism. For instance, the proposed EAEC can set objective criteria and a transparent process for determining eligibility of membership in the same way the EU does.

THE PATH OF ASIAN REGIONALISM

Concerns have been raised regarding the possibility that the formation of so many RTAs can produce the so-called "spaghetti bowl effect" and serve as stumbling blocks to the multilateral trading framework. Similar concern has been raised regarding financial regionalism. Given its past record of market-oriented policies, the challenge for Asia is how to ensure that its brand of regionalism is consistent with multilateral initiatives, such as WTO and IMF.

PHASED INTEGRATION

Given the large number of countries in the Asian region, it would not be feasible at the start to include all Asian countries.[32] Aside from the problem of manageability, some countries in the region may not be ready to join a regional trading arrangement within the next 5 or 10 years, although they might be ready to join other types of regional cooperation mentioned earlier. Hence, the issue of phasing economic integration becomes important. As the EU demonstrated, it might be feasible to start with a core group consisting of like-minded countries and later gradually enlarge the membership, using transparent and objective eligibility criteria. This leads to the question: Which countries should be included in the core group? There are four alternatives.

The first alternative is ASEAN, which has already started implementing its vision of building an ASEAN Economic Community by 2020. However, the ASEAN economy is small compared with other regional economic blocs, such as the EU and NAFTA, and offers limited complementarities (Table 1.1).[33]

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[32] As of December 2003, ADB had 43 Asian member economies.

[33] This is an updated version of Table 3.1 in Kumar (this volume).

TABLE 1.1
Size of Existing and Proposed Regional Economic Blocs, 2003

Parameter	EU	NAFTA	ASEAN	ASEAN+3 (JACK)	ASEAN+4 (JACIK)
GDP ($ trillion)	10.069	11.716	0.672	7.014	7.613
Percent to world total	(27.69)	(32.23)	(1.85)	(19.29)	(20.94)
GNI PPP ($ trillion)	10.132	11.855	2.095	13.030	16.098
Percent to world total	(19.75)	(23.10)	(4.08)	(25.39)	(31.37)
Exports ($ trillion)	2.603	0.996	0.447	1.552	1.607
Percent to world total	(34.80)	(13.32)	(5.98)	(20.75)	(21.48)
International reserves ($ trillion)	0.545	0.206	0.244	1.516	1.618
Population (billion)	0.418	0.323	0.537	2.001	3.065
Percent to world total	(6.66)	(5.15)	(8.56)	(31.91)	(48.87)

ASEAN=Association of Southeast Asian Nations; EU=European Union; GDP=gross domestic product; GNI=gross national income; JACIK=Japan, ASEAN, PRC, India, and Korea; JACK=Japan, ASEAN, PRC, and Korea; PPP=gross national income in purchasing power parity terms.
ASEANSources: *World Development Report 2005* and *Key Indicators 2004*, Asian Development Bank.

The second alternative is BIMSTEC. However, it is a much smaller economic grouping than ASEAN and has very little intraregional trade. Also, its RTA is not yet in place.

The third alternative is to start with the countries included in the proposed EAEC, namely Japan, ASEAN, People's Republic of China, and Korea (JACK). Their combined population accounts for one third of the world total and their gross national income (GNI) in purchasing power parity terms exceeds that of the EU and NAFTA. Moreover, there are already initiatives to build stronger economic cooperation among these countries.

The fourth alternative is to include India in the JACK, hence JACIK. It will be a significantly large regional economic bloc with a population size of about half of the world total, a combined GNI in purchasing power parity terms of about one third of the world total, and international reserves equivalent to half of the world total (Rajan, this volume; Kumar, this volume). The inclusion of India in the core group provides more complementarities between member countries. As one of the fastest growing economies in the world and second largest country in terms of population, India can provide a counterweight to the growing economic and political influence of the PRC in the region. India's "Look East" policy, its ongoing negotiation with ASEAN and separately with Thailand and Singapore for an EPA, and contribution to the ABF are clear indications of its interest in actively participating in economic cooperation and integration in the region. More importantly, results of simulation analysis show that all JACIK economies can expect some gains from integration. Such gains can reach a level equivalent to 3% of the combined GDP of JACIK economies if a regional trading arrangement is combined with investment liberalization and mobility in skilled labor (Kumar, this volume).

Among the alternatives, EAEC seems to be the better arrangement to pursue in the near term. ASEAN+3's economies are already integrated to a significant degree whereas India's degree of integration with ASEAN or with any of the Northeast Asian economies is still low. There is also ongoing financial cooperation among them. The challenge now is whether political leaders in these countries will be bold enough to move beyond the newly established East Asian Summit and create a truly East Asian Community.

SEQUENCING OF ECONOMIC COOPERATION AND INTEGRATION

The numerous possible areas for economic cooperation in the region raises the issue of appropriate sequencing of economic cooperation and integration, which is particularly important in the case of trade and financial and monetary regionalism. Trade and financial flows are highly complementary; hence, trade and financial cooperation can be pursued simultaneously (Rajan, this volume). However, this has to be qualified since there are various forms of regional financial cooperation, which can be viewed in terms of gradation of policy measures and institutional mechanisms required, and therefore can be implemented in phases (Montiel 2004). At the bottom is regional cooperation that involves information sharing and peer pressure to strengthen domestic financial systems. Above it is a form of regional cooperation aimed at developing effective mechanisms for regulation and supervision of financial institutions. The highest form of regional cooperation in the financial sector involves regional harmonization of regulations of financial systems to achieve full unification of regional financial markets. As the degree of financial cooperation becomes higher, the issues to be negotiated by participating countries will become more complicated, and thus require more time, effort, and resources that can considerably delay the completion of the negotiation. Given that, trade and the lower forms of financial cooperation can be implemented simultaneously (Rajan, this volume). Implementation of the highest form of financial cooperation can come after trade integration is fully achieved.

There are also various forms of monetary cooperation, ranging from the less intensive to the more intensive.[34] The weakest form of monetary cooperation involves information sharing in which a member country shares information about the country's monetary policies and conditions with other members. Another form of less intensive cooperation, albeit somewhat stronger than purely sharing information, is surveillance, which involves discussing member country reports on monetary policies and conditions in a joint forum and allowing opportunities for exerting "peer pressure." Reserve pooling is another form of monetary coordination that is stronger than information exchange and surveillance. This requires a stronger regional surveillance mechanism and well worked-out policy conditionality applied to a member country that draws resources from the regional reserve pool. Exchange

[34] This draws on Montiel (2004).

rate coordination is a more intense form of monetary cooperation that requires reserve pooling to implement it. It ranges from a less tight arrangement, such as loosely pegging to a basket of currencies, to a very tight arrangement, such as a single currency arrangement similar to that of the European Monetary Union (EMU). This type of cooperation should be done at the last phase when both trade and financial integration have already been fully achieved.

The content of other forms of regional cooperation needs to be examined in the context of the goal to achieve regional economic integration. Certain types of infrastructure development projects do not require some degree of economic integration between countries, but they can best be implemented through regional cooperation. One example is cleaning up a lake jointly shared by two or more countries. In this case, regional cooperation is limited only to an environmental project. There are types of infrastructure development projects that can facilitate integration. One example is a road network connecting two or more countries. Traffic on such a road network can increase significantly if the countries involved have an RTA that includes cooperation in transport services. Such projects can be highly profitable and hence can attract private sector funding in the form of a "build-operate-transfer" financing scheme. Therefore, such infrastructure projects may be better implemented if they are part and parcel of an RTA. There are infrastructure development projects that can yield direct benefits only to a few members. They may or may not be included in an RTA. They may be included if they are badly needed by the countries involved to help reduce disparity among members of an RTA.

DEGREE AND SPEED OF INTEGRATION

East Asia is heterogeneous in level of development. Thus, the development priorities of economies may greatly vary and thus can affect the degree and speed of integration in the region. The challenge here is how to craft an RTA in such a way that it provides flexibility to developing member countries to calibrate commitments to their level of development without undermining the integration process. Some RTAs have already incorporated this aspect, for example, by having a longer compliance period for low-income countries than for the rest of the members or by adopting a formula (e.g., "N-X") that will allow some members to be excluded from certain commitments without a definite time frame. Such approaches need to be revisited to find out whether or not they undermine the objective of deepening regional integration.

Role of Multilateral Organizations

International and regional multilateral organizations have a substantial role to play in advancing regional integration in Asia. They can provide advice to Asia on some aspects of the integration process that fall within the range of their mandate (De Brouwer, this volume). In fact, they have already introduced several initiatives that are supportive of regional integration in Asia. For instance, ESCAP has initiated work on developing a comprehensive framework for trade and investment for full regional integration in a WTO-consistent manner (Bonapace, this volume). A very important part of this framework is the development and promotion of a common format for bilateral RTAs and provision of assistance in harmonizing standards, procedures, and rules of origin among various bilateral free trade agreements in line with WTO principles. ADB has been organizing conferences, sometimes together with other multilateral organizations, to help policymakers in the region gain understanding of the scope, process, benefits, costs, and risks of regional integration.

The new wave of regionalism has brought with it new dimensions of economic cooperation that challenge the traditional roles of international and regional multilateral institutions. For instance, ADB has gone beyond its traditional role just to provide support to the East Asian integration process, such as helping ASEAN+3 set up the framework and build capacity for regional information exchange and economic surveillance. It is important to maintain linkage between regional and global integration processes. International and regional multilateral organizations can help facilitate such linkage by bringing into the global arena new and important concerns of regional integration.

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