

**ASIAN ECONOMIC COOPERATION AND INTEGRATION:
SEQUENCING OF FINANCIAL, TRADE AND
MONETARY REGIONALISM**

by

Ramkishen S. Rajan*

July 2004 (*revised version*)

* School of Economics, University of Adelaide, Australia. E-mail: ramkishen.rajan@adelaide.edu.au

This paper was drafted while the author was a Visiting Freeman Scholar at the Department of Economics, Claremont McKenna College (CMC). The author is grateful for the generous support provided by the Freeman Foundation. This paper has drawn partly on previous joint works by the author with Graham Bird and Reza Siregar. The final version of the paper benefited from comments on an earlier draft by Barry Eichengreen, Seiji Naya, Wisarn Pupphavesa, and other participants at the ADB workshop (July 1-2, Manila). The usual disclaimer applies.

1. Introduction

While “Asian economic cooperation and integration” has been a topic of long-standing debate in intellectual and policy arenas, there has been a particular heightening of interest in the subject over the last few years. This is so for a number of reasons. One, are the contagious effects of the Asian economic crisis of 1997-98, along with the perceived inadequate responses to the crisis by multilateral agencies and extra-regional economic powers like the United States (US) and the European Union (EU). Two, are some notable external developments in regionalism, including moves to create a Free Trade of the Americas (FTAAs), and more importantly, the enlargement of the EU and the successful launch of the Euro. Three, is the rapid and sustained growth in, and consequent economic emergence of the People’s Republic of China (henceforth China) and India, and the realization that these two emerging Asian giants have been altering the dynamics of the global economy and will continue to do so for some time to come (Roach, 2004 and Wilson, and Purushothaman, 2003)¹.

Despite the attention paid to the issue of Asian economic cooperation and integration, two fundamental questions have remained unanswered. First, how should one define “Asia” in the context of economic regionalism?² Second, what does one mean by economic cooperation and integration (broadly referred to as “economic regionalism” in this Chapter)?³

¹ See Agarwala (2004) for an overview of Asia’s current and projected significance in the world economy.

² This issue is also briefly noted by De Brower (2004).

³ The term “regionalism” is used in this Chapter in a completely neutral manner. There is no connotation of it implying that the region is “inward-looking” or “protectionist” (i.e. no “fortress Asia”).

With regard to the first question, while everyone would recognize the infeasibility of including all the forty-plus “Asian” members of the Asian Development Bank (ADB) or the UN-ESCAP, even something narrower like the twenty two member Asian Cooperation Dialogue (ACD) Forum may be too broad. As made apparent by the Asia Pacific Economic Cooperation (APEC) Forum, too broad-based a membership will make any sort of Asian economic alliance far too unwieldy and ineffective and susceptible to the “convoy problem”, whereby progress of the economic alliance is limited by the least willing member.

Assuming there is genuine interest in truly pan-Asian as opposed to sub-regional economic cooperation and integration, a logical starting point appears to be the so-called JACIK, i.e. Japan, ASEAN-10, China, India and South Korea. The JACIK would constitute fifty percent of the world’s population and one third of the global national income (in PPP terms) (see Kumar, 2004 and Asher and Srivastava, 2003 and Kumar, 2002). As Low (2004) has noted:

Asian regionalism in real terms has China at the helm...But India is weaving itself in with its “look East” policy...to...(be)..one with ASEAN. With China, India, Japan and not least, Korea for size and impact, plus ASEAN-10 for diversity and some buffer effect, emerging Asian regionalism is a force to be reckoned with at both regional and global levels of trade liberalization (p.19).

ASEAN has negotiated framework agreements for eventual trade pacts with China, India and Japan and will probably do so with Korea soon (Rajan and Sen, 2004). All four are Full Dialogue partners of ASEAN. There is also a high degree of complementarity in development strategies between ASEAN and China (highly dependent on foreign direct investment and labour-intensive manufacturing), on the one hand, and Japan, India and Korea (strong domestic corporations), on the other.

Some proponents of East Asian -- rather than pan-Asian -- cooperation and integration have suggested that Asian economic regionalism ought to be limited to the ASEAN Plus Three (APT) economies (or “JACK” rather than “JACIK”!). Such a view appears to be rather short-sighted for a number of reasons. India has been among the world’s fastest growing countries over the last decade after China. As Huang and Malkini (2003) and Wilson and Purushothaman (2003) and others have recently noted, with India’s favourable demographics and latent potential, if India continues on its path of economic reforms and alleviates some of the supply-side constraints and microeconomic distortions, it will be the best performing major economy over the medium and longer terms⁴. Just as China has become the “factory of the world”, India has become the “back office” to the world. More specifically, India is a leading destination for outsourcing of ICT services, call centre support and other back-end business process operations (BPOs). Outsourcing to India has not only involved low-to-mid skill areas like routine data-crunching tasks, but also more sophisticated and skills-based services including software development, research and development (R&D), financial portfolio analysis, patent writing, and product design and development.

While India’s current extent of economic integration with the APT countries is still rather limited, continued pursuit of India’s decade-long “Look East” policy is rapidly changing this, with countries like Singapore and Thailand engaging much more intensively with India in recent years. Indeed, both these ASEAN members are negotiating bilateral free

⁴ This is not to suggest by any stretch that economic prospects in India are unambiguously rosy. India has a number of pressing economic problems, as do other larger regional countries like China and Indonesia. In India’s case, some of the issues of concern are the growing rural-urban income disparity, insufficient employment generation, high fiscal deficit, unnecessarily high red-tape and poor quality (but gradually improving infrastructure, rigid labour laws, small-scale industries reservation, and need for improvement in governance.

trade agreements (FTAs) with India (Rajan and Sen, 2004)⁵. India-Korea economic relations are also significant and growing; while other important regional economies such as Japan and Chinese Taipei have also been paying for more attention to India as a means of hedging trade and investment links. Sub-regional cooperation between India and some of the ASEAN members such as Vietnam, Thailand, Myanmar, and Laos has also accelerated (Gaur, 2003 and Suryanarayana, 2003)⁶. In the financial and monetary spheres, India has also been an important contributor to the recent Asian Bond Fund (ABF). India is also one of the world's largest reserve holders in the world, with holdings of over US\$ 100 billion (along with Japan, China, Korea, Hong Kong, Chinese Taipei and Singapore)⁷.

From a political economy perspective, inclusion of India will also signal to the rest of Asia that regionalism in East Asia is not limited to "East Asia" but is open to any Asian country that is committed to market-oriented economic policies and peaceful co-existence. In this regard, it is significant that both India and China have acceded to the 1976 Treaty of Amity and Cooperation in Southeast Asia (TAC) as a means of furthering peace and stability with ASEAN, and are engaging ASEAN constructively in all spheres. Inclusion of India has been promoted by some in ASEAN, Korea and even Japan as a counterbalance to the growing influence of China in the region. This said, India's relations with China too are rapidly growing, and serious consideration is being given to a China-India FTA (Li Wei, 2003).

⁵ See Sen et al. (2004) for a detailed exploration of ASEAN-India economic relations.

⁶ These include the Mekong-Ganga Cooperation (MGC) and the BIMST-EC (Bangladesh, India, Myanmar, Sri Lanka, Thailand Economic Cooperation).

⁷ The international reserve management policies of the Reserve Bank of India (RBI) has been lauded by the IMF as being "comparable to the global best practices" (Business Line, May 29, 2004 and IMF, 2003).

The preceding suggestion of JACIK being the appropriate point of reference for Asian economic cooperation and integration will almost definitely not go uncontested⁸. Apart from the issue of whether India should be included, some observers are understandably even skeptical of including ASEAN as a group in view of the large and growing divide between the ASEAN members (the newer transition members and Indonesia, on the one hand, and Singapore and Thailand, on the other, with Malaysia and Philippines in between). This division in development levels and policy priorities among ASEAN members has been particularly apparent in recent attempts at creating an ASEAN-China FTA, so much so that Singapore and Thailand have chosen to “go-it-alone” rather than be held back by other ASEAN members (Rajan and Sen, 2004). Others have suggested that the appropriate “grouping” should include other successful economies in East Asia, viz. Hong Kong (SAR) and Chinese Taipei, though questions arise about their sovereign status (or lack thereof). Yet others argue that, geography notwithstanding, Australia and New Zealand should also be included in view of the close economic ties these two countries have with East Asia.

Clearly this membership issue will remain a live wire that will not be resolved easily. However, it is important to keep in mind that keeping out important Asian players in any alliance could lead the excluded parties to defensive or reactionary strategies whereby they attempt to create their own intra or extra regional groups. This in turn could spawn a number of cross-memberships between alliances, giving rise to a highly complex and rather untidy

⁸ There appears to be a definite lack of knowledge and appreciation by many observers in East Asia about the economic transformation that has been ongoing in India in the last decade. It would be unfortunate if ignorance, subjective biases or unwillingness to break out of one’s “comfort-zone” is the reason to eschew JACIK in favour of something narrower like APT. In this regard, while some still view India through the “South Asia” lens (a Cold War construct), they should follow the lead of the US and the UK, both of whom now view their relations with individual countries in the Indian subcontinent distinctly and judge each on its own merit. On its part, India needs to continue to show commitment to and interest in integrating more closely with its East Asian neighbours.

patchwork quilt of ineffectual and competing alliances in Asia. The inability to develop a cohesive Pan-Asian alliance will always limit the potential influence Asia might have in global affairs (compared to the smaller EU, for instance).

Keeping the foregoing in mind, one possible consensual and practical way to move forward would be to have tiers of cooperation or membership. The APT countries might be initial “core members”. India (i.e. JACIK) and possibly also Chinese Taipei, Hong Kong (SAR), Australia and New Zealand could be “Members Designate” (*a la* APEC), with an expectation of them being included as core members at a pre-determined stage in the future (two year time-frame?), as would other like-minded countries in Asia over time. Thus, while JACIK or JACIK-plus may be an appropriate initial starting point for Asian regionalism, the eventual aim ought to be to create an Asian economic community that includes all like-minded in the larger Asian region⁹.

We turn to the second question, viz. what does one mean by economic cooperation and integration? It is important to distinguish between three broad forms of economic regionalism, viz. trade, financial and monetary. Asian countries have, in recent years, made progress in all three areas¹⁰. Conceptual definitions of these measures of regionalism, the

⁹ Singapore’s Prime Minister, Goh Chok Tong, has been an important proponent of an Asian Economic Community linking South Asia, North and Southeast Asia. As he noted:

(T)he vision that we have..(is)..to bring India closer to Southeast Asia and to East Asia so that, together, we can realise, over the longer term, the Asian economic community — small “e” small “c”. Not with rules and regulations like the European Union, but a more integrated Asia. I see China becoming a very powerful economy. Of course, Japan will remain developed. Korea, Singapore, Thailand will also become developed economies, together with Malaysia. East Asia will therefore comprise developed countries and middle-income countries. It’s my hope that India can join East Asia as a middle-income country (reported in Bansal, 2004).

¹⁰ We do not consider regional cooperation and integration in some of the other areas discussed by Kumar (2004), including energy, technology and skills training, and infrastructure and transportation.

nexus between them, and policy measures to promote regionalism, will be the focus of the remainder of this Chapter.

The outline of this Chapter is as follows. Section 2 briefly explores the conceptual definitions of economic cooperation and integration in the financial, monetary and trade spheres. Section 3 delves into the links between the three forms of economic regionalism, with particular emphasis on trade and financial regionalism on the one hand, and monetary regionalism, on the other. Section 4 concludes with a discussion of steps that Asia might want to take to enhance cooperation and integration over time.

2 Conceptual Definitions: Cooperation versus Integration

2.1 Trade and Financial Regionalism

In the context of trade and finance, one might refer to *cooperation* as policy measures that facilitate cross-border trade and financial flows by removing frictions and obstacles (both subjective and objective resistances). In this Chapter we refer to trade and financial *integration* as the actual or *de facto* extent of trade and financial flows.

In the area of trade cooperation, there has been a proliferation of free trade agreements (FTAs) involving many Asian countries (see Bonapace, 2004 and Rajan and Sen, 2004). However, to date most of the FTAs have been largely bilateral arrangements rather than regional, and some of the FTAs are in fact cross-regional (involving the US, Mexico, EFTA, etc). The FTAs have gone well beyond just merchandise trade liberalization, also encompassing liberalization of services trade and other behind-the-border measures which lead to “deep integration” among partners. These measures include investment protection and liberalization, harmonization and mutual recognition of standards and certification,

protection of intellectual property rights (IPRs), opening of government procurement markets, streamlining and harmonization of customs procedures, and development of dispute settlement procedures. In other words, the focus is more on real sector rather than just trade (we use the two terms interchangeably in this Chapter).

In the area of finance, the most significant form of cooperation has been the creation of the Asian Bond Fund (ABF) (De Brouwer, 2004 and Rajan, 2003b, 2004b). More intensive financial cooperation would involve agreeing to regional financial standards and prudential measures, cross-trading of financial instruments in various national markets and facilitating intraregional payments and settlements.

Apart from actual trade flows, trade integration may be ascertained using measures like trade shares, intensity indices or gravity equations (as the benchmark) (Kawai, 2004). However, all this is limited to merchandise trade, detailed services data being unavailable on a bilateral or regional basis (indeed, the definition of services remains somewhat ambiguous). In addition, measuring real sector integration as opposed to trade integration more narrowly, is much harder.

Measuring financial integration is equally complex and multidimensional (see Figure 1 and Kawai and Motonishi, 2004). There are arbitrage price measures that revolve around the three interest parity conditions, viz. the covered interest parity (CIP), the uncovered interest parity (UIP), and the real interest parity (RIP). Each of these parity conditions has its limitations (see Phalapleewan et al., 2004, Cavoli et al., 2003 and Rajan, 2004a for details). Non-arbitrage price based measures include stock market correlations (both direct correlations as well as the extent to which international CAPM holds) or news-based measures (i.e. extent to which interest rates and other financial market variables are impacted

by common shocks versus country specific ones). There are at least two other broad non-price categories of financial integration. First are regulatory or institutional factors such as capital controls, prudential regulations and the degree of internationalization of the banking system (or barriers to foreign bank entry, thereof). An obvious limitation of these measures is the difficulty of obtaining good proxies to measure such barrier or regulatory impediments that prevent financial integration. Second are quantity based measures, including savings-investment (S-I) correlations, current account dynamics, consumption correlations and dynamics of private capital flows.

2.2 Monetary Regionalism

Almost by definition, monetary regionalism refers to policy-induced measures. Thus, the distinction between monetary cooperation and integration is less clear-cut and should probably be seen in terms of various gradations of policy measures.

In Asia, the two recent monetary initiatives have involved steps to enhance regional financial surveillance and policy dialogue (the weakest form of monetary regionalism), as well as the Chiang-Mai initiative (CMI), which is a series of bilateral swap and repurchase agreements among the APT countries. While there has been some discussion about regionalizing the CMI (Montiel, 2004), no significant steps have been taken in that direction. There is also some discussion about the possibility of pooling part of the region's international reserves as a means of safeguarding against financial crisis (Bird and Rajan, 2002a,d, Rajan, 2003a and Rajan and Siregar, 2004). More intensive forms of monetary regionalism would involve exchange rate coordination (including regional basket pegs or a regionally-harmonized exchange rate band) to full monetary integration incorporating a

single currency and common monetary policy (Eichengreen, 2004b). The criteria for ascertaining the feasibility of a common or optimum currency area (OCA) have focused on the degree of factor mobility between partners, size and openness, trade diversification, dissimilarity of commodity composition of production and trade baskets, macroeconomic trends and the synchronization of business cycles, the degree of labour market flexibility, and the scope for regional transfers of potential members.

3. Sequencing of Economic Regionalism: Financial, Monetary and Trade¹¹

The links between trade and financial regionalism are fairly straightforward. Efforts to facilitate trade and financial flows are largely complementary and can be undertaken simultaneously. For instance, presumably financial integration will make it easier for a country to obtain trade financing that is needed to grease the wheels of trade (Jinjarak, 2004). Availability of financing will also promote cross-border investments, hence facilitating trade integration (as much of trade occurs following FDI)¹². For instance, it is generally recognized that cross-border trade financing is a crucial determinant of trade flows. Similarly, FDI flows require complementary project financing¹³. Conversely, trade integration may lead to greater synchronization of business cycles (discussed below), leading to similar interest rate movements, i.e. *de facto* financial integration. For instance, Forbes and Chinn (2003) find bilateral trade flows to be an important determinant of cross-country financial linkages. In

¹¹ This section draws partly on Rajan (2002b, 2004) and Bird and Rajan (2002c).

¹² The FDI and trade nexus is outlined by Kawai (2004).

¹³ As a rule of thumb, in the case of emerging economies in Asia, equity financing tends to constitute about a quarter of total project cost, the remainder being financed by lending (usually bank lending but increasingly via bond financing).

terms of actual sequencing, trade and the weaker forms of financial cooperation can be undertaken simultaneously, while stronger forms of financial cooperation such as integrating institutional structures and harmonizing standards should come later¹⁴.

Less clear are the links between trade and finance regionalism, on the one end, and monetary regionalism, on the other. As noted, the economic case for or against monetary integration inevitably tends to be based on the optimum currency area (OCA) criteria which are conceived in terms of weighing the microeconomic benefits of a common currency (i.e. lower transactions costs, ability to economize on reserve holdings, reduction in regional price discrimination and elimination of other costs of interregional exchange rate uncertainty), against the costs of forsaking exchange rate adjustments as a policy instrument and loss of monetary policy autonomy (Mundell, 1961).

Does deeper financial integration imply that a region is closer or farther away from being an OCA? At a basic level, financial integration implies an enhanced degree of capital mobility and a consequent loss of monetary policy autonomy. This being the case, the next step to creating a common regional currency may not be very costly and could offer participants a number of microeconomic benefits. In addition, as pointed out early on by Mundell (1973), agents in countries with open capital accounts are able to adjust their portfolio wealth holdings in response to country-specific shocks (by borrowing or lending/investing abroad) or can cushion themselves from idiosyncratic shocks by drawing on income on foreign asset holdings (rentals, dividends etc). To the extent that this portfolio adjustment or income insurance mechanism reduces the need for exchange rate adjustments

¹⁴ Indeed, it is unclear whether some forms of stronger financial cooperation like standard harmonization ought even to be done at the regional level, with many arguing that the region should aim for international standards rather than regional ones.

in the event of asymmetric shocks (i.e. a shock that affects members of a union disproportionately), financial integration could help the region go some way toward satisfying the OCA criteria (also see Ching and Devereux, 2000, Ingram, 1962 and Kalemli-Ozcan, Sorensen and Yosha, 2003).

Does deeper trade integration imply that a region is closer or farther away from being an OCA? On the one hand, greater trade integration leads to a convergence in aggregate demand patterns in the trade partners, making them more likely to share common business cycles and rendering unilateral exchange rate adjustments relatively ineffective as an expenditure switching tool (McKinnon, 1963 and Frankel and Rose, 1998). On the other hand, if intraregional trade is dominated by industrial specialization and inter-industry trade, or intra-industry trade (IIT) involving vertical specialization, the countries' production structures may actually become more dissimilar and thus more vulnerable to asymmetric supply shocks¹⁵. This in turn could weaken the case for monetary integration since independent monetary tools or a flexible exchange rate may be needed to compensate for asymmetrical shocks (Krugman, 1993, Eichengreen, 1992 and Calderón et al., 2002). It is therefore an empirical issue as to which of these effects – supply (asymmetry) or demand (symmetry) – will dominate.

A study by Calderón et al. (2002) of 147 countries over the period 1960-99 using annual data finds that the impact of trade integration among industrial country pairs on output fluctuations is 0.092, significantly higher than the impact among developing country pairs (0.019) or between industrial and developing country pairs (0.037). The authors conjecture that this is due to higher IIT between industrial countries compared to inter-industry trade

¹⁵ Imbs (2003) confirms the direct impact of patterns of specialization on business cycle correlations.

involving developing countries. More specific evidence to date for selected Asian economies suggests that the volume of intra-Asian trade does not necessarily lead to more symmetrical business cycles and could actually cause more idiosyncratic business cycles (Lee, 2004). Shin and Wang (2003) further find that business cycle co-movements in Asia are strengthened only when trade is of the IIT variety. This appears to validate the theoretical propositions above¹⁶.

There is a growing body of literature which suggests that the tendency towards specialization in production could be fortified as financial integration permits the diversification or sharing of risks internationally (i.e. insurance via financial markets), hence allowing firms to locate production in one country and benefit from scale economies (or market size effects and linkages), thick labour markets and pure external economies (Kalemi-Ozkan, Sorensen and Yosha, 2001, 2003). This consequent lower degree of industrial diversification in turn makes countries more susceptible to idiosyncratic shocks and therefore less likely to satisfy OCA criteria (Kenen, 1969). Thus, even while financial integration may exacerbate supply side asymmetries between members, synchronization of business cycles may not be a pre-requisite for sharing a common currency if agents could insure themselves in international financial markets. Indeed, from the perspective of international risk sharing it would be preferable if member economies' financial market returns were not synchronized^{17,18}.

¹⁶ Nonetheless, one of the limitations of the Shin and Wang (2003) study is that they use a fairly high level of industrial aggregation (two, three and four digit). Thus, a lot of what might be classified as IIT trade may in fact be of the inter-industry variety.

¹⁷ In fact it has been argued that financial liberalization by (East) Asian economies has led to intensified *international* rather than *regional* integration. This is in contrast to the European experience (Park and Bae, 2002). Eichengreen and Park (2003) opine that part of the reason for the differing experience of Asia and Europe is because of the policy decision within the EU to harmonize

While the preceding discussion was on whether financial-cum-trade integration makes a common regional currency more feasible, some have suggested the reverse causation. By reducing transactions and information costs, a single currency may itself facilitate trade and financial flows amongst members. There is a large and growing body of evidence based on gravity models using both cross-sectional and time series data that suggests a common currency stimulates trade¹⁹. Similarly, and less controversially, it is generally recognized that elimination of costs that invariably exist with segmented domestic financial markets, as well as convergence in macro policies and micro-prudential statutes and regulations, will deepen and broaden regional financial markets and lessen the degree of intraregional financial segmentation. Proponents of European integration used such an argument extensively to justify the region's Economic and Monetary Union (Emerson et al., 1992) and they seem to have been proved correct at least in the case of the financial markets (Danthine, et al., 2000)²⁰. In other words, OCA criteria may be endogenous, i.e. the structure of the economy is endogenous to economic policy (Frankel and Rose, 1998).

national financial regulations *prior to* financial liberalization. In contrast, regional financial integration in East Asia may have been hindered by the absence of relevant market-supporting infrastructure (also see fn 21).

¹⁸ Kim et al. (2004) find that consumption risk sharing in East Asia is quite low (about 20 percent). Conceptually, while consumption-based Euler equation tests of capital mobility are attractive when attempting to discern whether a region is ripe for monetary union (as the degree of business cycle synchronization may be less relevant as long as agents can share consumption risks across borders), they are based on a number of restrictive assumptions that limit their practical usefulness.

¹⁹ Rose and Engel (2002) argue that a common currency area significantly increases international business cycle correlations. Frankel and Rose (2002), Glick and Rose (2002) and Rose (2000) estimate gravity models using both cross-sectional and time series data and conclude that a common currency is especially trade-stimulating. Corsetti and Pesenti (2002) formalize the theory behind this catalyzing role of monetary unions and the possibility of OCA criteria being satisfied *ex-post* even if they fail *ex-ante*.

²⁰ However, Eichengreen and Park (2003) argue the reverse causation may be true, i.e. "it is the more advanced development of European capital markets and institutions in the period leading up to the

Some have even argued that a regional trade-cum-financial arrangement may be undermined by lack of macroeconomic coordination and exchange rate instability amongst members (Eichengreen, 2002a and Fernandez-Arias et al., 2002). Competitive devaluations may generate a protectionist backlash which goes against the purpose of the regional trade-cum-financial arrangement and possibly even threatens its existence, as the recent experience of the Mercusor (FTA of Argentina, Brazil, Paraguay and Uruguay) seems to suggest. The devaluation of the Brazilian real in 1999 accentuated the overvaluation of the Argentine peso and contributed to the economic crisis in Argentina which in turn had significant negative repercussions on the Uruguayan banking system. Trade partners were effectively pursuing competitive exchange rate policies. More generally, recent evidence based on thirty seven countries and six regional FTAs suggests that the adverse effects of uncoordinated exchange rate policy may be more pronounced within the context of a regional trade arrangement (Fernandez-Arias et al., 2002). These adverse effects can be expected to be greater the deeper the real sector integration as the cross-price elasticity of demand for similar goods and services produced within the integrated region may rise (so-called “knife-edge” comparative advantage)²¹. It is in this context that Eichengreen notes (2002a):

The irony is that an FTA designed to foster better commercial relations between Argentina and Brazil has in fact seen a heightening of trade tensions between them, due largely to instability in currency markets (p.2).

removal of financial restrictions and capital controls that caused Europe to respond to developing deeper financial links within the region as well as globally”.

²¹ Concerns about the sustainability of Mercusor as only a regional trade agreement has given rise to suggestions in some policy circles that it be transformed into a full-fledged regional monetary union (Fратиanni, 2002 and Levy Yeyati and Sturzenegger, 1999). Eichengreen (2002a) argues against Mercusor establishing a monetary union and instead makes a case for the countries to adopt harmonized inflation targets (also see fn 23).

4. Summary and Concluding Remarks

What should Asia do moving forward to promote economic cooperation and integration? Leaving aside unresolved membership issues, as outlined above, there is a complex set of causal interconnections between financial, trade and monetary integration. While monetary integration may give rise to some self-validating processes that may facilitate trade-cum-financial integration, deeper integration is unlikely to occur dynamically following monetary integration. Given the divergences in economic and institutional structures in the region and the lack of genuine political commitment, any attempt to create a full-fledged Asian Monetary Union (AMU) is far too premature²². Asia's focus should instead continue to be on steps to enhance trade-cum-financial cooperation by reducing distortions and barriers to cross-border economic activity.

While deeper forms of monetary integration should be eschewed for now, greater efforts should be expended to enhance the quality of regional surveillance as well as to fortify regional liquidity arrangements such as the Chiang-Mai initiative (CMI). While the CMI is undoubtedly an important first step towards intensified monetary regionalism, on its own, and given the manner in which it is presently structured, its effectiveness is questionable. In some senses the term "monetary regionalism" to describe the CMI is a misnomer as it remains an uncoordinated and decentralized swap arrangement. An important next step would therefore be to augment and multilateralize the existing bilateral currency swap arrangements under CMI (which currently stands at US\$ 36.5 billion) if it is to be made a credible and effective financing mechanism. The multilateralized swaps could, over time, be institutionalized into a reserve pool (Chino, 2004).

²² Also see Eichengreen (2004b) for a detailed discussion of preconditions for an AMU.

An exploratory empirical analysis undertaken on reserve-sharing by Rajan and Siregar (2004) suggests that there are indeed significant economics gains to be reaped from *partial* as opposed *full* pooling of reserves. They suggest that it may be desirable to have “tiers of liquidity” or concentric defense lines (also see Bird and Rajan, 2002a,d and Rajan, 2003a). The top tier would be owned reserves. From a government’s perspective, an advantage associated with international reserves is that they may be used quickly and without conditions. The second tier would be regional liquidity arrangements. This tier can be further sub-divided into utilization of the country’s own reserves placed with the regional pool and other members’ reserves with the pool. The third tier would be conventional IMF lending. All in all, with such a tiered structure, the degree of liquidity could be inversely related to the degree of conditionality. An important precondition for the regional financial facility to operate effectively is that there *must* be a considerable strengthening of the regional surveillance mechanism with well worked out policy conditionality and effective surveillance (De Brouwer, 2004, Girardin, 2004 and Montiel, 2004). The issue of surveillance appears to be particularly problematic in the region. According to the ADB (2003):

At the present time, the informal surveillance system that is in existence among the ASEAN+3 economies and their central banks is deemed adequate to oversee the operations of the CMI. The only efforts being made at an institutional level are to establish early warning systems and to monitor short-term capital flows.

Clearly, no reserve pooling arrangement will be effective as long as the current state of affairs in Asia (regarding ineffective surveillance) persists. Beyond the immediate tasks of offering liquidity assistance and cooperating more closely to protect themselves from risks arising from capital account volatility, the broader aim of such a regional facility ought to be to support a move by the region towards closer monetary and economic coordination.

The benefits of reserve pooling are likely to rise substantially when the pool arrangement is undertaken as part of a larger process of monetary and trade integration (Rajan and Siregar, 2004). In the area of trade cooperation, FTAs that promote deep integration will continue to proliferate in Asia. It is, however, important for Asia to try and develop a common template that could form the basis for future FTA negotiations. Such a template should focus on, among other things, the nature and coverage of sectors, issues relating to rules of origin (ROOs), and terms of accession. It is also important to establish a clear and feasible roadmap on how to consolidate the various bilateral and sub-regional initiatives so as to advance region-wide and global trade liberalization.

There appears to be more scope for systematic cooperation on a region-wide basis in the financial arena. Regional governments should persist with attempts to develop well-functioning financial market and institutions. Particular attention needs to be paid to deepening and upgrading national and regional government and corporate bond markets as a means of reducing the region's heavy reliance of banks. While the Asian Bond Funds (I and II) are modest steps in the right direction, an interesting suggestion in this regard is to set up an Asian Bond Corporation (ABC) which is aimed at creating and issuing basket currency bonds (weighted combination of regional currencies of the underlying national bonds) backed by regional sovereign bonds (Ito, 2003). Conceptually, the ABC appears to be a particularly innovative proposal, and if successful, could (a) facilitate the development of regional bond markets; (b) reduce the extent of currency mismatch; and (c) provide a fillip for the eventual creation of an Asian Currency Unit (ACU)²³. One might even think of

²³ At the risk of thinking “long term”, once an ACU is created, it can act as a possible benchmark against which regional currencies might consider pegging to (though the tightness of the peg may differ between countries in the interim). Kawai and Motonishi (2004) advocate the possibility of a currency basket regimes for Asia. Also see Bird and Rajan (2002b) and Rajan (2002a). Eichengreen

expanding the role of the ABC to also take on the functions of an independent Asian Financial Institute (AFI). As proposed by Eichengreen (2004a), the AFI would be tasked with: (a) strengthening prudential supervision and regulation; (b) running training and capacity building programs for bank supervisors, securities and exchange commissioners and accountants; (c) helping design region-wide financial standards and regulations and provision of liquidity to countries that find it hard to adjust to the standards; and (d) facilitating regional clearing and payments settlements among central banks in the region.

However, we conclude with the usual -- but never irrelevant -- caveats. First, the devil lies in the details and poor implementation could kill even the best thought out proposal. Second, any proposal to establish a regional institution must take into account the transactions costs of setting up such a scheme. Third, while the successful implementation of these financial market initiatives ought to bolster the extent of regional financial integration, it is critical that they do not detract from domestic structural reforms to broaden and deepen individual capital markets. After all, a regional alliance is only as strong as its weakest link.

(2004b) advocates open economy inflation targeting and a flexible exchange rate regime for Asia. See Cavoli and Rajan (2004) for a discussion of inflation targeting in the Asian context.

Bibliography

Agarwala, R. (2004). "Asia's Re-emergence: Can and When Asia Reclaim Its Place in the World Economy?", **Chapter ?**, this volume.

Asher, M. and S. Srivastava (2003). "India and the Asian Economic Community", RIS Discussion Paper No.51, Research and Information Systems for the Non-Aligned and Developing Countries (RIS), New Delhi, India.

Asian Development Bank (ADB) (2003). "Progress and Institutional Arrangements for the Chiang Mai Initiative", Asia Recovery Information Centre, mimeo (February).

Bansal, R. (2004). "The Monday Interview: Goh Chok Tong", Financial Express, July 12.

Bird, G. and R. Rajan (2002a). "The Evolving Asian Financial Architecture", Princeton Essays in International Economics No. 226, International Economics Section, Princeton University (March).

Bird, G. and R. Rajan (2002b). "Optimal Currency Baskets and the Third Currency Phenomenon: Exchange Rate Policy in Southeast Asia", Journal of International Development, 14, 2002, pp.1053-1073.

Bird, G. and R. Rajan (2002c). "The Political Economy of a Trade First Approach to Regional Integration", mimeo (August).

Bird, G. and R. Rajan (2002d). "Regional Arrangements for Providing Liquidity in a Financial Crisis?: Developments in Asia", Pacific Review, 15, pp.359-379.

Bonapace, T. (2004). "Free Trade Areas in the ESCAP Region: Progress, Challenges and Prospects", **Chapter ?**, this volume.

Calderón, C.A, A. Chong and E. Stein (2002). "Trade Intensity and Business Cycle Synchronization: Are Developing Countries any Different?", Inter-American Development Bank, mimeo (March).

Cavoli, T. and R. Rajan (2004). "Exchange Rate Arrangements for East Asia Post-Crisis: Examining the Case for Open Economy Inflation Targeting", in F. Columbus (ed.), Asian Economic and Political Issues, Vol.5, Commack, NY: Nova Science Publishers, forthcoming.

Cavoli, T., R. Rajan and R. Siregar (2003). "A Survey of Financial Integration in East Asia: Trends, Issues and Implications", paper prepared for the Regional Economic Monitoring Unit of the Asian Development Bank (January).

Ching, S. and M. Devereux (2000). "Risk Sharing and the Theory of Optimal Currency Areas: A Re-examination of Mundell 1973", Working Paper No.8/2000, Hong Kong Institute for Monetary Research.

- Chino, T. (2004). "Consider a Single Asian Currency", Asian Wall Street Journal, June 1.
- Corsetti, G. and P. Pesenti (2002). "Self-Validating Optimum Currency Areas", mimeo (May).
- Danthine, J.P., F. Giavazzi and E.L. von Thadden (2000). "European Financial Markets After EMU: A First Assessment", mimeo (May).
- De Brouwer, G. (2004). "Monetary and Financial Integration in Asia: Empirical Evidences and Issues", **Chapter ?**, this volume.
- Eichengreen, B. (1992). "Should the Maastricht Treat Be Saved?", Princeton Studies in International Finance No.64, International Economics Section, Princeton University.
- Eichengreen, B. (2002a). "What Macroeconomic Measures are Needed for Free Trade to Flourish in the Western Hemisphere?", mimeo (November).
- Eichengreen, B. (2002b). "Lessons of the Euro for the Rest of the World", mimeo (December).
- Eichengreen, B. (2004a). "Financial Development in Asia: The Way Forward", inaugural lecture delivered on behalf of the Institute of Southeast Asian Studies (Singapore, January 14).
- Eichengreen, B. (2004b). "Real and Pseudo Preconditions for an Asian Monetary Union", **Chapter ?**, this volume.
- Eichengreen, B. and Y.C. Park (2003). "Financial Liberalization and Capital Market Integration in East Asia", mimeo (undated).
- Emerson, M., D. Gros, A. Italianer, J. Pisany-Ferry and H. Reichenbach (1992). One Money, One Market, Oxford: Oxford University Press.
- Fernandez-Arias, E., U. Panizza and E. Stein (2002). "Trade Agreements and Exchange Rate Disagreements", Inter-American Development Bank, mimeo (March).
- Forbes, K. and M. Chinn (2003). "A Decomposition of Global Linkages in Financial Markets Over Time", mimeo (February).
- Frankel, J. and A. Rose (1998). "The Endogeneity of the Optimum Currency Area Criteria", Economic Journal, 108, pp.1009-1025.
- Frankel, J. and A. Rose (2002). "An Estimate of the Effect of Currency Unions on Trade and Growth", Quarterly Journal of Economics, 117, pp.437-466.
- Fratianni, M. (2002). "The Case for Monetary Union in Mercusor", mimeo (undated).

Gaur, S. (2003). "ASEAN-India Ties Entering a New Phase", Business Times, Singapore, October 8.

Girardin, E. (2004). "Information Exchange, Surveillance Systems, and Regional Institutions in East Asia", in Monetary and Financial Integration in East Asia, Volume 1, Hampshire and New York: Palgrave-MacMillan Press for the Asian Development Bank.

Glick, R. and A. Rose (2002). "Does a Currency Union Affect Trade?: The Time Series Evidence", European Economic Review, 46, pp.1125-1151.

Hausmann, R., U. Panizza and E. Stein (2000). "Why do Countries Float the Way They Float?", Working Paper No.418, Inter-American Development Bank.

Huang, Y. and R. Malkini (2004). "China and India: The New Powerhouse of Asia", Economic & Market Analysis, Asia Pacific, Citigroup (January 9).

Imbs, J. (2003). "Trade, Finance, Specialization, and Synchronization", Working Paper No.03/81, IMF.

Ingram, J. (1973). "The Case for the European Monetary Integration", Princeton Essays in international Finance No.98, International Economics Section, Princeton University.

International Monetary Fund (IMF) (2003). "Guidelines for Foreign Exchange Reserve Management", report prepared by the Monetary and Exchange Affairs Department (March 26).

Ito, T. (2003). "The ABC of Asian Bonds", paper presented at the Second PECC Finance Forum Conference (Hua Hin, Thailand, July 8-9).

Jinjarak, Y. (2004). "On the Hidden Links Between Financing Costs and International Trade Patterns", mimeo (June).

Kalemi-Ozcan, S., B. Sorensen and O. Yosha (2001). "Economic Integration, Industrial Specialization and the Asymmetry of Shocks Across Regions", Journal of International Economics, 55, pp.107-137.

Kalemi-Ozcan, S., B. Sorensen and O. Yosha (2003). "Risk Sharing and Industrial Specialization: Regional and International Evidence", American Economic Review, forthcoming.

Kawai, M. (2004). "Trade and Investment Cooperation and Integration in Asia: Empirical Evidence and Issues", Chapter ?, this volume.

Kawai, M. and T. Motonishi (2004). "International Macroeconomic Interdependence in East Asia: Empirical Evidence and Issues", Chapter ?, this volume.

Kenen, P. (1969). "The Theory of Optimum Currency Areas: An Eclectic View", in R. Mundell and A. Swoboda (eds.), Monetary Problems of the International Economy, Chicago: University of Chicago Press.

Kim, S., S.H. Kim and Y. Wang (2004). "Financial Integration and Consumption Risk Sharing in East Asia", mimeo (January).

Krugman, P. (1993). "Lessons of Massachusetts for EMU", in F. Torres and F. Giavazzi (eds.), Adjustment and Growth in the European Monetary Union, Cambridge: Cambridge University Press.

Kumar, N. (2002). "Towards an Asian Economic Community-Vision of Closer Economic Cooperation in Asia: An Overview", RIS Discussion Paper No.32, Research and Information Systems for the Non-Aligned and Developing Countries (RIS), New Delhi, India.

Kumar, N. (2003). "Asian Economic Community: Towards a Vision of a Pan-Asian Economic Integration", **Chapter ?**, this volume

Lee, Y.F.L. (2004). "Trade, Business Cycles, and the Optimum Currency Area", mimeo (February).

Levy Yeyati, E. and F. Sturzenegger (1999). "The Euro and Latin America: Is EMU a Blueprint for Mercosur?", mimeo (April).

Li Wei (2003). "A Road to Common Prosperity: Examination of an FTA Between India and China", RIS Discussion Paper No.49, Research and Information Systems for the Non-Aligned and Developing Countries (RIS), New Delhi, India.

Low, L. (2004). "A Singapore Perspective of East Asian Regional Integration", paper presented at the AT10 Research Conference (Tokyo, February 3-4).

McKinnon, R. (1963). "Optimum Currency Areas", American Economic Review, 53, pp.717-725.

Montiel, P. (2004). "An overview of Monetary and Financial Integration in East Asia", in Monetary and Financial Cooperation in East Asia, Volume 2, Hampshire and New York: Palgrave-MacMillan Press for the Asian Development Bank.

Mundell, R. (1961). "A Theory of Optimum Currency Areas", American Economic Review, 51, pp.657-665.

Mundell, R. (1973). "Uncommon Arguments for Common Currencies", in H. Johnson and A. Swoboda (eds.), The Economics of Common Currencies, London: Allen and Unwin.

Park, Y.C. and K.H. Bae (2002). “Financial Liberalization and Economic Integration in East Asia”, paper presented at the PECC Finance Forum Conference on “Issues and Prospects for Regional Cooperation for Financial Stability and Development” (Hawaii, August 11-13).

Phalappleewan, A., M. Keil, R. Rajan, and T.D. Willett (2004). “Monetary Interdependence in Asia”, in progress.

Rajan, R. (2002a). “Exchange Rate Policy Options for Post-Crisis Southeast Asia: Is There a Case for Currency Baskets?”, The World Economy, 25, pp.137-163. To be reprinted in R.E. Allen (ed.), The Political Economy of Financial Crises, Edward Elgar.

Rajan, R. (2002b). “Examining the Links Between Trade and Monetary Regionalism”, Economic and Political Weekly, 37, November 2-9, pp.4493-4494.

Rajan, R. (2003a). “Safeguarding Against Capital Account Crises: Unilateral, Regional and Multilateral Options for East Asia”, in G. De Brouwer (ed.), Financial Governance in East Asia, London: Routledge.

Rajan, R. (2003b). “Is there a Case for an Asian Bond Fund? – It Depends!”, Economic and Political Weekly, 38, May 17, pp.1919-1921. Abbreviated version published as “A Bond Fund for Asia”, Far Eastern Economic Review, March 20, 2003.

Rajan, R. (2004a). “Financial Integration in ASEAN and Beyond: Implications for Regional Monetary Integration”, in D. Hew (ed.), Roadmap to an ASEAN Economic Community, Singapore: Institute of Southeast Asian Studies, forthcoming.

Rajan, R. (2004b). “The ABC of the Asian Bond Fund”, Business Times, Singapore, February 2.

Rajan, R. and R. Sen (2004). “The New Wave of Free Trade Agreements in Asia with Particular Reference to ASEAN, People’s Republic of China and India”, **Chapter ?**, this volume.

Rajan, R. and R. Siregar (2004). “Centralized Reserve Pooling for the ASEAN Plus Three (APT) Countries”, in Monetary and Financial Cooperation in East Asia, Volume 2, Hampshire and New York: Palgrave-MacMillan Press for the Asian Development Bank.

Rose, A. (2000). “One Money, One Market: Estimating the Effect of Common Currencies on Trade”, Economic Policy, 15, pp.7-46.

Rose, A. and C. Engel (2002). “Currency Unions and International Integration”, Journal of Money, Credit and Banking, 34, pp.804-826.

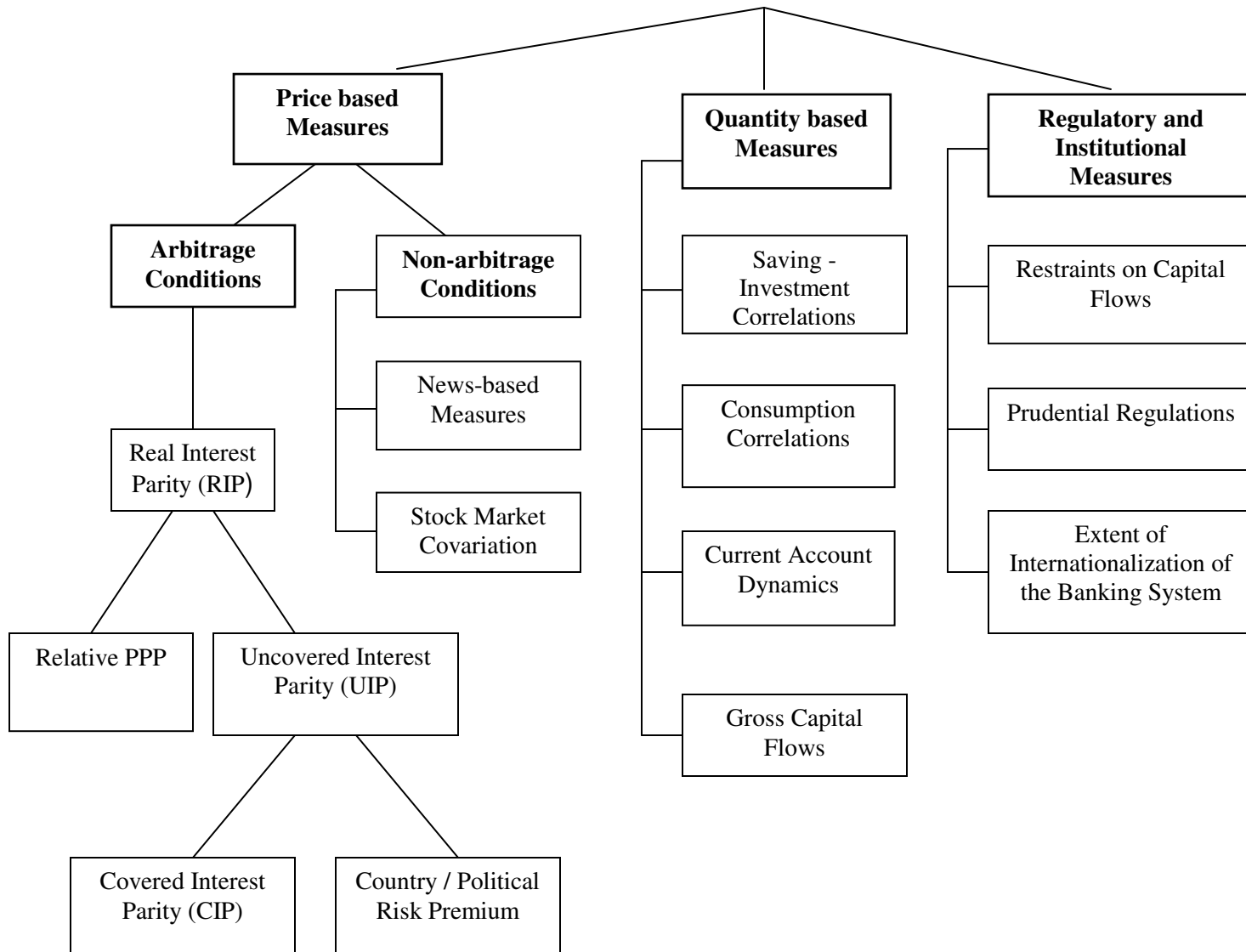
Sen, R., M. Asher and R. Rajan (2004). “ASEAN-India Economic Relations: Current Status and Future Prospects”, RIS Discussion Paper No.73, Research and Information Systems for the Non-Aligned and Developing Countries (RIS), New Delhi, India.

Shin, K.H. and Y. Wang (2003). "Trade Integration and Business Cycle Synchronization in East Asia", mimeo (January).

Suryanarayana, P.S. (2003). "India Enhances Connectivity with ASEAN", The Hindu, India, September 19.

Wilson, P. and R. Purushothaman (2003). "Dreaming with BRICs: The Path to 2050", Global Economics Paper No.99, Goldman Sachs (October).

Figure 1
Categorizing Measures of Financial Integration: A Simple Framework



Source: Author based on Cavoli, Rajan and Siregar (2003)