

Emerging Asian Regionalism

A Partnership for Shared Prosperity

Executive Summary

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Asia's economies are increasingly vital to each other—and to the world. Asia's output today roughly equals that of Europe or North America, and may well be 50% larger than theirs will be by 2020, in terms of purchasing power parity. The challenge for a prosperous and interdependent Asia is to strengthen and spread the benefits of regional cooperation while playing a substantial, constructive role in global economic leadership.

As Asia's economies have grown larger and more complex, they also have become more integrated—through trade, financial flows, direct investment, and other forms of economic and social exchange. Today, Asia trades about as much with itself as Europe and North America do with themselves. This study found that six measures of interdependence tracked for 16 major Asian economies have increased markedly since the 1997/98 Asian financial crisis. And a survey conducted for the study found that the region's opinion leaders welcome this interdependence and place a high priority on regional cooperation and integration.

Where markets lead, governments are following. The 1997/98 crisis underscored Asia's integration and shared interests and exposed weaknesses in the global policy architecture. The crisis gave impetus to emerging Asian regionalism and has already led to major intergovernmental initiatives. But Asia's official cooperation is still nascent. In time, Asia's institutions will need to address a wide range of problems that cannot be adequately handled by markets. The challenges include providing regional public goods, managing spillovers among economies, exercising Asia's influence in global economic forums, liberalizing trade and investment, and helping to improve national policies in which the region has a vital stake. Regional cooperation should not be pursued as a goal for its own sake, but as a tool for coping with the consequences of interdependence.

Dynamic and outward-looking Asian regionalism, consistent with the region's diversity and mindful of its stake in open global markets, will help to stabilize and power the world economy. Such regionalism is in everyone's interest. Indeed, in the global economic slowdown that is unfolding as this study goes to press, Asian cooperation—particularly on financial sector and macroeconomic policies—could provide an early example of Asia's growing capacity to contribute to economic progress both regionally and globally.

Integrating production

Asia's trade and investment ties are particularly advanced, and the regional integration of production has become central to Asia's leadership in global manufacturing. As production chains are broken into smaller steps, with each step produced in the most cost-efficient location, Asia's interconnectivity has become a key asset in attracting global investment and production. Asia is endowed with major production advantages—large and diverse labor forces, ample investment resources, and advanced technological capabilities—and can combine them efficiently due to low trade barriers and well-developed transport and communications links. Asia's intraregional trade has increased sharply, with parts and components trade playing an especially large role. The People's Republic of China (PRC) is often the hub of such production networks, but most regional economies participate in them. Asia's efficient production system is also closely tied to the global economy: a large share of the region's final goods exports is ultimately destined for European and North American markets.

The challenge for regional cooperation is thus twofold: to support the integration of Asia's production networks and to sustain an open, rules-based global system of trade and investment. This argues for using the region's influence vigorously to ensure the continued development of the global trading system. Yet with the World Trade Organization's Doha round deadlocked, many Asian economies have also turned to negotiating bilateral and plurilateral free trade agreements (FTAs). Substantial gains could be realized from consolidating the many FTAs into a single, region-wide one and from adopting best practices to guide future regional and subregional FTAs. Fostering integration to connect the region's economies also requires further investments in cross-border infrastructure—transport, communications, and energy systems.

Integrating financial markets

Asia is less integrated in finance than in trade. However, its financial markets are larger, deeper, and more sophisticated than they were a decade ago, and its legal and regulatory frameworks have improved. By several measures, Asia's financial integration has also progressed. However, most Asian funds are intermediated through distant global markets, despite the region's large savings and ample investment opportunities. A surprisingly low share of Asia's financial resources is invested in Asian assets. Deeper financial integration will depend on further improvements in the region's financial systems, including regulatory structures that generate confidence in financial institutions and protect investors. These improvements could lead to a virtuous cycle: greater investments in regional markets, including by Asian investors, would generate new products and services that make markets more efficient and attractive. Such a virtuous cycle could benefit many sectors, notably small and medium-sized enterprises, infrastructure development, and households.

Regional financial cooperation has increased markedly since the Asian financial crisis, notably through innovations such as the Asian Bond Markets Initiative (ABMI) and the Asian Bond Funds (ABF). But weaknesses remain. An immediate priority is to strengthen supervision, surveillance, and dialogue on financial markets; to this end, consideration should be given to creating a new, high-level "Asian Financial Stability Dialogue" to bring together finance ministries, central bank authorities, and other supervisors and regulators. This new institution would be useful to address financial market vulnerabilities and regulations, and to engage in dialogue with the private sector. Other priorities include steps toward the harmonization of financial regulations and the adoption of minimum standards that permit early mutual recognition of the standards, at least among subsets of economies. It will be also important to deepen and expand the ABMI and ABF, and to build a strong regional infrastructure for payments, settlement, and information exchange systems. And efforts should intensify to make national financial systems more efficient through the measured and prudent liberalization of capital accounts and cross-border financial service flows where these are still controlled.

Managing macroeconomic interdependence

With the growth of trade and financial ties, Asia's macroeconomic interdependence has also increased. The region's sensitivity to regional output shocks is rising and there is evidence of converging price movements. Over time, these trends are likely to reduce the extent to which Asia's economies are interconnected with those of Europe and North America, but so far the region's sensitivity to global shocks remains significant. Asia's macroeconomic policy settings currently show little evidence of cooperation—the region's strong and stable macroeconomic results in recent years reflect, in part, a favorable global environment. A challenging period may lie ahead. Global payments imbalances that appear increasingly unsustainable must be resolved. This will require major adjustments around the world; in Asia, it will mean reorienting output from exports outside the region to consumption and investment within it. And these shifts may need to occur rapidly if, for example, the current credit market turmoil and global slowdown deepen. The shifts could also be associated with large and potentially disruptive exchange rate adjustments. The challenge to Asian policy makers is to monitor global and regional developments closely, and to be prepared to act together if region-wide responses are appropriate.

Given its interdependence, Asia would benefit from strengthening its mechanisms for monitoring and potentially coordinating macroeconomic and exchange rate policies. Consideration should be given to a new central structure—such as an “Asian Secretariat for Economic Cooperation”—to support these and other functions with qualified, permanent staff. The current Economic Review and Policy Dialogue under the ASEAN+3 process should be further strengthened with agreements on the tools, indicators, and standards used to monitor economic activity. Governments might also explore early initiatives in policy coordination—for example, through ad hoc actions to manage a particular wave of exchange rate adjustments against third currencies, perhaps first by a subset of economies. To provide stronger tools for times of crisis, the Chiang Mai Initiative, the region's short-term financing facility, should be enhanced by making its arrangements multilateral and by easing constraints on their activation. The Secretariat could oversee the region's pooled foreign exchange resources and, in a crisis, negotiate economic policies with governments seeking support.

Making growth inclusive and sustainable

Asia's development has had a massive, positive impact on people's lives—most Asian economies have made remarkable progress in reducing poverty. Nevertheless, benefits have failed to reach significant numbers of people; in some countries, progress has lagged, especially on non-income measures; and sharp income disparities have emerged in some countries. Nearly all developing countries in the region share the challenge of making growth more inclusive. The policies that best address these issues are often national in scope, but the challenges also have important regional dimensions. Regional integration fosters inclusive development, both by boosting economic growth and by providing the resources for pro-poor policies. And the least developed countries in the region typically gain the most from it.

The battle for better lives begins with creating high-productivity jobs. Governments need to connect the poor to the thriving regional economy by eliminating labor market barriers, investing in workers' capabilities, and building infrastructure to connect disadvantaged regions with economic centers. Agricultural trade and aid focused on stimulating trade activities can play an especially important role, as the experience of the Greater Mekong Subregion shows. Rapid economic change also requires cost-effective and innovative social protection systems. And labor migration—within and among countries—can benefit both migrating workers and their hosts. Labor migration also needs to be managed carefully to ensure migrants' rights and to prevent human trafficking and forced labor.

Regional cooperation is equally essential for addressing a range of threats, including epidemics, natural disasters, and environmental degradation. Densely populated and closely integrated Asia needs world-class systems to monitor, prevent, and (if necessary) contain epidemics. It needs to cooperate to make responses to natural disasters faster, more effective, and less costly. And it needs to launch a common regional effort to control a wide range of cross-border environmental problems that are emerging as a consequence of rapid development.

Creating an architecture for cooperation

The case for greater cooperation in Asia is broad, deep, and compelling. The region's cooperative architecture today spans many forums, from subregional to interregional ones. They offer capabilities for addressing issues ranging from technical cooperation (such as on infrastructure projects) to broad global and interregional agreements (such as on information technology). These efforts are often centered on the Association for Southeast Asian Nations (ASEAN), which has a long history of and an advanced framework for regional cooperation. Together, the forums offer a multitrack, multispeed architecture that is well matched to the region's varied challenges and great diversity. This architecture also creates healthy competition among forums to prove their effectiveness.

It is premature to consider firm assignments of institutional functions to specific forums within the architecture—each has distinctive areas of comparative advantage. But ASEAN+3 (ASEAN and the PRC, Japan, and the Republic of Korea) is emerging as an especially useful coordinating unit: it benefits from ASEAN's experience and institutional support, incorporates Asia's three largest economies, and is generally closely integrated. ASEAN+3 is a logical venue for the proposed Asian Secretariat for Economic Cooperation. Asia's integration needs to remain flexible to accommodate groups with different or changing priorities and to absorb new economies and issues into the process. It also needs to focus on physical connectivity to ensure that, for example, the initiatives of ASEAN+3 or the East Asia Summit (ASEAN+3 and Australia, India, and New Zealand) are consistent with infrastructure plans of subregional groups and with the global policy framework emerging in interregional and global forums.

Eventually, Asian economies may have a single market with common regulations, a common currency, and substantial freedom of movement for workers. But immediate policy requires both a long-term vision and pragmatic initiatives that will show early, step-by-step results. Asia is likely to adopt some of the options identified in this study to facilitate integration, to manage its side effects, and to make growth more inclusive and sustainable. Asia's regionalism is becoming more confident in its potential to contribute to both regional and global welfare.

We are witnessing the beginnings of a strong, prosperous, outward-looking Asian economic community, regionally integrated yet connected with global markets, and with responsibility and influence to match its economic weight. Emerging Asian regionalism is a powerful historic force—a partnership for regionally and globally shared prosperity.

Integrating Asia’s regional economic cooperation: an agenda

Themes	Building an Asian economic community: the way forward	
	Priorities	Policy solutions
Integrating production	<ul style="list-style-type: none"> • Enhance investment in and the productivity of regional economies • Strengthen comparative advantage derived from integrated regional production chains • Promote technological upgrading and development of a knowledge economy 	<ul style="list-style-type: none"> • Support the global trading system • Pursue regional cooperation as widely and deeply as possible • Develop guidelines for best practices in subregional trade agreements • Enhance regional connectivity
Integrating financial markets	<ul style="list-style-type: none"> • Increase resilience against financial crises • Develop larger, deeper regional financial markets • Improve returns for investors and reduce capital costs to firms by strengthening the regional intermediation of savings 	<ul style="list-style-type: none"> • Improve financial market surveillance and create an “Asian Financial Stability Dialogue” • Promote consistent standards and mutual recognition • Strengthen financial markets (especially including local currency bond markets) and their infrastructure • Liberalize capital accounts and cross-border financial services prudently
Managing macroeconomic interdependence	<ul style="list-style-type: none"> • Increase macroeconomic and exchange rate stability • Smoothen global economic adjustments, including reallocation of the region’s external savings to regional demand • Increase investment and growth in slower-growing economies 	<ul style="list-style-type: none"> • Make macroeconomic consultation and surveillance more effective by creating an Asian Secretariat for Economic Cooperation • Strengthen Asia’s short-term financing facility (Chiang Mai Initiative) • Cooperate in exchange rate and macroeconomic policy management
Making growth inclusive and sustainable	<ul style="list-style-type: none"> • Reduce poverty and income disparities • Improve social safety nets and provide support for the aged • Fight epidemics and mitigate the impact of disasters • Address environmental issues 	<ul style="list-style-type: none"> • Connect the poor to the thriving regional economy • Develop cost-effective social protection systems • Facilitate and manage labor migration • Protect regional health and safety • Make development sustainable