Deeper Integration in East Asia: Regional Institutions and the International Economic System

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1. INTRODUCTION

A SEA change in East Asian perceptions of the international economic system is causing a determined thrust toward deeper East Asian integration through regional financial and trade institutions. The financial crisis of 1997–98 contributed to this change by revealing weaknesses in the international financial architecture at the same time that it bared weaknesses in domestic policies and institutions in East Asia. Many East Asians felt the existing international financial system failed to provide them with adequate prescriptions or aid at a time of great need. In response, governments are intensifying regional policy cooperation and have begun to develop regional institutional capacity to head off future financial crises and manage them if they occur. This change in perceptions of the international economic system has been reinforced by paralysis in the World Trade Organisation (WTO). The failure of governments to launch a new round of multilateral trade negotiations at the November 1999 WTO ministerial meeting in Seattle is helping to propel regional approaches to trade liberalisation.

Deeper integration in East Asia is a potentially substantial development, which will influence the future shape of the international economic system. In Section 2, I review the primary factors contributing to the financial crisis and discuss the implications for policy makers in East Asia, in a context of diminished confidence in global institutions. The emphasis is on macroeconomic policy management, structural reforms, changing incentive systems, overhauling crisis

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management, and the next steps for trade liberalisation. I also compare the policy lessons East Asians have drawn from the crisis with those in the mainstream literature. In Section 3, I analyse three main trends that underlie deeper integration: proliferation of bilateral and regional free trade arrangements (FTAs), development of regional financial arrangements (RFAs) and movement toward a regional crisis prevention and management capability. In Section 4, I raise key questions about the effectiveness and broader international impact of these regional trends. To be effective, new arrangements will require commitment to rules and regimes that enhance prospects for growth and stability albeit at the cost of some independence in domestic policy. In the final section, I offer some concluding thoughts. Not a single crisis economy turned inward despite the painful adjustments required in the wake of the financial crisis. This commitment to openness should be embedded in new regional institutions.

2. THE FINANCIAL CRISIS AND ITS IMPLICATIONS

East Asians were the early and natural globalisers in that market forces encouraged cross-border networks through which goods, services, capital, information and people have flowed. Two 'new' factors have been added, however – technology and policies. The information and communications technology (ICT) revolution is changing the ways business is done. ICT has been applied first and fastest in the financial sector. Private capital now flows rapidly around the globe. Capital markets are the channels for transmitting economic disturbances across borders and regions. In this kind of world, countries that attend diligently to the fundamentals (in the past that would have implied exchange rate stability) can be overwhelmed by short-term capital surges and reversals. Hence, the role of policy – to build infrastructural public goods, to reduce obstacles to cross-border flows, and also to improve the safety and soundness of financial systems.

Until recently, East Asian integration, both within the region and with the rest of the world, was largely market driven. In 1998, intra-regional exports averaged over 44 per cent of the regional total[1] (Table 1) and ranged from the heavy dependence of Australia, Indonesia and New Zealand on intra-regional markets (with shares over 50 per cent) to Japan whose share was just 35 per cent. FDI flows to emerging economies that originate within the region (including from Japan) range from as high as 80 per cent of the total in China to as little as 30 per cent in the Philippines (Table 2). Production networks of both indigenous firms and multinationals underpin these linkages. The latter slice up the value chain,

[1] According to IMF, *Direction of Trade, 1998*. WTO data indicate intra-Asian destinations accounted for 44.6 per cent of total exports in 1998, down from 50.9 per cent in 1995.

TABLE 1
Intra-regional Trade (Distribution of Exports, Asia12), 1998
(per cent shares)

	China	*S. Korea*	*Japan*	*H.K.*	*Taiwan*	*Indonesia*	*Malaysia*	*Philippines*	*Singapore*	*Thailand*	*Australia*	*New Zealand*	*Asia12*	*ROW*	*Total Export*
China	0.0	3.4	16.2	21.1	2.1	0.6	0.9	0.8	2.1	0.6	1.3	0.1	49.3	50.7	100.0
S. Korea	9.0	0.0	9.3	7.0	3.9	1.3	2.7	2.1	3.1	0.3	2.1	0.2	41.0	59.0	100.0
Japan	5.2	4.0	0.0	5.8	6.6	1.1	2.4	1.9	3.8	2.4	2.1	0.3	35.5	64.5	100.0
Hong Kong	34.5	1.0	5.3	0.0	2.5	0.3	0.8	1.0	2.3	0.8	1.3	0.2	49.9	50.1	100.0
Taiwan	0.8	1.3	8.4	22.4	0.0	1.2	2.1	2.4	2.9	1.7	0.2	1.5	44.9	55.1	100.0
Indonesia	4.2	5.2	17.7	3.4	3.4	0.0	2.7	1.2	10.8	1.5	3.8	0.2	54.2	45.8	100.0
Malaysia	2.7	2.3	10.5	4.6	4.1	1.4	0.0	1.6	16.9	3.2	2.3	0.3	49.9	50.1	100.0
Philippines	1.2	1.7	14.4	4.5	6.0	0.4	3.9	0.0	6.2	2.1	0.6	0.1	40.9	59.1	100.0
Singapore	3.7	2.3	6.6	8.4	4.3	0.0	15.2	2.2	0.0	3.8	2.9	0.3	49.8	50.2	100.0
Thailand	3.2	1.1	13.7	5.1	3.2	1.8	3.3	1.4	8.6	0.0	1.8	0.2	43.5	56.5	100.0
Australia	4.2	6.9	19.5	4.0	4.8	2.4	2.0	1.2	3.7	1.4	0.0	6.3	56.4	43.6	100.0
New Zealand	2.9	3.1	13.3	2.7	2.3	0.7	1.8	1.2	1.5	1.1	20.9	0.0	51.6	48.4	100.0
Asia12	7.7	2.7	7.9	8.5	4.0	0.9	2.9	1.6	4.1	1.7	1.9	0.6	44.5	55.5	100.0
ROW	1.2	1.1	3.5	1.0	1.0	0.2	0.4	0.3	0.9	0.4	0.8	0.1	11.1	88.9	100.0
Total Import	2.8	1.5	4.6	2.9	1.8	0.4	1.1	0.6	1.7	0.7	1.1	0.2	19.5	80.5	100.0

Source: IMF (1998).

TABLE 2
Inward FDI Stocks, Selected East Asian Economies, 1980 and 1994
(percentage shares)

Host Economy	*United States*	*Japan*	*East Asia*	*Others*
China				
1986	16.8	10.7	61.7	10.8
1994	8.1	8.0	74.0	9.5
Hong Kong				
1984	53.7	21.0	2.1	23.2
1994	31.6	32.5	10.1	21.8
Indonesia				
1980	4.7	37.5	13.7	44.1
1994	4.4	15.8	36.6	43.2
Malaysia				
1986	10.3	25.7	23.7	40.3
1993	6.2	33.7	36.8	23.3
Philippines				
1980	54.6	16.8	5.4	23.2
1994	38.2	18.2	10.9	32.7
Singapore				
1980	22.5	11.7	19.6	46.2
1994	17.9	21.5	13.0	47.6
Taiwan				
1980	35.0	18.6	30.3	16.1
1994	26.1	28.2	21.0	24.7
Thailand				
1980	35.6	28.9	17.5	18.0
1994	17.1	30.9	33.0	19.0

Sources: Dobson and Chia (1997, p. 8); APEC Economic Committee (1995) and unpublished data from Industry Canada.

allocating production to locations with comparative advantage and outsourcing the production of both goods and services within the region (Dobson and Chia, 1997; and Feenstra 1999). These activities increased the openness and integration of economies but also increased vulnerability to external shocks.

a. Stylized Facts About the Financial Crisis

A common cause of the East Asian crises was high ratios of short-term private sector debt to international reserves (Rodrik and Velasco, 1999; and Dobson and Hufbauer, 2001). The financial crises were characterised by significant volatility in short-term capital flows, particularly bank debt (Table 3), from or to (in the case of capital flight) international financial centres. International capital had been

TABLE 3
Net Capital Flows to Emerging Markets, 1990–2000

Emerging Markets	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*
Total private capital inflows (net)	47.7	123.8	119.3	181.9	152.8	193.3	212.1	149.2	64.3	68.3	118.5
Bank loans and other (net)	11.9	55.6	32.7	11.5	(35.5)	55.4	16.3	(57.6)	(103.5)	(71.8)	(50.1)
Portfolio investment (net)	17.4	36.9	51.1	113.6	105.6	41.2	80.8	66.8	36.7	21.6	40.2
Foreign direct investment (net)	18.4	31.3	35.5	56.8	82.6	96.7	115.0	140.0	131.0	118.5	128.4
Net official flows	26.6	36.5	22.3	20.1	1.8	26.0	(0.9)	24.4	41.1	9.4	(2.4)

Emerging Markets	*Total Flows 1990–2000*	*Average Deviation*
Total private capital inflows (net)	1,431.2	43.4
Bank loans and other (net)	(135.1)	43.8
Portfolio investment (net)	611.9	28.6
Foreign direct investment (net)	954.2	15.3
Net official flows	204.9	18.1

Source: IMF (Various years).

plentiful for several reasons. Rates of return in the OECD economies fell in the 1990s as inflation and interest rates dropped, making rates of return in emerging markets relatively more attractive to investors. In the OECD economies, intensifying competition in the financial sector spurred consolidation, creating global mega-firms, particularly among the banks. With OECD populations ageing, wealth management funds are proliferating (as are new financial instruments). Geographical diversification is a way to manage the risks these large capital pools face. Modest portfolio reallocation by these mega-institutions can have significant impacts on liquidity and currency volatility in emerging markets. Although it is well known that residents also contributed to financial volatility through capital flight, magnitudes are difficult to measure due to data limitations.

The crises were triggered by different combinations of macroeconomic policy mistakes, incentive problems and structural weaknesses:

- Macroeconomic policy in the crisis-prone economies in Southeast Asia (Indonesia, Malaysia, Thailand, Philippines) was characterised by fixed-but-adjustable exchange rate pegs that were incompatible with monetary policy independence and capital mobility (the open economy trilemma).[2] Central banks maintained the formal or de facto pegs long after they should have been revised to reflect changing economic fundamentals. Currency crises subsequently turned into banking and economic crises, in part because borrowers in foreign currency and investors alike assumed there was neither exchange rate nor interest rate risk. Defence of the pegs required high interest rates that pushed highly-leveraged business borrowers into insolvency, taking jobs, income and output with them.
- Structural weaknesses influenced vulnerability. Domestic financial systems, dominated by banks and debt finance, were slow to adapt to the added externally-generated risks of mobile capital. Lacking access to other forms of domestic finance than bank debt, many corporations became highly leveraged during the high growth years. Some borrowed heavily abroad in unhedged foreign currencies. Some governments also biased policies and incentives to favour foreign over domestic capital (for example, Thailand taxed foreign capital more lightly than other forms and South Korea restricted FDI inflows but encouraged foreign debt).
- Existing incentive systems contributed to debtor and creditor moral hazard. Both debtors and creditors assumed that either the national central banks or the IMF (or both) would act as lender of last resort in a crisis. On the creditor side, the 1988 Basel Capital Accord was responsible for a short-term debt bias. The risk weight on short-term interbank lending, for

[2] The open economy trilemma recognises that an economy can tolerate only two of three objectives: mobile capital, exchange rate stability and monetary policy independence. It must give up one of these objectives to ensure achievement of the other two.

example, required lending banks to allocate only 1.6 per cent of capital requirements to such loans. On the debtor side, central banks had previously bailed out banking systems when they got into trouble and were expected to do so in future.

During the crisis, international crisis management reflected a one-size-fits-all approach, yet the private sector nature of the crisis and the implications of bank-dominated financial systems and highly leveraged business systems naturally raised questions about alternative measures such as capital controls and a regional lender of last resort. The IMF role is being re-evaluated. Much has since been done to create frameworks that will increase the safety and soundness of the international financial system. National bank regulators cooperate globally at the Bank for International Settlements (BIS) and other regulators cooperate in designing guidelines of best practice in the Financial Stability Forum (FSF). But scepticism persists about how well these innovations serve the interests of East Asians in reducing their vulnerability to international economic shocks.

b. Implications for Policy

The crisis of confidence in the global institutions for trade and finance have a number of implications with respect to macroeconomic policy management, structural reforms, reforms of incentive systems, crisis management and trade liberalisation – for domestic policy makers, for regional cooperation and for the international system.

(i) Macroeconomic policy management

Most market-based East Asian economies (with the exception of the Philippines) have established strong records of prudent macroeconomic policies with low inflation, stable interest rates and exchange rates and fiscal prudence. Since the financial turmoil subsided, high interest rates have come down and exchange rates have stabilised, but large debt overhangs and fiscal imbalances persist as financial and non-financial firms are restructured and recapitalised or closed. Thus, one of the main concerns in the immediate future is the impact of fiscal consolidation on investment. Furthermore, since the crises, most of the region's central banks are managing their floating exchange rates, with the exception of China, Hong Kong and Malaysia's fixed rate regimes. Managed floating allows central banks to rebuild their foreign reserves (Table 4), one factor (but not the only one) that is recognised to have discouraged speculators from attacking Taiwan and Singapore during the crisis. Managed floating is also a way to resolve the open economy trilemma; accepting the mobile capital that is attracted to good performers, but stabilising exchange rates to preserve export competitiveness.

TABLE 4
Asian Economies: Changes in Reserves, 1992–2001
(billions of US dollars)

	1992	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*
Asia										
Crisis countries[1]	18.1	20.6	6.1	18.5	5.4	−30.5	52.1	44.5	17.2	20.3
Other Asian emerging market economies[2]	6.6	16.6	47.3	27.6	44.8	46.7	18.2	15.9	32.9	40.2

Notes:
[1] Indonesia, Korea, Malaysia, the Philippines, and Thailand.
[2] Includes Korea, Singapore, and Taiwan Province of China. No data for Hong Kong SAR are available.

Source: IMF (2000).

Some consensus is emerging that a combination of managed floating and temporary capital controls is a feasible and appropriate set of measures to respond to financial volatility, at least in the absence of more far reaching institutional changes, such as monetary integration, that would eliminate exchange rate volatility. Critics of one-size-fits-all argue that temporary capital controls and private sector solutions to restructure unsustainable debt profiles would have been more appropriate in the East Asian crises (Wade and Veneroso, 1998; De Gregorio et al., 1999; and Stiglitz, 1999). Indeed, temporary prudential capital controls have gained more respectability in the wake of the Malaysian experience. But even the Malaysians stress that such controls must be well designed and used with great care to buy breathing space for structural reform since they can be costly. Controls on outflows can undermine confidence in a financial system by trapping capital and unintentionally spurring capital flight. Controls on inflows, such as taxes on international transactions, can raise the cost of such borrowing and lengthen its term.

(ii) Structural reforms

Weak financial systems and weak corporate governance were two major sources of structural weakness. As economies become more complex, they need stronger financial systems that permit savers and investors to interact with confidence with borrowers and issuers not known to them. This requires strong banks, diversified institutional frameworks that supply financial instruments of longer duration such as bonds and commercial paper, and flows of transparent information and payments and settlement arrangements that make deep and liquid financial markets possible.

Stronger systems will require stronger supervisory oversight and enforcement of prudential standards, creation of adequate infrastructure, accounting and legal frameworks that promote transparency, and better corporate governance that promotes integrity and fairness. There are several constraints. One is the lack of trained manpower. Another is the lack of independent supervisors and vested interests in existing systems. East Asian financial sectors have improved, but still trail best international practice.[3]

One of the quickest ways to improve practices, provide new skills and modern risk management products is to increase foreign participation in national financial systems. Foreign institutions fan the winds of competition and innovation; they diversify the financial system and introduce institutions that reflect the stringent regulatory regimes of their home countries. Foreign participation is increasing in an ad hoc way in Thailand, South Korea and Japan as authorities look to foreigners to help recapitalise and modernise their financial institutions; there is still a long way to go.

The magnitude and nature of corporate distress indicates that better bankruptcy procedures are also required to speed restoration of corporate financial health. Beyond that, stronger more transparent corporate governance seems to be indicated, particularly for firms engaging in international business, with better representation of the interests of minority shareholders.[4]

(iii) Incentive systems

This issue is at the heart of debates about financial architecture because of concerns about moral hazard – where market participants take greater risks if they think they will be bailed out than they would if there were no such expectation. On the one side are advocates of leaving markets alone. They emphasise the basic principle of a well functioning economy – that those who take risks should be allowed to gain or lose (International Financial Institution Advisory Commission (IFIAC), 2000). They believe that market forces, not central banks or the IMF acting as lender of last resort, should resolve financial crises. On the other side are those who believe that leaving adjustment to the markets alone exacts too high a social cost. But if official institutions intervene, their interventions must be carefully designed and applied (Council on Foreign Relations, 1999). Accepting the second position, creditor moral hazard can be reduced by removing regulatory distortions, such as those in the 1988 Basel Capital Accord that bias credit allocation decisions towards short-term debt, and by creating a transparent framework for involving creditors in resolving crises (Eichengreen, 2000; and

[3] South Korea has created an independent supervisory agency but has left some key functions in the Finance ministry. Thailand and Indonesia have left supervision in the central banks, neither of which is independent (Claessens et al., 1999).

[4] Highly leveraged firms, dependent on domestic and foreign borrowing, have slowed recovery. Debt restructuring takes several forms: through negotiations between creditors (usually banks) and debtors in restructuring or workout arrangements, through bankruptcy proceedings, through transfers of bad assets to state-owned asset management agencies and through the outright nationalisation of banks weighed down by non-performing loans. Asset management organisations are now significant holders of corporate assets in Indonesia, South Korea and Malaysia (Claessens et al., 1999).

Dobson and Hufbauer, 2001). Borrower moral hazard can be reduced by, among other things, strengthening the oversight and transparency of domestic financial systems so that financial institutions improve their ability to evaluate and monitor risk (Goldstein, 1998).

(iv) Overhauling crisis management

Overhauling crisis management machinery requires first that governments decide what the IMF, which is at the heart of the global financial system, should do. Even the advocates of market-led adjustment accept that an international institution is necessary. A consensus is emerging that the IMF should become more focused – on crisis prevention through its basic surveillance mandate and on crisis management as a facilitator and arbiter among governments and private sector players (Kohler, 2000). Supplying unlimited liquidity should not be at the heart of its mandate. Instead, it should provide ‘working capital’ to keep an economy functioning while it restructures its obligations and fixes policy errors (Dobson and Hufbauer, 2001).

(v) Trade liberalisation

While greater openness has made the international financial system more crisis-prone, the international trading system – long a source of openness and stability – seems to be losing its liberalising momentum. The give and take of tariff reductions on goods has been exhausted. Since the end of the cold war, trade policy in the United States has drifted. The President lacks fast track authority (whereby congress authorises the executive branch to negotiate trade agreements and agrees to approve them on an up-or-down vote) considered essential for US participation in multilateral negotiations. Differences among major governments prevented the launching of the WTO millennium round of multilateral negotiations in Seattle in 1999 (Hufbauer, 1999). The presence of thousands of demonstrators protesting the WTO’s perceived role in ‘globalisation’ did not help. But the central lesson is that the OECD countries’ commitment to trade liberalisation is flagging. They have plucked the low hanging fruit in previous rounds. Now they must address entrenched domestic interests if they are to tackle agricultural trade and such sensitive topics as the environment, labour standards and social issues.

East Asia’s export-led growth has been highly dependent on trade liberalisation in the major OECD economies. If this source of growth momentum declines or is uncertain, other sources must be found. One is growth in domestic demand. The other is to accelerate the APEC-sponsored liberalisation process by pursuing sub-regional FTAs (SRTAs). The only WTO members who are not part of a regional trade arrangement are Japan and South Korea. Long committed to the WTO for historical reasons, Japanese policy began an unprecedented shift in

1998 when Japan initiated several bilateral negotiations. By early 2001, a number of studies of and commitments to negotiate SRTAs had proliferated in the region. As is argued below, the two trade approaches are not mutually exclusive. Lack of US participation and leadership at the global level is seen to make the second route imperative, both as a contingency plan and as strategic pressure on the US Congress and the new US president.[5]

c. Lessons From the Crisis in Comparative Perspective

East Asians have drawn their own lessons from the crisis. It is worth noting the similarities and differences between these lessons and those drawn in the mainstream literature. With respect to finance, critics of mainstream solutions cited earlier emphasise the region's diversity of economic systems and levels of economic development in considering how to reduce the risks of integrating into the world economy. They emphasise tendencies toward greater leveraging (given the dominance of banks in immature financial systems), relationship-based transactions (given the role of corporate and family groups) and producer-oriented and interventionist industrial and financial policies. While many recognise the need to remove structural obstacles to the operation of market forces, these are changes that cannot realistically be made overnight.

Contributors to the literature on finance and development emphasise the benefits of modern and diverse financial institutions and systems that facilitate capital accumulation and increase the efficiency with which capital is allocated (Levine, 1997; Demirguc-Kunt and Levine, 1999; and others). International financial instability has increased, however, as the barriers to cross-border capital flows have declined (Goldstein, 1998; and Lindgren et al., 1996). The international institutional structures for reducing financial instability are incomplete (Rogoff, 1999) but the *sine qua non* of reducing instability is strong domestic financial systems (Caprio and Honohan, 1999; Dobson and Jacquet, 1998; and others). The crisis has also demonstrated that financial liberalisation of emerging market economies must be sequenced. Financial systems should be modernised and strengthened before substantial capital account liberalisation is undertaken (Johnston et al., 1999; Dobson and Jacquet, 1998; and others). Furthermore, some even question the benefits of capital account liberalisation (Bhagwati, 1998).

East Asians are also debating regional financial arrangements that include building the infrastructure for more efficient intermediation of their own substantial savings. They are debating ways to reduce their vulnerability to volatility in world capital markets through managed floating exchange rate

[5] Hufbauer (1999) lists the political issues that make the United States, not the EU, the major stumbling block to launching the new global round.

regimes, temporary prudential capital controls, a regional lender of last resort capability, and closer macroeconomic policy cooperation.

These choices will have an impact on the international economy. Regional financial arrangements will not necessarily be discriminatory, but they could create distortions in international capital markets. The mainstream consensus, for example, has concluded that exchange rate arrangements should be floating or institutionally fixed. Intermediate solutions, it is argued, will attract speculative activity and volatility. Significant voices disagree, however, arguing for intermediate solutions such as managed floating or basket pegs, depending on a country's circumstances (Frankel, 1999; and Williamson, 2000).[6] There is also considerable scepticism that capital controls can be administered in ways that avoid serious distortions (Edwards, 1999). And those who favour lender of last resort facilities argue they should be international (Fisher, 1999).

More concern is voiced about regional trading arrangements because it is not clear that these will be non-discriminatory. Krueger (1999) surveys the debate over whether preferential trading arrangements (PTAs) are building blocks or stumbling blocks to global trade liberalisation. The empirical evidence on PTAs indicates they are trade-creating. Governments also use them as a device to 'lock in' domestic reforms and as strategic threats to encourage laggards back to the multilateral bargaining table. PTAs are also channels by which governments can move faster and in innovative ways that are not possible in the increasingly cumbersome multilateral rounds. Producers use PTAs to accelerate tariff reductions on intermediate goods.

Stumbling block proponents emphasise the dangers of trade diversion. They prefer unilateral liberalisation to preferential arrangements and prefer to see trade ministers focus their scarce resources on multilateral liberalisation. Krueger points out that most sophisticated models of the costs and benefits of PTAs show that they create trade. There are few other empirical studies on which to base conclusions. She concludes that PTAs are here to stay and the challenge is to make them compatible with multilateral liberalisation. As is well known, unilateral liberalisation has been a common practice in East Asia. More recently, APEC members have committed to free trade in the region by 2010 for developed economies and by 2020 for the less-developed economies.

In summary, while East Asians have drawn some different lessons for their financial policies and financial arrangements than those drawn in the mainstream literature there are also numerous areas of agreement – particularly with respect to the need to strengthen domestic financial systems and with respect to the advantages of PTAs. The outlines of these regional arrangements are the subject of the next section.

[6] See also MOF Japan 2000, a joint Discussion Paper prepared by the Japanese and French Treasuries in late 2000.

3. HOW IS DEEPER INTEGRATION TAKING PLACE?

East Asian scepticism about some of the lessons drawn in the mainstream literature is buttressed by their growing economic clout in the world economy. They account for a third of world output and they are leading traders. Their central banks own much of the world's international reserves; Japan and China alone account for roughly $450 billion (*Economist*, 2000). These strengths can be turned to advantage in reducing their vulnerability to external shocks – and in reshaping the international system. How will these initiatives play out? How should they play out so that they benefit both the region and international system?

The crisis was a catalyst for regional financial initiatives both for 'plumbing' (infrastructure) and architecture. With respect to the plumbing, since much of the region's significant savings are intermediated in world money centres, substantial infrastructure is required to strengthen the region's ability to intermediate its own savings more efficiently.

With respect to the architecture, cooperative regional mechanisms are also needed to promote closer monetary cooperation and possible regional monetary integration. The rationale for closer regional financial cooperation is developmental. Bad macro performance, as well as structural weaknesses in national financial systems, can spill over to neighbouring economies through interest rates and capital flows, exchange rates and capital and trade flows, as well as through migratory flows. It helps to have a hand on the policy levers of one's neighbours through surveillance discussions and through technical assistance for institution building. Investments in closer relationships also pay off in terms of early warnings of future crises and in cooperative management of crises.

ASEAN is East Asia's longest-standing regional grouping. It has had considerable difficulty in achieving closer economic cooperation because of its traditional principle of non-interference. In the 1990s it has negotiated the Asean Free Trade Area (AFTA). Implementation has slowed to a crawl since the crisis, however, because of Indonesia's political and economic turmoil and because of Malaysian resistance to tariff reductions in the auto sector (Yeoh, 2000). More recently ASEAN has initiated a study of deeper integration with the Australia and New Zealand Closer Economic Relationship (CER). The 'ASEAN+3' grouping (the ASEAN 10 plus China, South Korea and Japan) is developing closer cooperation on a range of regional issues. But the '3' are the prime movers.

A steady impetus for trade liberalisation and development has also come from the non-governmental sector. Track 2 forums date back more than thirty years to the founding of the Pacific Trade and Development (PAFTAD) network. This network of trade and development scholars has provided intellectual leadership through its regular conferences and through the participation of its members in other groups such as the PECC (Pacific Economic Cooperation Conference). PECC also has a long history of serving as a network and forum for scholars, the private sector, and governments. It contributes useful analytic inputs and periodic blueprints for liberalisation of trade and FDI. Another forum is PBEC (Pacific Basin Economic Committee) which is composed of private sector members. ABAC (Asian Business Advisory Committee) is an official part of the APEC system and provides private sector advice to APEC leaders.

Comparable track 2 financial groups do not yet exist. One of the reasons is that there is no accepted leader because of the historical legacy of mistrust among Japan, China, and South Korea. Japan has the largest economy but lacks an internationalised currency and the strong financial institutions that are required to intermediate mobile capital efficiently.

Instead, official regional financial institutions have evolved largely from initiatives involving the United States. Prior to the crises, there were two official forums. One is the APEC Finance Ministers (which some would not see as regional). It deals with a plethora of issues from social safety nets to capital flows. The second official grouping is a network of central banks, the Executives' Meeting of East Asian and Pacific Central Banks (EMEAP) which Japan and Australia organised in the early 1990s. This group has no secretariat and is organised each year by one of the participating central banks. Despite its informality, it has a solid record of technical cooperation to develop best practice templates and the infrastructure necessary for closer central bank cooperation in the region. Its technical groups are closely patterned on the lines of those at the Bank for International Settlements, which implicitly provides mandates, structures and benchmarks that work well. In addition, some monetary authorities are working intensively to develop bilateral cross-border clearing and payments mechanisms. In their initial stages, these arrangements are hub-and-spoke in nature, but as more bilateral linkages are built they will mature into broader networks that will increase the efficiency of financial transactions within the region.

Since the crisis, the Manila Framework Group (MFG) has also met regularly. It was proposed by the United States and convened a number of APEC members (including some non-Asians) before the 1997 APEC Leaders' Meeting in Vancouver to address crisis issues and to fill the vacuum left by the failure of Japan's Asian Monetary Fund proposal. MFG has also initiated regular macroeconomic surveillance discussions at senior official levels and discusses international financial architecture issues such as the dollar-yen fluctuations and the role of HLIs (highly leveraged institutions or hedge funds).

More recently East Asians have become increasingly serious about the ASEAN+3 grouping. This is the same grouping originally proposed some years ago by the Malaysian Prime Minister as the potentially exclusive East Asian Economic Caucus. Reintroduced in a more neutral way in the wake of the crisis, ASEAN+3 has held leaders' summits and work is under way, chaired by a former South Korean foreign minister, on a 'vision' for the group. The potential agenda of the ASEAN+3 is ambitious, with trade, finance, early warning mechanisms, and human security among the top items on its list. Membership is still an issue, with respect to Taiwan and other countries around the Pacific. As indicated earlier, the moving forces behind this grouping are the Northeast Asians – Japan, South Korea and China. They have the financial clout and the resolve to develop their own mechanisms for preventing and managing future financial crises; their leaders recognise, for very different reasons, the need for contingency plans in the event of continued paralysis at the WTO.

In the wake of the financial crisis and the failure at Seattle, three strategic initiatives have been taken that will influence the international economic architecture:

- Bilateral and sub-regional trade agreements (FTAs) to build free trade in the region;
- Regional financial arrangements (RFAs) to reduce vulnerability to capital flows and exchange rate volatility; and
- regional crisis prevention and management mechanisms that build on the region's financial strengths.

a. Trade – Bilateral and Sub-regional FTAs

A number of trade-liberalising initiatives are in various states of play (Table 5), ranging from the well-established AFTA to serious study of a Japan-South Korea FTA. These could eventually be linked into a region-wide arrangement. The implications of these potential arrangements may not always be fully understood by their proposers, so considerable study is probably required before formal negotiations begin. Free trade arrangements, for example, make little economic sense between two economies with complementary industrial structures. The gains from liberalisation are to be realised from reducing tariffs and the many technical barriers that prevent specialisation and intra-industry trade. This is especially true in services. In addition, such agreements will not be WTO-compliant unless they aim to free up trade in essentially all sectors on a non-discriminatory basis.

As Table 5 indicates, the list of proposals is a long one, but only a few have been implemented. Two countries, Singapore and Japan, are major movers. One of Singapore's objectives in pursuing FTAs with neighbours such as New Zealand and Japan and non-neighbours such as Canada is to create an incentive for its foot-dragging AFTA partners to become more serious about faster implementation of AFTA. Another objective is strategic: to head off concerns about a discriminatory block by stimulating cross-regional ties. Japan seeks a new form of *gaiatsu* (foreign pressure) to stimulate needed domestic reforms. Japan is also concerned to break its sense of isolation, created by the severity of its own domestic crisis and by its inability to project effective leadership in the regional

TABLE 5
Sub-regional Trading Arrangements, APEC Members, 2000

Being studied	
	Japan-South Korea (1998)
	Japan-Mexico (1998)
	Japan-Canada (2000)
	'P-5' feelers (US, Singapore, New Zealand, Australia, Chile)
	Northeast Asia research initiative (China, South Korea, Japan) (1998)
	AFTA-CER Task Force
	Singapore-Canada (2000)
	Singapore-US (2001)
	Korea-Chile (2000)
	'Asian' FTA (2001)
Negotiation	
	Singapore-Japan (2000)
Agreement Signed	
	Mexico-EU (1999)
	Singapore-New Zealand (2000)
Agreement Implemented	
	AFTA (1993)
	Canada-Chile (1996)

Source: author.

crisis. Discussions with Singapore are moving quickly in part because agriculture is an insignificant item in bilateral trade. While the Singapore-New Zealand agreement is between two very small economies,[7] that between Singapore and Japan is potentially significant, judging by the report of an official binational study group that laid the groundwork for negotiations.[8] This report recommends negotiation of the elements of a free trade agreement (reduction of tariff and non-tariff barriers; creation of dispute resolution mechanisms; inclusion of goods, services, investment, intellectual property, government procurement and competition policy). It also contains proposals to break new ground through bilateral cooperation on a wide range of 'new' issues in electronic commerce, multi-media, science and technology and trade and investment promotion.

The Japan-Singapore negotiation will set a significant precedent because of the new ground it proposes to cover. It could provide a flexible structure for future Japanese bilateral negotiations as well as provide a useful WTO-consistent model that others could adapt. Of course, much depends on what is actually produced by the imminent negotiations. First, Japan is hampered in these initiatives by its agriculture and forestry lobbies. Excluding these sectors from the negotiations would set a dangerous precedent that would probably doom any other Japanese

[7] Even so, the agreement itself is a textbook example.
[8] See *Japan-Singapore Economic Agreement for a New Age Partnership*, Joint Study Group Report (September 2000).

free trade initiatives.[9] Second, a key aspect of the study group report that could set another precedent is dispute settlement. One recommendation – for inter-governmental consultations on interpretation of the agreement and for monitoring progress on bilateral cooperation – is unlikely to be controversial. Another recommendation to formalise the two countries' respective Alternative Dispute Resolution mechanisms is a creative and also relatively uncontroversial one. But the third recommendation is for 'Government-to-Government dispute settlement procedures'. It is more troublesome because it is essential to the credibility of any framework but it is the least explicit.

b. Monetary Integration – Regional Financial Arrangements

The road to monetary integration is a very long one but governments have decided to begin the trip. Sub-regional financial arrangements began informally in the ASEAN economies when several central banks agreed to currency swap agreements in 1996–97. These agreements had relatively little effect during the crisis, but cooperative arrangements took a major leap forward when the idea was expanded and formalised among ASEAN+3 central banks in May 2000. ASEAN+3 central bank governors and finance ministers agreed to work out currency swap arrangements among central banks in Northeast and Southeast Asia. This initiative, known as the Network of Bilateral Swap Arrangements (NBSA), will supplement the reserves of such countries as Singapore with Japanese, South Korean and Chinese foreign exchange reserves that others can call upon in a crisis. Such an arrangement will replace a looser scheme of repurchase agreements. Details of the scheme are being worked out for quick activation and disbursement of swaps with associated decision making structures and a system of monitoring and surveillance of member economies (see, for example, MOF, 2000). While this network will take some time to become operational, the magnitude of resources being discussed informally, upwards of $60 billion, suggest the mechanism could have considerable clout.[10]

Work is also under way on arrangements to increase the region's ability to intermediate its substantial saving. Some EMEAP member central banks are working on bilateral payments and clearance mechanisms for specific financial instruments that could eventually grow into regional networks.

The economic feasibility of region-wide monetary integration is under study. Existing studies suggest that the degree of economic integration necessary for

[9] Japan is also talking to countries such as Australia which have substantial agriculture sectors with the aim of liberalising economic relations in areas other than agriculture. Such talks are seen to be part of new economic partnerships, but not as FTAs.

[10] Countries providing swap resources could deposit a certain share of their total commitments, in their own currencies or in US dollars, at an operating agency from which they would be paid interest.

smooth adjustment to external shocks under a unified monetary regime does not yet exist. Bayoumi and Eichengreen (1994) identified Japan, South Korea and Taiwan to be one possible regional grouping and Hong Kong SAR, Indonesia, Malaysia, Singapore and possibly Thailand to be another. Note that China was not seen to be part of any grouping. Kwan (1998) studied the possibility of monetary union using the yen as the common currency. Kohsaka (2001) found that the East Asian economies adjusted to simulated aggregate supply and demand shocks in a manner similar to the European economies, the implication being that the risks in the Asian economies, dissimilar as they are, are not much different than those with which the Europeans are now confronted.

These theoretical analyses say little about institutional and political feasibility. To realise the benefits of monetary union, countries must have similar macroeconomic policy objectives. Their central banks should have some institutional similarities and be independent of political pressure. They should have similar economic structures; trade and capital markets should be closely integrated and labour must be mobile. While trade and investment flows increasingly link the Asian economies, financial intermediation is still under-developed; labour movements are restricted; central banks are not independent; and governments still guard national sovereignty closely.

There are some intermediate options, however. One is to work towards sub-regional monetary integration involving subsets of economies with similar industrial structures and institutions. Another is to introduce an intermediate exchange rate regime such as a common basket peg (Williamson, 2000) or an Asian currency unit, ACU (Ito et al., 1999). Indeed, a former Philippines President has already called for the ACU. In the intermediate exchange rate regime, economies would choose an appropriate basket of currencies based on trade shares with their major trading partners and peg to that and to each other's currency. The common basket peg would suffer from some of the same problems of de facto pegs in that both the yen and US dollar shares would be large in such a basket. The ACU is more flexible in that, like the ECU before it, each country would peg to this common currency unit.

In summary, while region-wide monetary integration is not on the cards in the short term, some significant steps towards closer monetary cooperation have been taken by policy makers that will strengthen regional financial infrastructure and build shared understanding necessary for collective efforts to prevent and manage crises.

c. Regional Crisis Prevention and Management

Regional arrangements for crisis prevention and management allow for public intervention in the short term and a determined effort to deepen financial integration and cooperation through sub-regional financial agreements in the long term. Malaysia's experience with selective and temporary capital controls has provided support for short-term intervention by small open export-oriented economies with floating exchange rates that are overwhelmed by volatile international capital flows. Many economies are practising managed floating, allowing them to build up reserve positions that speculators have to respect. Macroeconomic monitoring and cooperation includes early warning indicators in surveillance of economic performance and policies. Assistance is being organised for countries that get into trouble because of external financial shocks. The Miyazawa Plan, which replaced the Asian Monetary Fund proposal, assisted a number of crisis countries and guarantees foreign borrowing by some countries. Many structural weaknesses, mentioned above, will remain, particularly in domestic financial systems and corporate governance. They will take time to fix and need to be addressed and monitored on an ongoing basis.

4. WILL THE NEW REGIONALISM SUCCEED?

East Asian integration had a defining impact on the world economy in the past decade as the region became an economic growth pole in the world economy. Will deeper integration in East Asia have a further defining impact on the international economic system and its institutions? The foregoing analysis of regional initiatives suggests four concerns that need to be addressed.

- Are bilateral and sub-regional trade initiatives filling a 'liberalisation vacuum' created by paralysis at the WTO, to be abandoned if WTO momentum is restored?

Early restoration of WTO momentum would slow the regional trend, but this seems unlikely because of the depth of disagreements, among the large players and between the developing countries and the industrialised countries. What seems more likely to slow things down is confusion in Japanese trade policy. While an historic policy shift seems to have occurred, excepting agriculture in the Japan-Singapore agreement could be an ominous precedent for other FTAs. Furthermore, enthusiasm for these bilateral agreements will depend on business support. If a plethora of bilateral trade agreements sprout, each with its own rules of origin and dispute settlement procedures, business may press for reduction of barriers among larger areas to simplify these arrangements or for a return to the WTO.

- Will regional surveillance mechanisms 'add value' in preventing international crises?

Experience has shown that effective surveillance relies on peer pressure during good times and requires 'interference', in the form of constructive criticism of each other's economic performance and policies – as well as conditions in return for financial assistance – to those that get into trouble. Peers must be willing to supply constructive criticism and those in potential or actual difficulty must be willing to accept objective analysis. Unless governments are willing to enter into this kind of give and take, the regional mechanism will simply become another overlay of officialdom.

- Will East Asians do things differently (such as restricting certain international private sector financial players; making liberal use of capital controls; imposing weaker conditions on troubled economies) than the rest of the world?

Substantially different approaches to financial development or to crisis management will invite arbitrage and create distortions in capital markets. Weak conditionality will simply delay the necessary strengthening of domestic financial systems. East Asian economies did not turn their backs on world capital markets in the recent crises; but international experience demonstrates that strong financial and corporate governance systems are essential to withstand external financial shocks.

- How durable will be the ASEAN+3 political and institutional framework for crisis prevention and management?

The ASEAN+3 initiatives will have to be integrated by skilful leaders and brought to life by some sort of administrative mechanism. European experience strongly suggests the importance of a political framework for economic integration. Asia's history and diversity is such that there is no grand vision comparable to the Franco-German vision of integration to end European wars. The Asian custom of consensus and incrementalism suggests the need for strong leadership from a country such as Indonesia or Thailand, or from a coalition of leaders with legitimacy, support and longevity. Gyohten (2000) proposes an intermediate step to address these difficulties. He suggests launching a core group of economically homogeneous (market-oriented) countries such as Japan, South Korea, Singapore, Australia, New Zealand, Hong Kong and Taiwan (the latter two if China agrees) to demonstrate how regional cooperation might work, before attempting closer cooperation among a more heterogeneous group.

The administrative issues are not insignificant ones either. How will monetary cooperation and other forms of economic cooperation be integrated into a coherent whole? Can this be done incrementally and in a pragmatic way? East Asian aversion to international bureaucracy is evident in the minimalist arrangements for APEC. Yet implementing a grand design for integration such as Europe's, while based on political consensus, required a 'centre' with permanent expertise.

China will be a major factor in the answers to these questions in three respects. First, stable relationships among China, Japan, and the United States will be necessary for a regional initiative to be successful. If this trilateral relationship destabilises, regional efforts will be submerged by geopolitical issues. Since the 1997–98 crises, support from the Northeast Asians – South Korea, Japan and China – has been the driving force behind ASEAN+3 initiatives. Despite old antagonisms, leaders of the three economies have demonstrated their commitment to cooperate on regional issues. Second, China's internal balance will affect its neighbours. China faces huge challenges to transform its large state-owned enterprises (SOEs) into profitable enterprises. The continued problems of the SOEs will influence its objectives of modernising its financial institutions and building a safe and sound private banking system. Exacerbation of its internal problems will divert attention from its international pursuits and regional spillovers could be felt, particularly through the increasingly close intra-regional trading arrangements – and through the financial system if there is a significant effective exchange rate devaluation. Third, once it accedes to the WTO, China will have to decide where it will focus. It is possible that WTO obligations will crowd out regional matters and regional relationships could suffer.

5. CONCLUSION

A sea change has occurred in East Asia. Deeper integration – beginning with sub-regional trade and financial arrangements and with mechanisms to prevent and manage financial crises – could have a significant impact on the world economic system. It would be a mistake to under-estimate the catalytic effects of the financial crisis and the difficulties of the WTO on Asian determination 'never again' to be as dependent on outsiders as at the outset of the 1997–98 crisis.

The way forward will be uneven and uncertain, as most developmental efforts of this nature tend to be. It is unlikely that any one or two Asian leaders will have the legitimacy to provide a blueprint or overall leadership that are seen to have been critical factors in Europe's deeper integration. An incremental process based on consensus is more likely. Such a process is bound to be time consuming and inward looking, but it should not be compared unfavourably with the European vision to end their wars.

Deeper integration in East Asia does not occur in a vacuum. Both Europe and the United States, which have managed the world economy for the past 50 years, are likely to perceive discriminatory arrangements as a direct challenge to which they may react in unpredictable and unanticipated ways. Thus it will be important that East Asians view their process in a broad strategic context. Priority should be accorded the necessity to explain and interpret proposed arrangements to the European Union and the United States. More priority also should be accorded to cross-regional FTAs, such as those with Chile, Mexico, Canada and the United States listed in Table 5.

Closer regional monetary cooperation, if it is successful, will have a major impact on the leadership role and prescriptions of the IMF. Regional trading arrangements will reduce the clout of the WTO as the global trade negotiation forum. But these organisations should not be duplicated on a regional basis. Instead, both the IMF and the WTO should be the global coordinating mechanisms among the world's major regions as well as the generators and arbiters of universal principles, norms, rules and standards.

To ensure regional arrangements are building blocks rather than stumbling blocks in the global system some basic principles are essential:

- Preserve the principle of open regionalism.
- Be open to the region. Australia and New Zealand, like Indonesia, send more than 50 per cent of their exports to other economies in the region. They are increasingly closely integrated with their neighbours. The ASEAN+3 should be an ASEAN+5.
- Trade agreements among neighbours, or with more distant economies, should be WTO- and APEC-consistent.
- Financial arrangements and macroeconomic cooperation should be linked to the IMF. World capital markets are so tightly intertwined that certain markets trying to operate with different rules will create arbitrage and distortions. Effective regional surveillance will help to bring peer pressure to bear in time to head off problems that could build into crises. But financial crises will still occur and they will be systemic in nature, requiring either a global institution, resources and management or very well-developed global coordination among regional mechanisms.

In conclusion, these principles, if observed, will enhance international acceptance and effectiveness of the regional initiatives. Just as the crisis economies persisted with their outward orientations despite the painful adjustments required in the wake of the crisis, the commitment to openness which has served the region so well over the years should be embedded in any new regional institutions.

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