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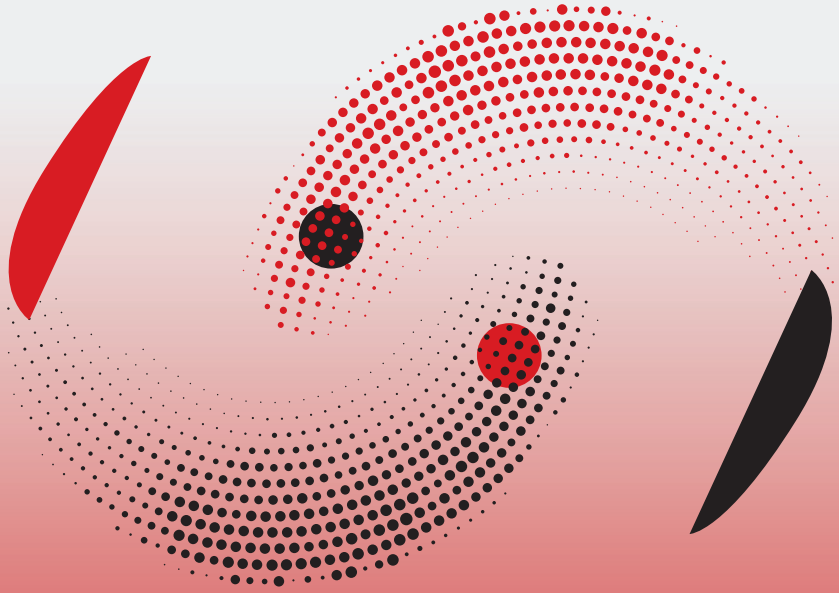

Regional Cooperation and Economic Integration in Asia

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VI

Iwan J Azis

RCI in Asia - Quo Vadis?

1. Introduction

Asia's regional cooperation and integration (RCI) has been progressing steadily albeit gradually, and it has been following the standard sequence where trade integration has advanced more than financial integration. Unlike in Europe, this progress occurred without strong regional institutions, an extensive regional structure, or a single currency. While that has served the region well, however, I argue that new emerging challenges – especially after the 2008 Global Financial Crisis (GFC) – warrant some rethinking on the next steps for Asia's RCI.

Two challenges are particularly highlighted: falling growth in productivity and growing risks of financial instability. For the former, premature deindustrialization is identified as a major reason. For the latter, the ineffectiveness of existing regional financial cooperation to provide financial safety nets is the reason why global uncertainty can be costly especially in an increasingly interconnected world of finance.

The nature of cooperation and the trend of integration are analyzed by neither treating the two equally nor using them interchangeably. The discussions on the challenges for Asia's RCI are put in the context of prevailing concerns that I believe the region needs to focus on. For that purpose, two simple concepts related to RCI are first highlighted.

2. Cooperation-Integration and Benefits-Risks

Although the terms 'cooperation' and 'integration' are related and often used interchangeably, they are not the same. One reason for the confusion is that both reflect the unification of economic policies between different states or economies. When two or more countries agree to build a joint infrastructure project, it requires cooperation from which mutual benefits can be reaped (for example, cross-border roads, power generation, railroad and other measures to strengthen connectivity). In trade, a regional policy may take the form of a partial or full abolition of tariff and non-tariff restrictions to allow greater cross-border flows of goods and services. In finance, countries may cooperate to harmonize rules and standards to attract more financial flows between them. All these measures are expected to deepen the RCI.

But not all regional cooperation is intended for, or will result in, greater integration. Cooperation to secure financial stability by providing a pool of resources in a time of crisis is a notable example (discussed in more detail later). On the other hand, not all integration is the result of regional cooperation. Asia displays a prominent example in this regard. The region's strong trade and growing financial integration has been largely due to domestic, unilateral policy rather than regional cooperation through free trade agreements (FTAs) and regional financial arrangements. A simplified typology of RCI with some examples is depicted in Figure 1.

Figure 1: Benefits and Risks of Integration

	Cooperation	*Non-Cooperation*
Integration	*Infrastructure/ Connectivity*	*Unilateral Trade Liberalization (Regional Production Network)*
Non-Integration	*ABMI & Regional Financial Safety Net (CMIM)*	*Unilateral Financial Liberalization*

ABMI stands for Asian Bond Market Initiatives; CMIM stands for Chiang Mai Initiative Multilateralized

Source: Author's construction

Another concept often overlooked are the risks or downsides of integration. While integration promises benefits, like any strategy it can also produce some downsides. A balanced view of integration is therefore needed (Azis, 2015).

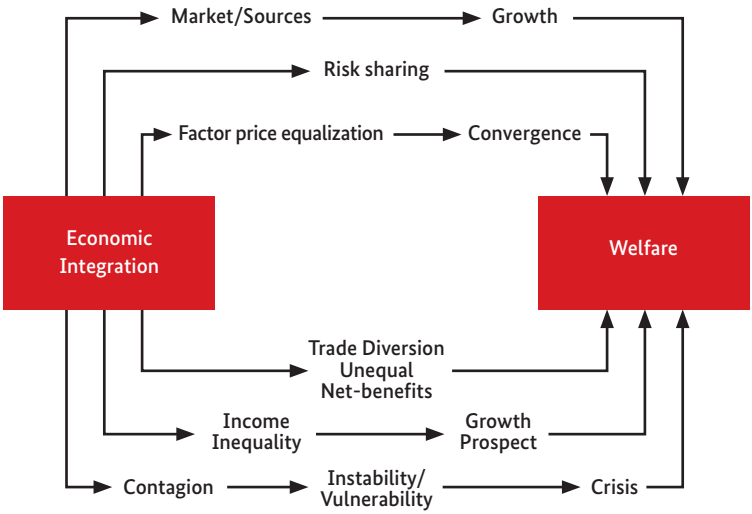
Expanding markets and input sources beyond national boundaries are some of the most compelling arguments for integration. With expanded markets for both inputs and outputs, economies in the region can produce stronger growth and improved welfare (Figure 2). Integration also helps to make resource allocation more efficient, although it may not generate the same level of benefits for all (distribution of benefits matters; see Venables 2009). Another potential benefit of regional integration is (the chance) to reduce income disparity between member countries, among others through equalization of factor returns. The income convergence can come from the diffusion of common development policies, regulations, and common rules. Through integration, risks can also be shared, although perfect risk sharing is unlikely as the quality of institutions and the degree of openness to capital flows differ between countries.

But integration can be risky too. One of the major risks is its likelihood to exacerbate contagion in times of crisis. Examples abound where financial crises rapidly spread from one country to another, especially when integration is deeper. Another risk is trade diversion. It occurs when prioritized sectors have a comparative advantage relative to partner countries but not globally.[105] To the extent that market competition and labor-capital balance of power is a key determinant of income inequality, integration can also worsen income inequality within countries (see again Figure 2) by way of increasing wage competition between workers.[106]

105 The trade-off between trade creation and trade diversion [?] is often used to back north-south trade-off between trade creation and trade as south-south arrangements are more prone to trade diversion.

106 While both globalization and regional integration will increase market competition, labor markets expand more readily and are more competitive within regions than between regions. Consequently, firms can more easily exercise control over subsidiaries within than between regions. Political institutions are also more similar within than between regions.

Figure 2: **Benefits and Risks of Integration**



Source: Iwan J Azis (2015) 'Integration, Contagion, and Income Distribution,' in Nijkamp, Peter; Rose, Adam, Kourtit, Karima (Eds.) Regional Science Matters, Springer

3. Asian RCI and Its Progress

Asia represents an extreme form of diversity. It is the home of rich and poor economies, each with their own idiosyncratic set of assets and liabilities. The diversity – also in non-economic factors – is far greater than that in the European Union (EU) and the North American Free Trade Area (NAFTA). On paper, therefore, Asia is not an ideal case for RCI. In reality, however, that depends on what goals RCI is expected to achieve. If intended to reach a singular fixed set of beliefs, as in the case of the EU, a heterogeneous region like Asia is indeed not an ideal case for RCI. But that is hardly the goal of cooperation in Asia.

Most cooperation in the region has been intended to manage the existing diversity, not to form 'One Asia.'[107] In almost all areas of cooperation, one finds components that would ensure a level playing field first before applying the same set of rules to all parties. Thus, in trade cooperation, economies with high tariffs can take more time to prepare for the enabling environment to settle before committing to lower tariffs. Institutional and financial supports such as aid for trade have also been used. In financial cooperation, less developed members are given some provisions to strengthen their capital market before being treated the same as others. In public good and other infrastructure, special provisions are also granted to the less developed members.

While numerous economic cooperation initiatives have been established, only a few are effective in the sense of producing concrete and tangible benefits to members. Indeed, Asia's economic performance and integration have been driven more by the individual countries' unilateral policy rather than regional policy. In most areas of progress, formal and strong regional institutions are absent. And that is deliberate. For decades that has served the region well.

What about Asia's integration? The region's interest in integration was commensurate with the widespread adoption of liberalization policies embraced by many countries around the world during the 1980s. Even with limited formal cooperation, economies in Asia have been steadily integrating. In the case of trade, cross-border flows of exports and imports began to show a marked increase after the 1997 Asian Financial Crisis (AFC). The integration process has intensified since countries in East and Southeast Asia have become part of global supply chains and production networks. Electronic components produced in the Philippines are exported to Thailand from which they make hard disks that will be exported to China to be installed in a final form of computers. These computers are then exported to the rest of the world, including Asia, the U.S., and Europe. Such a classic example also applies to other items like textile and apparel, electronics, automotive, and other consumer products.

107 This is unlike in the European case where individual sovereignty would be a thing of the past. As remarked by a former Vice President of the European Commission, Viviane Reding 'We need to build a United States of Europe with the Commission as government and two chambers.'

The whole process not only boosted Asian integration but also made the region's trade more efficient and growth more robust. As a result, over the course of three decades, emerging Asia's share of world GDP surged from 10% to 30%, enabling the region to lift half a billion people out of poverty. During the GFC, about two-thirds of global growth came from the region.

As the process continued, however, global imbalances emerged. By the mid-2000s, Asia's current account surplus reached almost half of global surpluses, while current account deficits in the U.S alone reached an all-time high at 70% of the total global deficits. Imbalances between saving and investment (excess savings in Asia and deficits in the U.S) also increased. The resulting capital inflows from Asia that flocked into U.S government bonds despite bonds' low returns helped 'finance' the U.S deficits. On the other hand, through the operation of global banks, U.S private investors invested large sums of money into Asia (round-tripping capital flows, see Azis 2016).[108]

When the GFC broke out, tensions flared. Asia was accused of helping to trigger the crisis by creating 'saving gluts,' and the U.S was blamed for creating 'global bank glut' where sub-prime loans grew rapidly with little oversight and the investment and global banks were allowed to intermediate such loans (see p10 in Azis, 2016).

In terms of integration, following the GFC, cross-border trade within Asia jumped again, a repeat of what happened during the post-1997 crisis. This led some to conjecture that Asian integration is crisis-driven in nature. Falling demand of advanced economies following the GFC surely contributed to such a trend, but the fact that the value and volume of intra-Asian trade have also increased suggests something else. As trade between Asia and other emerging markets in Africa, Europe, and Latin America also surged, the interest in 'South-South trade' was renewed.

The fact that rising trade integration coincided with the proliferation of FTAs involving Asian countries, however, does not necessarily imply causality. Most surveys show that the utilization of FTA facilities

108 This was like recycling of petrodollars in the 1970s/1980s, when the oil-related surge in savings in oil-producing countries was channeleds to Western countries.

has been limited, suggesting that Asia's growing trade and integration has been largely driven by unilateral liberalization, not by regional policy. For example, a survey conducted by the Economist Intelligence Unit shows that the average utilization of FTAs in ASEAN (Association of Southeast Asian Nations) is only around 26% (EIU 2014). The complexity of rules and agreements and a low margin-of-preference are cited as the top reasons for such a low utilization rate. Yet, the region's trade has been growing robustly.

In the financial sector, Asia is less integrated. The region's cross-border investment in equity markets is less than a quarter of the total, and only 16% in the bond market. Asia's finance has always been more integrated with economies outside the region, particularly with the advanced economies. US investors dominate in the equity market, Europeans are major investors in Asia's bond market. Some argue that higher efficiency would have been attained if the sector were regionally more integrated, and this should be the aim. While indeed this is what most standard textbooks suggest, I beg to differ.

Take the case of the bond market. Among ASEAN+3 countries (10 ASEAN members plus Japan, China, and Korea), cooperation has been established through the Asian Bond Market Initiative (ABMI) since 2002. The initiative has helped to develop the domestic bond market in member countries especially those where the capital market is still in its infancy. That by itself is a positive development and is consistent with the characteristics of Asian cooperation. The fact that cross-border bond flows in the ASEAN+3 subregion remain small (around 10%, smaller than in Asia as a whole) should not be a reason for concern. If anything, that reflects the market risk and returns consideration. It may have also saved the region from a nasty contagion that would have led to a crisis during the market turbulence like in 2013 (taper tantrum episode).[109] Rather than targeting cross-border investment, the cooperation should continue to focus on

[109] *Following the Federal Reserve's announcement on May 22, 2013, that it would begin tapering back its MBS program, Asian markets rattled especially in those countries where the financial sector was more integrated and the inflows of capital since 2009 were quite massive.*

harmonizing rules and standards to let regional investors feel comfortable to invest in the region. But at the end, they should be free to decide where to invest. There should neither be a target or aim to increase intra-Asian flows of bond investment.

Given a set of fundamental changes in the global economic and financial conditions, however, RCI and the related progress in Asia may have to face new challenges, one of which is a slowing growth in productivity.

4. Slowing Productivity Growth

The growth of total factor productivity (TFP) in Asia has not been exemplary. Depicted in Figures 3A, 3B, and 3C the trend shows that after suffering from a fall in the per-capita GDP and TFP growth during the AFC, the region managed to recover in the early 2000s. With the more intensive use of capital, the TFP growth re-accelerated since 2002/3, at almost double the rate before the AFC.[110]

Growing trade and foreign direct investment (FDI) significantly contributed to such accelerating growth. But the TFP growth tumbled again during and after the GFC. Although weak global demand has surely played a role, persistently low spending on infrastructure combined with languishing reforms made the deceleration unusually sharp.

110 This, however, is mostly a China (and to some extent India) story, where rapid capital accumulation accompanied reforms and reduced distortions in product and factor markets, higher spending on research and development (R&D), rising numbers of patents, and further economic opening to foreign capital and international trade. If you exclude China, Japan, and India, the productivity recovery is less dramatic. In the case of labor productivity, the growth rate never recovered from the AFC shock.

Figure 3A: Percent Growth of GDP/Cap: Asia

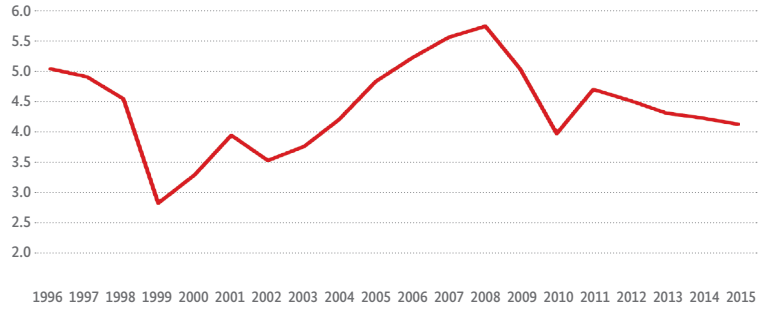


Figure 3B: Percent Growth of Labor Productivity: Asia

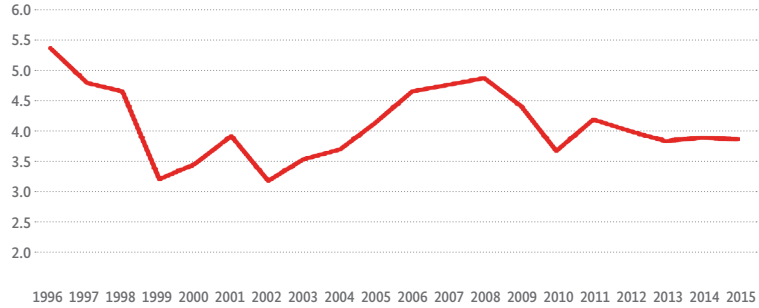
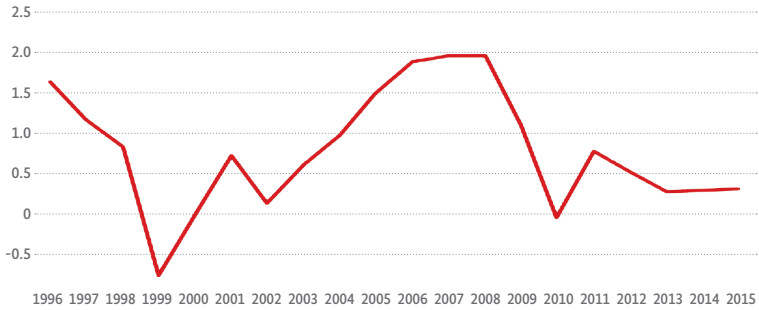


Figure 3C: Percent Growth of TFP: Asia



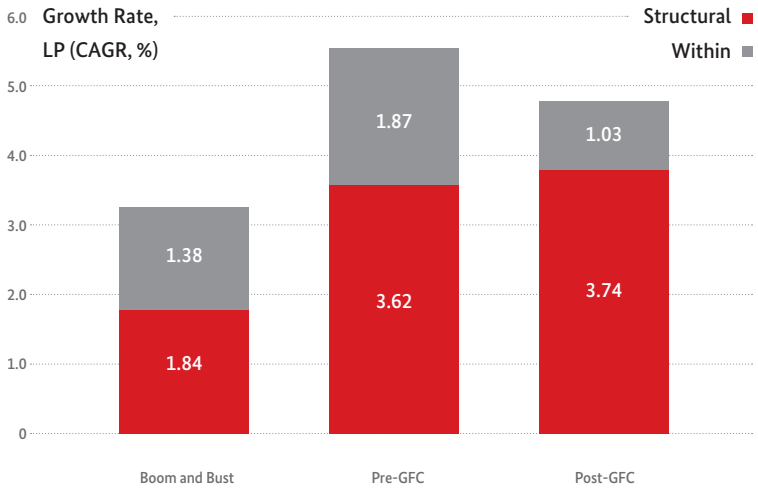
Breaking down labor productivity into 'within' and 'structural' components, and classifying observations into three phases—boom-and-bust, pre-GFC, and post-GFC— Figure 4 shows that the region did relatively well during the pre-GFC period.[111] This was supported by a more productive use of capital, where the increase of factor proportions occurred along with an accelerated TFP growth (note that the 'structural' component share was relatively high—1.87 out of 5.49 or 34% during the period). Strong FDI inflows, trade, and growing regional integration enabled many economies to adopt a better technology, enhance human resources, and expand existing industries or create new ones. However, a reversed trend occurred in phase-3, where the 'within' component actually increased but such an increase failed to offset a rather sharp decline in the 'structural' component such that the overall labor productivity fell.

The latter highlights the importance of structural reform which has been either languishing or non- growth-enhancing in some countries. Even when productivity improved in certain activities, the improvements did not spill over to the rest of the economy. Economy-wide productivity takes place only when the fast-growing sectors are where the productivity growth is most rapid.[112]

111 *Rapid capital sectoral composition is mostly a China (and to some extent an India) story. In China, some sectoral composition changes without altering sectoral productivity. When the first component dominates and aggregate productivity growth decelerates, it indicates that improvements in selected sectors fail to diffuse to the rest of the economy; productivity improvements remain isolated in those sectors. On the other hand, when reforms lead to a marked shift in sectoral share with little changes in each sector and aggregate productivity growth decelerate, these concepts are useful to guide policy. For example, resource allocation and structural reforms following trade liberalization may boost aggregate productivity (a positive contribution of the 'structural' component). But when adversely affected industries expand, and unproductive industries continue to exist due to the difficulty to 'exit', the 'within' component has a negative effect on productivity.*

112 *Size also matters. If the sectors are relatively small, the aggregate picture depends on the productivity trend of other sectors. If they are large, there is still a chance that the aggregate productivity will improve—especially if those positive ingredients in a sector's productivity enhancement are effectively diffused to the rest of the economy.*

Figure 4: **Breakdown of Labor Productivity: Asia**



Notes:

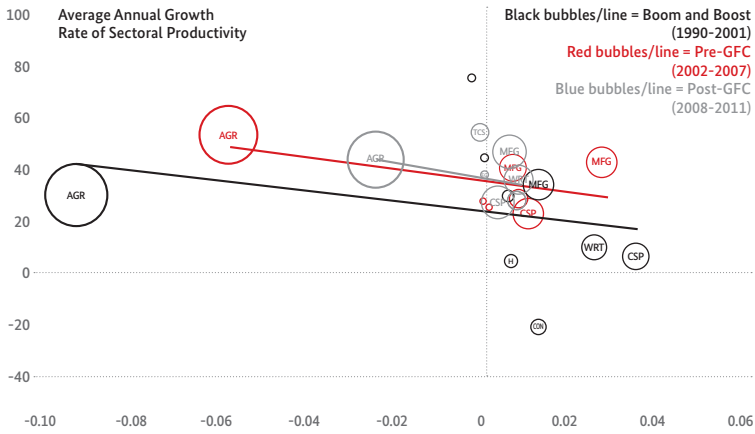
CAGR = compound annual growth rate.
Boom and bust = 1990-2001; Pre-GFC = 2002-2007; Post-GFC = 2008-onward

Source: Calculated based on data from APO; and 'Timmer, Marcel P. and Gaaitzen J. de Vries (2009), "Structural Change and Growth Accelerations in Asia and Latin America: A New Sectoral Data Set" Cliometrica, vol 3 (issue 2) pp. 165-190.'

In Figure 5, the trend indicates that the fast-growing sectors in several Asian economies were not those experiencing rapid productivity improvements. In some cases, a shift from manufacturing to services was accompanied by a fall in the aggregate productivity growth because the expanding services were mostly of the low-end type that have contributed only marginally to low productivity growth (retail trade, construction,

and informal activities).[113] In other cases, services with rapid productivity growth (for example, telecommunication and transport) did not expand fast enough for their share in the economy to expand. Although in general, the productivity growth in agriculture and transport improved, their share in the economy declined. On the other hand, the share of activities with lower productivity growth increased (Figure 6).[114]

Figure 5: Sectoral Growth and Productivity Growth: Asia 1990–2011



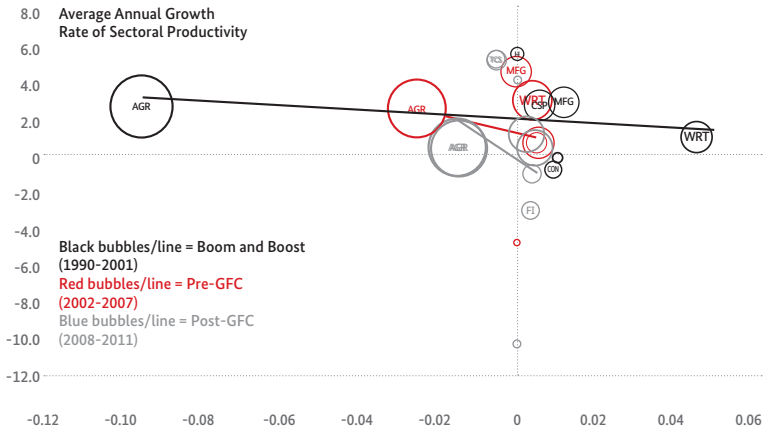
Notes:
1. Size of circle represents employment share in: 1990 (red bubble); 2002 (green bubble); 2008 (blue bubble). Growth rate uses CAGR.

Source: Calculated based on data from APO and Timmer, Marcel P. and Gaaitzen J. de Vries (2009).

113 While it is difficult to have a precise measure of productivity in the service sector, it is widely acknowledged that the bulk of the services sector in many developing countries constitutes retail trade, informal and self-employed activities with dismal conditions and low productivity.

114 Apart from China, Japan, and India, the productivity growth in social services, construction, and finance had been slow, yet expanded faster than transport and manufacturing. All these contributed to decelerating aggregate productivity growth.

Figure 6: Sectoral Growth and Productivity Growth: Asia ex-Japan, China, India 1990–2011



Notes:
Post-GFC: Slow productivity growth sectors (CON, FI) grew faster compared to fast productivity growth sectors (TCS, EGW). Pre-GFC vs post-GFC: sectors whose labor productivity decelerated are those that grew faster (MFG and WRT); while those whose labor productivity accelerated grew slower (TCS, EGW).

Source: Calculated based on data from APO and Timmer, Marcel P. and Gaaitzen J. de Vries (2009).

2. Abbreviations: AGR = Agriculture, Hunting, Forestry and Fishing; MIN = Mining and Quarrying; MFG = Manufacturing; EGW = Electricity, Gas and Water Supply; CON = Construction; WRT = Wholesale and retail trade, hotels and restaurants; TCS = Transport, communication and storage; FI = Financial Intermediation, Real Estate, Renting and Business Activities; CSP = Community, Social and Personal services.
3. Post-GFC: The share of AGR and TCS continued to fall despite its faster productivity growth, while the share of most other sectors with lower productivity growth increased (WRT, CON, CSP). Pre-GFC vs Post-GFC: some sectors whose labor productivity accelerated are those that did not grow fast (MFG, TCS and CSP).

Together with domestic measures, regional policy through RCI could help alter such a dismal trend. Increased connectivity either through infrastructure, harmonized regulations, or trade, allows countries to take advantage of the economies of scale arising from large-scale investment with shared costs. The resulting lower costs on inputs can boost productivity.

Another challenge for Asia's RCI is how to make the existing regional financial safety nets work more effectively. Given the current global economic and financial conditions, the risk of a crisis driven by financial contagion cannot be underestimated. This is where safety nets are needed. Some countries learned the hard way during the AFC. During the 2008 GFC and the subsequent European crisis, Asia experienced financial contagion again. What is striking is, in the latter case, the affected asset market in one Asian country generated spillovers not only in the same market but also in other asset classes in other Asian countries (Azis et.al, 2013). The effect would have been more severe had the region's financial sector been more integrated.

Realizing the danger of contagion and given the unfortunate experience with the IMF policies during the AFC, in the early 2000s authorities of ASEAN+3 agreed to cooperate to establish a mechanism known as the Chiang Mai Initiative (CMI), later renamed Chiang Mai Initiative Multilateralized (CMIM). It followed from an earlier idea to set up an Asian Monetary Fund (AMF), a proposal that was shelved because of the opposition by the US and the IMF. China was also not supportive at the time, albeit for a different reason.[115] The episode did not stop the group from establishing the CMI by expanding the swap arrangements among ASEAN countries to include Japan, China, and Korea.[116]

When the CMIM announced in 2010 that the agreed amount of swap arrangements had been raised from USD 90 billion to USD 120 bil-

115 Hong Kong-based The Asia Time Online wrote in an editorial published several days after the ASEAN+3 Finance Minister Meeting in 2000 in Chiang Mai, Thailand: 'The idea that the existence of a currency swap arrangement or the wider concept of an Asian monetary fund [...] could have prevented the Asian crisis or the worst of it, is both wrong and politically noxious.'

116 The proposal also stipulates the importance of regional surveillance and monitoring, particularly of capital flows, and the need to complete a network of Bilateral Swap Arrangements (BSA) that would provide liquidity support for member countries when needed.

lion, ASEAN+3 authorities correctly stressed the importance of enhancing market confidence and collaborating with the IMF on the surveillance work.

ASEAN+3 officials also agreed to set up an independent regional surveillance unit, the ASEAN+3 Macroeconomic Research Office (AMRO). The unit, located in Singapore, officially became an international organization only in early 2016. This marked the region's first step toward institutionalizing financial cooperation, an early form of an Asian Monetary Fund. While on the surface things looked promising, in practice the effectiveness of it was highly questionable because of inconsistency and an absence of real cooperation.

The most serious flaw in the arrangement was the decision to link the provision of the CMIM facility with the IMF (also known as the 'IMF-link'). Only 20% of the CMIM borrowing quota can be taken by member countries without linking it to an IMF program. This was an obvious inconsistency with the raison d'être of CMIM. Given the short-term nature of the facility (90 days), and recognizing the fact that the effect of any attached conditionality would be much longer, the link made no sense. More seriously, the fact that the stigma against the IMF remains widespread in Asia suggests that those who made the arrangement clearly did not expect the CMIM facility would ever be used or implemented. The sincerity of ASEAN+3 to provide a regional financial safety net was seriously questioned. No wonder rather than using the CMIM facility, member countries opted for bilateral swaps, including with non-members.[117]

The decision in 2011 to raise the committed amount and the IMF de-linked portion to USD 240 billion and 30s%, respectively, did not do much to counter the doubt.[118] First of all, the committed amount is not more than 5% of the group's total foreign reserves, and until now that

117 For example, during the heightened financial stress in 2008, Korea and Singapore each requested the US Federal Reserve for USD 30 billion 'swap' lines of credit. Even ASEAN members preferred to use the bilateral swap arrangements instead of the CMIM facility.

118 They also agreed to lengthen the maturity of both the IMF-linked and IMF-delinked portion, i.e., from 90 days to 1 year, and from 90 days to 6 months, respectively. Similarly, the supporting period was lengthened from 2 years to 3 years, and from 1 year to 2 years, respectively. At the same time, they also introduced a crisis prevention facility extending it from 90 days to 6 months.

amount has never been increased. On the de-linked portion, when the announcement was made it was clearly stipulated that if conditions warrant, the IMF de-linked portion would be raised to 40% in 2014. In reality, this never happened. Not a single change has been made until today, not even the explanation of what conditions that warrant a change.

Some argue that the facility was designed to be used by only selected ASEAN countries; certainly not for the '+3.' Hence, the committed amount and conditions were considered sufficient. This argument is flawed at least on two fronts. First, it is inconsistent with the whole concept of cooperative efforts to deal with a potential contagion. To assume that a crisis in one ASEAN country will not affect the '+3' is not different from saying that financial contagion will never happen even in an increasingly interconnected world. The fact is, the region or the world for that matter is now far more interconnected than before. Think about Europe. Does it make sense if the liquidity support facility in the Eurozone area is intended only for Greece and not for other members like Spain and Italy? As it is now, the CMIM represents nothing but the interests of a group of 'givers' and 'takers', far from representing a true cooperation.

One cannot help but think that complacency is the likely explanation for a lack of seriousness to make the system work more effectively. Such complacency seems strengthened by the fact that foreign capital continues to flow into the region as the conditions and growth in Europe and the U.S remain lethargic. Indeed, financial troubles in advanced economies since 2008 have so far provided 'good luck' for ASEAN+3 as a group through massive capital inflows coming to the region. But with an uncertain prospect of the global economy and financial conditions, it is ill-advised for ASEAN+3 to push the luck too far.

5. Final Remarks

Openness and technological progress have fostered economic integration around the world. But experiences differ between regions. While the extent of the benefits and risks of integration in Asia is not the same as in other regions, the nature and characteristics of cooperation are also different. So are the speed and the intensity of integration. Some but not all cooperation in Asia has led to increased integration, and not all integration taking place in Asia is the result of regional cooperation.

The region's progress and steady increase of integration have mostly been supported by unilateral – not regional – policy. Even in China's 'One Belt, One Road' strategy that will involve 65 countries with a total population of 4.4 billion by building infrastructure and boosting financial and trade ties, the proposed projects are in practice initiated bilaterally rather than going through formal regional arrangements.

As in other regions, Asia's trade integration has advanced more than financial integration. Regional cooperation is largely directed towards managing the existing diversity rather than creating 'One Asia' or achieving a singular fixed set of beliefs as in the case of the EU. The absence of formal and strong regional institutions is deliberate, and it has served the region well. However, new developments and changes in global conditions pose some serious challenges that warrant a rethink about the next steps of RCI.

Two of such challenges highlighted in the paper are slowing the growth of productivity and increased risks of financial instability. The former requires closer cooperation to strengthen the connectivity that allows countries to reap the benefits from economies of scale by strengthening the manufacturing sector and avoid premature deindustrialization. The latter calls for a revamping of thinking about the risks of financial contagion and more effective regional financial safety nets.

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