REGIONAL ECONOMIC INTEGRATION AND COOPERATION IN EAST ASIA

By

Masahiro Kawai
Professor of Economics
Institute of Social Science
University of Tokyo

June 7, 2004

This paper is prepared for presentation to the Experts' Seminar on the "Impact and Coherence of OECD Country Policies on Asian Developing Economies," which is organized by the Policy Research Institute of the Japanese Ministry of Finance and the OECD Secretariat and to be held in Paris, June 10-11, 2004. This is a revised version of a draft paper that was presented to the Mid-term Review Workshop held in Paris, April 19-20, 2004. The author is thankful to Ken Heydon and other participants in the workshop for comments and suggestions.

I. INTRODUCTION

Over the last two decades, the East Asian economies have achieved substantial liberalization of foreign trade and direct investment (FDI) regimes within the frameworks of GATT/WTO and APEC. The resulting expansion of trade and FDI has become the engine of economic growth and development in East Asia. Trade and FDI openness has encouraged domestic institutional and governance reforms, which has further promoted trade and investment. Since the early 1990s, emerging East Asia has also experienced increasing financial openness. Financial openness contributed to rapid economic growth by attracting both long-term and short-term capital and, together with trade and FDI openness, deepened market-driven economic interdependence in East Asia. But it added financial vulnerabilities, culminating in the form of a financial crisis in 1997-98.

Following the crisis, the East Asian economies have embarked on regional economic cooperation in the areas of trade/investment and money/finance. The crisis prompted the regional economies to realize the importance of closer economic cooperation among themselves which were increasingly interdependent and to undertake various initiatives for the institutionalization of such interdependence. For example, Japan and Singapore concluded an economic partnership agreement (EPA), and many official discussions and negotiations for bilateral and sub-regional free trade agreements (FTAs)—such as Japan-Korea EPA, China-ASEAN FTA and Japan-ASEAN EPA—are currently underway. In the financial area, the ASEAN+3 members—comprising ASEAN, China, Japan and Korea—began to undertake the Chiang Mai Initiative, economic surveillance and policy dialogue, and the Asian bond market development initiative.

The objectives of this paper are threefold. First, it examines the extent to which the regional economies are integrated through trade, FDI and finance and are interdependent in macroeconomic cycles. Second, it explores the factors behind recent economic regionalism in East Asia, in the areas of trade and investment on the one hand and money and finance on the other, and identifies its important features. Finally, it discusses the role of OECD country policies to further assist economic integration and cooperation in East Asia. The main message of the paper is that, for regional economic integration and cooperation in East Asia, OECD countries—notably Japan, Korea, the United States, Australia, New Zealand and those in Europe—have played critical roles by maintaining stable macroeconomic and financial environments, a liberal trading system, stable flows of private risk capital, particularly FDI, and setting effective ODA policies. One of the lessons from the East Asian experience is that developing economies must strengthen domestic policy, institutional and governance frameworks so that they can benefit from good policies pursued by OECD countries.

The organization of the paper is as follows. Section II summarizes the impact of the East Asian crisis on economic regionalism in East Asia. Section III discusses the logic of regional economic cooperation in East Asia, emphasizing the importance of increasing economic interdependence among the regional economies and the lack of regional institutions and mechanisms that match such interdependence. Section IV reviews the current states of regional trade arrangements and examines the challenges for further institutionalization of trade and investment integration in East Asia. Section V reviews the current states of regional financial cooperation and investigates the challenges for greater institutionalization of regional financial integration. Section VI turns to the role of OECD country policies for further economic integration and cooperation in East Asia. Section VII provides concluding remarks, arguing that deeper economic integration in trade, investment and finance and further institutionalization of such integration can mutually reinforce each other and that OECD countries should encourage such regional efforts.

II. IMPACT OF THE ASIAN FINANCIAL CRISIS

1. Causes and Lessons of the 1997–98 Crisis

There is now a consensus that the East Asian financial crisis of 1997–98 was triggered by massive reversals of capital flows and contagion. Though deeper, structural causes of crises vary, there was a common factor across countries: Imprudently managed domestic financial institutions over-extended loans to corporations that in turn invested the borrowed funds in unproductive projects. Furthermore, an initially benign-looking currency crisis evolved into a full-blown economic crisis due to the mutually reinforcing impacts of currency depreciation, financial sector deterioration, and corporate sector distress. Essentially the crisis was the result of interactions between the forces of financial globalisation and domestic structural weaknesses (World Bank 1998, 2000).[1]

Forces of financial globalisation. The crisis-affected countries had liberalised international capital flows and had been integrated with the international capital markets before the crisis. Many emerging East Asian economies clearly benefited from the liberalisation and globalisation of financial markets. From the mid-1980s to the mid-1990s, large inflows of capital, particularly long-term capital such as FDI, helped finance the region's rapid economic development and growth. In the several years leading up to the crisis, however, countries had received large inflows of capital in the financial and corporate sectors, particularly in the form of unhedged short-term capital due to relatively high domestic interest rates with *de facto* U.S. dollar-pegged exchange rates. As a result, the ratios of short-term external debt to foreign exchange reserves had risen to levels greater than one. The potential risk due to the "double mismatch" problem had become serious.[2] When market perceptions changed rapidly in 1997, these economies saw sudden outflows of capital and

[1] IMF (1998a, 1998b) and Summers (2000) emphasized the importance of domestic structural weaknesses, while Radelet and Sachs (1998, 2000) and Furman and Stiglitz (1998) emphasized the importance of fianncial globalization.

[2] When an emering market economy borrows from abroad short-term, foreign-currency denominated bunds, it faces both maturity and currency mismatches—hence the "double mismatch"—because the borrowed funds tend to be invested at home with long-term maturites in domestic currency. As a result, the economy is exposed to both maturity risk (unanticipated rejection of roll-over of short-term liabilities) and currency risk (unanticipated currency depreciation).

consequent large downward pressures on the currency. The currency crisis was triggered by the sudden reversal of capital flows, which is why the crisis is often called the "capital account crisis" (Yoshitomi and Shirai 2000; Kawai, Newfarmer and Schmukler 2003).

Regional contagion of the crisis was spectacular. The Thai baht crisis spread to Malaysia, Indonesia, the Philippines and eventually South Korea within a few months, resulting in acute crises. At a later stage, Hong Kong was also affected, where the authorities managed successfully to contain its impact using unconventional policy measures.

Domestic structural weaknesses. The affected countries also had domestic structural weaknesses. Some foreign capital was intermediated by domestic financial institutions that over-extended loans to domestic sectors, including non-tradable real estate and construction; some found its way directly into domestic corporations. Over-investment in real estate and other assets contributed to the generation of asset bubbles, which left financial institutions with serious problems of non-performing loans when the bubble ultimately burst. In this way, financial institutions that intermediated foreign capital to domestic sectors were exposed to currency and maturity mismatches. Domestic corporations that were highly leveraged were also exposed to interest and exchange rate shocks. Inadequate regulatory and supervisory frameworks had left banks and corporations with imprudent financial management and, more generally, weak corporate governance. Steep exchange rate depreciation, high interest rates and tight budgets, induced by the eruption of a currency crisis in 1997, aggravated financial and corporate sector distress and led to a sharp contraction of overall economic activity in 1998.

Major lessons of the crisis. There are at least two major lessons from the crisis episode. First, policymakers in both developed and emerging market economies need to pay greater attention to managing the forces of financial globalisation, particularly in a world of rapid short-term capital flows. Until the crisis, implications of the scope and magnitude of short-term capital flows were not fully understood by international investors, policymakers of the lending and borrowing countries, or international financial institutions. More fundamentally, there was a lack of concern over the volatile nature of capital flows and the need for monitoring and managing rapid capital flows. Management of financial globalisation requires global frameworks that reduce capital flow volatility and enhance borrower countries' capacity to mitigate undesirable impacts of globalization, including macroeconomic and exchange rate policymaking.

Second, emerging market economies need to strengthen domestic economic systems, in particular their financial and corporate sectors. This task requires effective regulatory and supervisory frameworks for enhancing management and governance of financial institutions and corporations. Specifically, economies need to strengthen banks' asset-liability management capacity so as to avoid over-extension of loans and excessive currency and maturity mismatches; improve corporations' financial management capacity so as to maintain their sound financial discipline; and develop sound capital markets so as to provide alternative financing sources for corporations. If the domestic economic system becomes robust and resilient, a crisis could be prevented, or its impact on the economy would be mitigated even if a crisis occurred.

While not immediate causes of the crisis, declining productivity and relatively weak public sector governance are often identified as the fundamental weakness of pre-crisis East Asia. In fact, with high productivity and better governance, the negative impact of the currency crisis on the financial and real sectors of the economy would have been limited. There is indeed a case for reviving productivity and strengthening governance, because the rewards on them are high.

2. International Financial Architecture

Reflecting on these lessons, there was an increasing recognition that putting effective mechanisms in place to manage the forces of globalisation and to strengthen the underpinnings of national economic systems was key to crisis prevention, management and resolution. Global efforts to reform the functioning of international financial markets and national efforts to strengthen country economic underpinnings have been made under the title of the "international financial architecture."[3]

Global efforts to reform the international financial system. At the global level, various reforms for crisis prevention, management and resolution have been proposed and some have been put in place. First, the IMF has introduced new lending facilities to meet the greater financial needs of member countries at times of crises or as preventive measures. The Supplemental Reserve Facility was established in December 1997 and has been used in South Korea, Brazil, Argentina and Turkey. It provides large financial assistance, without access limit, to members facing exceptional balance of payments difficulties resulting from a sudden and disruptive loss of market confidence. The Contingent Credit Line (CCL) was created in 1999 as a precautionary line of defense to help protect member countries in the event of an exceptional balance of payments need arising from the spread of financial crises, provided that the countries have pursued strong policies.

Second, the IMF has improved the transparency of its operations and policy deliberations. It has also decided to streamline its conditionality, particularly structural conditionality, in order to enhance ownership and effectiveness of its program.[4] The new

---

[3] See Eichengreen (1999) and Kenen (2001) for a discussion of reforms of the international financial architecture.

[4] When the IMF intervened in crisis-affected countries in East Asia to contain the crisis, many veiwed at elast part of the IMF policies as not only inappropriate in some key areas but also exacerbating the severity of the crisis. A case in point is the initial Indonesian program (November 1997), where the IMF insisted on the closure of 16 commercial banks without adequate protection of bank deposits, thereby exacerbating systemic bank runs (Sachs 1998). In the January 1998 program, the IMF added a long list of structural reforms, specifying in minute detail such things as clove monopoly and selling plywood (Feldstein 1998), which were largely irrelevant to the currency crisis. Misguided or excessively broad and detailed structural conditions undermined the country's

approach is to formulate IMF programs on the presumption that structural conditionality shall be limited to a core set of essential features that are macro-relevant and in the IMF's core area of responsibility,[5] with a broader approach requiring justification based upon the specific country situation. Hence, IMF structural conditionality is expected to cover only those reforms that are relevant for a program's macroeconomic objectives. If those structural reforms that are critical for the achievement of the program's macroeconomic objectives are outside the IMF's core areas of responsibility, the IMF should seek assistance from relevant international organizations—such as the World Bank and regional development banks—to provide inputs in designing and monitoring the reform measures.

Third, private sector involvement (PSI) has been an important focus of reform. Given that the volume of private resources far exceeds that of official resources, private sector involvement is vital for crisis prevention and resolution. If official intervention were to bail out private investors without making them pay for their bad investment decisions, this would create a serious moral hazard problem. While private financial institutions decided to share the burden in helping crisis-affected countries in several cases, such as South Korea and Brazil, a definitive framework has yet to be developed. This is particularly the case for the restructuring of emerging economy bonds because of the large number and dispersion of bondholders involved.[6]

National efforts to strengthen domestic underpinnings. At the national level, developing economies have made efforts to step up "self-help" mechanisms for crisis prevention and management, such as the accumulation of adequate foreign exchange reserves, appropriately sequenced capital account liberalization, allowance of prudential regulations of capital inflows as financial safeguards, and upgrading of regulatory capacity to monitor capital flows and to impose official standstills if necessary. They also have made efforts to strengthen policy and institutional frameworks with an emphasis on macroeconomic management capacity and financial sector reform. Attention has focused particularly on the need to improve regulatory and supervisory frameworks in the financial system, to

---

"ownership" of the program and damaged its successful implementation. The IMF programs should have focused on the immediate need to stem capital outflows and restore currency market stability.

[5] The IMF's core areas of responsibility include: macroeconomic stabilization; monetary, fiscal and exchange rate policy, including the underlying institutional arrangements and closely related structural measures; and financial sector issues including the functioning of both domestic and international financial markets.

[6] The international community has begun to explore possible mechanisms for the debt restructuring of international sovereign bonds in the recognition that, at the time of a liquidity crisis, holders of sovereign bonds, along with other creditors, would need to contribute to the resolution of such crises. Two methods have been recommended: a contractual approach and a statutory approach. A contractual approach considers collective action clauses in sovereign bond contracts as a useful device for orderly resolution of crises; their explicit inclusion in bond documentation would provide a degree of predictability to the restructuring process. A statutory approach (Krueger 2002) attempts to create the legal basis—through universal treaty rather than through a set of national laws in a limited number of jurisdictions—for establishing adequate incentives for debtors and creditors to agree upon a prompt, orderly and predictable restructuring of unsustainable debt. Similar approaches might be needed for private debt instruments as well, because of the surge in private-to-private capital flows—as was the case in East Asia.

strengthen corporate governance, and to establish effective domestic insolvency procedures to deal with non-viable banks and corporations. The expectation is that with stronger domestic underpinnings in these areas, crises are less likely to occur and, even if they do, their impact on the economy tends to be limited.

One of the principal instruments for strengthening domestic policies and institutions is international best practice information in macroeconomic policymaking, financial sector regulation and supervision, and capital market infrastructure. Reports on the Observance of Standards and Codes (ROSCs), supported by various international organisations and agencies and adopted by the IMF in September 1999, cover 12 issues in three main areas. The macroeconomic policy area includes monetary and financial policy transparency, fiscal transparency, and special data dissemination standards in addition to the general data dissemination system. The financial sector regulation and supervision area includes banking supervision, securities regulation, insurance supervision, payments systems, and anti-money-laundering. The capital market infrastructure area includes corporate governance, accounting standards, auditing standards, and insolvency and creditor rights.[7] These processes are undoubtedly useful, but take time to be effectively implemented. And even if ROSCs are fully in place, crises may still occur.

3. Emergence of a New Regional Financial Architecture

While the international community and emerging market economies have focused on global and national policy reforms, a well-designed regional framework can also contribute to the stability of the international financial system for three reasons.[8] First, the global efforts are still inadequate and national efforts take more time to become effective. Though the global initiative has delivered certain results, they are far less than satisfactory—particularly in the areas of the IMF contingent credit line (CCL) and private sector involvement (PSI).[9] Second, as regional integration is deepening through trade, FDI and financial flows—as will be explained in more detail below—an effective framework for regional financial cooperation is essential to manage integration. Third, as economic contagion tends to begin with a geographic focus, a regional framework for financial cooperation to address crisis prevention, management and resolution is a logical way to proceed.[10] From these perspectives, the regional economies have jointly embarked on initiatives to strengthen the regional financial architecture (see Table 1).

---

[7] The most prominent among these is the Financial Sector Assessment Program (FSAP) supported jointly by the IMF and the World Bank. The FSAP is intended to strengthen the monitoring and assessment of financial systems in view of the fact that financial sector weaknesses have played an important role in damaging a country's overall economic health.

[8] See also Bird and Rajan (2002).

[9] The CCL was virtually abolished in November 2003 because no country had been willing to use the facility due to the fear (a) that a CCL agreement with the IMF may send a wrong signal to the market that the country in question is in need of IMF financing, and (b) that possible cancellation of a CCL status can send a signal that the country's macroeconomc and financial conditions have deteriorated considrably, thereby triggering a crisis.

[10] See Kawai, Newfarmer and Schmukler (2003).

Table 1. Summary of Policy Lessons from the Asian Financial Crisis

Objective	National Measures	Global Measures	Regional Measures
	Improve mechanisms for crisis prevention, management and resolution at the national level.	***Improve mechanisms for crisis prevention, management and resolution at the global level.***	***Improve mechanisms for crisis prevention, management and resolution at the regional level.***
Preventing or reducing the risk of crises	***Avoid large current account deficits financed through short-term, unhedged capital inflows.***		
	• Secure adequate foreign exchange reserves • Maintain sound fiscal and monetary policy • Adopt a viable exchange rate regime • Establish orderly capital account liberalization	• Improve transparency and disclosure by IFIs • Strengthen IMF surveillance and policy advice • Remove regulatory biases to short-term and excessive international lending	• Strengthen regional policy dialogue and surveillance • Maintain intra-regional exchange rate stability • Develop a regional early warning system • Reduce "double mismatch"
	Aggressively regulate and supervise financial systems to ensure that financial institutions manage risks prudently.		
	• Strengthen regulatory and supervisory frameworks over financial institutions • Allow prudential regulation as financial safeguards and cushions • Improve information transparency • Introduce limited deposit insurance	• Tighten regulations over financial institutions that lend to highly leveraged institutions • Support implementation of international standards and codes	• Establish regional initiatives to improve regional regulatory and supervisory frameworks
	Erect an incentive structure for sound corporate finance to avoid high leverage and excessive reliance on foreign borrowing.		
	• Establish good corporate governance • Introduce greater competition to product, factor and financial markets • Develop capital market-based finance • Better information disclosure	• Identify best-practice corporate governance and its implementation tailored to specific country conditions	• Develop regional capital markets for mobilization of regional savings • Undertake regional initiatives for better corporate governance
Managing crises	***Mobilize timely external liquidity of sufficient magnitude.***		
	• Restore market confidence through coherent policy packages • Reduce moral hazard problems	• Strengthen IMF liquidity support, including CCL	• Establish a regional liquidity support facility to contain crises and contagion
	Adopt appropriate macro and structural policies to reflect the specific conditions and reality of the economy.		
	• Adopt appropriate monetary and fiscal policy contingent on the specific conditions of the economy	• Streamline IMF conditionality on macroeconomic and structural policies	• Strengthen regional capacity to formulate needed adjustment policies
	Bail-in private international investors.		
	• Impose official stand-stills • In extreme cases, allow involuntary private sector involvement (PSI)	• Establish international rules of the game through private sector involvement (PSI)	• Involve international creditors from outside the region
Resolving the systemic consequences of crises	***Move swiftly to establish resolution mechanisms for impaired assets and liabilities of banks and corporations.***		
	• Establish procedures for bank exits, recapitalization and rehabilitation • Establish legal procedures and formal frameworks for corporate insolvencies and workouts	• Establish international frameworks for PSI in external debt resolution • Strengthen capacity for official budgetary support	• Finance regional programs to help accelerate bank and corporate restructuring through regional MDBs and bilateral donors
	Cushion the effects of crises on low-income groups through social policies to ameliorate the inevitable social tensions.		
	• Strengthen social safety nets and to mitigate social consequences of crises	• Finance the activity through the World Bank and other international organizations	• Finance regional programs to help mitigate social impact through regional assistance

Source: Revision of Table 8 in Kawai (2002a) and Table 1 in Kawai, Newfarmer, and Schmukler (2003).

Crisis prevention. Regional information sharing, policy dialogue, economic surveillance and monitoring are instrumental to crisis prevention at the regional level. The process should focus on both macroeconomic and structural issues, such as monetary and exchange rate policies (including domestic and foreign assets and liabilities of the central banks), fiscal positions and debt management, capital flows and external debts, financial system conditions, and corporate sector developments. Developing a reliable early warning system is useful in detecting macroeconomic, external and financial sector vulnerabilities. With effective surveillance mechanisms in place, each economy in the region is expected to be under peer pressure to pursue disciplined macroeconomic and structural policies that are conducive to stable external accounts and currencies. In addition, the regional economies need to ensure intra-regional exchange rate stability as well as reconstruct the banking sector and develop capital—particularly bond—markets to mobilize regional savings for regional investment, thereby reducing the “double mismatch” problem.

Crisis management. Once an economy is hit by a currency crisis, appropriate policy responses and timely provision of international liquidity are needed to prevent the economy from slipping into a serious economic contraction of systemic proportions. The pace of liquidity disbursement at the global level may be slow in times of crisis or contagion, because of cumbersome processes and disagreements over policy conditionality. To avoid long delays and to augment globally available resources, a regional financing facility can help close the gap. A financing facility that can rapidly mobilise a large amount of liquidity to head off a speculative attack is an obvious benefit if the attack is the result of irrational herd behaviour. For such a financing facility to be effective, its provision must be accompanied by appropriate adjustment policy measures and, hence, the region must develop analytical capacity to formulate appropriate conditionality. This approach, however, must be consistent with, and complementary to, the global framework governed by the IMF, in order to exploit the synergy between the two, ensure policy consistency, and involve private creditors from outside the region.

Crisis resolution. To resolve a crisis, international efforts are needed to ensure that a crisis-affected economy returns to a sustainable growth path. In the face of a systemic crisis in the banking, corporate and social sectors, fiscal resource mobilisation is essential for the quick resolution of the crisis. Fiscal resources that are needed to recapitalise weak banks, facilitate corporate debt restructuring and strengthen social safety nets may be limited by the lack of fiscal headroom or constraints to external financing on market terms. Fiscal resources are also needed for social sector protection.[11]

III. LOGIC OF REGIONAL ECONOMIC COOPERATION IN EAST ASIA

1. Deepening of Economic Interdependence

The most fundamental rationale behind the emergence of regional economic

[11] A good example is the New Miyazawa Initiative of 1998, which supported the fiscal needs of crisis-affected countries in East Asia for restructuring and social spending. See below.

cooperation is the deepening of regional economic interdependence in East Asia. Economic cooperation can resolve the “collective action” problem and internalize externalities and spill-over effects that arise from interdependence.

Trade and FDI integration. East Asia has long enjoyed a market-driven expansion of trade and foreign direct investment (FDI) and the resulting *de facto* integration of the regional economies, within a multilateral liberalization framework under the GATT/World Trade Organization (WTO) and open regionalism through Asia-Pacific Economic Cooperation (APEC). Several GATT liberalization rounds have reduced tarrifs and nontariff barriers to trade on a sustained basis. A key feature is that the region has avoided discriminatory trade practices. The APEC process was successful in encouraging China—as well as Chinese Taipei—to pursue trade and FDI liberalization outside of the WTO framework. Regional economic integration has been strengthened through an expansion of trade and FDI.

FDI flows to the emerging East Asian economies, driven largely by Japanese multinational corporations after a steep yen appreciation following the Plaza Accord of 1985, expanded rapidly in the second half of the 1980s. Multinational corporations began to fragment their production process into different sub-processes and locate each of them in countries according to the required factor proportions and technological capabilities. Such a strategy has generated a web of intra-regional, intra-industry trade in parts, components, semi-finished products, and finished products within East Asia, contributing to a more efficient division of labor and deeper economic integration. The resulting FDI-trade nexus is a distinct feature in the region, making such FDI a complement of, not a substitute for, trade. More recently, China’s rise as an economic powerhouse has also been accompanied by expansion of, and linkages through, trade—particularly intra-industry trade—among the East Asian economies, most of which are generated by multinationals.

The degree of regional integration through trade in East Asia has been rising fast over the last twenty years. Table 2a summarizes changes in the share of intra-regional trade for various groupings in the world over the period of 1980-2001. The table demonstrates that the share of intra-regional trade for East Asia in its total trade has risen from 23 percent in 1980 to 41 percent (excluding Japan) or from 34 percent to 51 percent over the same period (including Japan). This trend means that more than 50 percent of East Asia’s recent trade is with itself. The share of intra-regional trade within East Asia is still lower than that in the European Union (62 percent), but exceeds that of the North American Free Trade Area (46 percent) in 2001.

Table 2b summarizes changes in the intra-regional trade intensity indices for the same groupings over the same period.[12] The table demonstrates that within East Asia, whether including Japan or not, the trade intensity indices are larger than those for NAFTA or EU-15. This observation confirms that the degree of regional integration through trade in East Asia is

[12] The advantage of trade intensity indices over trade shares is that the former control for a region’s relative size in world trade and, hence, present a better measure of closeness of the economies within a region.

quite large and comparable to levels seen in North America or Europe.

Table 2a. Intra-Regional Trade Share[a] (in percentage)

Regions	1980	1985	1990	1995	2000	2001
East Asia-10, including Japan[c]	33.6	36.2	41.6	50.1	50.1	50.8
Emerging East Asia-9[d]	22.6	26.3	32.8	38.4	39.5	41.0
NIEs-4	8.5	9.5	12.3	14.0	13.6	13.2
ASEAN-4	3.5	4.9	3.9	5.2	7.9	7.9
NAFTA	--	36.6	36.8	41.9	46.5	46.3
European Union-15	52.6	53.8	64.9	64.1	62.1	61.9

Table 2b. Intra-Regional Trade Intensity Index[b]

Regions	1980	1985	1990	1995	2000	2001
East Asia-10, including Japan[c]	2.31	2.02	2.08	1.99	2.06	2.22
Emerging East Asia-9[d]	3.02	2.66	2.66	2.19	2.23	2.44
NIEs-4	2.00	1.62	1.56	1.31	1.32	1.41
ASEAN-4	1.58	2.27	1.45	1.28	2.15	2.17
NAFTA	--	1.82	2.06	2.28	2.10	2.12
European Union-15	1.39	1.55	1.45	1.66	1.73	1.67

Note: (a) The intra-regional trade share is defined as: $\{(X_{ij}/X_{i.}) + (X_{ij}/X_{.j})\}/2$ where X_{ij} represents exports of region i to region j, $X_{i.}$ represents total exports of region i, and $X_{.j}$ represents total exports of the world to region j (or total imports of region j). In the table, the share is defined only for economies within the same region, so that i=j.

(b) The trade intensity index is defined as: $(X_{ij}/X_{..})/\{(X_{i.}/X_{..})(X_{.j}/X_{..})\}$ where X_{ij} represents exports of region i to region j, $X_{i.}$ represents total exports of region i, $X_{.j}$ represents total exports of the world to region j (or total imports of region j), and $X_{..}$ represents total world exports. In the table, the index is defined only for economies within the same region, so that i=j.

(c) East Asia-10 includes Emerging East Asia-9 and Japan.

(d) Emerging East Asia-9 includes NIE-4 (Korea, Chinese Taipei, Hong Kong, and Singapore), ASEAN-4 (Malaysia, Thailand, Indonesia, and the Philippines) and China.

Financial and macroeconomic interdependence. Market-driven financial integration has also been underway as a result of the increased deregulation of the financial system, opening of financial services to foreign institutions, and liberalization of the capital account in the East Asian economies. Commercial banks have extended cross-border loans to banks and corporations throughout the region, and such banks have contributed to a closely connected banking sector within East Asia. Opening of securities markets, particularly equity markets, has attracted foreign portfolio capital inflows. Active commercial bank loans and portfolio flows have linked the economies in the region financially, creating positive correlations of asset price movements within the region. At least part of the contagion of currency crises in the region in 1997 was a reflection of such financial linkages.

Macroeconomic interdependence within the region has recently become stronger, as evidenced by a simultaneous contraction of economic activity throughout East Asia in 1998 and a simultaneous expansion in 1999–2000. Though the regional economies may have been affected by some common global factors such as US economic cycles and information technology (IT) stock price movements, many of the recent, synchronized economic activities in the region can be attributed to strong macroeconomic interdependence.

Cross-country correlation analyses of major macroeconomic variables—such as real GDP growth rates, real private consumption, real fixed investment, and price inflation rates—over the last twenty years indicate that macroeconomic activities of the East Asian economies are generally highly correlated with each other, with the exception of China. Table 3 is a summary of factor loadings obtained from the first principal components of East Asian economies' variables.[13] The table indicates that Japan's real activity variables are more highly correlated with those of emerging East Asia than are US activity variables. On the other hand, inflation rates of the United States and Japan are equally highly correlated with those of emerging East Asia. This suggests that the degree of emerging East Asia's real economic interdependence with Japan is greater than with the United States, while the degrees of its nominal interdependence with Japan and the United States are equally strong.[14]

Table 3. Factor Loadings of the First Principal Components for East Asian Variables (1980-2002)

Countries	Real GDP	Real Consump.	Real Investment	Real Mon. Supply	Real Stock Price	GDP Deflator	CPI
USA	-0.11	-0.34	-0.41	-0.46	0.37	0.32	0.69
EU-15	0.04	0.17	-0.14	0.17	0.33	0.35	0.75
Australia	-0.21	-0.16	-0.21	-0.01	0.32	0.63	0.62
New Zealand	0.27	-0.04	0.20	-0.06	0.11	0.63	0.61
India	0.08	0.03	-0.04	-0.03	0.10	0.39	-0.02
Japan	0.58	0.39	0.41	0.15	0.72	0.26	0.56
Korea	0.85	0.78	0.67	0.01	0.89	0.26	0.42
China	0.05	-0.16	-0.27	-0.09	--	0.13	-0.01
Chinese Taipei	0.44	0.26	0.27	0.07	0.71	0.08	0.49
Hong Kong	0.71	0.63	0.58	0.15	--	0.37	0.37
Singapore	0.72	0.75	0.60	0.29	--	0.20	0.60
Malaysia	0.87	0.87	0.95	-0.13	--	-0.38	0.27
Thailand	0.92	0.93	0.88	-0.02	--	0.10	0.28
Philippines	0.39	0.32	0.55	0.20	0.91	-0.12	0.39
Indonesia	0.90	0.63	0.89	-0.16	--	-0.25	-0.55
Brunei	0.25	--	--	--	--	-0.41	0.59
Vietnam	0.11	--	--	--	--	1.00	--
Laos	-0.36	--	--	0.99	--	0.07	--
Myanmar	-0.18	-0.07	0.08	-0.65	--	-0.12	-0.94

Notes: (a) The variables are defined in terms of the log first difference.
(b) The figures are correlation coefficients between the first principal components for East Asia and the original, log

[13] See Kawai and Motonishi (2004) for details.

[14] Earlier studies by Eichengreen and Bayoumi (1999) found that, in terms of supply shocks, some East Asian nations were just as closely connected with one another as European countries were. In terms of demand shocks, ASEAN countries were also well connected. More specifically, these authors have found that two groups of economies in the region—one for Japan, Korea and Chinese Taipei, and another for Hong Kong, Indonesia, Malaysia, Singapore and possibly Thailand—are natural groups of countries that are closely integrated. See also Bayoumi and Eichengreen (1994) and Bayoumi et al. (2000). Goto and Kawai (2001) also found rising macroeconomic interdependence in East Asia in the 1990s, in terms of movements of real output and shocks to real investment.

first-differenced series.
Source: Kawai and Motonishi (2004).

Institutionalization of economic integration. In view of the rising trade and FDI integration in East Asia, there is a growing need for setting up more formal institutional mechanisms for trade and investment facilitation, harmonization of rules, standards and procedures, and dispute settlements. The deepening macroeconomic and financial interdependence also suggests a need for concerted efforts to internalize externalities and spillover effects, because macroeconomic/financial developments and policies of one country can easily affect other countries' performance and developments. It makes sense for such interdependent regional economies to institutionalize *de facto* integration through the establishment of regional cooperative frameworks, such as trade and investment agreements and macroeconomic and financial cooperation mechanisms. Given that one country's turbulence, shocks and crises could be easily transmitted to other economies within the same region, it is critical to establish financial safety nets. Cooperation among such economies would be easier because they are small in number—so the transactions cost for cooperation is small—and tend to face similar shocks and similar policy challenges.

2. Response to the Financial Crisis

There are several motivations behind the recent move to closer regional cooperation in the macroeconomic and financial area. Some of them are defensive responses to the Asian financial crisis, while others are more proactive:

- Hard lessons of the Asian financial crisis in 1997-98—a need to establish regional "self-help" mechanisms for effective prevention, management and resolution of regional financial crises;
- Dissatisfaction with the existing global financial system governed by the IMF;
- Regional financial stability as a basis for global financial stability; and
- Willingness to increase the Asian voice in global financial management.

As has been discussed earlier, the Asian financial crisis taught an important lesson, that is, there is a clear need for effective prevention, management and resolution of financial crises and contagion. The global initiative for the new international financial architecture has been less than satisfactory and the national efforts to strengthen national economic fundamentals take time to bear fruit. In addition, the East Asian economies have been dissatisfied with the way the IMF handled the crisis, particularly in Thailand and Indonesia. Hence, the general sentiment in East Asia has been that the regional economies must establish their own "self-help" mechanisms through systematic macroeconomic and financial cooperation for prevention and management of possible crises in the future. Such cooperation should include information exchange, policy dialogue, a regional liquidity support arrangement, and joint policymaking in certain critical areas—such as exchange rate policy coordination.

There are some proactive responses to the crisis. Since regional financial stability is a basis for global financial stability, effective regional financial cooperation is an obvious benefit not only for the regional economies but also for the global community. In this sense the East Asian regional financial architecture is consistent with, and even strengthens, the IMF's global role. At the same time, given the perceived imbalance and unfairness of the current distribution of IMF quotas, which is unrealistically skewed against East Asia, the regional economies have the desire to increase their voice in global financial management. Indeed they believe they can better achieve a greater voice by joining forces together.

3. Response to Economic Regionalism in Europe and North America

The regional economies have initiated efforts toward greater institutionalization of trade and FDI interdependence essentially for four reasons:

- Defensive response to the proliferation of regional trade arrangements (RTAs) elsewhere—particularly in Europe and the Western Hemisphere;
- Dissatisfaction with the slow progress on trade/investment liberalization at the global and trans-regional levels;
- Willingness to enhance productivity and international competitiveness through exploitation of scale economies and dynamic efficiency; and
- Greater regional institution building.

Regionalism elsewhere—economic and monetary integration in Europe and its subsequent expansion to the east as well as the success of NAFTA and its move to FTAA in the Western Hemisphere—is the first factor that has motivated the East Asian economies to pursue regional trade arrangements. There had already been 184 RTAs reported to the WTO for the whole world by 2003. Governments in East Asia fear that unless they form their own free trade areas, they would be disadvantaged in global competition and multilateral negotiations. They increasingly realize that unless they are united they would not be able to gain bargaining power vis-à-vis the European Union, the United States and other groupings in multilateral liberalization negotiations. This fear has been added by the slow process of WTO/Doha liberalization and the perceived ineffectiveness of the APEC process.

As multilateral trade and investment liberalization at the global and trans-regional levels has been slow and limited, the East Asian economies are increasingly of the view that they need to secure a bigger market within their own region so that scale economies and dynamic efficiency gains can be exploited. In this way, they believe they can raise both productivity and international competitiveness. In addition, these RTAs are perceived as facilitating trade and investment, promoting harmonization of rules-making, standard-setting and procedures, and providing dispute resolution mechanisms, particularly in the areas of services, labor mobility, investment, competition policy, intellectual property rights, contingency protection and rules of origin—areas that are difficult to make progress in the multilateral framework (OECD 2003b). This is essentially a process of formal institution building for further deepening of trade and investment integration.

IV. INITIATIVES FOR REGIONAL TRADE ARRANGEMENTS

1. Early Attempts

ASEAN. The only formal, regional trade arrangement in East Asia has long been the Association of South East Asian Nations (ASEAN) Free Trade Agreement (AFTA) introduced in 1992.[15] Despite the slow pace of trade liberalization, the AFTA has been in effect among the original five ASEAN members—Indonesia, Malaysia, Singapore, Thailand and the Philippines—since January 2002. Although the exclusion list is long and individual country circumstances vary, the bulk of goods traded between these countries are now subject to tariffs of only 0-5 percent. Furthermore, Viet Nam is to comply with the same tariff standards by 2003, Laos and Myanmar by 2005, and Cambodia by 2007. Advanced ASEAN members are expected to eliminate tariffs by 2010 and less advanced ASEAN members by 2015. By then ASEAN as a whole is expected to become a tariff-free FTA.

At the ASEAN Summit in October 2003, ASEAN leaders adopted the Declaration of ASEAN Concord II, whereby they declared the creation of an ASEAN Economic Community (AEC).[16] According to the Declaration, the AEC is expected to realize a free flow of goods, services, investment and freer flow of capital, with equitable economic development and reduced poverty and socio-economic disparities by 2020. It remains to be seen how ASEAN can implement the core elements of the AEC over time.[17]

EAEG/EAEC proposal. Following the unsatisfactory progress of the Uruguay Round Ministerial meeting in December 1990, Malaysian Prime Minister Mohamad Mahathir proposed the formation of a regional trade grouping—comprised of ASEAN countries, Japan, China, Korea and Hong Kong. This group of economies was called the "East Asian Economic Group (EAEG)." Objectives behind his proposal were to establish a regional trade arrangement for the group in response to the emergence of preferential regional trade arrangements elsewhere, including in North America, and to exercise a global impact on trade issues, like the Cairns Group. In October 1991, ASEAN Economic Ministers considered Mahathir's proposal as useful and renamed the grouping as the "East Asian Economic Caucus (EAEC)" which would facilitate discussions on regional economic issues.

However, the United States objected to the EAEG/EAEC initiative on the ground that it could divide the Asia-Pacific, by excluding the United States, and reduce the effectiveness of the trade/investment liberalization process within APEC. Japan showed hesitation in

---

[15] In AFTA, the Common Effective Preferential Tariff (CEPT) Shceme is used to reduce the tariffs within the region to 0 from 5 percent. The ASEAN Industrial Coperation Scheme (AICO) applies the CEPT rate of tariffs (0 to 5 percent) on approved AICO products to strengthen industrial cooperation within the region. AFTA is also complemented by the Framework Greement on the ASEAN Invetment Area (AIA), which promotes free investments, skilled workers, professoinals and technologies within the region.
[16] The other two pillars were the ASEAN Security Comminity and the ASEAN Socio-cultural Community.
[17] See Hew and Soesastro (2003) for a number of ideas on deepening ASEAN economic integration.

supporting the initiative because of its consideration of US opposition—Japan had trade conflicts with the United States and did not wish to make the bilateral relationship worse—as well as because of the strategic priority it placed on the APEC process. China also took a cautious approach. Interest in the EAEG/EAEC initiative waned eventually in the absence of support from key countries in Northeast Asia.[18] But when the leaders of Japan, China and Korea were invited to the informal ASEAN Leaders' meeting in December 1997, in the midst of the Asian financial crisis, the *de facto* ASEAN+3 process began. The EAEG/EAEC initiative can be considered a precursor to the ASEAN+3 process, because membership of the latter overlaps that of the former.

APEC as a trans-regional forum. Asia-Pacific Economic Cooperation (APEC), established in 1989, played a useful role in encouraging trade and investment liberalization on a voluntary and unilateral fashion within an Asia-Pacific context, including the United States, Canada, and Australia as members. Australia played a major role in promoting APEC as a trans-regional forum with the basic principle of "open regionalism." One of its most important achievements was to induce unilateral, voluntary trade liberalization of non-WTO members such as China and Chinese Taipei. In addition, the Bogor Declaration (1994) set the goal of zero tariffs by 2010 for developed countries and by 2020 for developing countries. The modality of achieving the Bogor goals was clarified in the so-called Osaka Action Agenda.

Although APEC's basic principles still prevail, its prominence appears to have substantially diminished since the Asian financial crisis because of its inability to effectively respond to the crisis. In addition, the recent proliferation of regional and bilateral RTAs pursued by the regional economies has reduced the role of APEC. But this does not necessarily mean that APEC's basic principle of "open regionalism" has been abandoned. To the contrary, recent RTAs in East Asia take APEC—and WTO—principles as a liberalization infrastructure and go beyond such basic principles.

2. Moves for Regional and Bilateral FTAs

Recently, several economies in East Asia have embarked on RTAs on a larger scale. Notably, Japan recently concluded a bilateral FTA with Singapore, made effective in November 2002,[19] and came to *de facto* conclusion with Mexico. It has also begun, or is expected to begin, bilateral negotiations for similar arrangements with Korea, Malaysia, Thailand, the Philippines and Australia. In particular, Japan and Korea have already agreed to complete the negotiation by 2005. China is currently negotiating with ASEAN on a free trade area (FTA) arrangement to be completed by 2010 for advanced ASEAN members and by 2015 with less advanced members. China has already implemented the so-called "early

---

[18] Nonetheless, this initiative was not completely forgotten. When the Asia-Europe Meeting (ASEM) was created in 1996, the Asian participants were essentially EAEG/EAEC economies.

[19] More precisely, the Japan-Singapore agreement is called the "Agreement between Japan and the Republic of Singapore for a New-Age Economic Partnership" and goes beyond a conventional FTA.

harvest" measures beginning January 2004.[20] Japan will also negotiate on an economic partnership agreement (EPA) with ASEAN by 2005 with a view to achieve free trade by 2012. Korea is considering a similar negotiation with ASEAN. Other countries in the region are also negotiating bilateral FTAs (Table 4).

Table 4. FTA/EPA Initiatives in East Asia

Countries/Regions	**Current Status**
Japan-Singapore (EPA)	*Effective (November 2002)*
Japan-Mexico (EPA)	Negotiation completed (January 2004)
Japan-South Korea (EPA)	Under negotiation (since December 2003)
Japan-Malaysia (EPA)	Under negotiation (since January 2004)
Japan-Thailand (EPA)	Under negotiation (since February 2004)
Japan-Philippines (EPA)	Under negotiation (since February 2004)
Japan-Indonesia (EPA)	Agreed to establish a working group (July 2003)
Japan-Australia (EPA)	Agreed to establish a study group (July 2003)
Japan-ASEAN (EPA)	Framework Agreement on economic partnership (October 2003); Negotiatoin to begin in 2005
Japan-China-Korea (EPA)	Joint statement to pursue FTA (October 2003)
South Korea-Chile (FTA)	*Effective (April 2004)*
South Korea-Singapore (FTA)	Under study (since Spring 2003)
South Korea-New Zealand (FTA)	Under study (since March 2003)
South Korea-ASEAN	Agreed to establish a working group (September 2003)
China-Hong Kong (CEPA)	*Effective (January 2004)*
China-ASEAN (FTA)	Under negotiation (January 2003) folllowing the Framework Agreement (November 2002); Early harvest in effect (since January 2004)
China-New Zealand (FTA)	Framework Agreement (June 2004); Negotiation to begin in 2005
Hong Kong-New Zealand (CEPA)	Under negotiation (since January 2001)
Singapore-New Zealand (CEPA)	*Effective (January 2001)*
Singapore-EFTA (FTA)	*Effective (January 2003)*
Singapore-United States (FTA)	*Effective (January 2004)*
Singapore-Australia (FTA)	Negotiation completed (November 2002)
Singapore-Mexico (FTA)	Under negotiation (since July 2000)
Singapore-Canada (FTA)	Under negotiation (since January 2002)
Singapore-P3 (FTA)	Agreed to begin negotiation (October 2002)
Singapore-India (FTA)	Agreement as a long term goal (November 2002)
Singapore-Chinese Taipei (FTA)	Agreed to begin negotiation
Thailand-Bahrain (FTA)	Framework Agreement (December 2002)
Thailand-Australia (FTA)	Under negotiation (since August 2002)
Thailand-United States (FTA)	Under negotiation (since 2003)
ASEAN-India (FTA)	Framework Agreed (Fall 2003)
ASEAN-United States (FTA)	Framework agreement (September 2003)
ASEAN-European Union (FTA)	Framework agreement (April 2004)
ASEAN-CER (Aust-NZ) (CER)	Joint statement of AFTA-CER Closer Economic Partnership (September 2002)

Notes: (a) The shaded arrangements are those within East Asia (ASEAN+3, Chinese Taipei and Hong Kong).
(b) Italics are those FTAs/EPAs that have been made effective.
Source: Compiled from Ministry of Economy, Trade and Industry, Japan; Ministry of Finance, Japan; other official sources

[20] "Early harvest" refers to provisions of the "Framework Agreement on China-ASEAN Comprehensive Economic Cooperation," intended to liberalize, before the full completion of the FTA, tariffs in proority sectors of interest and implement other trade and investment facilitation deemed to generate immediate benefits to ASEAN and China.

One of the interesting features of the East Asian move toward regional and bilateral FTAs/EPAs is that these economies have also concluded, or been negotiating, with countries or groups outside of East Asia. For example, Japan has concluded its negotiation with Mexico ad Korea has concluded its negotiation with Chile. Singapore has made effective a closer economic partnership agreement (CEPA) with New Zealand and FTAs with the European Free Trade Area (EFTA) and the United States, has concluded its negotiation with Australia, and is currently negotiating with Mexico and Canada. Thailand is negotiating with the United States and Australia. ASEAN as a group is also considering similar negotiations with India, the United States and the European Union. These attempts suggest that the economies in the region wish to maintain open trading relations with other parts of the world.

Japan's conclusion of a bilateral FTA/EPA with Singapore symbolizes a change in its long-standing policy of pursuing trade liberalization only in a multilateral framework based on the WTO and APEC. Japan has decided to shift its trade policy to a three-track approach based on global (WTO-based) cum trans-regional (APEC-based), regional (within ASEAN+3), and bilateral liberalization. For Japan, regional and bilateral liberalization is an attempt to achieve deeper integration with its trading partners on a formal basis, going beyond reductions in border restrictions—pursuing investment liberalization, promoting greater competition in the domestic market, and harmonizing standards and procedures. Its challenge is to maintain not only consistency with, but also to promote, the WTO liberalization framework, which remains an important element of Japanese trade policy.

3. Challenges for Further Institutionalization of Trade Integration

Next steps toward an East Asia-wide RTA. To establish a single East Asia-wide FTA is not an easy task once there is a proliferation of many different FTAs/EPAs in the region. Each FTA/EPA may have different rules of origin and external tariffs. One challenge is how to avoid the so-called "spaghetti bowl" effect by ensuring consistency across different trade arrangements. To make the task easier, each FTA/EPA should have transparent, simple rules with regard to external tariffs, exclusion lists, rules of origin, and harmonization of standards, procedures and regulations. Convergence towards identical rules and common tariff rates, rules and standards is highly desirable.

Impediments to a region-wide trade arrangement. There are four possible impediments to forming RTAs in East Asia:

- East Asia's global orientation in trade and FDI—trade and FDI openness to North America and Europe;
- Concern about possible conflict with global liberalization governed by the WTO—fear of protectionism, discrimination and the resulting trade diversion;
- Hesitation of further sectoral adjustments due to trade liberalization, particularly in the face of intensified competition from the rising economic powerhouse, China; and

- Heterogeneity and diversity of economic and social developments within East Asia—difference in per capita income, industrial structure, and domestic institutional capacities.

Skeptics might argue that forming an East Asia-wide RTA, without the United States and Europe, is not a commendable idea because they are still important markets for the region's final products. The belief is that the expansion of intra-regional trade in East Asia, supported by FDI, has been made possible by open markets in the United States and Europe that have been absorbing East Asian finished products. They would suggest, therefore, that trade and investment liberalization within the WTO, or at least within APEC, would be more desirable than through regional FTAs. Hence, the global or trans-regional process should be pursued in East Asia. This argument tends to be supported by those who refuse East Asian trade regionalism because it might undermine the WTO principle of maintaining a liberal, non-discriminatory, and multilateral trade system.[21]

Another possible impediment is the politically difficult adjustment costs, brought about by further liberalization of trade, to certain non-competitive, sensitive sectors in each economy, like agriculture in Japan and automobiles in Malaysia. Such costs could be even higher for ASEAN members in the presence of China's exploding export performance. Since the Asian financial crisis, the ASEAN countries have lost large amounts of FDI, much of which has flown into China due to its favorable growth prospects. This trend is likely to continue for some time to come as many ASEAN countries are direct competitors of China in labor-intensive products in third markets. They are likely to be severely affected by China's competitiveness.[22]

One of the most serious challenges is that the East Asian economies are quite diverse and varied in their economic systems and stages of economic and social developments—such as per capita income levels, industrial structures, trade openness and patterns, human resource developments, institutional capacities, and health and other social conditions.[23] Diversity and heterogeneity imply that low-income countries—where private sector firms are insufficiently developed—will be slow in trade liberalization and market opening and, hence, it will be difficult to integrate themselves with the rest of East Asia at a fast pace. This constitutes an obvious impediment to trade and investment cooperation. In addition, given such economic diversity and heterogeneity, economies in the region have different policy objectives and priorities and desire to maintain national sovereignty over economic policies. In order for the economies to take joint action at the regional level, there must be substantial economic convergence.

---

[21] Lloyd (2002) argues that bilateralism/FTAs will likely lead toward, and not impede, multilateralism, while Brown, Deardorff and Stern (2003) continue to believe in superiority of multilateralism.

[22] Wong and Chan (2003) emphasize that China is an economic threat to ASEAN countries, which must reform.

[23] Ravenhill (2001) argues that diversity of membership and conflicts of power and interest sharply limit potential for cooperation in East Asia, while Terada (2003) provides a constructive and relatively optimistic account of the regional grouping.

Assessments of the impediments. It is useful to point out that some of these impediments are not so serious. The United States is no longer the most dominant economic partner for many East Asian economies, and the regional markets for final products are expanding fast. Large part of inward FDI flows in the region now originates from within the region. In addition, East Asia is in no way inward looking as evidenced by the fact that many of them are negotiating on FTAs with countries outside of the region and are at the same time focusing on domestic structural reforms, higher productivity and economic growth, thus minimizing trade diversion effects. The East Asian approach is to regard the WTO principle—and APEC principles—as the basic infrastructure for international trade rules and achieve greater liberalization beyond the commitments of the WTO and APEC—called the "WTO-plus" or "APEC-plus" approach.

Trade and FDI liberalization and the required structural reforms are indispensable at any rate to increase the regional economies' international competitiveness, with or without China's aggressive export behavior in the regional and global markets. With China's emergence as a large production base, it is even more important for the neighboring countries—particularly ASEAN members—to improve their investment climate and continue to attract, or, at least, not lose, FDI.

Despite heterogeneity and differences in economic and social systems among the countries in the region, they have increasingly come to realize that the economic logic for strengthening regional frameworks for trade and investment integration is overriding. They have found the large benefit of economic integration and its institutionalization to outweigh the costs of not doing so. It is extremely important to raise the economic basis of poor members within East Asia to encourage them to grow. For the time being, the only realistic approach would be a multi-track approach in the sense that countries that are ready for liberalization and deeper integration negotiate on RTAs, while those countries not ready are advised to pursue structural, institutional and governance reforms to enable them to participate in trade and FDI and to benefit from liberalization and integration.

V. INITIATIVES FOR REGIONAL FINANCIAL COOPERATION

1. Early Attempts

ASEAN. In August 1977 the original five ASEAN central banks and monetary authorities—Indonesia, Malaysia, the Philippines, Singapore, and Thailand—signed the first memorandum of understanding on the ASA with the total facility of US$100 million. In 1978, the total was increased to US$200 million, with each member contributing US$40 million. The objective was to provide immediate, short-term swap facilities to any member facing a temporary liquidity shortage or a balance of payments problem.

The ASEAN established a Surveillance Process in October 1998, with the objective of strengthening policy dialogue and policymaking capacity in monetary, fiscal and financial areas through information exchanges, peer reviews and recommendations for action at the regional and national levels. For this purpose, the ASEAN Surveillance Process has two components: a monitoring mechanism that allows early detection of any irregular movement in key economic and financial variables; and a peer review mechanism that induces appropriate policy responses to issues emerging from the monitoring exercise. The process is the first concrete attempt by a group of developing countries to establish mechanisms for regional policy dialogue.

Asian Monetary Fund (AMF) proposal. Following the success of the August 1997 meeting in Tokyo to agree on a much-needed financial support package for crisis-affected Thailand, Japan, with support from South Korea and the ASEAN countries that participated in the Thai package, proposed in September to establish an Asian Monetary Fund (AMF) to supplement IMF resources for crisis prevention and resolution. The United States and the IMF opposed this proposition on grounds of moral hazard and duplication. They argued that an East Asian country hit by a currency crisis would bypass the tough conditionality of the IMF and receive easy money from the AMF, thereby creating potential for moral hazard; and that an AMF would be redundant in the presence of an effective global crisis manager, the IMF. Without China's support, the idea had to be aborted.

In November 1997 the East Asian economies, together with the United States, Canada, Australia and New Zealand, agreed to establish the so-called "Manila Framework Group." Many, but not all, of the MFG member economies participated in the Thai financial package.[24] Its objective was to develop a concerted framework for Asia-Pacific financial cooperation in order to restore and enhance the prospects for financial stability in the region. Its initiatives included the establishment of a new mechanism for regional surveillance to complement IMF surveillance; enhancement of economic and technical cooperation, particularly in strengthening domestic financial systems and regulatory capacities; strengthening the IMF's capacity to respond to financial crises; and development of a cooperative financing arrangement for the region to complement IMF resources.

New Miyazawa Initiative. Another example, which was highly successful, was the so-called "New Miyazawa Initiative" which contributed to the resolution of the Asian financial crisis. In October 1998, Japan pledged US$30 billion to support the economic recovery of the crisis-affected countries. Half of the pledged amount was dedicated to short-term financial needs during the process of implementing economic restructuring and reform, while the rest was earmarked for medium- and long-term reforms. Part of short-term financial support was dedicated to currency swap arrangements with Korea (US$5.0 billion) and Malaysia (US$2.5 billion). The initiative provided major assistance for restructuring corporate debt, reforming financial sectors, strengthening social safety nets, generating employment, and addressing the credit crunch. A commitment to provide a large amount of resources helped stabilize the regional markets and economies, thereby facilitating the recovery process.

[24] These economies were called the "Friends of Thailand"—including Japan, Australia, China, Hong Kong, Malaysia, Singapore, Brunei, Indonesia and South Korea.

Asia Growth and Recovery Initiative. With the announcement of the New Miyazawa Initiative, the United States decided to take its own initiatives within a multilateral framework in order to assist the economic recovery of the crisis-affected countries. In November 1998, the US and Japan jointly announced the Asia Growth and Recovery Initiative (AGRI), which was a multilateral effort to stimulate economic growth in Asia. With support from the World Bank and the Asian Development Bank (ADB), AGRI was intended to initially target the mobilization of US$5 billion in bilateral and multilateral support to further corporate restructuring and restore market access to private capital, including for small and medium firms. Although it did not generate additional resources for East Asia's restructuring process nor yielded visible results, it strengthened/established bond guarantee functions of the World Bank and the ADB.

2. Current States of Regional Financial Cooperation

Regional financial cooperation in East Asia has focused on three major initiatives:[25]

- Creation of a regional liquidity support arrangement;
- Establishment of surveillance mechanisms; and
- Development of Asian bond markets.

Liquidity support facility. The hallmark financing arrangement in East Asia is the Chiang Mai Initiative, which is designed to manage regional currency attacks, contagion and crises.[26] The Asian financial crisis highlighted the importance of establishing an effective financing facility so that the economies in the region can respond more effectively to the needs of their peers in a world of increased financial globalization. The finance ministers of ASEAN+3 who met in Chiang Mai in May 2000 agreed to establish a regional network of swap arrangements (BSAs) for its members, thus embarking on the so-called the Chiang Mai Initiative (CMI). The CMI comprised of two elements—the expansion of the existing ASEAN Swap Arrangement (ASA) in both amounts and membership and the creation of a new network of bilateral swap arrangements among ASEAN+3 members.[27] By the end of December 2003, sixteen BSAs had been concluded in line with the main principles, reaching a total of US$36.5 billion excluding the commitments made under the New Miyazawa Initiative, and US$44 billion including these commitments (see Table 5).[28] This signified the conclusion of all conceivable BSAs at the time, and no further BSA negotiation is currently

---

[25] See Kawai (2002a) and Kuroda and Kawai (2002).
[26] There is another arrangement under the Manila Framework Group, that is, the MFG Cooperative Financing Arrangement, but this is intended to be only a second line of defence and is considered as ineffective.
[27] ASEAN Swap Arrangement (ASA), established among the original ASEAN-5 in August 1977 with a total facility of US$100 million, expanded to a total of US$200 million in 1978. Under the CMI, ASA membership was extended to include all ASEAN members, and its facility was further augmented to US$1 billion.
[28] This is the sum of all BSAs, including the amount that Japan committed under the New Miyazawa Initiative—a total of US$7.5 billion, or US$5 billion with South Korea and US$2.5 billion with Malaysia—, except that two-way BSAs are doubled for calculation purposes. Excluding the amount committed under the New Miyazawa Initiative, the total sum is US$36.5 billion.

under way.

Table 5. Progress on BSAs under the Chiang Mai Initiative (as of end-December 2003)

BSAs	Currencies	Conclusion Dates	Size
Japan-South Korea	USD-Won	July 4, 2001	US$ 7.0 billion[(a)] (1-way)
Japan-Thailand	USD-Baht	July 30, 2001	US$ 3.0 billion (1-way)
Japan-Philippines	USD-Peso	August 27, 2001	US$ 3.0 billion (1-way)
Japan-Malaysia	USD-Ringgit	October 5, 2001	US$ 3.5 billion[(b)] (1-way)
China-Thailand	USD-Baht	December 6, 2001	US$ 2.0 billion (1-way)
Japan-China	Yen-Renminbi	March 28, 2002	US$ 3.0 billion[(c)] (2-way)
China-South Korea	Renminbi-Won	June 24, 2002	US$ 2.0 billion[(c)] (2-way)
South Korea-Thailand	USD-Won or USD-Baht	June 25, 2002	US$ 1.0 billion (2-way)
South Korea-Malaysia	USD-Won or USD-Ringgit	July 26, 2002	US$ 1.0 billion (2-way)
South Korea-Philippines	USD-Won or USD-Peso	August 9, 2002	US$ 1.0 billion (2-way)
China-Malaysia	USD-Ringgit	October 9, 2002	US$ 1.5 billion (1-way)
Japan-Indonesia	USD-Rupiah	February 17, 2003	US$ 3.0 billion (1-way)
China-Philippines	Renminbi-Peso	August 29, 2003	US$ 1.0 billion[(c)] (1-way)
Japan-Singapore	USD-Singapore dollar	November 10, 2003	US$ 1.0 billion (1-way)
South Korea-Indonesia	USD-Won or USD-Rupiah	December 24, 2003	US$ 1.0 billion (1-way)
China-Indonesia	USD-Rupiah	December 30, 2003	US$ 1.0 billion (2-way)

Notes: (a) The amount includes US$5.0 billion committed (on June 17, 1999) under the New Miyazawa Initiative.
(b) The amount includes US$2.5 billion committed (on August 18, 1999) under the New Miyazawa Initiative.
(c) The amounts are US dollar equivalents.

Members requesting liquidity support under the CMI can immediately obtain short-term financial assistance for the first 10 percent of the BSA facility. The remaining 90 percent is provided to the requesting member under an IMF program. Linking CMI liquidity support to IMF conditionality is designed to address the concern that balance of payments difficulties may be due to fundamental problems, rather than a mere panic and herd behavior by investors, and that the potential moral hazard problem could be non-negligible in the absence of an effective adjustment program.[29]

Surveillance mechanism. Establishing mechanisms for frequent exchanges of views and consultations among regional-country financial officials is an obvious first step for meaningful financial cooperation. Information sharing and policy dialogue are essential to this process. Economic surveillance involves not only analyses of macroeconomic and financial conditions and policies of member countries but also identification of vulnerable aspects of the economy and finance as well as appropriate policy responses. This process requires frank and candid exchanges of views among other member economies, and will hopefully induce good policies through peer pressure.

There are several mechanisms for regional information sharing, policy dialogue, and economic surveillance (see Table 6). The most important mechanism of all is the ASEAN+3

[29] Although up to 10 percent of the BSA drawings under the CMI can be provided for a limited period without an IMF program, subsequent additional disbursements have to be linked to an IMF program and, therefore, its conditionality.

Process. Other major mechanisms include the ASEAN Surveillance Process, the Manila Framework Group (MFG), EMEAP (Executives Meeting of East Asia-Pacific Central Banks), and trans-regional forums such as APEC and Asia-Europe Meeting (ASEM).

Table 6. Regional Forums for Finance Ministries and Central Banks[a]

	Finance Ministries and/or Central Banks					Central Banks		
Groups (No. countries)	**ASEAN (10)**	**ASEAN+3 (13)**	**MFG[b] (14)**	**APEC (21)**	**ASEM[c] (25)**	**SEANZA (20)**	**SEACEN (11)**	**EMEAP (11)**
Year Established	**1967.8**	**1999.4**	**1997.11**	**1994.3**	**1997. 9**	**1956**	**1966.2**	**1991.2**
Japan		○	○	○	○	○		○
China		○	○	○	○	○		○
Korea		○	○	○	○	○	○	○
Hong Kong			○	○		○		○
Chinese Taipei				○			○	
Singapore	○	○	○	○	○	○	○	○
Brunei	○	○	○	○	○			
Cambodia	○	○						
Indonesia	○	○	○	○	○	○	○	○
Laos	○	○						
Malaysia	○	○	○	○	○	○	○	○
Myanmar	○	○					○	
Philippines	○	○	○	○	○	○	○	○
Thailand	○	○	○	○	○	○	○	○
Vietnam	○	○		○	○			
Mongolia						○	○	
Macao						○		
Papua New Guinea				○		○		
Australia, New Zealand			○	○		○		○
Nepal, Sri Lanka						○	○	
Bang., India, Iran, Pak.						○		
USA, Canada			○	○				
Chile, Mexico, Peru				○				
Russia				○				
EU-15					○			

Notes: (a) APEC = Asia-Pacific Economic Cooperation; ASEAN = Association of Southeast Asian Nations; EMEAP = Executives Meeting of East Asia-Pacific Central Banks; MFG = Manila Framework Group; SEACEN = South East Asian Central Banks; SEANZA = South East Asia, New Zealand, Australia.
(b) MFG includes the International Monetary Fund, the World Bank, the Asian Development Bank and the Bank for International Settlements.
(c) ASEM includes the European Commission.
Source: Kuroda and Kawai (2002).

The purpose of the ASEAN+3 ERPD process, introduced in May 2000 by ASEAN+3 finance ministers, is to strengthen policy dialogue, coordination and collaboration on the financial, monetary and fiscal issues of common interest. Its major focus is on issues related to macroeconomic risk management, monitoring of regional capital flows, strengthening of the banking and financial systems, reform of the international financial architecture, and enhancement of self-help and support mechanisms in East Asia. Steps have been taken for cooperation in monitoring short-tem capital flows and developing a regional early warning system to assess regional financial vulnerabilities, with a view to preventing financial crises in the future. However, this process has not yet been as effective as it should be. There is no independent, professional organization that prepares comprehensive papers for analyses, assessments and issues to support the process, except that the ADB provides some data on developing member economies.

Asian bond market development. Initiatives have been taken to develop Asian bond markets in view of the need to channel a vast pool of savings to long-term investment for growth and development within the region. This effort reflects the recognition that the financial system in East Asia has been too dependent on bank financing domestically and on foreign-currency financing externally and, hence, needs to be strengthened through the development of local capital—in particular bond—markets. By developing local-currency denominated bond markets, it is also hoped that the "double mismatch" problem of international capital flows—currency and maturity mismatches—will be reduced.

The EMEAP-led central bank process has established an Asian Bond Fund (ABF) to facilitate bond issuance. Its idea is to help expand the bond market through the purchase of bonds using foreign exchange reserves. So far, only US dollar-denominated bonds have been purchased. To address the issue of the "double mismatch," Asian currency-denominated bonds must be purchased. The ASEAN+3 Finance Minister process has undertaken the Asian Bond Market Initiative (ABMI) to develop local currency denominated bonds. One of its aims is to establish a bond guarantee agency in the region and to promote bonds denominated in a basket of Asian currencies.

3. Challenges for Further Institutionalization of Financial Integration

Next steps for closer financial cooperation. The ASEAN+3 countries have agreed to review the CMI starting in May 2004, including the amount, modality and IMF linkages. The total amount covered by the CMI may be increased, and its bilateral nature may be modified to become multilateral. If the degree of IMF linkages is to be reduced, effective surveillance would have to be put firmly in place. In addition to this review, the member countries may wish to consider further steps going beyond the CMI, which is essentially a short-term liquidity support mechanism. A medium-term financing arrangement that would be extended for two to three years—or longer—may need to be developed.

Another issue concerns surveillance and policy dialogue, that is, how to make the surveillance process effective, like the G-7 process and OECD processes (EPC, EDRC, WP3). Currently MFG serves better in terms of the quality of surveillance and frankness of policy dialogue than other processes in East Asia. A challenge is how to create a good surveillance culture within ASEAN+3. On Asian-currency denominated bond market development, incentives must be created to develop such markets on the part of both investors and issuers. In particular corporate governance for potential issuers needs to be enhanced, and well-designed national and regional market infrastructure needs to be developed—including disclosure requirements, accounting and auditing standards, rating agencies, bond default treatment, and depository and clearance systems.

So far no concrete attempt has been made to initiate exchange rate policy coordination. This presents a serious problem because intra-regional exchange rate stability is a public good for regional growth and economic stability.

Impediments to closer financial regionalism. There are four possible impediments to further financial cooperation at the regional level:

- East Asia's global orientation in finance—financial integration with the OECD countries and dependence on the US dollar;
- Concern about possible conflict with the global financial system governed by the IMF;
- Diversity and heterogeneity in financial structure and capital account liberalization; and
- Hesitation of further coordination due to the fear of loss of national sovereignty.

Some authors argue that East Asia is more closely integrated financially with the OECD countries than with regional economies and that the region can gain more from further integration with the global market than with the regional economies in terms of risk sharing for smooth consumption. The East Asian economies are also still highly dependent on the US dollar—for exchange rate stabilization, trade invoicing, external asset holding, foreign exchange reserve holding, and external liabilities. This dependence means that it will not be easy to reduce the role of the US dollar and increase the use of Asian currencies for international transactions. The region's global orientation in finance leads to the view that the global financial system governed by the IMF could be more important than an alternative, regional financial system.

Once again diversity and heterogeneity within East Asia—in the areas of financial market development, scope and extent of exchange and capital controls, and institutional capacities—can constitute a serious impediment to regional financial cooperation. Diversity and heterogeneity imply that low-income countries—where financial infrastructure is insufficiently developed—will be slow in capital account liberalization and financial opening and, hence, it will be difficult to integrate themselves financially with the rest of East Asia at a fast pace. Given such diversity and heterogeneity, economies in the region have different policy objectives and priorities and desire to maintain national sovereignty over economic policies—fiscal, monetary, exchange rate, financial and structural. This preference for national policy independence would make it difficult to conduct serious economic and policy surveillance and to apply strong peer pressure for better policies. Closer economic policy coordination would be more difficult.

Assessments of the impediments. Some of these impediments are real, but they are not insurmountable either. It is true that financial integration tends to be global and the role of the US dollar is still predominant in East Asia. However, the regional economies have found the need to manage financial globalization through various measures, including the strengthening of a regional financial architecture, which complements the global financial arrangement governed by the IMF. The region's governments have also found the cost of excessive reliance on the US dollar very high so that they have embarked on measures to increase the use of regional currencies—such as the Asian bond market development.

Heterogeneity and diversity are not the ultimate impediment to regional financial cooperation, but political will is more crucial. For closer economic cooperation, again, a multi-track approach of strengthening cooperation among countries that have enough convergence would make sense. At the same time, the ASEAN+3 member economies, with assistance from Japan, Korea and other OECD donor countries and multilateral development banks, must make every effort to guide low-income countries to upgrade their institutions and market infrastructure. With regard to the issue of economic sovereignty, the regional economies are increasingly realizing that their economies are highly interdependent so that closer economic policy cooperation is inevitable.[30]

VI. THE ROLE OF OECD COUNTRY POLICIES

OECD countries affect developing economies directly through their individual or collective policies or indirectly through international organizations in which they participate. This section discusses the role of OECD country policies to further assist economic integration and cooperation in East Asia.

1. Impact through Individual OECD Country/Area Policies

Macro, financial and trade. OECD economic conditions—particularly those in Japan, Korea, the United States, Australia, New Zealand and those in Europe—have affected prospects for growth, development and poverty reduction in the East Asian developing world through the impact on trade and capital flows. First, these OECD countries' stable macroeconomic and financial conditions have helped developing East Asian economies benefit from trade and investment openness. Though volatile short-term capital flows interacted with weak domestic fundamentals and induced the Asian financial crisis in 1997-98, the East Asian economies have been able to strengthen financial resilience since then. Second, these OECD countries' liberal trade and investment regime and provision of market access—through reductions of industrial tariffs and non-tariff barriers—to developing East Asian economies' exports of labor-intensive manufactured products have encouraged the latter's industrialization. For this purpose, the OECD countries accepted industrial adjustment on their part by making the labor markets flexible. Third, these OECD countries' steady supply of long-term risk capital—such as FDI—to developing East Asia has been crucial, because it has directly provided long-term funding, facilitated transfers of production technology, management know-hows and organizational skills, and enabled developing East Asian firms to participate in the global and regional production chains and in

[30] Stubbs (2002) takes the view that the ASEAN+3 will rise as a major regional and international player.

the innovation process.

An important challenge is how to integrate the low-income countries in East Asia—such as Cambodia, Laos and Myanmar—into the regional and global markets. The OECD countries can help this process, together with the regional middle-income countries, by maintaining stable macroeconomic and financial environments, a liberal trading system, stable flows of private risk capital, particularly FDI, and setting effective ODA policies targeted at these low-income countries. For the time being, a realistic approach would be a multi-track approach in the sense that countries that are ready for deeper integration should begin the process, while those not ready are advised to pursue structural, institutional and governance reforms to enable them to participate in trade and FDI and to benefit from liberalization and integration. At the same time, the ASEAN+3 member economies, with assistance from Japan, Korea and other OECD donor countries and multilateral development banks, must make joint efforts to upgrade their institutional basis.

Role of aid. Given that these low-income economies have adversary problems in their initial conditions, the OECD countries' ODA needs to assist them in overcoming these unfavorable conditions and pursuing private sector-led development in the context of globalization. As the East Asian experience demonstrates, ODA can have greater positive impact, in terms of economic development and poverty reduction, on the recipient economies if it stimulates private investment and trade through provision of basic industrial infrastructure, human capital development and institutional capacity building. The international community shares a consensus view that development aid works effectively under the following conditions:

- *The policy environment in the recipient country is right.* Development cannot take place without a commitment to peace and political stability and a commitment to sound macroeconomic, structural and social policies, good governance, and the rule of law.
- *The recipient country takes ownership of the development program.* Strong country ownership of its own development program is instrumental because without it policy and institutional reforms for economic development and poverty reduction cannot be effective.
- *Donors coordinate their assistance efforts.* The donor community needs to coordinate, and even harmonize, ODA policies and procedures in order to reduce transactions costs and focus its assistance efforts on the country with sound economic management and good governance (see OECD 2003a).
- *Donors and recipient countries take partnership.* The donor community and the recipient country should work together, by involving other stakeholders, in achieving the recipient-owned goal of economic development and poverty reduction as the only objective. This reflects the past experience that aid-effectiveness is reduced when aid is tied to other often politically motivated objectives of donors.

Collective action. The OECD countries can contribute to the development and poverty reduction of developing economies through their collective action. Coordination of economic policies at the global and regional levels—such as the G7 process and the European Commission—is essential to ensure a stable global or regional economy.

One area where global collective action is needed is environmental sustainability. The OECD countries bear much of the responsibility for the preservation of the global environmental commons, as they are the major contributors to the degradation of the commons and possess the financial and technical capacities for prevention, mitigation and rehabilitation. Developing economies must play their part by improving their environmental management capacities and institutions. While there has been good progress on protecting the ozone layer, much progress needs to be made in greenhouse emissions and bio-diversity.

It is often argued that while leadership for further integration is lacking in East Asia. There is no single hegemonic leader—like the United States in the Western Hemisphere—or a bipolar alliance—like Germany and France in Europe—which is willing to provide regional public goods. According to some skeptics, Japan's leadership role has been diminishing due to its domestic economic difficulties, while China will have to wait a long time before assuming a leadership role because of its incomplete transition to a market economy, the presence of a weak banking system, the unresolved poverty issue, and uncertainty with regard to the timing and modality of political transition. The reality is that in East Asia, Japan has been exercising its leadership role through presenting the AMF proposal—albeit it failed—, providing financial support to Thailand, Indonesia, Malaysia, the Philippines and Korea—jointly with the IMF program or via the New Miyazawa Initiative—and guiding the ASEAN+3 process, particularly the CMI. It is expected that Japan, China, Korea and ASEAN will jointly exercise a leadership role.

2. Impact through International Organizations

OECD countries have affected the East Asian economies and will continue to affect the future of regional economic integration and cooperation in East Asia through international organizations because of their influence on them.

First, one of the major objectives of the IMF is to help maintain stable global finance, and it is in this context that the IMF has focused on the international financial architecture in recent years. In this discussion, the roles to be played by various actors, including the IMF, are generally well established. Emerging market economies must make efforts to reduce risks of crisis through strengthening domestic policy and institutional frameworks, particularly through ROSCs. Industrial countries must regulate and monitor their financial institutions to reduce their bias toward short-term lending and to improve their risk management. The IMF must make efforts to strengthen surveillance, to provide international liquidity, to establish effective conditionality, and to involve private creditors. In addition, the role of regional institutions needs to be recognized. It is natural for a group of interdependent regional economies to take concerted action for financial stability at the regional level. A clearly focused regional approach, designed to reduce vulnerabilities and crisis risks and to cope with the eruption of crises, can contribute to global financial stability. The IMF, as a global crisis coordinator, can benefit greatly from such regional initiatives.[31] Indeed, the IMF works with several regional forums in Asia, including the APEC Finance Ministers and the Manila Framework Group.[32]

The IMF needs to rectify the imbalance and unfairness of the current distribution of IMF quotas, which is heavily skewed against East Asia. The East Asian quotas are unrealistically small in relation to their actual weights in the world economy. Greater allocation of quotas to East Asia would undoubtedly make its representation at the IMF Executive Board consistent with the changing reality and restore fairness and integrity in its decision-making process.

Second, the World Bank has assisted poor countries to pursue structural reforms, strengthen policy and institutional underpinnings, improve their investment climates, and integrate them with the global trading system. It needs to re-emphasize the importance of broadly based economic growth and development as a means of achieving poverty reduction and improving social conditions. The World Bank appears to have extended its businesses beyond its competency—into the areas of religion and culture—but it needs to take a more focused approach to development. In addition, the World Bank is often criticized for its slow response in a crisis situation. So it should change its business culture and mode of operation, by creating a system that enables quick mobilization of its experts at times of crisis.

Third, the WTO needs to accelerate the Doha process. Putting the Doha round back on track must be the highest priority for OECD countries, which must lead the process by showing good examples. They need to eliminate completely tariffs on manufactured products and subsidies for agricultural exports, decouple completely all domestic subsidies from production, reduce tariffs on agricultural products, and commit to ensure free cross-border trade in services. In addition, it needs to continuously monitor regional trade arrangements so that they do not go against the WTO principles of ensuring a liberal, non-discriminatory and multilateral trading system.

Fourth, the OECD is a unique organization which overseas both developed country policies and official development assistance. Specifically it monitors progress on structural reforms of member economies, ODA flows and policies of members, and development issues for non-member developing economies. Hence, its comparative advantage naturally lies in assessing policy coherence. It can apply peer pressure to its member countries to improve their structural policies in a way that can positively affect both the members themselves and non-members. From this perspective, the OECD has undertaken several initiatives recently: a "horizontal program" on policy coherence for development that looks at the impact of a broad range of OECD country policies on developing economies; greater emphasis in DAC

[31] Because crisis management and resolution can require involvement of international creditors from outside the region, a regional approach needs to be linked with a global framework.
[32] The IMF Tokyo Office has been providing a secretariat function for the Manila Framework Group.

peer review to issues of policy coherence among members; and greater involvement of the Development Centre in policy coherence. The OECD is advised to continue to strengthen its analytical capacity on policy coherence, particularly on the actual, quantitative impact of OECD country policies on developing economies as well as on case studies of policy coherence.

Finally, it is important to ensure that international organizations reduce incoherence among themselves so that they can jointly work for economic development and poverty reduction of developing countries. Incoherence may arise between the IMF and the WTO, or between the IMF and the World Bank. The reason for such incoherence is that the major focus of the IMF tends to be on adjustment—including fiscal improvements—while the major focus of the WTO is on trade liberalization—which can reduce tariff revenues—and that of the Bank is often on fiscal support and growth. Serious incoherence can be observed in a crisis situation, where the IMF and the World Bank need to work closely with each other on programs that anticipate the latter's expertise and financing. In the Asian crisis, the IMF often went to crisis countries alone, or with a minimal representation from the World Bank, despite the fact that the World Bank's contribution to crisis resolution turned out to be substantial. This type of situation should be avoided. When the IMF has no comparative advantage in formulating and monitoring structural reforms, it must involve the World Bank or other relevant institutions from the outset.

VII. CONCLUDING REMARKS

This paper has argued that the emerging East Asian economies have achieved sustained economic development and poverty reduction through domestic structural, institutional and governance reforms as well as through market-driven integration with the global and regional markets. Though this process was temporarily interrupted by the Asian financial crisis in 1997-98, the economies have pursued further liberalization and reforms, deepened economic integration through trade, FDI and finance, and regained dynamic growth.

OECD country policies—particularly those in Japan, Korea, the United States, Australia and Europe—helped the East Asian economies to growth, develop and reduce poverty in at least six ways. First, they helped maintain peace and security, which has been critical: Security and growth have been mutually reinforcing. Second, they maintained a relatively stable macroeconomic and financial environment ensuring stable flows of capital, except at times of the crisis. Third, they maintained an increasingly open trading system, with no reversal or backtracking. Fourth, they enacted pro-FDI policies by sending inefficient industries abroad through industrial restructuring and adjustment and by expanding imports from East Asia of those manufactured products which would be costly to produce domestically. Fifth, they facilitated transfers of production technology and organizational skills. Sixth, ODA played a role in helping to build industrial infrastructure and human resource capacity and in social spending. ODA also helped, especially through the international financial institutions, to strengthen the recipient country's policy frameworks and institutional fundamentals.

Regional economic cooperation in East Asia—through the institutionalization of deepening economic interdependence—is still in its infancy stage. Nonetheless some important progress has been made in the areas of trade and finance for regional institution building. There is a mutually reinforcing interaction between economic interdependence and the formal institutionalization of integration. Joint cooperative action for such endeavors at the regional level also nurtures a sense of identity and community contributes to trust building. All of these are critical to maintaining regional growth and economic stability and reducing the security concerns in the region. Japan, China and ASEAN must move more aggressively to achieve deeper, real integration, which will contribute to the growth of the world economy. The OECD community needs to embrace East Asian regionalism as a strong building block for a more liberal, yet stable international economic system.

There are several challenges for the region. First, the regional economies should accelerate negotiations on Japan-Korea EPA, Japan-ASEAN EPA—including bilateral EPAs—and China-ASEAN FTA so as to conclude them as soon as possible. Such regional trade agreements need to avoid the counterproductive "spaghetti bowl" effect and maintain WTO consistency. Of course this requires substantial structural reforms on the part of all economies, including in both manufacturing and agricultural sectors. This is particularly the case with ASEAN: Its middle-income member states must reform their economies to cope with greater international competition, particularly vis-à-vis China, while its low-income members must pursue institutional and governance reforms to enable them to benefit from trade and FDI openness.

Second, the regional economies need to make further progress on strengthening liquidity provision mechanisms and policy dialogue and economic surveillance processes as well as developing the Asian bond market. It is crucial to enhance the functioning of the CMI on the occasion of its review starting in May 2004 through: the enlargement of its size by as much as ten times the current commitment: multilateralization and joint activation of the currency swap arrangements; reduction of its IMF linkages with enhanced economic surveillance; and greater use of Asian currencies for swap arrangements. For such reforms, however, the region must address the earlier concern that an AMF that could lend too generously with too little conditionality might create a moral hazard for the government at the receiving end as well as for investors with stakes in the countries in question. It is therefore essential to make the surveillance process effective, improve the regional capacity to formulate appropriate adjustment policy in the event of liquidity crisis and, to the extent necessary, enforce effective private sector involvement. Once these efforts are made, East Asia will have effectively established an Asian Monetary Fund that can contribute to regional financial stability without creating fears of moral hazard.[33]

Third, not much progress has been made in the area of exchange rate coordination or

[33] Nonetheless, Rapkin (2001) takes a pessimistic view of an AMF.

rate stabilization in East Asia. But it is time to initiate exchange rate policy coordination. The first step would be for the regional economies to discuss exchange rate issues as part of an enhanced surveillance process. Second, given that emerging East Asian countries have diversified trade and investment relationships with the tripolar currency area countries and that the exchange rates among the major currencies would continue to be volatile, a G-3 currency basket arrangement based on the Japanese yen, the US dollar and the euro would be an attractive option.[34] Third, it is also useful to introduce a regional common unit of account in East Asia—an Asian Currency Unit (ACU). Just like the European currency unit (ECU) under the EMS (1979–98), the weights of the regional currencies would reflect the relative importance of the countries in the region. The ACU could be used to denominate economic transactions (trade and capital flows) and asset stocks (foreign exchange reserves and cross-border Asian bonds) and to measure the degree of each currency's exchange rate deviation from the regional average. It would be useful for ASEAN+3 to discuss member countries' exchange rate deviations from the regional average in reference to the ACU.

Finally, it is important to overcome various impediments to closer regional economic cooperation. Some of the impediments will become less serious as economic interdependence deepens in the region, while others require fundamental efforts such as integrating ASEAN late-comers with the regional and global markets. The region must nurture the sense of mutual trust and community by developing a long-term vision for the political and economic future of East Asia and having such a vision shared by the general public in the region. Developing a long-term vision of creating an economic and security community in East Asia would be essential to this exercise. One vision for a future East Asian economic community would be a full-fledged economic and monetary union with a single currency like the euro zone. Given the multi-polar nature of East Asia, regional economic cooperation takes a European- style, symmetric approach, rather than a North-American style, US-centered, asymmetric—hub and spoke—approach.

[34] See Kawai (2002b) for detailed discussions.

REFERENCES

Baldwin, Richard E. 1997. "The Causes of Regionalism." *World Economy*, 20:7 (November), pp. 865-888.

Bayoumi, Tamin and Barry Eichengreen. 1994. "One Money or Many? Analyzing the Prospects for Monetary Unification in Various Parts of the World." *Princeton Studies in International Finance*, No. 76, International Finance Section, Princeton University.

Bayoumi, Tamin, Barry Eichengreen and Paolo Mauro. 2000. "On Regional Monetary Arrangements for ASEAN." *Journal of the Japanese and International Economies*, 14 (June), pp. 121-148.

Bird, Graham and Ramkishen S. Rajan. 2002. "The Evolving Asian Financial Architecture," *Essays in International Economics*, 226 (February), International Economics Section, Princeton University, Princeton.

Brown, Drusilla K., Alan V. Deardorff, and Robert M. Stern. 2003. "Multilateral, Regional and Bilateral Trade-Policy Options for the United States and Japan." *World Economy*, 26:6 (June), pp. 803-828.

East Asia Study Group. 2002. "Final Report of the East Asia Study Group." ASEAN+3 Summit (November 4), Phnom Penh, Cambodia.

East Asia Vision Group. 2001. "Toward an East Asian Community: Region of Peace, Prosperity and Progress." East Asia Vision Group Report.

Eichengreen, Barry. 1999. *Toward a New International Financial Architecture: A Practical Post-Asia Agenda*, Washington DC: Institute for International Economics, February.

Eichengreen, Barry and Tamim Bayoumi. 1999. "Is Asia an Optimum Currency Area? Can It Become One? Regional, Global and Historical Perspectives on Asian Monetary Relations." S. Collignon, J. Pisani-Ferry and Y.C. Park, eds., *Exchange Rate Policies in Emerging Asian Countries*, London: Routledge, pp. 347–366.

Feldstein, Martin. 1998. "Refocusing the IMF." *Foreign Affairs*, 77, March/April, pp. 20-33.

Fischer, Stanley. 2003. "Globalization and Its Challenges." *American Economic Review (AEA Papers and Proceedings)*, 93:2, May, pp. 1-30.

Furman, Jason and Stiglitz, Joseph E. 1998. "Economic Crises: Evidence and Insights from East Asia." *Brookings Papers on Economic Activity*, 2: 1998, pp. 1–135.

Goto, Junichi and Masahiro Kawai. 2001. "Macroeconomic Interdependence in East Asia," paper presented to the international conference on “Economic Interdependence: Shaping Asia-Pacific in the 21st Century” (22–23 March), International Monetary Fund and World Bank, Tokyo.

Hew, Denis and Hadi Soesastro. 2003. “Realizing the ASEAN Economic Community by 2020—ISEAS and ASEAN-ISIS Approaches.” *ASEAN Economic Bulletin*, 20 (3), December, pp. 292-296.

International Monetary Fund (IMF). 1998a. *International Capital Markets: Development, Prospects, and Key Policy Issues*. Washington, DC.

International Monetary Fund (IMF). 1998b. *World Economic Outlook.* Washington, DC.

International Monetary Fund (IMF). 2003. “The IMF and Recent Capital Account Crises: Indonesia, Korea, Brazil.” Evaluation Report, Independent Evaluation Office, Washington, DC.

Kaminsky, Graciela L., Carmen M. Reinhart and Carlos A. Vegh. 2003. “The Unholy Trinity of Financial Contagion.” *Journal of Economic Perspectives*, 17 (4), Fall 2003, pp. 51-74.

Kawai, Masahiro. 2002a. “Global, Regional and National Approaches to the International Financial Architecture: Lessons from the East Asian Crisis.” *International Economy* (Japan Society of International Economics), Vol. 7, pp. 65-108.

Kawai, Masahiro. 2002b. “Exchange Rate Arrangements in East Asia: Lessons from the 1997-98 Currency Crisis.” *Monetary and Economic Studies, Special Edition*, 20 (December), Institute for Monetary and Economic Studies, Bank of Japan, pp. 167-204.

Kawai, Masahiro and Taizo Motonishi (2004) “Real, Financial and Macroeconomic Interdependence in East Asia.” Mimeographed (forthcoming), Institute of Social Science, University to Tokyo, Tokyo.

Kawai, Masahiro, Richard Newfarmer, and Sergio Schmukler. 2003. “Crisis and Contagion in East Asia: Nine Lessons.” *Eastern Economic Journal* (forthcoming). [*Policy Research Working Paper* No. 2610 (June), World Bank, Washington, DC.]

Kawai, Masahiro and Shinji Takagi. 2000. “Proposed Strategy for a Regional Exchange Rate Arrangement in Post-Crisis East Asia.” *Policy Research Working Paper* No. 2502 (December), World Bank, Washington, DC.

Kawai, Masahiro and Shujiro Urata. 2004. “Trade and Foreign Direct Investment in East Asia.” Gordon de Brouwer and Masahiro Kawai, eds., *Economic Linkages and Implications for Exchange Rate Regimes in East Asia* (forthcoming).

Kenen, Peter B. (2001) *The International Financial Architecture: What's New? What's Missing?* Washington DC: Institute for International Economics.

Krueger, Anne. 2002. "New Approaches to Sovereign Debt Restructuring: An Update on Our Thinking," paper presented to a conference on "Sovereign Debt Workouts: Hopes and Hazards" (April 1), Institute for International Economics, Washington, DC.

Kuroda, Haruhiko and Masahiro Kawai. 2002. "Strengthening Regional Financial Cooperation in East Asia." *Pacific Economic Papers*, 51 (October).

Krumm, Kathie and Homi Kharas. 2003. "Overview." Kathie Krumm and Homi Kharas, eds., *East Asia Integrates: A Trade Policy Agenda for Shared Growth* (Washington, DC: World Bank), pp. xv-xliv.

Lloyd, Peter. 2002. "New Bilateralism in the Asia Pacific." *World Economy*, 25 (9), September 2002, pp. 1279-1296.

McCauley, Robert N., San-Sau Fund, and Blaise Gadanecz. 2000. "Integrating the Finances of East Asia." *BIS Quarterly Review*, December, pp. 83-95.

Organisation for Economic Co-operation and Development (OECD). 2003a. *Harmonizing Donor Practices for Effective Aid Delivery, DAC Guidelines and Reference Series*. Development Assistance Committee, Paris.

Organisation for Economic Co-operation and Development (OECD). 2003b. *Regionalism and Multilateral Trading System*. Secretary General, Paris.

Pangestu, Mari and Sudarshan Gooptu. 2003. "New Regionalism: Options for East Asia." Kathie Krumm and Homi Kharas, eds., *East Asia Integrates: A Trade Policy Agenda for Shared Growth* (Washington, DC: World Bank), pp. 39-57.

Radelet, Steven and Jeffrey D. Sachs. 1998. "The East Asian Financial Crisis: Diagnosis, Remedies, Prospects." *Brookings Papers on Economic Activity*, 1: 1998, pp. 1–90.

Radelet, Steven and Jeffrey D. Sachs. 2000. "The Onset of the East Asian Financial Crises." Paul Krugman, ed., *Currency Crises*, pp. 105-153.

Rapkin, David P. 2001. "The United States, Japan, and the Power to Block: the APEC and AMF Cases." *Pacific Review*, 14:3 (August), pp. 373-410.

Ravenhill, John. 2001. *Asia Pacific Economic Cooperation: The Construction of Pacific Rim Regionalism*. Cambridge: Cambridge University Press.

Sachs, Jeffrey. 1998. "The IMF and the Asian Flu." *American Prospect*, 37, March-April, pp.

16-21.

Sakakibara, Eisuke and Sharon Smith Yamakawa. 2001. "Regional Integration in East Asia: Challenges and Opportunities." Mimeographed (December). Global Security Research Center, Keio University, Tokyo.

Stubbs, Richard. 2002. "ASEAN Plus Three: Emerging East Asian Regionalism?" *Asian Survey*, 42:3, May/June, pp. 440-455.

Summers, Lawrence H. 2000. "International Financial Crises: Causes, Prevention, and Cures." *American Economic Review (AEA Papers and Proceedings)*, 90:2, May, pp. 1-16.

Terada, Takashi. 2003. "Constructing an 'East Asian Concept' and Growing Regional Identity: From EAEC to ASEAN+3." *Pacific Review*, 16:2, pp. 251–277.

Wong, John and Sarah Chan. 2003. "China-ASEAN Free Trade Agreement: Shaping Future Economic Relations." *Asian Survey*, 43:3 (May/June), pp. 507-526.

World Bank. 1998. *East Asia: The Road to Recovery*. Washington, DC.

World Bank. 2000. *East Asia: Recovery and Beyond*. Washington, DC.

Yoshitomi, Masaru and Sayuri Shirai. 2000. "Policy Recommendations for Preventing Another Capital Account Crisis," Technical Background Paper (July 7), Asian Development Bank Institute, Tokyo.

Yusuf, Shahid, et.al., eds., *Innovative East Asia: The Future of Growth*. 2003. (Washington, DC: World Bank).