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Economic Integration in Asia: Trends and Policies[1]

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Executive Summary

Unlike in other parts of the world, such as Africa and Latin America, regionalism (or the adoption of regional cooperation policies) is a relatively new phenomenon in Asia. Aside from the establishment of the Association of Southeast Asian Nations in 1967, the South Asian Association for Regional Cooperation in 1985, and several efforts to promote intra-regional trade, few policy actions were taken by the Asian countries to promote regional cooperation with each other until the mid-1990s.

The Asian financial crisis of 1997-98 was a watershed as it focused the region's attention on growing interdependence and shared interests and East Asian policymakers became interested in supporting market-led integration with various regional cooperation efforts. This sentiment has been the strongest in East Asia (ASEAN+3) where the adverse impacts of the crisis and the contagion were the most significant. South Asia also joined the bandwagon in the 1990s when it initiated its economic reform programme and started to implement the "Look East" policy. The major factor that ignited the interest of the East Asian countries towards regional monetary and financial integration was the virulent contagion of the East Asian financial crisis and the policy mistakes made by the International Monetary Fund in managing it. The slow progress of the Doha Round under the auspices of the World Trade Organisation and the popularity of regionalism elsewhere also encouraged the East Asian countries to promote regionalism in trade. In the post-crisis period, East Asia realised that it needed to be more self-reliant and gain fuller control of its destiny. The ongoing global economic crisis has further enhanced the case for Asian regionalism for a number of reasons.

Reflecting mainly market forces and, to a lesser extent, government efforts, Pan-Asian trade – comprising intra-regional trade between the East Asian countries, intra-regional trade between the South Asian countries and inter-regional trade between South Asia and East Asia – has been surging rapidly, albeit from a low base, especially after 2000.

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This paper reviews the steps taken and progress made in Asian economic integration at the sub-regional levels and recommends actions to promote Asia-wide economic integration, including South Asian integration, which has been stuck at a low level.

I. Introduction

While the dynamism of East Asia and the emergence of China and India as major players in the global economy are frequently discussed and debated in academic literature and popular press, much less attention has been placed on Asian economic integration and the rapid increase in Pan-Asian[3] trade and investment.[4] Unlike in Europe, this process is being led mainly by market forces (which enhance efficiency in production and augment dynamic gains through trade) with government-related regional cooperation policies also starting to play a role more recently. The rapid increase in Pan-Asian trade has made growth and development in Asia more dynamic and self-sustained. A regionally integrated but globally connected Asia is starting to emerge. As the experience with the ongoing global economic crisis has shown, Asia has not yet "de-coupled" completely from the Organisation for Economic Co-operation and Development. Asian countries are, however, becoming more symmetric and business cycles are becoming more synchronised.

Unlike in the other regions of the world, such as Africa and Latin America, regionalism (or the adoption of regional cooperation policies) is a relatively new phenomenon in Asia.[5] Aside from the establishment of the Association of Southeast Asian Nations (ASEAN) in 1967 and the South Asian Association for Regional Cooperation (SAARC) in 1985, and several efforts to promote intra-regional trade, the Asian countries made little effort to promote regional cooperation with each other until the mid-1990s. During much of the colonial period in the 19th and 20th centuries, South Asia was relatively isolated from East Asia (defined as ASEAN+3). South Asian countries also isolated themselves from each other behind high tariff and non-tariff barriers, and during the mid-1960s, the level of intra-regional trade among them made up about only two percent of their total trade. This policy started to change after the implementation of the "Look East" policy in India.

The Asian financial crisis of 1997-1998 was a watershed as it focused the region's attention on growing interdependence and shared interests, and East Asia policymakers became keen to support market-led integration with various regional cooperation efforts. This sentiment was the strongest in East Asia where the adverse impacts of the crisis and the contagion were the most significant. South Asia has also joined the bandwagon after the 1980s and 1990s when several of the South Asian countries initiated their economic reforms and announced their "Look East" policies.

3 The paper defines Pan-Asia as the South Asian and East Asian sub-regions of Asia. Other sub-regions of Asia are not considered as their levels of intra-regional or inter-regional trade is low.

4 The recent emergence and integration of Asia are not without historical precedence. During much of the first 18 centuries of human history, Asia not only dominated the world economy but was a "regionally integrated and globally connected" region of the world (Rana 2009).

5 Regionalism or regional cooperation policies refer to official activities that encourage regional integration and/or help to shape coordinated action and responses to developments that affect the region. Regional integration is a process that leads to greater interdependence within a region. Regional integration may be market-driven or regional cooperation policy-led. Regional cooperation policies in Africa and Latin America were not successful because they sought to promote import-substitution policies at the regional level. Regionalism in Asia is, by contrast, open-regionalism which sees regionalism as a stepping stone to multilateralism.

The major factor that ignited the interest of East Asian countries towards regional monetary and financial integration was the virulent contagion of the East Asian financial crisis and the policy mistakes made by the International Monetary Fund (IMF) in managing it.[6] It was also felt that the resources of the IMF were limited and that it might not have adequate resources to handle a capital-account crisis associated with large surges and outflows of short-term private capital. Slow progress in the Doha Round under the auspices of the World Trade Organisation (WTO) and the popularity of regionalism elsewhere (such as the European Union and the North American Free Trade Agreement [NAFTA]) also encouraged East Asian countries to promote regionalism in trade. Additional factors were the desire to internalise the benefits of growing interdependence and the realisation that regionalism could help maximise the benefits and minimise the costs of globalisation. In the post-crisis period, East Asia realised that it needed to be more self-reliant and gain fuller control of its destiny (MAS 2007).

The ongoing global economic crisis has further enhanced the case for Asian regionalism for a number of reasons. First, the crisis has strengthened the case for rebalancing growth not only at the national level but also by finding economies of scale at the regional level. Second, the global crisis and the high and growing level of economic interdependence among Asian countries have increased the need for policy coordination at the regional level to take into account the spillover effects. Third, the global economic crisis has highlighted the need for joint policy statements and a show of force to reverse the flight to quality and loss of investor confidence in the region. Fourth, the global crisis has once again revived interest in the reform of the international financial architecture and the G20 has been given the lead role in spearheading discussions on these issues. Asian countries should, therefore, coordinate their views and positions to create an effective representation and make their voices heard at the G20.

Reflecting mainly market forces and, to a lesser extent, government efforts, Pan-Asian trade – comprising intra-regional trade between East Asian countries, intra-regional trade between the South Asian countries, and inter-regional trade between South Asia and East Asia – has been surging rapidly, albeit from a low base, especially after 2000. It tripled during the period from 1990-2000 and has since nearly tripled again to US$2.2 trillion in the next seven years. Intra-regional trade among the East Asian countries has grown the fastest and presently accounts for about 94 percent of total Pan-Asian trade, with East Asia-South Asia trade accounting for five percent and intra-South Asian trade a mere one percent (Francois, Rana, Wignaraja 2009).

The objectives of this paper are to review the steps taken and progress made in Asian economic integration at the sub-regional levels; and recommend actions to promote Asian economic integration including South Asian integration which has been stuck at a low level. Section II of the paper focuses on East Asian integration, while Section III focuses on growing economic linkages between South Asia and East Asia, and Section IV on South Asian integration.

[6] Given that the Asian financial crisis was a capital account crisis, the IMF should not have required Asian countries to tighten fiscal policy and raise interest rates. It should also not have gone overboard in requiring these countries to meet many structural conditions that were imposed in its programme. Its approach to financial and corporate reforms was also inappropriate, at least, in Indonesia. Subsequently, the IMF accepted many of these criticisms (IMF 2003).

II. Trade and Financial Integration and Macroeconomic Policy Coordination in East Asia

Trade Integration

On trade integration, East Asia has made encouraging progress with intra-regional trade reaching 57 percent of total trade (up from 43 percent in 1990), which is higher than the level for NAFTA (46 percent) but lower than that for the European Union (67 percent). Much of this expansion has been driven by market forces especially the establishment of production networks in East Asia. The traditional production networks were triangular, whereby Japan and the newly industrialising economies exported parts for electrical appliances, office and telecommunications equipment and textiles and garments to China and the third generation countries (Indonesia, Malaysia, Philippines, and Thailand). These countries in turn completed the processing and exported the final product to markets in the United States and Europe. Since the mid-1990s, more sophisticated and complex production networks have emerged which involve the transhipment of components – back and forth trade in parts and components across Asian countries (Gill and Kharas 2007). These networks in the so-called "factory Asia" model are being increasingly centred in China, following the country's rapid emergence.

East Asian governments began to use free trade agreements (FTAs) as instruments of trade policy in the late 1990s. In 2000, only three FTAs were in effect, but today there are 47 bilateral and plurilateral FTAs in effect, with another 64 in the pipeline.[7] FTAs will no doubt proliferate further if the Doha Round continues to falter. If they are designed properly, FTAs can help countries reap the benefits of their comparative advantage. That is why FTAs are allowed as exceptions to the anti-discrimination rules of the General Agreement on Tariffs and Trade/WTO. However, there is a risk that the proliferation of FTAs could come at the expense of trade with non-members, known as trade diversion. It could also create an "Asian noodle bowl" effect and raise administrative costs of trade especially for small and medium-scale enterprises. The multiplicity of bilateral and plurilateral deals could also hinder the push towards a global trade agreement.

A recent firm level study by the Asian Development Bank (ADB) found that many businesses view FTAs as a benefit rather than a burden and use them to expand trade to a far greater degree than had been previously thought. The benefits of FTAs include wider market access and preferential tariffs that make it easier to import intermediate materials needed for finished goods. Multiple country rules of origin (ROOs), which determine where goods originate for a variety of purposes, including quotas and labelling, may result in some additional administrative and transaction costs. But the large majority of exporters do not view ROOs as a significant hindrance to business activity. In addition, bilateral and plurilateral FTAs counter protectionist tendencies amid the current economic uncertainty. They provide a valuable stepping stone toward broader trade liberalisation in support of economic recovery (Kawai and Wignaraja 2009).

Financial Integration

The lack of data makes it difficult to measure the level of financial integration in East Asia, but those that are available suggest that it is now starting to increase, albeit from low levels

[7] The Asian Development Bank's database at www.aric.adb.org.

(MAS 2007, Rana 2007). East Asian countries have taken collective actions to develop local currency bond markets as these markets will reduce the “double mismatch” problem, which was at the heart of the crisis, and overcome the so-called “original sin” problem.[8] The basic idea is to mobilise the region’s vast pool of savings to be intermediated directly to the region’s long-term investment, without going through financial intermediaries outside of the region. Regional financial intermediation through bond markets would diversify the modes of financing in the region and reduce the double mismatch. The initiatives include the Executives’ Meeting of East Asia-Pacific Central Banks (EMEAP) Asian Bond Fund (ABF) Initiative and the ASEAN+3 Asian Bond Markets Initiative (ABMI).

The EMEAP introduced the ABF in June 2003. The idea was to help expand the bond market through a demand-side stimulus from purchases by the central banks of sovereign and quasi-sovereign bonds issued by eight EMEAP emerging members (including China, Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore and Thailand) using foreign exchange reserves from all 11 members. The initial attempt was to purchase US$1 billion of United States dollar-denominated bonds (ABF-1). Given the recognition that local currency-denominated bonds need to be promoted in order to address the “double mismatch” problem, the central bankers introduced ABF-2 in December 2004, involving purchases of the equivalent of US$2 billion worth of sovereign and quasi-sovereign local currency-denominated bonds.

The ABF-2 consists of two components, a Pan-Asian Bond Index Fund (PAIF) and a Fund of Bond Funds (FoBF). The PAIF is a single bond fund index investing in local currency bonds, issued in eight economies. A FoBF has a two-tiered structure with a parent fund investing in eight sub-funds, each of which invests in local currency sovereign and quasi-sovereign bonds issued in their respective markets. The PAIF and the eight sub-funds are passively managed by private fund managers against a Pan-Asian bond index and predetermined benchmark indexes in local markets. The ABF-2 is designed to facilitate investment by public and private sector entities, through the listing of local currency exchange-traded bond funds – already listed in Hong Kong, Malaysia and Singapore.

The ASEAN+3 Finance Ministers’ process launched the ABMI in August 2003. The ABMI aims to focus on facilitating market access to a diverse issuer and investor base and on enhancing a market infrastructure for bond market development, thereby creating robust primary and secondary bond markets in the region. The ABMI initially created six working groups and later reorganised these into four working groups and two support teams (the Ad-hoc Support Group and the Technical Assistance Coordination Group). Currently the four working groups are focusing on: (i) the issuance of new securitised debt instruments; (ii) the establishment of a regional credit guarantee agency to help mitigate risks through credit enhancement; (iii) the exploration of the possible establishment of a regional clearance and settlement system to facilitate cross-border bond transactions without facing the Herstatt risk (that is, the risk of being in a different time zone); and (iv) the strengthening of regional rating agencies and harmonisation of rating standards.

[8] The “double mismatch” problem refers to borrowing unhedged foreign funds to lend long-term in domestic currency and borrowing short-term to lend long-term. The “original sin” is a situation where emerging economy residents cannot borrow abroad in domestic currency nor borrow long term, even domestically. Hence domestic banks and corporations tend to face a currency or maturity mismatch or both, thus facing balance-sheet vulnerabilities to sharp changes in exchange rates and/or interest rates.

The ADB launched the AsianBondsOnline website in May 2005,[9] which has become a popular one-stop clearinghouse of information on sovereign and corporate bonds issued in the ASEAN+3 countries. In May 2009, the ASEAN+3 Ministers endorsed the establishment of the Credit Guarantee and Investment (CGIM) as a trust fund of the ADB with an initial capital of US$500 million. Issues relating to the establishment of the CGIM are to be discussed at the working level and the decision taken in May 2010.

Macroeconomic Policy Coordination

Macroeconomic policy coordination is essentially a post-crisis phenomenon in East Asia. There is an ascending order of intensity of these efforts in the sense that they involve progressively increasing constraints on the amount of discretion that individual countries can exercise in the design of macroeconomic policies. By the level of intensity, these efforts have ranged from economic review and policy dialogue to establishing regional financing arrangements and eventually coordinating exchange rate policies.

Economic Review and Policy Dialogue

In the area of economic review and policy dialogue, there are three major ongoing initiatives. First, the ASEAN Surveillance Process was established in October 1998 to strengthen the policy-making capacity within the group. Based on the principles of peer review and mutual interest, this process reviews global, regional, and individual country developments and monitors exchange rate and macroeconomic aggregates, as well as sectoral and social policies. Under this Process, the ASEAN Finance Ministers meet annually and the Ministries of Finance and central bank deputies meet semi-annually to discuss issues of common interest.

Second, with the formation of the ASEAN+3 Finance Ministers Process in November 1999, the ASEAN+3 Economic Review and Policy Dialogue (ERPD) process was introduced in May 2000. Under the ERPD, the ASEAN+3 Finance Ministers meet annually and their deputies meet semi-annually. Initially, the deputies would meet for a couple of hours but now their meeting lasts for two days and discussions focus on (i) assessing global, regional and national conditions and risks; (ii) reviewing financial sector (including bond market) developments and vulnerabilities; and (iii) other topics of interest.

The value of regional surveillance is that countries tend to be more frank with each other in a regional forum as they focus on issues of common interest (such as high oil prices, avian flu, global payments imbalances and capital inflows). However, so far, the ERPD is in transition from the simple “information sharing” stage to “peer reviews” among the member countries. Currently, the ADB and the IMF provide assessments of regional economic and financial conditions and risks and individual countries provide self-assessments of their respective economic situations. With a move towards ‘peer reviews”, the participating members are expected to conduct more active discussions of other countries’ policy making.

Steps have been taken to monitor short-term capital flows and to develop early warning systems of currency and banking crises. National Surveillance Units have been established in many ASEAN+3 countries for economic and financial monitoring and operating the early

[9] This website tracks developments in East Asia’s local currency bond markets and provides detailed progress reports on the various ABMI initiatives, among others.

warning system with the ADB's support and so has a Technical Working Group on Economic and Financial Monitoring. A Group of Experts has also been appointed. However, the ASEAN+3 does not have a technical secretariat which prepares a comprehensive assessment of the member countries' economic and financial outlook and risks.

Third, central bank governors in the region have also developed their own forums for regional economic information exchange, analysis and policy dialogues, including the EMEAP, the South East Asian Central Banks (SEACEN), South East Asia, New Zealand and Australia (SEANZA). The EMEAP is the most prominent group and was organised in February 1991 with the leadership of the Bank of Japan and the Reserve Bank of Australia. Its major objectives include enhanced regional surveillance, exchanges of information and views, and the promotion of financial market development. Its activities include annual meetings of the EMEAP central bank governors, semi-annual meetings of the deputy governors, and three working groups concerned with bank supervision, financial markets, and payments and settlement systems. Like the ASEAN+3 finance ministers' process, the EMEAP does not have a secretariat.

Until its dissolution in December 2005, the Manila Framework Group was another forum that brought together deputies from a wider range of countries for policy dialogue. There are trans-regional forums such as the Asia-Pacific Economic Cooperation Finance Ministers and the Asia-Europe Meeting (ASEM) Finance Ministers for trans-regional processes.

Regional Financing Arrangement

Progress has also been made in establishing regional financing arrangements. They are designed to address short-term liquidity needs in the event of a crisis or contagion, and to supplement the existing international financial arrangements. At their May 2000 meeting in Chiang Mai, the ASEAN+3 Finance Ministers agreed on the Chiang Mai Initiative (CMI) to expand the ASEAN Swap Arrangement (ASA) to all ASEAN members, and to set up a network of bilateral swap arrangements (BSAs) among ASEAN+3 countries. The ASA expansion was done in November 2000, and its size increased from US$200 million to US$1 billion. In April 2005, the ASA size was again increased to US$2 billion. A network of BSAs has been signed among the "plus-3 countries" (China, Japan and Korea) and between a "plus-3 country" and members of the ASEAN grouping. To date, eight ASEAN+3 members have signed 16 BSAs amounting to US$84 billion.

One of the important features of the CMI BSA is that members requesting liquidity support can immediately obtain short-term financial assistance for the first 20 percent (originally 10 percent) of the committed amount. The remaining 80 percent is provided to the requesting member under an IMF programme. Linking the CMI liquidity facility to an IMF programme and, hence, its conditionality is designed to address the concern that the liquidity shortage of a requesting country may be due to fundamental problems, rather than mere panic and herd behaviour by investors, and that the potential moral hazard problem could be non-negligible in the absence of tough IMF conditionality.

The general view is that, with the region's currently limited capacity to produce and enforce effective adjustment programmes in times of crisis, linking the CMI to the IMF's programmes is prudent, at least for the time being.

Substantial progress has been made on the CMI multilateralisation (CMIM) since its launch. Some of the major developments over the last few years include:

- Integration and enhancement of ASEAN+3 ERPD into the CMI framework (May 2005);

- Increasing the ceiling for withdrawal without an IMF programme in place from 10 percent to 20 percent of the total (May 2005);

- Adoption of the collective decision-making procedure for the CMI swap activation, as a step toward multilateralising the CMI (May 2006);

- Agreement in principle on a self-managed reserve pooling arrangement governed by a single contractual agreement as an appropriate form of the CMI multilateralisation (May 2007);
- Agreement that the total size of the multilateralised CMI would be at least US$80 billion (May 2008);

- The size of the multilateralised CMI was increased to US$120 billion (February 2009); and

- The CMIM is to be implemented by the end of December (May 2009).

On the CMIM, at their meeting in Hyderabad in 2006, the ASEAN+3 Finance Ministers decided that "all swap providing countries can simultaneously and promptly provide liquidity support to any parties involved in bilateral swap arrangements at times of emergency". At their Kyoto meeting in 2007, the Ministers decided to establish a "self-managed reserve pooling arrangement". At their May 2008 meeting in Madrid, the Ministers "agreed that the total size of the multilateralised CMI would be at least US$80 billion". In response to the global economic crisis, at the Special ASEAN+3 Finance Ministers meeting in Phuket in February 2009, the amount was subsequently increased to US$120 billion.[10] At their May 2009 meeting, the Ministers announced that they had agreed to implement CMIM before the end of this year. They also announced an agreement to establish an independent surveillance unit to monitor and analyse regional economies and support CMIM decision-making. As a start, they agreed to establish an advisory panel of experts to work closely with the ADB and the ASEAN Secretariat to enhance the current surveillance mechanism. The Ministers also welcomed Hong Kong to participate in the CMIM.

The ASEAN+3 independent surveillance unit is not intended as a substitute for the IMF. It is intended to enhance objective monitoring by supplementing the IMF, especially its new Short-term Liquidity Facility, which enables certain countries to borrow unconditionally.

Exchange Rate Issues

Despite the close and rising interdependence of East Asian economies through trade, investment and finance, there has been no exchange rate policy coordination in place in East

[10] Japan and China are to contribute identical shares of the total reserve pool (32 percent) double of Korea's share (16 percent). The remaining 20 percent will be covered by ASEAN. See www.aseansecretariat.org/22536.htm for other details.

Asia. Moreover, the region's exchange rate regimes are in serious disarray. In contrast to the pre-crisis period where many emerging market economies in East Asia maintained *de jure* or *de facto* United States dollar pegged regimes, the post-crisis period exhibits a greater diversity in exchange rate regimes. The two giant economies in the region, Japan and China, adopt different exchange rate regimes – Japan a free float, and China a heavily-managed regime targeted at the United States dollar.

So far, only some research has been conducted, under various forums such as the ASEAN+3 Research Group. This will, however, undoubtedly change as the integration process moves forward, business cycles become more synchronised, and macroeconomic policy interdependence becomes even stronger. In fact, at the May 2006 meeting, the ASEAN+3 Finance Ministers had endorsed a study on "regional monetary units," or Asian currency units.

Next Steps

East Asia's market-led integration, which now is also being driven by various policy actions, is expected to deepen further. One reason for this optimism is that the increasing level of trade integration and bilateral trade intensity has led to a greater synchronisation of output and business cycles in the region. This means that symmetric shocks are expected to prevail, enhancing the case for cooperation and coordination of policies (Rana 2008) perhaps more than in Europe, where the level of vertical integration is lower (Rana, Chen, Chia 2009).

Going forward, Asian economic integration is expected to follow what Senior Minister Goh Chok Tong (2006) once referred to as the "variable geometry, flexible borders" approach. The process will be multi-track with a trade (including infrastructure), finance, and monetary track with new members coming on board when they feel that they are ready. The CMIM has set the stage for institutionalising East Asian regionalism. Hence new institutions to support Asian integration are also expected to emerge. The "bottom-up" integration in East Asia is starting to be "top down" as well, following the European approach.

On the trade track, effort should be made to (i) make the FTAs compatible with each other (by having similar rules of origin as in Europe); and (ii) consolidate the proliferation of FTAs into a deeper and wider FTA such as the East Asian FTA (including India). Kawai and Wignaraja (2007) have shown that an ASEAN+6 FTA would provide more gains than an ASEAN+3 FTA. Connectivity issues including infrastructure development and trade facilitation are also being addressed.

On the finance track, Asian bond markets should be developed further. Regional institutions to deepen local-currency bond markets – such as regional settlement agencies – need to be established. With the progress in reforming market infrastructure at the national levels, a regional regulatory agency that promotes coordination of capital market rules and regulations (micro-prudential supervision) and monitors the stability of the financial system throughout the region through early warning systems (macro-prudential monitoring) such as an Asian Financial Stability Dialogue could be established.[11]

[11] These correspond to the newly-established European System of Financial Supervisors and the European Systemic Risk Council.

On the macroeconomic policy track, many of the decisions of the Ministers in relation to the CMIM must be implemented as scheduled by the end of this year. It is understood that the details on contributions, voting rights, decision-making rules, and other operational aspects have already been finalised. The ERPD should also be strengthened beyond “information sharing” to “peer review” and ultimately to “due diligence”.

The deepening regional and financial integration in the region, together with the synchronisation of business cycles suggest that East Asia should initiate actions to coordinate exchange rate policies using a step-by-step approach. The first step could be to promote greater exchange rate flexibility while maintaining a certain amount of intra-regional stability by monitoring deviations from an Asian Currency Unit basket (Kawai and Rana 2008).

Some commentators see recent trends in the region as heralding the eventual adoption of a single currency or the establishment of an East Asian monetary union. Europe’s experience shows that a monetary union imposes stringent demands on policy coordination and institution building that need strong political will and a deep sense of common purpose, which East Asia lacks at present (MAS 2007).

In addition to being multi-track, East Asian regionalism is also expected to be multi-speed – with the pace of progress for different aspects of regional cooperation and integration varying with members, from within and without East Asia, joining as and when they feel that they are ready to do so.

Regionalism in East Asia is expected to improve the medium- and long-term economic outlook for the region and enhance the region’s resilience to external shocks through the expansion of trade and investment based on the comparative advantages of member countries; lead to greater monetary and financial stability and prevent financial crises; and provide cross-border connectivity which is essential for the movement of goods, services, labour, and information across countries. Competitiveness, industrial production, and productivity of East Asian countries are expected to increase.

III. Economic Relations between South Asia and East Asia[12]

Prior to 1990, the South Asian and East Asian countries were relatively isolated from one another. The only trade agreement that covered the two sub-regions was the Bangkok Agreement signed in 1975 (now called the Asia-Pacific Trade Agreement). The adoption of the “Look East” policy in India in 1991 and similar policies in other South Asian countries, together with the economic dynamism of India and China, has now heightened the interest towards the evolving economic relationships between the two sub-regions.

South Asia’s total merchandise trade with East Asia has grown significantly in absolute terms albeit from a low base. It increased twelve-fold during 1990-2007, from US$12.4 billion to US$148.2 billion. The annual growth rate was relatively moderate until 2000 but it has surged after that, growing by over 25 percent per annum and nearly 50 percent per annum in recent years. As expected, a large part of the increase (roughly one-third) in South Asia-East Asia trade is accounted by the bilateral trade between the two giant economies of India and China.

[12] This section draws on Chapter 4 of Rana and Dowling (2009)

In relative terms, however, the level of South Asia/East Asia trade accounted for 18.9 percent of South Asia's total trade in 1990 and is now about 25 percent. On the other hand, South Asia accounted for a mere 1.3 percent of East Asia's trade in 1990 and a slightly higher two percent in 2007. Hence, East Asia is a more important trading partner for South Asia than vice versa.

The absence of comparable data on foreign direct investment by source limits an analysis of investment relationships between South and East Asia. The data that are available from national sources and the ASEAN Secretariat show that investment relations between the two regions, although starting to increase in recent years, are still limited.

The calculation of revealed comparative advantage indices shows that there is potential for enhancing trade between the two regions. South Asia has a comparative advantage mainly in primary goods and labour-intensive manufactures and information-technology services, while East Asia has comparative advantage across a much wider range of products. These include primary goods such as crude rubber and fish, labour-intensive manufactures such as textiles, travel goods and footwear, and more capital- and knowledge-intensive items such as office machines and telecommunications equipment.

More recently, as in other parts of the world, there has been a proliferation of FTAs between South Asia and East Asia. In 1975, there was only the Bangkok Agreement. Now seven FTAs are already in effect, and twelve are either under negotiation or have been proposed (Table 1). The most significant of these, so far, is the signing of the India-Singapore Comprehensive Economic Cooperation Agreement (CECA) on June 2005. The CECA became effective in August 2005 and covers not only trade in goods but also services, investments and cooperation in technology, education, air services, and human resources. The Asia-Pacific Trade Agreement went into effect in 1976, the Group of Eight (G8) FTA in 2006, the China-Pakistan FTA in 2007 and the Malaysia-Pakistan FTA – Malaysia's first with a South Asian country – in 2008. Earlier in 2009, the India-ASEAN and the India-Korea FTAs became effective. Although comprehensive in terms of trade liberalisation, the former allows India to protect its agriculture and services sector for some time. The India-Korea FTA has the potential of attracting Korean investment into India for export to third country markets.

Looking forward, a number of policy actions could be taken to increase the level of South Asia-East Asia integration. First, the levels of tariffs and non-tariff barriers (NTBs) are already low in many East Asian countries and since the 1990s, South Asia has made encouraging progress in the same direction. However, there is room for further reductions in tariffs and NTBs in both regions (especially NTBs in East Asia because tariffs are already low). Second, in addition to reducing tariffs and NTBs, South Asian countries and several East Asian countries also need to make progress in implementing the remaining reform agenda – namely, developing the social (such as schools, hospitals and rural medical centres) and physical (power, water, roads and railways) infrastructure and implementing the so-called second generation reforms to enhance transparency, good governance, and the quality of fiscal adjustment. These include, among others, reforms of civil service and of delivery of public goods, creating an environment that is conducive to private sector opportunities (greater competition, better regulations, and stronger property rights), and reforms of institutions that create human capital (such as health and education).

Third, the South Asian and East Asian countries need to consolidate their FTAs. Quantitative estimates using the computable general equilibrium model and the Global Trade Analysis

Project database suggest that a broader regional approach will have large beneficial impact. The estimated impact on national income of an ASEAN+3 and South Asia FTA is much higher than that of an ASEAN+3 and India FTA, which in turn is higher than that of an ASEAN FTA. While India benefits from an ASEAN+3 and India FTA, other South Asian countries lose. However, a broader ASEAN+3 and South Asian FTA is a win-win for all. Countries should also deepen FTAs – extend coverage beyond trade in goods into services, investment, technology etc. The Comprehensive Economic Partnership Agreement for East Asia, which is an FTA that includes all East Asia Summit countries, is being established and the Economic Research Institute for ASEAN and East Asia has been established to sensitise and support the process.

The fourth measure that could significantly impact the level of trade between South Asia and East Asia is a reduction of trading costs through investment in trade-related infrastructure. Most cargo between South Asia and East Asia moves by water and air as there is no land transport services that are operational at the present time. Rapid growth in trade has been accommodated through the introduction of larger container ships. The expansion and diversification of feeder services and bottlenecks, primarily in public ports, remain to be addressed.

Land transit through Myanmar is not possible at the present time. Additional corridors between India and China with Bangladesh, Bhutan and Nepal as "land bridges" will have to be developed. China has plans to extend the recently-opened Qinghai-Tibet railway to Nepal and India. The proposed Asian Highway and Asian railway have missing links and are not fully operational. The proposal to establish an Asian Infrastructure Fund with financing from various multilateral agencies and private-public partnership is making progress. The Pan-Asian Infrastructure Forum to sensitise issues related to promoting greater connectivity in Asia is in the process of being established. The ADB has identified 21 high ticket infrastructure projects to connect Asia.

Finally, countries should make effort to reduce logistic constraints to facilitate movement of goods between the two regions. These include delays in customs inspection, cargo handling and transfer, and processing of documents. Customs procedures could be modernised by (i) aligning the customs code to international standards; (ii) simplifying and harmonising procedures; (iii) making tariff structures consistent with the international harmonised tariff classification; and (iv) adopting and implementing the WTO Customs Valuation Agreement. South Asian and East Asian countries have made progress in implementing many of these procedures but much more remains to be done.

IV. Economic Integration in South Asia

The World Bank (2004) has estimated that the volume of trade among South Asian countries before the Partition of India and Pakistan in 1947 was around 20 percent of their total trade. This fell to about four percent by the 1950s and to two percent in 1967 mainly because of mutual mistrusts and political conflicts in the region. Also for four decades after independence, South Asian countries had adopted inward-looking development strategies with high barriers to trade and investment. The two landlocked countries, Nepal and Bhutan, had maintained close trade links with India but not with other South Asian countries and the rest of the world.

This trend of declining intra-regional trade in South Asia started to reverse only in the late 1980s and 1990s when South Asia abandoned import-substituting policies and began to adopt market-oriented reforms including trade liberalisation. Nevertheless, the level of intraregional trade presently stands at only a dismal five percent of total trade. The comparative figures for East Asia are about 25 percent in the case of ASEAN and 57 percent in the case of ASEAN+3.

The lacklustre performance of South Asian integration can be explained by several factors. First, the deep mistrusts and political conflicts of the past continue. Second, the presence of India as a large country arouses a fear of hegemony and economic dominance among the smaller neighbouring countries. Third, complementarities that existed in the 1940s may have lessened considerably as countries have developed similar types of industries (World Bank 2004). A recent ADB/UNCTAD (2008) study, however, finds enormous potential for intra-regional trade among the South Asian countries.

With the view of promoting intra-regional trade, the SAARC initiated the South Asian Preferential Trading Arrangement (SAPTA) in 1995. But the SAPTA's progress was painstakingly slow because of the product by product approach to tariff concessions, low product coverage, and stringent rules of origin. One study found that many trade restrictions maintained by South Asian countries were designed not to restrict imports from outside the region but to keep out exports of neighbouring countries, particularly from India (Weerakoon 2008).

In certain ways, the South Asian Free Trade Area (SAFTA) of 2004 was a leap forward as it sought to eliminate all tariffs and import restrictions over a period of time. It was formally launched on 1 July 2006, six months late because of Pakistan's failure to ratify it on time. Unfortunately, the SAFTA also had its own weaknesses. Among others, the services trade, which is emerging as a major export item from South Asia especially India, was excluded and so was the issue of non-tariff barriers. Despite this, a recent model-based study by the ADB/UNCTAD (2008) finds that the successful implementation of the SAFTA would provide significant trade and income gains for both the larger and smaller countries in the region.

On money and finance, the SAARCFINANCE, which is a network of central bank governors and finance secretaries set up following the 1998 Colombo SAARC Summit, has achieved some success in forging closer cooperation on macroeconomic policies. The SAARC has also decided to hold regular meetings of the South Asian Finance Ministers modelled after the ASEAN and ASEAN+3 Finance Ministers meetings. The more recently announced goal of attaining a South Asian Economic Union and the expressed desire of a common currency will, however, have to wait for some time in the future as they can be feasible only in the longer term with economic convergence achieved in the region.

In the area of cross-border infrastructure development, the South Asia Subregional Economic Cooperation (SASEC) programme initiated by four members of the SAARC (Bangladesh, Bhutan, India, and Nepal) has made notable progress in identifying projects in the six priority sectors (transport, energy and power, tourism, environment, trade and investment, private sector cooperation). However, the implementation of the SASEC initiatives has been modest.

More recently, there have been signs which suggest that South Asia's mindset on regional integration agenda is perhaps starting to change somewhat. The recent elections in

Bangladesh, Pakistan, and India and decisions by Sri Lanka and Pakistan to deal with insurgencies may have created an environment which is more favourable to inter-country cooperation. India, in particular, appears to have adopted a more positive stance on South Asia befitting its rapid emergence in the global economy. The ADB's India 2039 study notes that India has the potential of achieving an average of 9.5 percent growth per annum over the next 30 years provided it continues its economic reform programmes.[13] By that time, India could be the second largest in the world, second only to China and surpassing the United States. A prosperous South Asia would be beneficial for all. Last year, India announced that it would provide free market access to imports from its least developed neighbours and signed a FTA with Sri Lanka. It also made commitments to reduce its negative list and to promote regional connectivity. More recently, India has also proposed a Dhaka-Delhi-Lahore railway line to connect to the proposed Islamabad-Tehran-Istanbul service.

Positive signs are not confined to India alone. Despite the terrorist attacks, India-Pakistan relations appear to have thawed a little. Pakistan has also increased the list of items in its positive list resulting in rapid growth of its imports from India. The new regime in Nepal has made progress in advancing discussions on a number of hydroelectric projects.

In this changing context, and based on East Asia's successful experience with regional integration, South Asia needs to learn lessons from East Asia's successful experience with economic integration. The need for further cooperation in South Asia is clear. Burki (2009) argues that "South Asia has two options – it could pursue national interests or it could work as a region with the countries in the area prepared to step back a little from including only national interests in their economic strategies (in addressing regional and global issues). South Asia could do so much better by adopting a regional approach." Three lessons are particularly relevant for South Asia.

The first is for South Asia to take advantage of the recent positive signs and promote integration within itself by giving primacy to economic issues and not allowing political differences to stand in the way of regional integration efforts. The East Asian countries have not been immune to political conflicts. Despite these problems, however, the East Asian leaders have pressed ahead and agreed to keep their political differences aside on the regional cooperation agenda. It is now time for South Asia's leaders to also follow suit and implement ongoing integration schemes effectively and deepen them further.

The second is for the South Asian leaders to adopt the East Asian concept of "open regionalism" rather than the failed concept of "closed regionalism". This means extending any preferences granted by a country to its neighbours, and eventually to the rest of the world as well, or "multilateralising regionalism". Successful implementation of "open regionalism" in East Asia has contributed to the establishment of regional production networks and increased intra-regional trade without trade being diverted from the rest of the world. In fact, East Asia's trade with its three main partner groups (the European Union, the United States and the rest of the world) has increased. This, in turn, has had favourable spillover effects on East Asian intra-regional trade and investment. South Asia could also "multilateralise regionalism" by promoting trade with the rest of the world, including East Asia.

[13] This requires a formidable set of reforms to (i) tackle disparities among various social groups; (ii) improve the environment; (iii) eliminate pervasive infrastructure bottlenecks; (iv) renew education, technological development and innovation; (v) transform the delivery of public services especially in cities (vi) revolutionise energy production and consumption; and (vi) foster a prosperous South Asia and become a responsible global power.

The third is for South Asia to adopt the East Asian approach to sequencing integration and not the European one. When the Europeans initiated the integration process in the post-World War II period, there was a strong political will to cooperate and promote peace in order to avoid wars in the future. That is the reason they went for a customs union and an economic union. Efforts to promote monetary integration began only later in 1979 when the European Monetary System (EMS) was established. The East Asian sequence was different. Given the weakness in the global financial architecture, East Asia initiated cooperation by establishing the ASEAN and the ASEAN+3 Finance Ministers Process. Efforts to promote trade integration started after 2000 when countries started to promote FTAs. For South Asia too, given the lack of political will, it might be advisable to build up on the various activities of SAARCFINANCE, and maybe even establish an EMS-type system of fixed but adjustable exchange rates before trade integration. The increased level of intra-regional trade brought by such an exchange rate regime could play a catalytic role in encouraging cooperation on trade.

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Table 1: FTAs Involving South and East Asian Countries[14]

FTAs in Effect
• Asia-Pacific Trade Agreement (APTA, formerly known as the Bangkok Agreement), signed in 1975 and in effect since 1976
• India-Singapore Comprehensive Economic Cooperation Agreement (CECA), signed in June 2005 and effective since August 2005
• Preferential Tariff Arrangement-Group of Eight Developing Countries (D-8 PTA),[15] signed in 2006
• People's Republic of China-Pakistan Free Trade Agreement, signed on 24 November 2006 and in effect as of 1 July 2007 (agreement on Early Harvest Programme was also signed)
• Malaysia-Pakistan Closer Economic Partnership, signed in November 2007 and took effect in January 2008
• Association of Southeast Asian Nations (ASEAN)-India Free Trade Agreement, signed in August 2009
• India-Korea Comprehensive Economic Partnership Agreement (CEPA), signed in August 2009
FTAs Under Negotiation
• India-Thailand Free Trade Area
• Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC) Free Trade Area
• Pakistan-Singapore Free Trade Agreement
• Pakistan-Indonesia Free Trade Agreement
• Trade Preferential System of the Organization of the Islamic Conference (TPS-OIC)
FTAs Proposed
• Pakistan-Brunei Darussalam Free Trade Agreement
• China-India Regional Trading Arrangement
• India-Indonesia Comprehensive Economic Cooperation Arrangement
• Japan-India Economic Partnership Agreement
• Pakistan-Philippines Free Trade Agreement
• Pakistan-Thailand Free Trade Agreement
• Singapore-Sri Lanka Comprehensive Economic Partnership Agreement

[14] Source: ADB FTA Database (www.aric.adb.org).
[15] D-8 PTA members are Bangladesh, Egypt, Iran, Malaysia, Nigeria, Pakistan, Indonesia, and Turkey.

Table 2: South Asia-East Asia Economic Relations: Some Landmarks

1975	• Signing of Bangkok Agreement by Bangladesh, India, Lao People's Democratic Republic (Lao PDR), Republic of Korea, Sri Lanka, and People's Republic of China (PRC).
1985	• Formation of the South Asian Association for Regional Cooperation (SAARC) by Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka. Afghanistan joined in 2007.
1991	• India adopted "Look East" Policy to strengthen economic relationships with East Asian countries.
1992	• India became a sectoral dialogue partner of ASEAN.
1996	• India became a full dialogue partner of ASEAN.
2000	• PRC joined the World Trade Organisation (WTO), starting with an Early Harvest Programme that liberalised 600 farm products. An agreement to trade in goods was signed in 2005, liberalising 7,000 trading goods.
2002	• India-ASEAN partnership was upgraded to summit-level dialogue.
2003	• Signing of a Framework Agreement on Comprehensive Economic Cooperation between India and ASEAN, incorporating free trade agreement (FTA), at the Bali Summit.
2004	• Signing of a Long-Term Partnership for Peace, Progress and Shared Prosperity by India and ASEAN at the Lao PDR Summit. • Signing of Early Harvest Scheme for the India-Thailand Free Trade Framework Agreement under which preferential concessions have been exchanged on a specified set of commodities. • Signing of a Framework Agreement under the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC) by Bangladesh, Bhutan, India, Myanmar, Nepal, Sri Lanka, and Thailand.
2005	• Signing of a Comprehensive Economic Cooperation Agreement (CECA) between India and Singapore. • Renaming of the Bangkok Agreement as the Asia-Pacific Trade Agreement (APTA), which would offer up to 4,000 tariff concessions among members. • Signing of a Comprehensive Economic Framework Agreement between Pakistan and Indonesia.
2006	• PRC became an observer of SAARC. • Ongoing Japanese proposal for a comprehensive agreement covering ASEAN+3, India, Australia, and New Zealand. • Signing of an FTA between the PRC and Pakistan.
2007	• Signing of Pakistan-Malaysia Free Trade Agreement – Pakistan's first comprehensive FTA and Malaysia's first bilateral FTA with a South Asian country.
2009	• Signing of the ASEAN-India FTA in August 2009. • Signing of the India-Korea Comprehensive Economic Partnership Agreement in August 2009.