

# **East Asian and Pacific Integration Strategies**

**A paper presented by**

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## *Introduction*

I have been asked to give an Australian perspective on strategies for East Asian and Pacific economic integration, with a particular focus on how South Asia can more effectively integrate with, and leverage of, the rapid economic growth occurring in its neighbouring region – and engage with east Asian approaches to trans-regional integration.

### *What do we mean by ‘integration’?*

It is customary to think of integration in terms of concrete measures of trade and financial flows. By a number of these measures, East Asian countries can be considered quite integrated.

Intra-regional trade, that is, trade between countries within East Asia, has risen from 35 per cent of the region’s trade in 1980 to 55 per cent in 2005. A key factor in driving this integration has been the emergence of regional supply networks for manufactured goods, increasingly centred on China. Further, East Asia’s trade with the rest of the world – while accounting for a smaller proportion of total trade – has increased from 14 per cent of world trade in 1980 to 26 per cent in 2005.

East Asia has also witnessed considerable developments in the size and sophistication of regional financial markets. Since the Asian financial crisis, the size of East Asia’s (ex. Japan) financial markets (defined as the sum of bank sector deposits, equity markets and bond markets) have increased over three-fold<sup>1</sup>. Nevertheless, intra-regional financial linkages remain much more limited than trade linkages, and redressing this imbalance remains a particular focus of the continuing domestic and collective policy efforts of east Asian economies.

However, for the purposes of today’s discussion it may be limiting, and potentially misleading, to think of integration solely in such terms. One only needs to reflect on the fact that, by traditional measures of trade openness, the US would not be considered to be very integrated with the rest of the world – something that is clearly not true – to ask whether it may be more useful to look for alternative understandings of ‘integration’ to help shape today’s exchange.

For example, are we actually more interested in the integration of economic interests, rather than merely focusing on the degree of measured trade and financial flows? Putting this another way, we need to ask ourselves whether ‘integration’, to the extent we have a policy interest in it, is: an end in itself; a reflection of something else more interesting from a policy perspective; or a means to a policy objective.

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<sup>1</sup> The sum of East Asia’s banking sector deposits, equity markets and bond markets have increased from around US\$3,593 billion in 1998 to US\$11,053 billion in 2005.

Of course integration can be all three, but I would suggest that the latter two dimensions are perhaps the more interesting.

In fairly basic terms, 'integration' is a reflection of the degree to which economies both adopt and foster openness in a globalised economy. Such openness may be preferential or non-discriminatory (although theory and experience tells us more is to be gained from a non-preferential approach). And integration can also be thought of in terms of the collective policies and institutions which can help manage the risks and shape the opportunities associated with the challenge of globalisation.

The current challenges posed by the disruptions to international financial markets provide a timely illustration of the value of thinking about integration less in terms of ex-post financial flows and more in terms of shared national economic interests – in this case restoring stable, well functioning global financial markets which price risk appropriately and transparently and ensure adequate access to credit and liquidity.

While emerging market economies remain relatively unaffected in a direct sense from the sub-prime loans crisis, or from their financial institutions involvement in innovative structured financial products, all are potentially exposed to the real economy flow-on effects to trade and investment of a continued slow-down in the US domestic economy combined with widespread disruptions to global credit markets. No economy can be insulated from such challenges. Rather, the pattern and the structure of integration, both in terms of actual trade and financial flows as well as policy and institutional settings, will determine how these risks are managed and how costs are distributed.

#### *The Importance of domestic policy settings to integration*

Domestic policy settings designed to increase openness are, therefore, a key integration strategy, but the ultimate goal of such policy is enhancing domestic economic wellbeing, not integration for integration's sake.

East Asia's long-term growth prospects will continue to depend ultimately on the quality of member countries' domestic institutions and economic policy frameworks.

Specifically, increasing trade flows improve wellbeing as economies open to product and factor flows; labour moves to specialise in areas of comparative advantage; integrated markets enable economies of scale; and stronger competitive pressures improve productive output. Increasing capital flows boost productivity as financial sectors move to adopt global best practice and corporate governance, capital is allocated more efficiently, technology transfer increases and information flows rise.

India's experience is also testimony to this. While the pace of reform may have ebbed and flowed, the cumulative story has been one of the progressive liberalisation and opening up of the Indian economy. In the area of foreign trade for example, import licensing has been abolished and many tariff rates have been substantially reduced. India's foreign investment and exchange rate controls have also been significantly liberalised, indeed much of 2007 saw record levels of foreign inflows to India, particularly debt and portfolio inflows. Private sector participation in the telecommunications industry has increased, leading to improved levels of service provision across India. Other sectors of the economy including insurance and banking have also been opened to domestic and foreign private investors.

And, while there is no doubt more to be done, the results are impressive.

Over the past ten years, India has emerged as one of the world's fastest growing economies having expanded at an average rate of around seven per cent and over the last two years reached rates of growth of around nine per cent. India has also accounted for around 7 per cent of global growth in that time.

In a recent 2008 piece on financial integration, Lane and Milesi-Ferretti highlighted the following interrelated drivers:

- the degree of trade openness – which directly generates cross border financial flows and improve information flows and thereby increases the willingness to invest in foreign assets;
- the extent of domestic financial development - which facilitates international asset trade among domestic residents as well as generating institutional capability which lowers barriers to acquiring foreign assets as well as foreign investment;
- the level of economic development and country size – larger economies allow for more domestic portfolio diversification and more developed economies have lower learning costs and higher wealth making domestic residents less risk averse toward international investment; and
- the history of capital account restrictions – which has a negative impact on accumulated stocks of foreign assets and liabilities as well as preventing progress of domestic financial development from spilling over into greater financial integration.

Australia's reform experience over the last 25 years is certainly consistent with these findings, and underscores the fact that reform aimed at enhancing economic wellbeing by fostering openness needs to be broad based and reflect the inherent interconnectedness of markets and sectors.

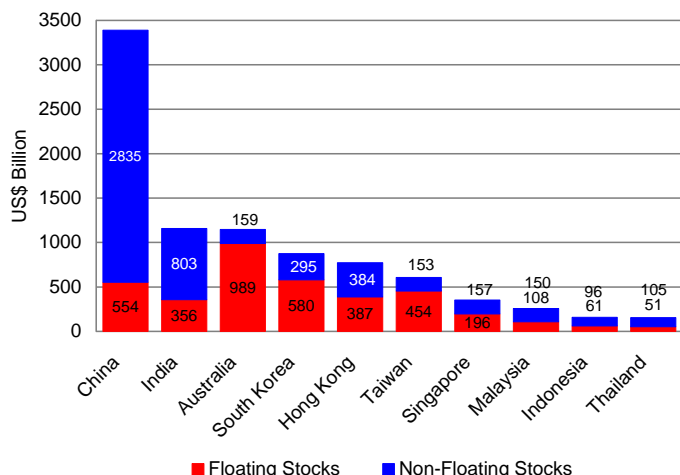
Our reform story is generally seen to have commenced with the floating of the Australian dollar in 1983, and the associated removal of capital controls and liberalisation of the financial sector. This, in turn, acted as a catalyst to parallel efforts to significantly reduce trade tariffs, and in due course a commitment to far-reaching reform in labour markets, the non-traded goods sector, and in the architecture of macro-economic policy tools. The process was far from linear, and involved many false steps along the way, including the need for significant re-thinking of the appropriate structure of financial sector regulation in a more open economy and the management of transition costs and safety nets.

But the results have been impressive. Most importantly, Australia has enjoyed over the last decade or so a sustained period of economic growth which is arguably the envy of other OECD economies, built on an enhanced productivity performance and the flexibility of the economy to adapt to external shocks. Moreover, this is reflected in measures of integration as trade as a percentage of overall economic activity in Australia has risen in recent decades, reflecting greater openness, and is now around 40 per cent up from around 25 per cent in the early 1970's. Equally, in terms of financial integration, Australian equity and debt markets for example have grown significantly over time and are now among the largest in the region (see Box 1 and Box 2). And Australia's managed funds industry is one of the major markets for managed funds in the world (Chart 1) and the largest in the Asia-Pacific, with total funds under management of A\$1.4 trillion (US\$1.2 trillion). Conservative industry estimates forecast that total funds under management will grow to around A\$2.5 trillion (US\$2 trillion) by 2015.

Of course, the domestic reform story in Australia, as anywhere else, is not one that stops. The newly elected Australian Government has committed itself to a significant agenda to reverse recent

declines in Australia's productivity performance – including as the foundation for further enhancing our engagement with the region and with the global economy.

### BOX 1: MARKET CAPITALISATION OF ASIA-PACIFIC STOCK MARKETS



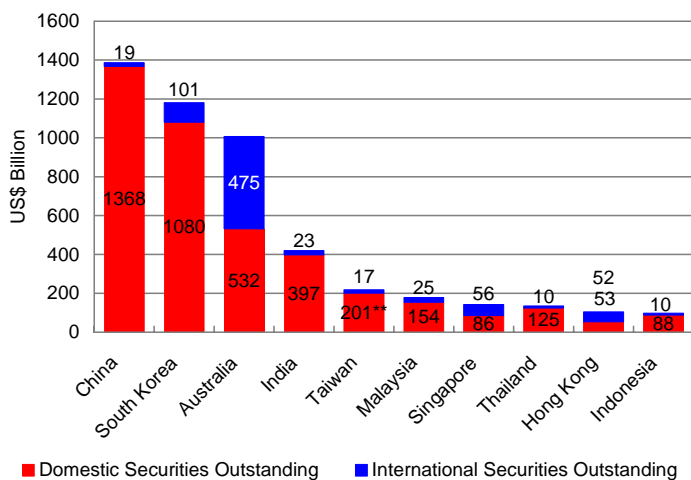
Australia's stock market is the largest and most liquid (measured by floating stocks) in the Asia-Pacific region behind Japan.

Market capitalisation of floating stocks in Australia is around 70 per cent larger than that of South Korea or of Hong Kong and Singapore combined.

Japan (not shown) is the largest stock market in the region with US\$3136 billion floating stocks and US\$1064 billion non-floating stocks.

Source: Market capitalisation, US\$billion, Standard & Poor's *Global Stock Market Review, The World By Numbers*, January 2008.

### BOX 2: SIZE OF ASIA-PACIFIC DEBT MARKETS



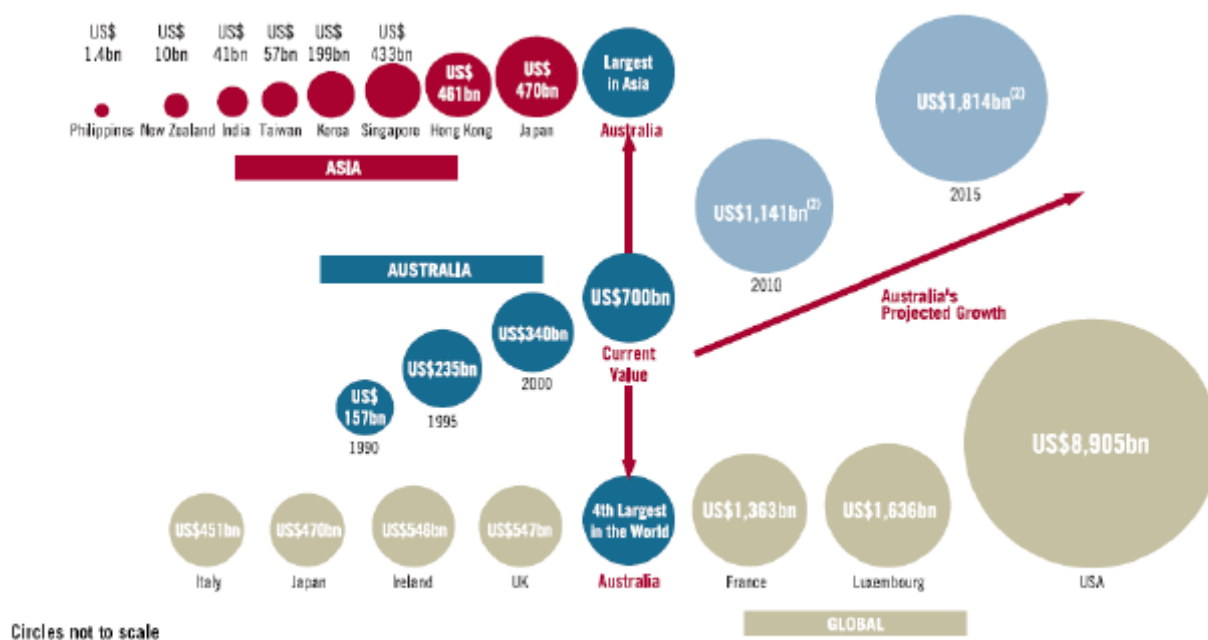
Australia has more international debt securities outstanding than any other Asia-Pacific nation and ranks fourth in terms of domestic debt securities.

Japan (not shown) has the most domestic debt securities outstanding (US\$8145 billion) but has less international debt securities outstanding (US\$151 billion) than Australia.

Source: Amounts outstanding by residence of issuer US\$billion at June 2007. BIS *Quarterly Review* December 2007.

\*\* At December 2006 – more recent data not available for Taiwan.

**Chart 1: Investment Fund Assets, \$US Billion, December Quarter 2005.**



Source: Axiss Australia (Aug 2006)

### *The complementary role of regional institutional architecture*

While domestic policies are fundamental to fostering integration, global and regional institutional arrangements are also important.

I do not intend to dwell today on the relevant global institutions, other than to note the obvious important role played by the WTO, the IMF, the FSF, and the various core international standards and codes of best practice in financial and corporate regulation, in establishing and enforcing global benchmarks and rules to promote greater economic openness, and set the groundwork for regional and domestic policymakers to pursue policies that facilitate greater economic integration. Current developments in international financial markets remind us not only of the importance of these arrangements but also of the need to constantly review their effectiveness.

Rather, given the focus of this conference, I will concentrate my comments on the complementary role for regional arrangements in supporting further global economic integration, as evidenced by the experience of East Asia. Regional institutions and initiatives can work to produce shared commitments to openness, reduce and abolish barriers to trade and financial flows within the region, increase political momentum toward integration, and allow for the collective management of risks and vulnerabilities through coordinated surveillance mechanisms.

East Asian has in recent years, as elsewhere, seen significant activity in the negotiation of bilateral and multi-country Free Trade Agreements. Such agreements can clearly help integrate emerging market economies and deliver gains faster than through multilateral processes alone. Moreover, so long as such agreements are comprehensive in scope and coverage and open to new members, they can also reinforce and provide momentum to the multilateral trading system.

Equally noteworthy has been the deepening and broadening of East Asian regional forums focused on fostering integration – especially in financial markets – and developing shared regional

approaches to emerging policy challenges. Each of these forums is the product of unique political and policy forces, and it would be wrong to imply that they somehow represent a preconceived grand design. Nevertheless, together they form a complementary set of partially overlapping regional structures, each with its specific strengths, and with significant scope to reinforce and support one another's efforts.

One way of thinking of these regional forums is as a set of concentric circles of countries, expanding from ASEAN to ASEAN+3, the East Asia Summit (EAS) and APEC. These expanding circles enable views to be expressed and consensus to be formed over progressively large groups of countries with deep shared but also complex economic interests. These groupings also have different and complementary characteristics, with each forum offering something unique and important to the Asia Pacific region.

## ASEAN

ASEAN is a relatively formal body and often involves contractual, legal and binding agreements between parties. Australia has a longstanding and deep relationship with ASEAN, covering cooperation in a range of areas from security, cultural, economic, education and development. Australia has worked in partnership with ASEAN for over 30 years to build economic cooperation and prosperity in the region, with significant success.

In 2003, the ASEAN Leaders resolved that an ASEAN Community would be established comprising three pillars, namely, the ASEAN Security Community, ASEAN Economic Community (AEC) and ASEAN Socio-Cultural Community. Focussing on the AEC, ASEAN Leaders proposed to establish the region as a single market and production base by 2020, turning the diversity that characterises the region into opportunities for business complementarity and making the ASEAN a more dynamic and stronger segment of the global supply chain. Following a range of successful agreements, in January 2007 ASEAN Leaders brought forward their target for a single market to 2015.

In moving towards the AEC, ASEAN has agreed to:

- institute new mechanisms and measures to strengthen the implementation of its existing economic initiatives including the ASEAN Free Trade Area (AFTA), ASEAN Framework Agreement on Services (AFAS) and ASEAN Investment Area (AIA);
- accelerate regional integration in the following priority sectors by 2010: air travel, agro-based products, automotives, e-commerce, electronics, fisheries, healthcare, rubber-based products, textiles and apparels, tourism, and wood-based products;
- facilitate movement of business persons, skilled labour and talents; and
- strengthen the institutional mechanisms of ASEAN, including the improvement of the existing ASEAN Dispute Settlement Mechanism to ensure expeditious and legally-binding resolution of any economic disputes.

In terms of the progress of the ASEAN free-trade area, as of 1 January 2005, tariffs on almost 99 per cent of the products in the Inclusion List of the ASEAN-6 (Brunei Darussalam, Indonesia, Malaysia, the Philippines, Singapore, and Thailand) had been reduced to no more than 5 per cent. More than 60 per cent of these products have zero tariffs.

While the ambitious objectives of the AEC are obviously limited to a subset of the East Asia region, it nonetheless has the potential to significantly bolster the depth and quality of economic integration

in the region as a whole, strengthening the basis on which the ASEAN economies can engage with others.

### ASEAN+3

Formed in the wake of the Asian financial crisis, ASEAN+3 is focussed primarily on increasing financial integration within the region. However, as the grouping has matured, it has also sought to consolidate greater regional trade integration through an ASEAN+3 FTA. Given the varying level of economic development of the members, and differing degrees of financial and trade integration, ASEAN+3 is important in fostering both a policy and political resolve toward openness in the region.

Given the impetus of the Asian financial crisis, ASEAN+3 has emerged as the regional forum with the broadest regional financial cooperation and integration agenda, including the Chiang Mai Initiative (CMI). CMI is a network of bilateral swap arrangements between ASEAN+3 member countries with a total value of US\$83 billion, designed to provide short-term liquidity to member countries in support of IMF programs. The CMI is also intended to improve regional surveillance mechanisms and promote greater information sharing between members.

ASEAN+3 also has a number of initiatives aimed at supporting the further development of regional bond markets, including the Asian Bond Market Initiative (ABMI) – an initiative aimed at widening the issuer and product bases of domestic bond markets.

### APEC

At the outer extreme of these concentric circles is APEC, which prides itself on the cooperative, voluntary and informal nature of interaction between 21 economies, including significant Pacific players, most notably the US. This provides it with a comparative advantage in addressing some of the basic contemporary challenges facing the Asia Pacific.

The founding vision of APEC was the potential to boost economic growth in the Asia Pacific Region through the promotion of open and non-discriminatory free trade and investment in the Asia-Pacific region. APEC economies have a firm belief that trade and investment liberalisation will progress at a faster pace if sustained by well targeted economic and technical cooperation and effective capacity-building program. Since APEC was founded average tariff rates have declined significantly, from 16.6 per cent in 1988 to 6.4 per cent in 2004.

This objective is encapsulated in the Bogor Goals, endorsed by Leaders in 1994, which aim to achieve free and open trade and investment in the Asia Pacific region by 2010 for developed economies and 2020 for developing economies.

More recently, this focus on trade and investment has been supplemented by an increasing awareness of the importance of ‘behind border’ measures in influencing integration. APEC’s voluntary, cooperative approach makes it particularly well suited to foster dialogue on such issues in a non-threatening way, and Australia will be hosting a meeting of relevant APEC ministers on structural reform in August of this year.

This evolution in APEC’s focus is reflected in the APEC Framework for Strengthening Regional Economic Integration, endorsed by APEC leaders in Sydney in September 2007. The Framework:

- promotes and supports further liberalisation of trade in goods and services and investment flows in a manner that reflects the Bogor Goals and supports the multilateral trading system.

In this way it will lay the foundation for a possible Free Trade Area of the Asia-Pacific in the longer term;

- places a greater focus on behind-the-border reform and a business environment conducive to maximising the benefits obtainable from cross-border liberalisation;
- seeks to strengthen and deepen regional financial markets to make it easier to mobilise financial resources; and
- includes initiatives in specific sectors, such as transport and communications.

### The East Asia Summit (EAS)

I have left to last the most recent addition to the concentric circles of the regional architecture – the EAS – which incorporates ASEAN+3, plus India, Australia and New Zealand. Established in 2005, the fledgling EAS provides the only Leaders-led regional forum for strategic dialogue and discussion of key challenges facing East Asia. Clearly, as the only regional forum which links both east and south Asia, it offers unique potential for progressing closer intra-regional integration.

In 2006, EAS Leaders agreed to make ‘finance’ one of five priority areas that the EAS would focus on. Within this context, the EAS has established its Regional Financial Cooperation and Integration (RFCI) Initiative, aimed at exploring ways for the EAS to complement the existing regional financial architecture, including ASEAN and ASEAN+3. In November 2007, EAS Leaders welcomed a number of recommendations made by Finance officials to support cooperation on financial integration, including establishing an Informal Senior EAS Finance Officials’ Dialogue.

The RFCI initiative is intended to play a complementary and mutually reinforcing role with other regional mechanisms, including the ASEAN and ASEAN+3 forums. As noted earlier, notwithstanding considerable progress since the Asian financial crisis in reforming and developing domestic financial systems, regional financial markets remain relatively underdeveloped in terms of size and liquidity. Further developing East Asia’s financial markets would assist in a more efficient allocation of savings to domestic investment needs, allocate risk more effectively, and promote greater technological transfer.

The RFCI initiative provides a valuable opportunity for Australia and India to work with ASEAN+3 economies regarding the region’s regional financial architecture. Importantly, it provides a multilateral environment to achieve these goals. The benefits of a multilateral approach is that it has a smaller administrative burden than supporting a range of bilateral discussions and it offers a better chance of taking a consistent, regional approach to regional architecture, as opposed to a series of uncoordinated bilateral agreements.

Both Australia and India are well placed to make strong contributions to the RFCI initiative. Australia has over two decades of financial market reform experience. As a consequence, Australia can offer the benefit of its experiences to East Asian economies that are considering reform of their own financial system.

India, by virtue of having one of the largest financial markets in the region and being one of the world’s fastest growing economies in the world, will shape the region’s financial flows for decades ahead. The EAS offers an opportunity to influence the shape of intra-regional integration, including in support of India’s aspirations of developing Mumbai into a global financial centre.

### *In Summary*

From a policy perspective, it is arguably less useful to think of integration as an end in itself and more useful to focus on, first, the evidence it provides of market responses to economic liberalisation in the pursuit of enhanced economic wellbeing, and, second, in an institutional sense, its role in helping to manage the risks and optimise the benefits of operating in a globalised economy.

The East Asian experience is one which underscores the importance of:

- domestic reform, and in particular a reform agenda which increasingly acknowledges the interrelationship between trade and financial sector integration; and
- complementary regional forums for active dialogue and collective action, the latest of which, the EAS, provides a vehicle for Indian engagement in this process with potentially significant benefits for intra-regional integration.

Thank you.