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# Regional Integration in East Asia

## Challenges and Opportunities

### Part II: Trade, Finance, and Integration

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## Abstract

Sakakibara and Yamakawa analyze the patterns of East Asia's trade and foreign direct investment (FDI) from a global and intraregional perspective, taking into account the importance of trade and FDI interlinkages. They propose two regionally-focused approaches to promoting trade and FDI in East Asia—regional agreements and regional production networks.

The East Asia crisis strengthened appeals for regional cooperation in the financial area. As a result, a number of financial arrangements and initiatives have emerged since the crisis, the most prominent of these, the Chiang

Mai Initiative. (The Association of Southeast Asian Nations plus China, the Republic of Korea, and Japan decided at their meeting in Chiang Mai, Thailand, in May 2000, to establish a regional network of swap arrangements.) While opening of the capital account is considered desirable in the long run, it is associated with considerable risk, particularly if macroeconomic policies are not sound and financial supervision and regulation is weak. Because of the potential volatility associated with floating regimes and the desire to avoid another crisis in the region, the authors discuss a number of options.

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This paper—a product of the Poverty Reduction and Economic Management Sector Unit, East Asia and Pacific Region—is part of a larger effort in the region to analyze integration through trade. Policy Research Working Paper 3078 on History and Institutions is part I of this paper. Copies of this paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Shahid Yusuf, room MC2-509, telephone 202-458-2339, fax 202-522-1150, email address [syusuf@worldbank.org](mailto:syusuf@worldbank.org). Policy Research Working Papers are also posted on the Web at <http://econ.worldbank.org>. Sharon Yamakawa may be contacted at [yamakawa@gsec.keio.ac.jp](mailto:yamakawa@gsec.keio.ac.jp). June 2003. (149 pages)

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**WORLD BANK EAST ASIA PROJECT**

**REGIONAL INTEGRATION IN EAST ASIA: CHALLENGES AND  
OPPORTUNITIES**

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**Part Two: Trade, Finance and Integration**

Chapter IV – Trade and FDI: A Role for Regionalism

Chapter V – Financial and Monetary Integration

Chapter VI – Conclusion: Observations on Integration

Chapter VII – Looking Ahead

*Note: part one of this report is presented as  
a separate working paper.*

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## Introduction to Part Two

As stated in the "Overview" presented in Part One, the purpose of this study is to evaluate the pattern and gauge the progress of regional integration in East Asia from a political-economic viewpoint. The focus is on the trade, investment, and financial/monetary aspects of regional cooperation in projecting a viable framework for integration in the coming decade and assessing the prospects for its success in bringing prosperity to East Asia. The study examines the causal factors of regionalism in East Asia and the underlying dynamics of the movement. In this process, differences between Asia's type of regionalism and that of other regions of the world, in particular Europe and North America, will become apparent.

Part One set the stage for a discussion of regional integration in East Asia (1) by reviewing Asia's historical trade and economic presence in the world, (2) by assessing its current degree of openness to, and integration with, the global economy, and (3) by evaluating the status and performance of regional institutions in the region in the post-World War II era. The review of Asian economic history in Chapter I revealed two aspects of trade in the region (i.e., intraregional and global) that overlapped and interacted in such a way as to have effectively functioned as one system. This, in addition to the evidence of Asia's prominent role in the global economy at that time, supports the argument that Asian trade has been open and global for centuries.

A look at East Asia's social, economic and political structures in Chapter II revealed a region of enormous diversity, particularly when compared with other regions of the world. The characteristics of various regional groupings (e.g., ASEAN and APEC) were examined in an effort to determine if one or another of these institutions brings greater benefit to the region and the economies therein. While a group comprising developmentally similar economies could be a more workable arrangement in which smaller members would have more influence, there is a slightly more compelling argument in favor of agreements between industrial and developing economies in that they can bring significant benefits to the developing partners.

Chapter III pointed out that the development of regional institutions was not an initial goal of East Asian integration; however, most East Asians would now like to see a strong regional institution in place to lead the region toward closer cooperation and deeper integration. Regional cooperation has reached the stage in East Asia where more structure and leadership is needed. However, most find the current condition of regional institutions in East Asia to be discouraging. The ASEAN-Plus-Three grouping, although currently operating on the sidelines of ASEAN and having no secretariat of its own, is perceived by many to be the most workable and potentially beneficial grouping for the region.

Part Two of the study, "Trade, Finance and Integration," includes Chapters IV through VII. Chapter IV analyzes the patterns of East Asia's trade and foreign direct investment (FDI) from a global/intraregional perspective, taking into consideration the importance of trade and FDI interlinkages. In this context, we propose two regionally focused approaches to the promotion of trade and FDI in East Asia: regional agreements and regional production networks.

Taking the East Asian crisis as the point of departure, Chapter V looks at monetary and financial cooperation in the region. Prior to the crisis, economic

cooperation efforts in East Asia were focused on trade and investment. The occurrence of the crisis strengthened appeals for regional cooperation in the financial area. As a result, a number of financial arrangements and initiatives have emerged since the crisis. These are discussed in some detail with special attention paid to the most prominent of these, the Chiang Mai Initiative.

This chapter then reviews financial development in the region. In conjunction with this, financial structure (bank-based versus capital market-based systems) is examined in an effort to determine its effect, if any, on financial development.

Chapter V also addresses the issue of capital account liberalization and its advisability for emerging markets. While opening of the capital account is considered desirable in the long run, it is associated with considerable risk, particularly if macroeconomic policies are not sound and financial supervision and regulation is weak. Many factors related to an individual country's stage of development and current level of involvement in global capital markets need to be considered in setting realistic goals and objectives in this area.

Also, arising out of the Asian crisis and related to the issue of financial system reform is an ongoing debate on the appropriate currency regime for East Asian economies, extending to the suitability of a regional monetary arrangement for the region. Prior to the crisis, currencies of the crisis-affected countries were "effectively" pegged to the U.S. dollar. During the crisis, many of these countries switched to a floating rate regime. Because of the potential volatility associated with floating regimes and the desire to avoid another crisis in the region, a number of options are being discussed. This chapter discusses the pros and cons of these options.

Chapter VI summarizes the whole study (Parts One and Two) and concludes by providing some perspective on the current state of cooperation and integration in the region.

Chapter VII looks at regional integration from a future perspective. This chapter endorses the establishment of a genuine regional institution in East Asia. In addition, it takes a look (both short- and long-term) at what type of currency arrangements might be suitable for the region.

## **Chapter IV – Trade and FDI: A Role for Regionalism**

Trade and foreign direct investment (FDI) have played a role, indeed a major role, in the development of East Asia. The phenomenal growth of the 1980s and early 1990s has been attributed to East Asia's liberalization in these two areas. Trade and FDI interact in such a way as to be mutually promoting. The importance of this linkage has grown along with the increased integration of the international production network. Together, they facilitate the efficient functioning of this system. Furthermore, the potential for growth is enhanced when there is coordination in the formulation of trade and FDI policies.

In this chapter we will look at regionalism in East Asia from the perspective of trade and FDI, the objective being to determine if regional cooperation has a role to play in their promotion. In this process we will show that East Asia's trade and FDI have both global and intraregional elements that are essential to the continued development of the region. Given that and the trend in the region to seek regional solutions to common issues, we will suggest two regionally focused approaches to the promotion of trade and FDI in East Asia: regional agreements and regional production networks.

### **Trade and FDI Linkages**

In recent years, the topic of trade and FDI linkage has generated intense interest in the international community and has been discussed at length in major reports produced by international organizations such as UNCTAD, the WTO, and the OECD, as well as being addressed in smaller studies.<sup>1</sup> The common debate on this issue centers mainly on whether trade leads to FDI or vice versa and whether they are substitutes or complements. In fact, the interrelationship between them is quite complex. It may vary by product, economic sector, and across countries. In other words, it depends upon the type of FDI and the location and developmental level of the countries concerned.

For example, in the case of natural resources (resource-seeking FDI), trade often leads to FDI, which in turn supports (and/or creates) trade. If this type of FDI exploits the same competitive advantages as firms in the host economy it will most likely reinforce existing export patterns of that economy, but if it exploits different resources, it can change export patterns. In manufacturing (export-oriented manufacturing FDI), existing advantages can be reinforced (e.g., low-cost labor used to make clothing for export) or changed through the introduction of technologies, skills, brand names and networks that do not exist in the host country.<sup>2</sup> In the final analysis, it appears that first, trade leads to FDI, and then, FDI leads to more trade.<sup>3</sup>

However, the accuracy of this assessment seems to be in doubt because of the evolution of the international production network. It is now less an issue of whether trade leads to FDI or FDI to trade, or whether FDI substitutes for, or complements, trade or the other way around. "Rather, it is: how do firms access resources – wherever they are located – in the interest of organizing production as profitably as possible for the national, regional or global markets they wish to serve? In other words, the issue becomes: where do firms locate their value-added activities? In these circumstances, the decision where to locate is a decision where to invest and from where to trade. And it becomes a FDI decision, if a foreign location is chosen. It follows that, increasingly,

what matters are the factors that make particular locations advantageous for particular activities, for both, domestic and foreign investors.”<sup>4</sup>

Trade and FDI are becoming more tightly linked in today’s international production system and they function together as the machinery that enables the system to operate. And, increasingly, TNCs are the facilitators of this process. Their growth in size and function has been phenomenal. The estimated 850,000 foreign affiliates of 65,000 TNCs worldwide today account for one-tenth of world GDP and one-third of world exports.<sup>5</sup> Their coverage has also broadened to include the whole range of manufactured exports from low- to high-technology goods, as well as services. TNCs in their integrated international and regional production strategies can locate production largely wherever they choose. Different activities of the production process can be located in different countries or regions in order to take advantage of lower costs, better resources, transport facilities and markets.<sup>6</sup> Thus the connection between trade and FDI is intensified and for countries where this production is located, opportunities for trade based on comparative advantage can increase. Of course, countries must first be a part of the TNC’s organizational structure in order to have the opportunity to benefit from these closer trade-FDI linkages.<sup>7</sup>

Both trade and FDI are well recognized today as facilitators of growth and development. They impact development separately and directly, as well as indirectly through their linkages. Capital, technology, management expertise, training for the local workforce and access to wider markets are some of the benefits that FDI can bring to host countries. These can complement the resources and capabilities of the host country and, thus, increase its export competitiveness.<sup>8</sup> Export competitiveness is a key element in the promotion of economic development as it can result in (1) increased foreign exchange earnings, which can be used for the import of products, services and technologies necessary for increasing productivity and living standards; (2) diversification away from primary commodity exports to higher technology exports; (3) better realization of economies of scale through larger and more diverse markets; (4) exposure to higher standards; and (5) easier access to information.<sup>9</sup>

There are, of course, situations where these potential benefits are not realized in the host country because TNCs: (1) may concentrate solely on a host country’s static comparative advantages and never develop the dynamic ones, (2) may fail to build linkages to the domestic business community, (3) may fail to bring high level technologies or training to local labor, and (4) may suddenly depart if conditions in the host country are perceived to have changed so they no longer meet the TNC’s criteria for operating there.<sup>10</sup>

Still, the relationship between global FDI flows and the growth of world GDP can be characterized as a “stable and positive relationship.”<sup>11</sup> The overall conclusion of recent studies<sup>12</sup> is that FDI in general does contribute positively to both income growth and factor productivity in host countries although the precise magnitude of the impact is difficult to determine. Growth is affected by an increase in total factor productivity or an increase in efficiency in the usage of resources in the host country.<sup>13</sup> This occurs through “the linkages between FDI and foreign trade flows; the spillovers and other externalities vis-à-vis the host country’s business sector; and the direct impact on structural factors in the host economy.”<sup>14</sup> Although some of these studies found that FDI “crowds out” domestic investment, others found the opposite to be true. Some even found that



“crowding out” can have an overall beneficial effect if scarce domestic funds are released.

In order to attract and reap the benefits of FDI, a certain level of development in education, technology and infrastructure, as well as financial markets, is necessary. More specifically, macroeconomic stability, institutional predictability, fiscal discipline, efficient and equitable tax systems, prudent public-sector debt management, strong domestic financial systems, developed capital markets, transparency, openness to foreign trade, and an educated workforce are important in this regard. Creating this enabling environment, in many cases, requires policy changes on the part of national governments.<sup>15</sup>

The interlinkages between trade and FDI and their combined effect on growth and development make it necessary for policies in these two areas to support one another in terms of objectives and efficient implementation, because ignoring them can lead to weakening of the developmental contribution of each, whereas acting on them can lead to synergies that can promote growth and development further than if they were dealt with autonomously.<sup>16</sup> The importance of this coordination increases as the international production system becomes more integrated, as is now taking place.

Many policies for the promotion of trade and, particularly, FDI are currently developed and implemented at the national level.<sup>17</sup> However, for some countries, particularly lesser developed countries, a national approach can be difficult because of the lack of knowledge and skills in foreign investment related policymaking and in the negotiation and implementation of treaties and agreements.<sup>18</sup> In such cases, a regional or multilateral approach may work better.

## **Patterns of Trade and FDI: Global and Intraregional**

As revealed in Part One of this study, East Asia has a historical legacy of openness and global integration that continues today. However, the data and discussion presented in Part One do not tell us anything about the current intraregional/global mix of trade and FDI in the region. In this section, we will make that assessment by examining trading and investment patterns in East Asia over the last decade or so.

### **Trading Patterns**

East Asia has experienced tremendous growth in trade over the last two decades with imports increasing fivefold and exports sixfold between 1980 and 2000 reaching a level of \$1,349 billion and \$1,589 billion, respectively, in the latter year. Between 1990 and 2000, growth was slower but still both imports and exports roughly doubled over those 10 years. The growth rate in imports and exports for both ASEAN and ASEAN-Plus-Three mirrors the regionwide rate for both time periods.<sup>19</sup>

Trade can be measured in several ways. In our analysis we will use two measures: (1) trade share is a simple measure that indicates the magnitude of trade of one country with another. It is easy to calculate and commonly used in general discussions of trading affiliations but has a number of shortcomings that will be discussed later. (2) The trade intensity index is a more complex measure in terms of its calculation as well as the

information it provides. It gives a clearer, more accurate picture of the trading patterns of countries and, especially of regions, than does the trade share measure. Using these two indices, we will take a look at current trading patterns and how they have evolved over the last two decades with the focus on regional/multilateral patterns and shifts.

### **Trade Measured in Shares**

A snapshot of East Asia's average trade shares for 1998-2000 (Table 4.1), reflects both the global and intraregional nature of East Asia's trade. (See Table S.6 in appendix<sup>20</sup> for separate import and export shares.) All but the smallest nations conduct a significant amount of trade with the EU and the U.S. (between 10 and 30 percent share of their total trade). But intraregionally, the trade shares of individual countries are even larger with ASEAN; in this case, it is the smaller countries that have the larger share. If the expanded ASEAN-Plus-Three (APT)<sup>21</sup> is considered, the shares rise significantly for all countries, primarily because of the high level of trade with Japan (representing 10 to 28 percent for most countries), except for Hong Kong in which case it is trade with China that pushes up the share with APT.

Table 4.1

Total Trade <sup>1</sup> Shares (%) 1998-2000															
	BRU	CAM	CHN	HKG	IDN	JPN	KOR	LAO	MLS	MYN	PHL	SGP	TWN	THA	VNM
Japan	27.6	3.2	16.8	8.8	19.9	-	15.0	20.9	12.1	7.9	18.2	11.9	18.2	19.3	15.2
Korea	7.6	2.9	6.3	3.2	6.9	5.2	-	0.8	3.9	5.7	5.6	3.2	4.1	2.5	7.6
China	0.7	4.1	-	38.5	5.2	9.2	8.6	2.7	3.0	15.6	2.5	4.3	0.0	3.8	6.1
Hong Kong	1.2	8.3	16.3	-	2.6	3.5	4.1	0.9	3.6	2.9	4.8	5.4	12.0	4.2	3.0
Taiwan	0.7	5.5	5.5	6.1	4.1	5.9	3.6	0.8	4.7	3.5	7.2	4.1	-	4.2	7.6
Brunei	-	0.0	0.0	0.0	0.1	0.2	0.1	0.0	0.2	0.0	0.0	0.3	0.0	0.3	0.0
Cambodia	0.0	-	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.0	0.3	1.3
Indonesia	2.4	1.7	1.2	0.7	-	2.5	2.4	0.2	2.0	5.4	1.3	3.8	1.6	2.0	3.3
Laos	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-	0.0	0.0	0.0	0.0	0.0	0.4	0.4
Malaysia	7.5	2.3	1.3	1.6	3.3	3.1	2.5	0.1	-	9.0	3.8	16.3	2.9	4.5	2.7
Myanmar	0.0	0.0	0.1	0.0	0.2	0.0	0.1	0.0	0.2	-	0.0	0.2	0.0	0.0	0.0
Philippines	0.1	0.1	0.6	0.9	1.0	1.9	1.6	0.0	1.9	0.2	-	2.4	2.1	1.6	1.2
Singapore	16.2	12.3	2.3	3.4	10.2	3.1	2.8	3.1	16.9	15.3	6.9	-	3.2	8.5	9.7
Thailand	7.3	10.2	1.1	1.3	2.5	2.8	1.0	41.8	3.5	0.0	2.6	4.4	1.9	-	4.1
Vietnam	0.0	10.9	0.4	0.2	0.9	0.5	0.6	2.7	0.4	0.0	0.5	1.0	0.7	0.9	-
ASEAN	33.5	33.9	7.0	8.1	18.1	14.0	11.2	48.0	25.2	29.8	15.2	28.7	12.4	18.2	22.2
ASEAN+ 3	69.4	44.0	30.1	58.6	50.1	28.5	34.9	72.4	44.1	59.0	41.5	48.2	34.6	43.9	51.0
APEC	85.6	76.0	75.1	82.5	75.6	71.7	69.7	76.6	75.9	74.1	84.5	78.4	76.3	73.4	71.2
CER	2.9	0.4	1.9	1.3	4.0	3.3	3.1	0.2	2.6	0.3	1.8	2.3	2.2	2.4	4.9
EU	12.9	9.7	14.4	12.5	14.9	15.7	12.4	11.7	13.3	9.2	14.6	13.6	14.6	14.4	17.5
U.S.	11.3	17.4	17.8	14.9	13.0	26.6	20.4	1.7	19.7	7.8	27.4	17.7	21.7	17.6	4.0
NAFTA	11.3	17.6	19.5	16.2	14.5	29.5	22.8	2.0	20.7	8.5	28.7	18.6	23.4	18.9	4.6

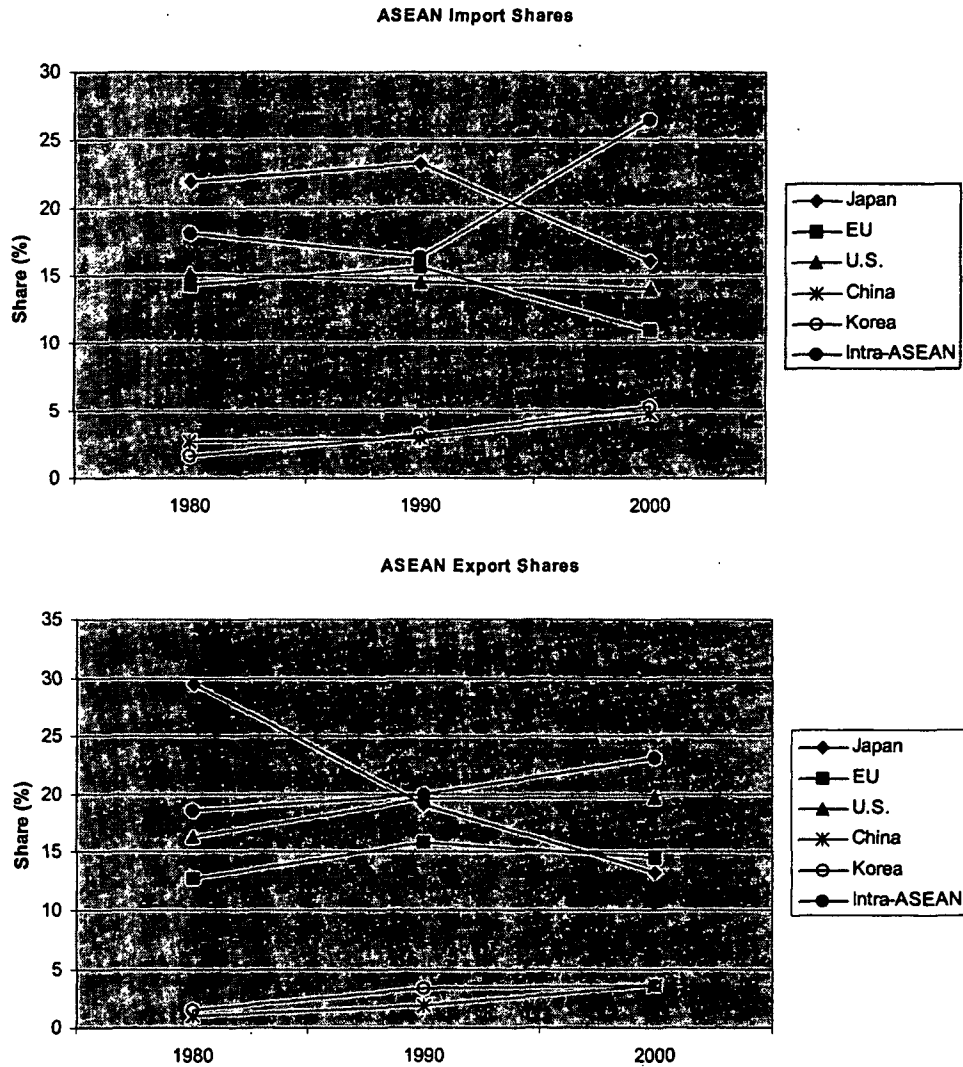
<sup>1</sup> Total Trade = sum of imports and exports

Table reads as total trade share of a country in the top row with a partner country in the left-hand column; e.g. starting top left - .  
 Brunei's exports to and imports from Japan as percentage of Brunei's total trade.  
 Some data for the year 2000 was estimated, including all countries' trade with Taiwan and some countries' trade with Vietnam.  
 Singapore does not report its trade with Indonesia to the IMF; therefore, Singapore's trade with Indonesia is estimated using data from Indonesia.  
 Source: Author's calculations based on data from IMF, Direction of Trade Statistics

The trading patterns of East Asian countries, however, have shifted over time. A review of these shifts can reveal regional/global trends in the trade of these countries. The following three figures (six graphs) reveal how the trade shares of selected economies (i.e., ASEAN, Japan and China)<sup>22</sup> with some of their major trading partners have changed between 1980 and 2000.

**ASEAN** – The graphs in Figure 4.1 reveal changes in the shares of ASEAN's trade with its major partners between 1980 and 2000. (See Table S.7 in appendix for data table for this figure.)

Figure 4.1



Source: Authors' calculations using IMF, Direction of Trade Statistics

Japan was ASEAN's primary trading partner in both imports and exports in the 1980s. However, this relationship had declined significantly by 2000 with the share of imports from Japan dropping from 23 to 16 percent between 1990 and 2000 and export share declining from 30 to 13 percent between 1980 and 2000. ASEAN's imports were, of course, negatively impacted by the East Asian crisis; however, the post-crisis decline in the level of imports from Japan (37 percent between 1996 and 1998) was greater than the decline in ASEAN's total imports (26 percent for the same period). The dollar value of exports to Japan increased between 1980 and 2000 (to above pre-crisis levels), but this

did not keep pace with the growth rate of ASEAN's total exports, which increased sixfold over the 20 years to reach \$432 billion in 2000.

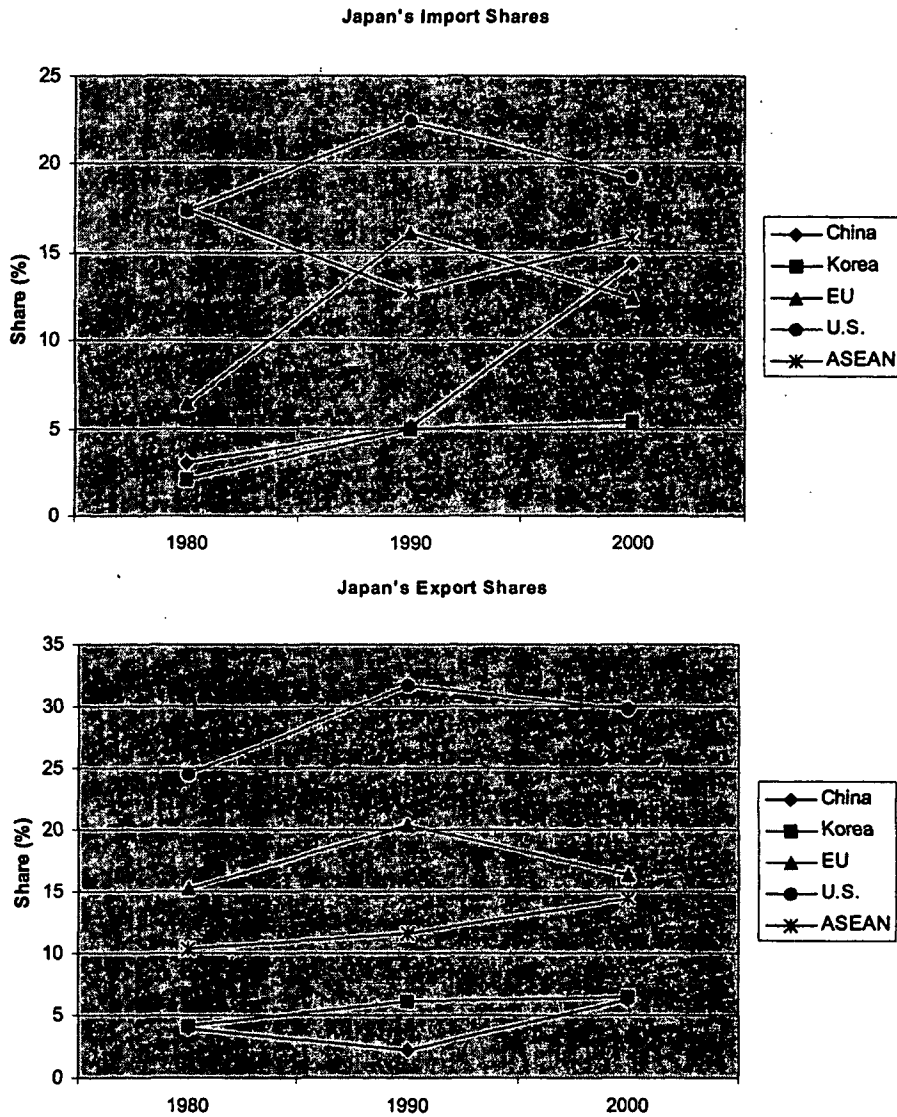
By 2000, this decline in share of exports dropped Japan's position below that of the U.S. and the EU, for which the share has remained virtually unchanged since 1990. Shares of imports from the U.S. and EU, like that from Japan, have fallen off somewhat.

While the importance of Japan, the U.S. and the EU in ASEAN's trade deteriorated, that of China and South Korea appreciated. The shares of both imports from and exports to these two countries increased fairly steadily between 1980 and 2000.

Figure 4.1 also shows that intra-ASEAN trade has appreciated quite considerably. There was an increase in the share of intra-ASEAN imports of ten percentage points between 1990 and 2000, from 16.4 percent to 26.5 percent placing it well above that of Japan (16 percent), the U.S. (14 percent) and the EU (11 percent). The share of intra-ASEAN exports rose a bit more slowly, by three percentage points to 23 percent in 2000, but still ended up being a larger proportion than that of the U.S. (20 percent), the EU (15 percent) and Japan (13 percent).<sup>23</sup>

**JAPAN** – Japan's pattern of trade shares has shifted noticeably (and similarly for both imports and exports) over the last 20 years. (See Figure 4.2.)

Figure 4.2



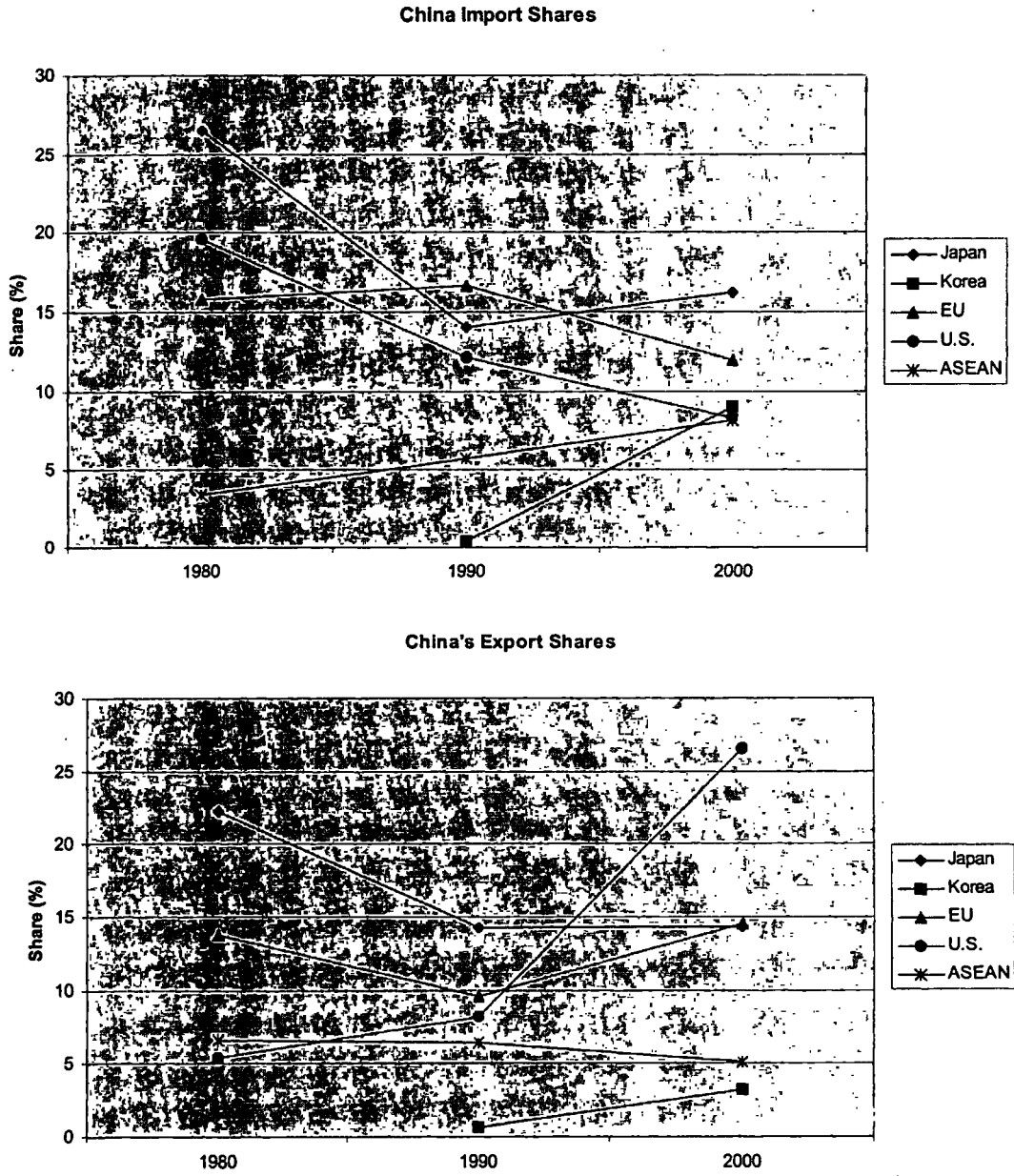
Source: Authors' calculations using IMF, Direction of Trade Statistics

The proportion of trade with the U.S. and the EU, although still prominent, is on a downward trend while that with ASEAN and China is sloping upward. The U.S. remains Japan's most prominent trading partner with imports from that country making up 19 percent of Japan's total imports, 30 percent in the case of exports. More remarkable, however, is that since 1990, Japan's imports from China have more than tripled in value

to \$54 billion in 2000 and now make up 14 percent of Japan's total imports, surpassing the share of imports from the EU (12 percent) and coming close to that of ASEAN (16 percent). On the other hand, Japan's exports to China, although having increased somewhat since 1990, are still only 6 percent of total exports, the same as that of South Korea.

**CHINA** –Between 1996 and 2000, China's imports grew 70 percent to \$236 billion and exports doubled to \$311 billion. Although still supplying the largest share of China's imports, the share from Japan has dropped from 27 percent in 1980 to 14 percent in 1990 but rose 2 percentage points by 2000. (See Figure 4.3.) The shares of imports from the EU and U.S. also declined between 1980 and 2000 to 12 and 8 percent, respectively. The shares of imports from ASEAN and South Korea have risen over the last 10 to 20 years to reach the same level as that of the U.S. in 2000.

Figure 4.3



Source: Authors' calculations using IMF, Direction of Trade Statistics



In exports, the U.S. share has risen dramatically since 1980 to reach 27 percent in 2000, far surpassing that of Japan and the EU (14 percent for both). This is a complete reversal of the share pattern in 1980 when exports to the U.S. made up the smallest share (5 percent) and the share for Japan was the largest (22 percent). This reflects improved relations between the U.S. and China over the last 20 years, as well as the fact that U.S. and EU TNCs are moving production to China and exporting from there.

### Intraregional Trade Shares

Figure 4.1 revealed that during the 1990s the gap between the share of intra-ASEAN trade and the share of ASEAN's trade with its major non-Asian partners, the U.S. and the EU, had progressively widened. Does this mean that East Asia's trade is becoming more intraregional as opposed to global? Examining the intraregional trade of the entire region (not just ASEAN) in comparison with that of other regions over a longer period of time and in relation to (1) world trade as a whole and (2) East Asia's total trade (intraregional and extraregional) will help to answer that question.

The tables below present two measures based on trade shares for major Asian and non-Asian groups.

Table 4.2

Intraregional Trade Merchandise Exports Within Regional Group (as share of world exports) Absolute Measure							
(% of world exports)	1970	1980	1990	1996	1998	1999	2000
APEC	20.9	19.1	27.1	33.2	32.2	33.5	35.6
ASEAN	0.5	0.7	0.9	1.6	1.3	1.4	1.6
ASEAN Plus Three	n.a.	3.7	4.6	7.2	5.5	6.2	7.0
All East Asia*	n.a.	4.6	7.8	12.7	10.5	11.2	12.7
European Union	27.3	24.4	29.5	24.1	22.7	24.8	22.3
NAFTA	7.9	5.5	6.8	8.3	9.7	10.3	10.7

NOTE: Table shows sum of exports by members of a group to other members of the group as a percent of world exports. Service exports are excluded. Although data has been calculated back to 1970 or 1980 on the basis of current group membership, most of the groups came into existence in later years and their membership may have changed over time. Intratrade in earlier years may not have been affected by the same preferences (as set forth in preferential arrangements) as in recent years.

\* All East Asia includes ASEAN plus Japan, Korea, China, Hong Kong, and Taiwan. Taiwan not included in 1980 and 1990 data.

Source: For APEC, EU, and NAFTA: calculated using World Bank, World Development Indicators 2002; for all others: calculated using IMF, Direction of Trade Statistics

Table 4.3

Intraregional Trade Merchandise Exports Within Regional Group (as share of group's total exports) Relative Measure								
(% of total exports)	1970	1980	1990	1996	1998	1999	2000	
APEC	57.8	57.9	68.3	72.1	69.7	71.9	73.2	
ASEAN	22.9	18.6	19.9	25.4	21.7	22.2	23.1	
ASEAN Plus Three	n.a.	29.5	27.1	36.8	28.8	31.4	32.0	
All East Asia*	n.a.	33.8	40.4	50.4	43.0	44.8	46.3	
European Union	59.5	60.8	65.9	61.4	57.0	63.3	62.1	
NAFTA	36.0	33.6	41.4	47.6	51.7	54.6	55.7	

NOTE: Table shows sum of exports by members of a group to other members of the group as a percentage of the group's total exports. Service exports are excluded. Although data has been calculated back to 1970 or 1980 on the basis of current group membership, most of the groups came into existence in later years and their membership may have changed over time. Intratrade in earlier years may not have been affected by the same preferences as in recent years.

\* All East Asia includes ASEAN plus Japan, Korea, China, Hong Kong, and Taiwan. Taiwan not included in 1980 and 1990 data.

Source: For APEC, EU, and NAFTA: used World Bank, World Development Indicators 2002; for all others: authors' calculation using IMF, DOTS

The first measure (Table 4.2) places a group's intraexports in the context of total world exports reflecting the degree of importance of its intraregional trade in total world trade. The second measure (Table 4.3) places a group's intraexports in the context of its own total exports reflecting the degree of importance of its intraregional trade relative to its extraregional trade.<sup>24</sup>

The patterns (both between regions and for each region over time) in Table 4.3 are similar to those in Table 4.2. First, since 1990, APEC has had the largest intraexport share of world exports and of its own total exports, followed by the EU, NAFTA, "All East Asia", ASEAN-Plus-Three and, finally, ASEAN.<sup>25</sup> Second, the fluctuation patterns in each group's intraexport share over time, or in other words, the increases and decreases in the importance of each group's intratrade in world trade and in its own trade, have generally followed the same pattern over the last two decades.

The increases in these measures for most regional groups, except the EU which experienced a decline that is noteworthy considering it is the region that has become the most integrated during that time, reflect members' intraexport growth relative to the growth of world exports and of their own total exports.<sup>26</sup> In other words, intratrade for East Asian groups generally increased in importance relative to both world trade and their own trade over the last 10 to 20 years. However, this does not indicate that a group's trade is more biased in favor of group members.

Trade share as a measure of trade has certain shortcomings, primarily that the share size of a trading group is a direct reflection of the number of countries in the group and of the trading volume of those countries; i.e., shares are larger for large groups that include high-volume-trade countries and smaller for small groups of low-volume-trade countries.<sup>27</sup> Furthermore, the larger the group, the larger is a country's share in that group.<sup>28</sup> Thus, in order to accurately assess the level of East Asia's intraregional trade, we need to know not only the magnitude of intratrade of the countries within the region (as shown above) but also whether members of the region trade more intensely with one another than they do with those outside the region. A measure that has been developed to adjust for the shortcomings of trade shares, and that comes closer to revealing the true nature of intraregional trade, is the "trade intensity index".<sup>29</sup>

## Trade Intensity Index

The trade intensity index is used to determine the actual intensity of one group member's trade with another group member or, in other words, the bias within a group of members to trade with one another.<sup>30</sup> Tables 5 (1995-97) and 6 (1998-2000) show merchandise trade intensities for East Asian countries.<sup>31</sup>

Table 4.4

Trade Intensity, East Asia, 1995-97																		
	Asia	AUS	CAM	CHN	HK	IDN	JPN	KOR	LAO	MYS	NZL	PHL	SGP	THA	TWN	VNM	USA	EU
AUS	3.2	-	0.7	1.5	0.9	4.0	2.9	2.1	0.6	1.6	22.3	2.4	1.1	1.5	2.3	1.2	0.3	0.3
CAM	2.6	0.2	-	2.0	1.4	0.8	0.4	0.1	-	2.7	0.0	0.0	5.5	17.1	0.8	-	0.7	1.3
CHN	1.7	0.9	1.7	-	5.9	1.2	2.8	1.8	2.5	0.6	0.5	1.1	0.9	0.7	1.0	2.8	1.1	0.4
HK	1.7	0.9	1.5	10.5	-	0.8	0.8	0.4	0.4	0.8	0.5	1.9	1.8	0.9	1.6	1.6	1.6	0.4
IDN	2.3	2.1	6.1	1.5	0.9	-	3.9	2.4	0.3	1.6	0.8	2.2	3.7	1.3	1.8	3.7	0.9	0.4
JPN	1.9	1.5	0.6	1.8	1.5	2.7	-	2.4	0.9	2.3	1.3	2.8	1.9	3.2	3.1	1.3	1.6	0.4
KOR	2.0	1.2	0.6	3.3	2.0	3.1	1.9	-	0.5	1.8	0.6	2.4	1.6	1.5	1.5	6.2	1.1	0.3
LAO	1.7	0.1	-	1.1	0.1	0.2	1.6	0.2	-	0.0	0.0	0.0	0.9	14.2	1.9	-	0.4	1.1
MYS	2.2	1.4	4.2	0.9	1.4	1.8	1.9	1.1	0.3	-	1.0	1.9	8.1	3.1	2.0	2.1	1.2	0.4
NZL	2.4	16.4	0.4	1.0	0.8	2.0	2.4	1.9	0.1	1.6	-	2.0	0.6	1.1	1.5	1.4	0.6	0.4
PHL	1.3	0.7	0.3	0.5	1.2	0.8	2.7	0.9	0.1	1.9	0.4	-	2.4	2.8	2.0	1.8	2.3	0.5
SGP	4.4	1.9	16.7	1.0	2.3	-	1.2	1.1	3.9	12.1	1.1	2.9	-	4.2	2.1	7.2	1.1	0.4
THA	6.9	1.3	16.3	1.2	1.4	2.3	2.6	0.7	53.8	2.7	0.7	1.6	5.1	-	1.4	3.1	1.2	0.4
TWN	1.8	1.3	1.0	1.8	4.9	1.8	1.7	0.8	0.3	1.8	0.9	2.4	1.6	2.0	-	3.1	1.5	0.4
VNM2	0	3.8	-	1.7	0.8	2.7	4.1	1.1	-	1.4	0.7	3.4	2.6	0.9	1.4	-	0.3	1.0
USA	0.8	1.4	0.1	0.7	0.5	0.7	1.4	1.3	0.1	0.9	0.9	1.4	0.9	0.8	1.3	0.3	-	0.5
EU	0.3	0.5	0.2	0.3	0.3	0.5	0.3	0.3	0.2	0.3	0.3	0.4	0.3	0.3	0.3	0.3	0.4	-

NOTE: Table reads as trade intensity of a country in the left-hand column with a country in the top row.  
The Asia trade intensity is the unweighted average of trade intensities with the rest of East Asia.  
Source: DeBrouwer 2002, Table 12.2, p. 291

Table 4.5

Trade Intensity Index, 1998-2000																						
	BRU	CAM	CHN	HK	IDN	JPN	KOR	LAO	MYS	MYN	PHL	SGP	THA	TWN	VNM	ASEAN	APT	APEC	EU	NAFTA	CER	U.S.
BRU	-	-	0.2	0.0	3.6	8.0	5.9	-	2.4	0.0	0.2	3.8	11.9	0.3	0.1	4.2	4.9	2.0	0.1	0.5	2.6	0.7
CAM	-	-	0.5	0.6	0.1	0.3	0.0	-	0.5	-	0.2	5.0	3.0	0.9	68.5	4.4	1.7	1.3	0.3	1.4	0.1	1.8
CHN	0.1	1.9	-	6.2	1.5	2.8	1.7	0.8	0.7	5.0	1.1	1.1	0.7	0.8	2.0	1.0	1.9	1.6	0.4	1.0	1.2	1.3
HK	0.6	3.1	11.1	-	0.8	1.0	0.7	0.5	0.7	0.9	1.8	1.2	1.0	1.0	1.1	1.1	2.9	1.7	0.4	1.0	1.1	1.2
IDN	2.7	4.0	1.6	0.9	-	3.8	3.0	0.0	2.5	7.4	2.4	5.7	2.0	2.0	2.9	3.7	3.2	1.6	0.4	0.7	2.4	0.8
JPN	0.4	0.4	1.8	1.6	2.3	-	2.5	0.5	2.2	1.1	3.6	2.0	3.0	3.5	1.7	2.3	2.2	1.7	0.4	1.3	1.6	1.6
KOR	0.4	2.0	3.2	1.9	3.2	1.9	-	0.5	2.1	3.1	3.9	1.5	1.3	2.3	4.3	2.1	2.3	1.5	0.4	0.9	1.5	1.1
LAO	-	-	0.5	0.0	0.0	7.9	0.1	-	0.0	-	-	0.5	9.6	0.5	0.0	1.7	3.4	1.2	0.5	0.2	0.0	0.2
MYS	9.3	1.8	0.9	1.4	2.9	2.1	1.4	0.2	-	7.6	2.9	8.9	3.7	2.3	2.0	5.9	2.8	1.7	0.4	1.0	2.0	1.2
MYN	1.6	-	2.0	0.7	1.1	1.2	0.5	-	3.2	-	0.4	3.5	-	0.9	-	2.1	1.6	1.1	0.4	0.9	0.2	1.0
PHL	0.5	0.2	0.5	1.5	0.7	2.6	1.3	0.0	3.5	0.4	-	3.6	2.8	4.0	1.0	2.9	2.1	1.7	0.5	1.4	0.6	1.8
SGP	15.1	12.1	1.2	1.8	4.3	1.3	1.5	2.2	14.0	9.1	4.4	-	4.8	2.1	5.9	8.1	3.0	1.6	0.4	0.8	2.2	1.0
THA	2.5	23.7	1.2	1.6	3.7	2.7	0.8	61.5	3.2	0.0	2.9	4.6	1.9	-	4.9	4.1	2.6	1.6	0.5	1.0	1.9	1.2
TWN	-	-	-	6.6	2.0	1.8	1.0	-	1.9	-	3.6	1.7	-	2.0	4.7	2.1	1.5	1.7	0.4	1.1	1.2	1.4
VNM	0.2	30.8	1.0	0.6	7.2	3.3	1.0	32.8	1.8	-	3.8	2.5	2.8	1.8	-	3.1	2.5	1.3	0.8	0.3	6.3	0.3

NOTE: Table reads as trade intensity of a country in the left-hand column with a country in the top row.  
Some 2000 import and export data was estimated, including all countries' trade with Taiwan and some countries' trade with Vietnam. Singapore does not report its trade with Indonesia to the IMF; therefore, Singapore's trade with Indonesia is estimated using Indonesia's data.  
For calculation of index see endnotes.  
Source: Authors' calculations based on data from IMF, Direction of Trade Statistics

The above two tables reveal that most of the indices are above "one", indicating that these countries trade with each other above the "normal" level of trade based on their trade with the rest of the world. Singapore and Thailand have an intense trading relationship with the largest number of countries in the region and some of these are at a very high level, particularly with the newer ASEAN members.

Table 4.6 summarizes the data in the previous two tables indicating the top five trading partners (with an index of 1 or above) for each East Asian country.

Table 4.6

Top Five Trading Partners for East Asian Economies (Based on Trade Intensity Index)												
	1995-1997						1998-2000					
Brunei	N.A.						THA	JPN	KOR	SGP	IDN	
							11.9	8.0	5.9	3.8	3.6	
Cambodia	THA	SGP	MYS	CHN	HK		VNM	SGP	THA	USA		
	17.1	5.5	2.7	2.0	1.4		68.5	5.0	3.0	1.8		
China	HK	JPN	VNM	LAO	KOR		HK	MYN	JPN	VNM	CAM	
	5.9	2.8	2.8	2.5	1.8		6.2	5.0	2.8	2.0	1.9	
Hong Kong	CHN	PHL	SGP	TWN	VNM	USA	CHN	CAM	PHL	USA	SGP	
	10.5	1.9	1.8	1.6	1.6	1.6	11.1	3.1	1.8	1.2	1.2	
Indonesia	CAM	JPN	SGP	VNM	KOR		MYN	SGP	CAM	JPN	KOR	
	6.1	3.9	3.7	3.7	2.4		7.4	5.7	4.0	3.8	3.0	
Japan	THA	TWN	PHL	IDN	KOR		PHL	TWN	THA	KOR	IDN	
	3.2	3.1	2.8	2.7	2.4		3.6	3.5	3.0	2.5	2.3	
South Korea	VNM	CHN	IDN	PHL	HK		VNM	PHL	CHN	IDN	MYN	
	6.2	3.3	3.1	2.4	2.0		4.3	3.9	3.2	3.2	3.1	
Lao PDR	THA	TWN	JPN	CHN	EU		THA	JPN				
	14.2	1.9	1.6	1.1	1.1		9.6	7.9				
Malaysia	SGP	CAM	THA	VNM	TWN		BRU	SGP	MYN	THA	PHL	IDN
	8.1	4.2	3.1	2.1	2.0		9.3	8.9	7.6	3.7	2.9	2.9
Myanmar	N.A.						SGP	MYS	CHN	BRU	JPN	
							3.5	3.2	2.0	1.6	1.2	
Philippines	THA	JPN	SGP	USA	TWN		TWN	SGP	MYS	THA	JPN	
	2.8	2.7	2.4	2.3	2.0		4.0	3.6	3.5	2.8	2.6	
Singapore	CAM	MYS	VNM	THA	LAO		BRU	MYS	CAM	MYN	VNM	
	16.7	12.1	7.2	4.2	3.9		15.1	14.0	12.1	9.1	5.9	
Taiwan	HK	VNM	PHL	THA	CHN	IDN	MYS	HK	VNM	PHL	IDN	THA
	4.9	3.1	2.4	2.0	1.8	1.8	1.8	6.6	4.7	3.6	2.0	2.0

Top Five Trading Partners for East Asian Economies (Based on Trade Intensity Index)											
Thailand	LAO	CAM	SGP	VNM	MYS		LAO	CAM	VNM	SGP	IDN
	53.8	16.3	5.1	3.1	2.7		61.5	23.7	4.9	4.6	3.7
Vietnam	JPN	AUS	PHL	IDN	SGP		LAO	CAM	IDN	PHL	JPN
	4.1	3.8	3.4	2.7	2.6		32.8	30.8	7.2	3.8	3.3

Note: Only trading relationships with an index of 1.0 or above are included in table.  
Source: Compiled by authors based on data in Tables 5 and 6.

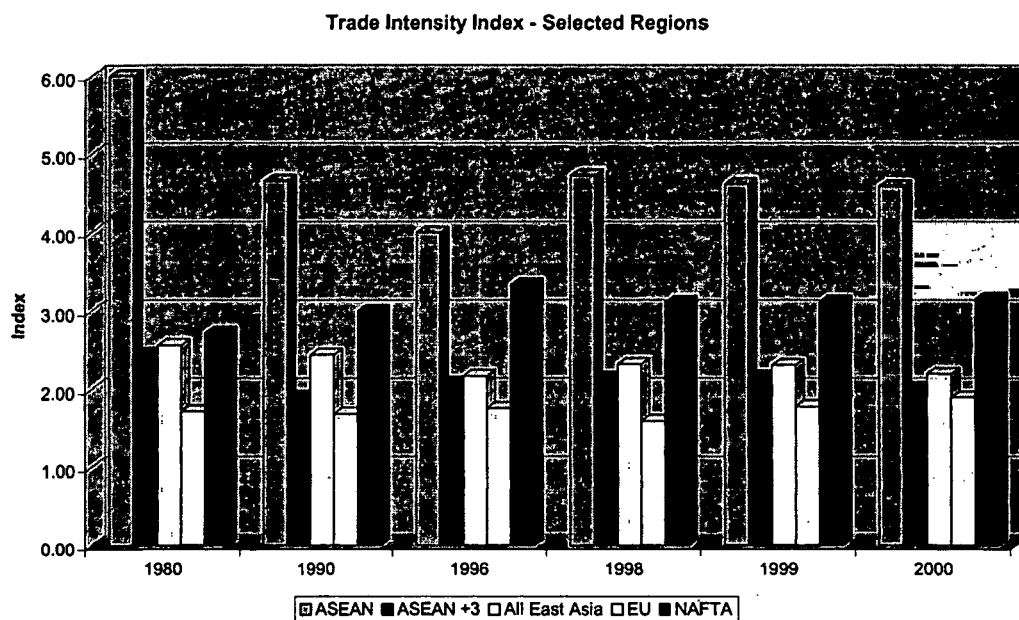
The above analysis using trade share revealed that the trade of East Asian countries with the U.S. and EU is quite significant. This conclusion is supported by the intensity index in the case of the U.S., but not the EU. Although the U.S. appears among the top five trading partners in 1998-2000 for only Cambodia and Hong Kong, there are in fact 11 East Asian countries that have an intensity index of 1 or above with the U.S. (see Table 4.5). On the other hand, the intensity indices with the EU are all well below 1 (in fact, most are below 0.5). Thus, the intensity index confirms an above-normal trading relationship with the U.S., but not with the EU.

During 1998-2000, Japan was among the top five trading partners for seven East Asian countries, including China, Indonesia, the Philippines, and most of the newer ASEAN countries. It is interesting to note that the intensity indices of several of these countries with Japan are nearly the same in 1998-2000 as in 1995-97, but Japan's position among their top five partners has dropped indicating a relative weakening of Japan's trade relationship with these countries relative to their other trading partners.<sup>32</sup> This indicates that Japan has declined slightly as a trading partner for some East Asian countries, which is consistent with the findings in our earlier trade share analysis.<sup>33</sup> Nevertheless, the indices of East Asian countries with Japan as a partner are all 1 or above (except for Cambodia) and many are 2 or higher indicating a still strong trading relationship.

The newer ASEAN countries, in 1998-2000, are more often among the top five trading partners of the East Asian countries than they were in 1995-97.<sup>34</sup> This could be attributed to the effect on their trade of membership in ASEAN during the latter half of the 1990s.

Figure 4.4 below compares trade intensity indices of selected regional groups in Asia, Europe and North America.

Figure 4.4



See Endnotes for calculation of index.

All East Asia includes ASEAN plus Japan, China, South Korea, Hong Kong and Taiwan. No Taiwan data for 1980 and 1990.  
 Source: IMF DOTS Yearbooks 1985, 1992, 2000 & 2001; IMF DOTS Quarterly Updates; and World Bank, *World Development Indicators 2002*.

Prominent in this figure is that ASEAN, in all years shown, had a higher intensity index than any of the other groups. (See Table S.8 in appendix for intensity index data table.) Its index of 4 to 6 between 1980 and 2000 was well above that of the EU, for which the index was only between 1.7 and 1.9. Although NAFTA's index was higher (about 3.0 in all years), this was still below that of ASEAN. This tells us that ASEAN has had a higher degree of intraregional trade than the EU or NAFTA in 1980 and the 1990s. This is the opposite of the findings based on the trade share analysis presented earlier. (See Tables 3 and 4.)

If the ASEAN group is widened to include China, Japan, and South Korea (ASEAN-Plus-Three), the intensity drops considerably; i.e., to about 2 or slightly above. The reason for this could be the low level of trade between ASEAN and China relative to China's large share of exports to the U.S. and EU. Whereas if the "All East Asia" group is considered, the intensity goes up somewhat, probably because of the inclusion of Hong Kong which trades heavily with China. Both of these groups (ASEAN-Plus-Three and "All East Asia") have indices greater than that of the EU, but less than that of NAFTA.

Although these indices have not changed dramatically, there was an overall decline in intensity with some fluctuation over the 20-year period for the East Asian groups. However, for ASEAN most of the decline occurred between 1980 and 1990.

The trade intensity indices of NAFTA and the EU moved in the opposite direction. That of NAFTA rose between 1980 and 1996 but dropped off by 1998 and, thereafter, remained virtually unchanged. The EU's index fluctuated a bit but generally rose steadily between 1980 and 2000.<sup>35</sup>

There are few clear regional trends that emerge in the foregoing discussion although it does reinforce the argument that East Asia's trade continues to be open and global but with a strong intraregional component. While the results based on two different measures – trade share and trade intensity – are not always consistent, some general observations can be made. Despite some decline, the U.S. remains a major trading partner of most East Asian countries, including Japan. There is still a significant share (although declining) of East Asia's trade that is conducted with the EU, although the trade intensity index reveals no bias.<sup>36</sup> It does not appear from the analysis that East Asia's trade is necessarily becoming more intraregional, in fact, there is some indication of the opposite based on trade intensity. However, within the region itself there are shifts; for example, ASEAN's trade with Japan is declining while that with China and South Korea is rising. Japan, on the other hand, is trading slightly less with extraregional partners and more intraregionally. China is exporting much more to the U.S. and slightly more to the EU but importing more from within the region.

Trade within the region will almost assuredly continue to change significantly over the next decade and developing trends will be affected in no small way by further progress in China's reforms, by developments in Japan's economy, as well as in the global economy, and by the direction and extent of regional integration efforts within East Asia. The region has the power to steer these changes in a direction that will be advantageous to its growth and development but this will take some concerted effort and a well-developed cooperative strategy. Some relevant suggestions in this area will be made later in this paper.

## **Patterns of FDI Flows**

Although there is some variability country to country, overall, FDI plays a critical role in economic expansion for East Asian economies, as evidenced by the FDI share of gross fixed capital formation shown in Table 4.7.

Table 4.7

Inward and Outward FDI Flows as Percentage of Gross Fixed Capital Formation (Percentage)						
Region/Economy	1990-1995 (Annual average)	1996	1997	1998	1999	2000
Japan:						
inward	0.1	-	0.3	0.3	1.1	0.7
outward	2.2	1.8	2.1	2.3	1.9	2.6
European Union:						
inward	5.5	6.5	8.1	15.7	28.5	50.1
outward	7.7	10.8	14.0	24.8	41.8	60.0
U.S.:						
inward	4.3	7.0	7.8	11.9	18.0	17.5
outward	6.1	7.0	7.2	8.9	11.1	9.6
South, East and South-East Asia:						
inward	6.7	9.1	10.0	10.5	11.5	14.0
outward	3.8	5.3	5.4	3.9	4.4	9.0

Source: UNCTAD, World Investment Report 2002, Annex table B.5

The rise in FDI inflows to East Asia in the last decade has been remarkable. (See Table S.9 in appendix.) The value of inflows has tripled from \$45 billion in 1990-95 (annual average) to \$136 billion in 2000. This level declined somewhat (by 29 percent to \$96.4 billion) in 2001 but still represents a doubling of inflows since the beginning of the 1990s. Among regional subgroups, inflows to ASEAN declined over that period while those to ASEAN-Plus-Three rose by 80 percent, reflecting a sharp increase in flows to China along with post-crisis disinvestment in Indonesia and a significant decline in flows to Malaysia. The growth in FDI, as in trade, was spurred by significant liberalization in these areas during the 1980s and early 1990s, although this growth was reversed by the East Asian crisis of 1997-98.

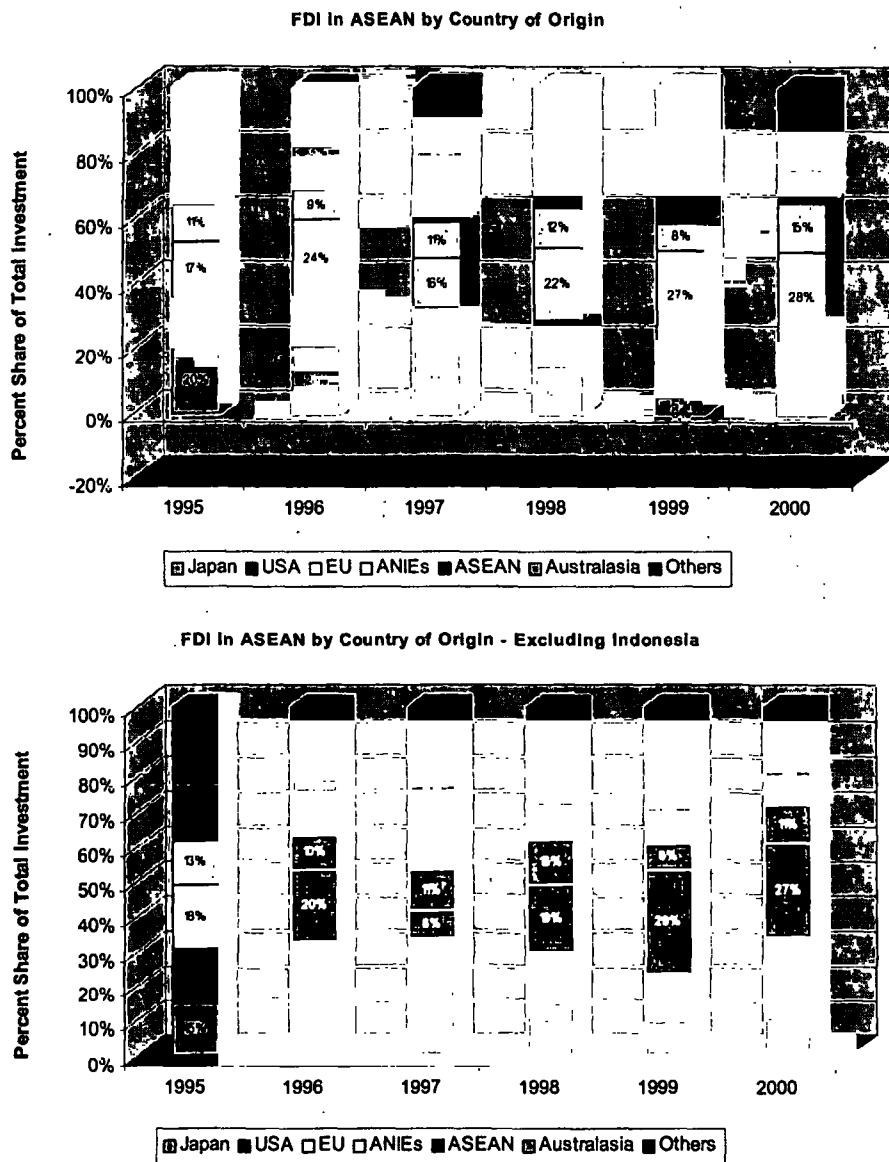
In 2001, China attracted the largest share of inflows in the region, as well as in the developing world, when the value of its inflows reached a high of \$46.8 billion. After doubling from \$19 billion to \$40 billion between 1990-95 (annual average) and 1996, its flows remained close to that level until 2001 when they increased further. During the first half of 2002, inflows rose by 19 percent over the same period in 2001, and this trend is expected to continue.<sup>37</sup>

### Sources of FDI

A look at the sources of these FDI flows will help in the assessment of FDI flow patterns for East Asia. We will first look at ASEAN as a group (Figure 4.5) and then at individual East Asian countries (Table 4.8).



Figure 4.5



Source: Compiled from *Statistics of Foreign Direct Investment in ASEAN: Enhanced Data Set*, 2001 Edition, Tables 3.1.2. – 3.1.7., pp24-35.

Figure 4.5 reveals which countries/regions are the primary investors in ASEAN and how these relationships have changed over the last half decade. The bottom chart in this figure, excluding Indonesia, is presented because of the distortion effect of Indonesia's recent disinvestment on ASEAN as a whole.

The investor with the largest share of FDI in ASEAN is the EU which accounts for 20 to 30 percent of investment between 1998 and 2000, compared to only 17-18 percent in 1995.<sup>38</sup> This considerable rise in share may have been helped by the efforts of

the transregional trade arrangement, ASEM (Asia-Europe Meeting), under its Investment Promotion Action Plan (IPAP).<sup>39</sup> The next largest investor is the U.S. with a share of 14 to 23 percent in 1998-2000. The intra-ASEAN share dropped precipitously after 1997, which is understandable given the deterioration in the major ASEAN economies during the crisis.

While all source countries/regions had a net withdrawal of investment from Indonesia in 2000,<sup>40</sup> the largest was that of Japan (i.e., US\$1.7 billion, or 38 percent of Indonesia's \$4.5 billion of lost investment). But even without the effect of its disinvestment in Indonesia, the share of ASEAN's FDI that comes from Japan dropped significantly over this time period – from 19 percent in 1997 to only 10-11 percent in 1999-2000.

Table 4.8 gives an idea of the major sources of FDI for individual countries in East Asia, but it covers different time periods, types of flows and is drawn from different sources for each country. It is thus not comparable across countries.

Table 4.8

Distribution of FDI in Selected Developing Countries		
Country and Data Year	Top Three Sectors (% of total)	Top Three Originating Countries (% of total)
China (1998-2000 accumulated flows)	Manufacturing (46%) Real estate management (16%) Utilities (6%)	Hong Kong (41%) United States (10%) Virgin Islands (9%)
Hong Kong (2000 year-end stock)	Investment holding/real estate (60%) Wholesale/retail (11%) Banking (9%)	Virgin Islands (32%) Mainland China (31%) Bermuda (10%)
Indonesia (cumulative 1967-mid 2000)	Chemicals and pharmacy (30%) Paper (11%) Electronics, trading and other services (10%)	Japan (16%) United Kingdom (9%) Singapore (8%)
Malaysia (flows 2000-01)	Electrical and electronics (51%) Paper, printing, publishing (9%) Non-metallic mineral products (8%)	United States (28%) Japan (16%) Netherlands (11%)
Philippines (flows 2000)	Manufacturing (46%) Energy-related (32%) Service export (13%)	United States (36%) Japan (27%) Hong Kong (11%)
Singapore (2000 inflows)	Electronic products and components (48%) Chemicals and chemical products (30%) Transport equipment (5%)	United States (40%) Japan (16%) France (4%)
Taiwan (total approved flows 1952- 2000)	Electronics and electrical (24%) Banking and insurance (15%) Services (11%)	United States (24%) Japan (21%) Hong Kong (8%)
Thailand (total net inflows 1995-99)	Trade (25%) Machinery and transport (11%) Electrical appliances (10%)	Japan (27%) United States (17%) Singapore (13%)
Vietnam (flows 2000)	Oil and gas (59%) Light industry (18%) Heavy industry (9%)	United Kingdom (30%) India (25%) Taiwan (15%)
NOTE: Concentrations are not comparable across countries as they are defined differently by national governments. Source: Compiled from OECD, <i>Foreign Direct Investment for Development</i> , 2002, 56.		

For most of the countries in this table inward FDI comes from only a few sources i.e., around 60 to 70 percent from only three source countries. The lack of diversification

in FDI sources, as well as in destination sectors, which lean heavily toward electrical and electronic products is a risk factor for East Asian economies.

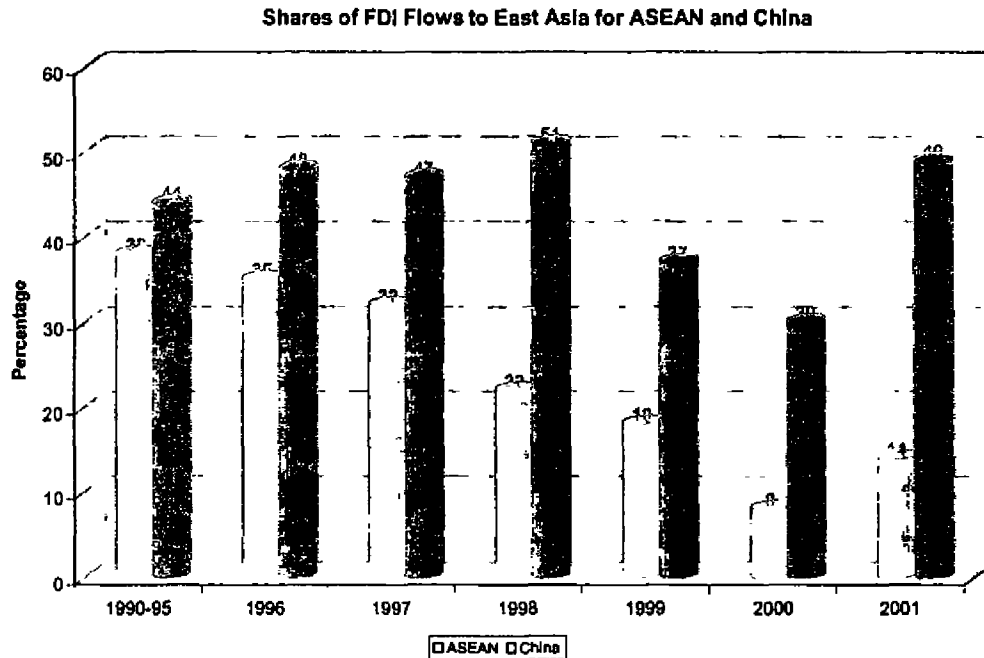
Source countries within East Asia that appear among the top three in this table are Japan and Hong Kong, which may not be surprising, but the table also shows that some of the NIEs (specifically Singapore and Taiwan) are among the top three investors in some countries.<sup>41</sup> From outside the region, the major source of investment, unsurprisingly, is the U.S. In Figure 4.5, the EU was shown to be the top investor in ASEAN. Table 4.8 shows this investment comes primarily from only a few European countries – the Netherlands (in Malaysia), France (in Singapore), and the U.K. (in Indonesia and Vietnam).<sup>42</sup>

Although Japan appears as the number one or two investor in the ASEAN-5<sup>43</sup> countries in Table 4.8, according to Figure 4.5, its share of investment in ASEAN has declined in recent years. Does this mean that Japan is investing less in ASEAN and more in other countries? In fact, one-fifth of total Japanese FDI in 2001 went to East and Southeast Asia, some of which was redirected from the U.S.<sup>44</sup>; however, 30 percent of this amount went to China while ASEAN received less. Although Japan is not included as a top-three investor in China in Table 4.8, the Japanese investment gap between China and the four ASEAN countries of Indonesia, Malaysia, the Philippines and Thailand has become almost nil since 1999. Prior to that, Japan invested more in the ASEAN-4<sup>45</sup> but this began to decline sharply in 1997.<sup>46</sup>

Japanese transnationals began to increase their investment in China in the 1990s. A recent survey conducted by Japan Bank for International Cooperation (JBIC)<sup>47</sup> revealed that Japanese companies with overseas manufacturing bases in China rose rapidly from about 100 in 1993 to nearly 700 in 2001. Although the survey also revealed the number of companies with bases in ASEAN-4 was higher than that (over 1,000 in 2001), it is possible the number in China will surpass that in the next few years. China has been at the top of the list of promising destinations for manufacturing FDI by Japanese companies over the medium term as reported in these annual surveys since 1996. Other ASEAN countries ranked below China but Thailand, Indonesia, Malaysia and Vietnam were among the top ten in all years.<sup>48</sup> Nicholas Lardy<sup>49</sup> points to the relocation of Japanese electronics manufacturing to China as “emblematic” of the trend of MNCs to redirect FDI from Southeast Asia to China.<sup>50</sup>

Figure 4.6 presents the shares of East Asia’s FDI inflows for China and ASEAN and gives a fairly clear indication that China is taking shares of FDI from ASEAN.

Figure 4.6



Source: Compiled from UNCTAD, *World Investment Report 2002*, Annex B I 303-306

Over the course of this period, ASEAN's share of inflows to East Asia steadily declined from 38 percent (annual average for 1990-95) to a low of 8 percent in 2000. This recovered slightly in 2001 to 14 percent. On the other hand, China's share of East Asian inflows rose from an average of 44 percent for 1990-95 to over half by 1998. Thereafter, it declined for two years, having lost share to Hong Kong (particularly in 2000), but rose to reach 49 percent in 2001, close to its earlier peak.

ASEAN countries were able to easily attract FDI in the 1980s because of their relatively high degree of openness in a market comprising fewer recipients than there are today. In the 1990s, competition for FDI increased markedly.<sup>51</sup> Furthermore, the crisis of 1997-98 had a severe impact on flows to the ASEAN economies, but not on flows to China. Some countries have been slow to recover from that shock. The Philippines is the only ASEAN country in which 2001 inflows reached the peak levels of the 1990s.

China's potential to attract large amounts of FDI has caused considerable concern among the ASEAN countries. Its accession to the WTO has made it more attractive to TNCs worldwide and lower costs there have become a major reason for TNCs in industrial countries to move production to China. Malaysia is one country that has reportedly lost electronics-related inflows to China.<sup>52</sup> In 2001, Malaysia's inflows dropped to only \$554 million after two years of inflows of nearly \$4 billion. (See Table S 10 in appendix.) This has been attributed to a loss of flows that have gone to China instead, particularly in electronics production, which in the past has played an important role in Malaysia's economy.<sup>53</sup> Capital investment applications for electronics projects to be located in Malaysia dropped from 18.6 billion ringgit in 2000 to 7.3 billion ringgit in 2001.<sup>54</sup> For China, foreign affiliates' share of exports in technology-intensive industries

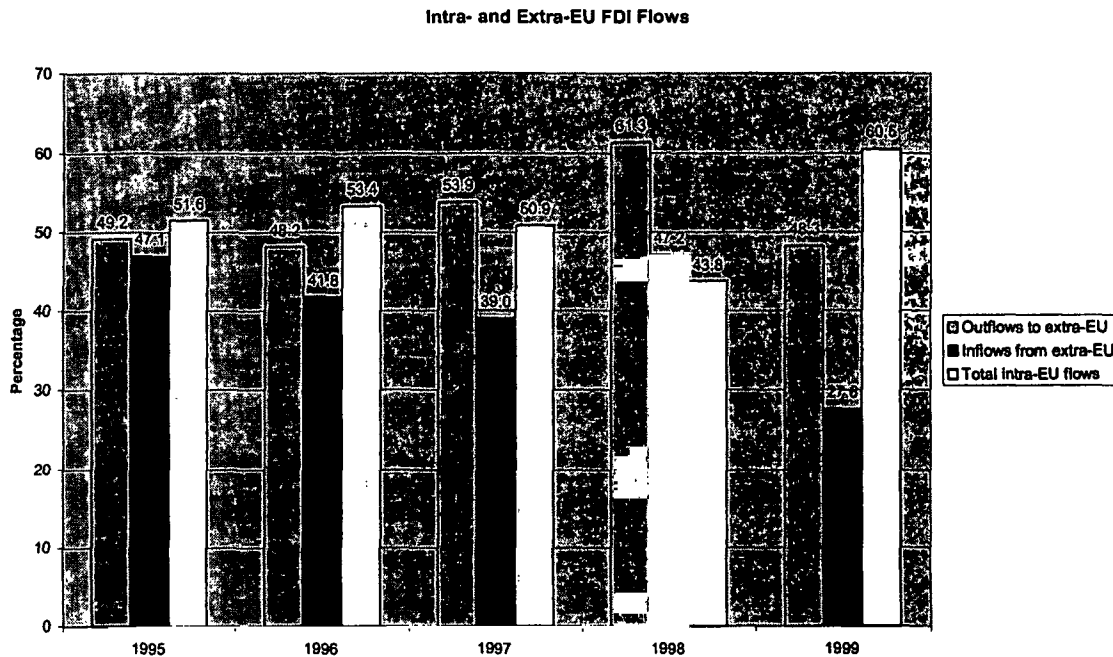
increased 22 percentage points between 1996 and 2000 (from 59 percent to 81 percent). One example is the export of electronic circuits of which foreign affiliates' share grew from 78 percent of total exports in 1996 to 93 percent in 2000 with Intel and Samsung being two major exporters.<sup>55</sup>

On the positive side, there is also the potential for China to increase its own outward investment in ASEAN. The possibilities for this are explored later in the discussion of intraregional production networks.

### Intraregional FDI

Compared to the EU and NAFTA, intra-ASEAN flows make up a smaller share of total flows. Figure 4.7 below shows intra-EU investment increased from 51 percent in 1997 to over 60 percent in 1999. In 2001, the largest share of the EU's FDI flows went to other EU members.<sup>56</sup>

Figure 4.7



Note: Intra-EU figures represent the average of inward and outward flows as declared by Member States.

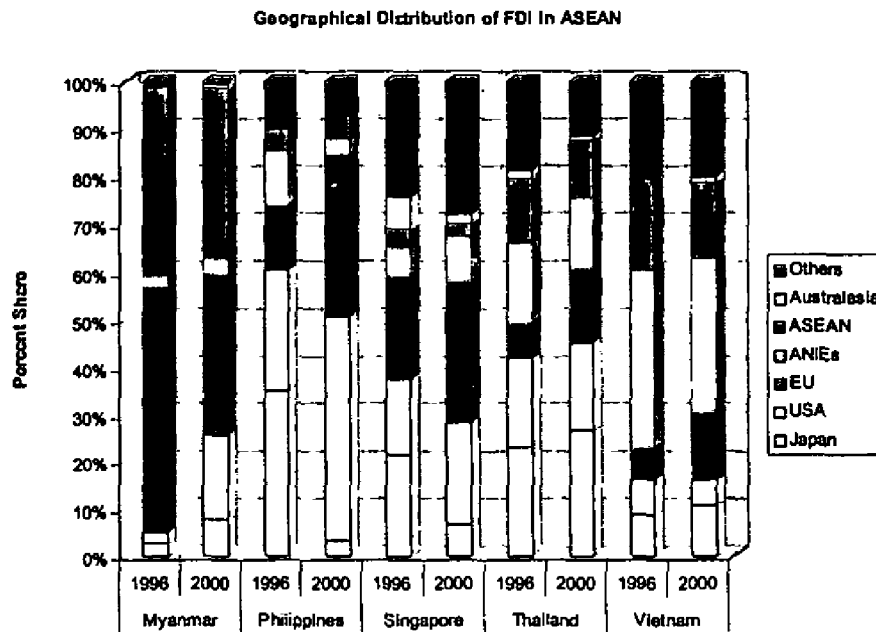
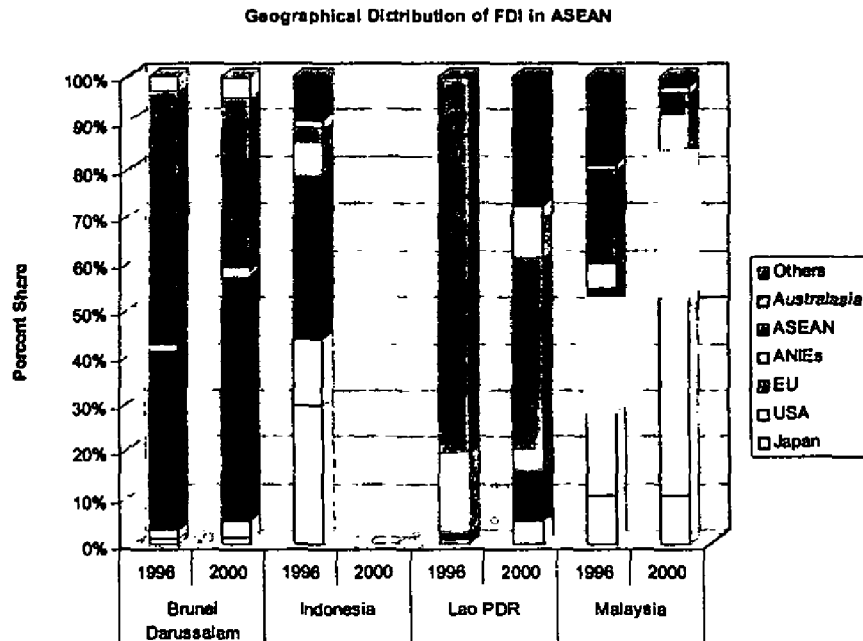
Source: UNCTAD, *World Investment Report 2001*, Figure I.8, p. 18.

In the first seven years of NAFTA (1994-2000), average FDI inflows to Canada were US\$21.4 billion and to Mexico were \$11.7 billion, which were four times and three times, respectively, the average annual amounts received in the seven years prior to NAFTA.<sup>57</sup> In order to take advantage of the enlarged market that Mexico's membership in NAFTA provides, a number of TNCs have established or upgraded production in that

country.<sup>58</sup> Of the total U.S. direct investment outflows in 2001, 25 percent went to Canada and Mexico. Mexico benefited as the host country of the third largest cross-border M&A deal in the world in that year valued at US\$12.5 billion and involving Citigroup of the U.S.<sup>59</sup>

Intra-ASEAN flows are small having declined from around 20 percent of ASEAN's inflows in 1997 to less than 10 percent in 1999 and 2000. (see Figure 4.5) On an individual country basis, only the smaller ASEAN countries, e.g., Brunei Darussalam and Lao PDR and Myanmar, rely heavily on investment from ASEAN and this has actually declined for each of them, as well as for other countries in the region, between 1996 and 2000. (See Figure 4.8 and Table S.11 in appendix.)

Figure 4 8



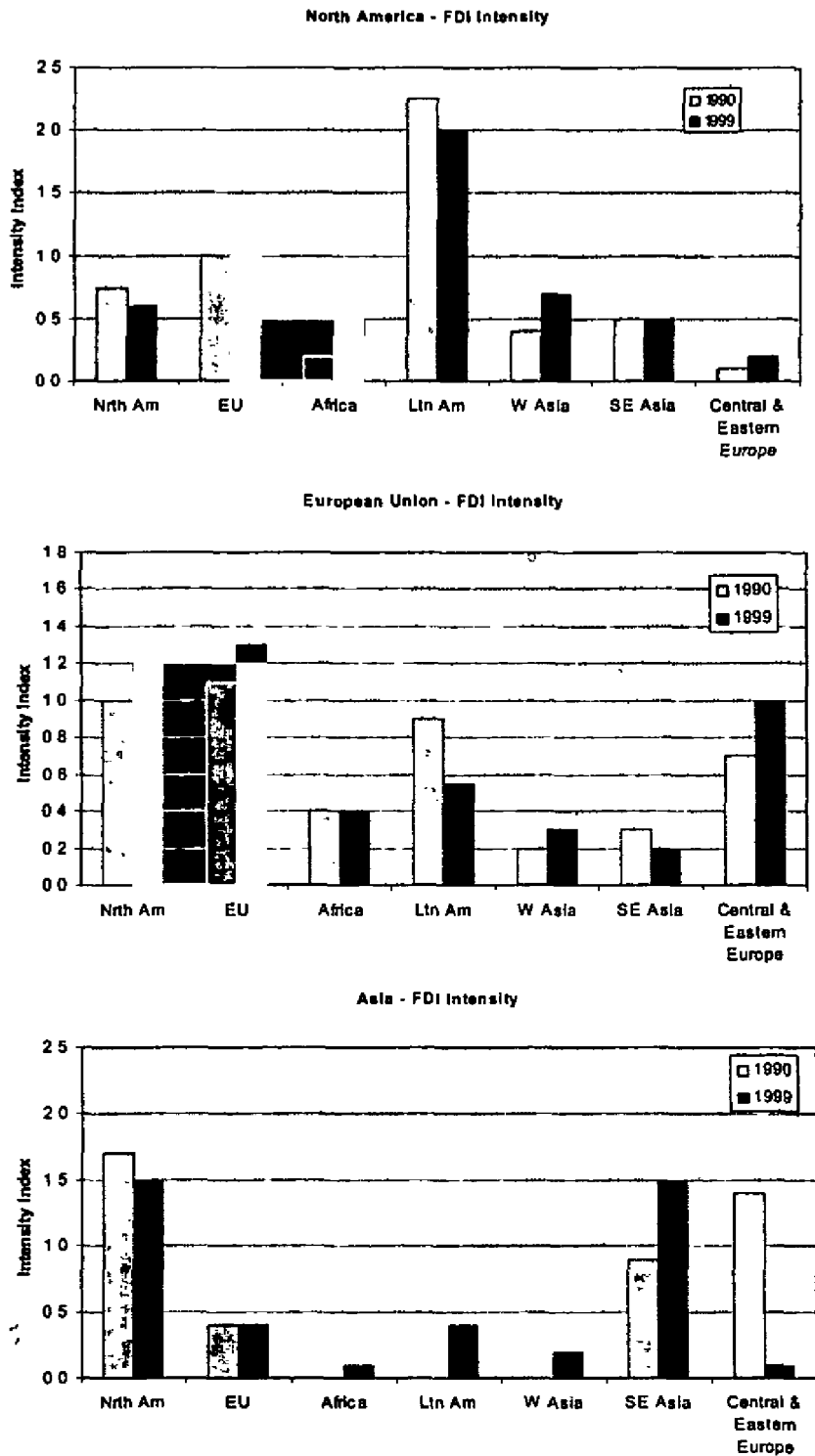
Source: Compiled from *Statistics of Foreign Direct Investment in ASEAN, Enhanced Data Set, 2001 Edition*

Like the trade intensity index, the FDI intensity index<sup>60</sup> can be used to show the bias within a group for members to invest in one another. In this case, the results are

broadly consistent with those of the above FDI share analysis. The index is shown in the three graphs in Figure 4.9 for the regions of North America, the EU and Asia<sup>61</sup> and their respective partner regions in the years 1990 and 1999.



Figure 4.9 – FDI Intensity Index, 1990 and 1999



Source UNCTAD, World Investment Report 2001, Figure II 10, p 57

NAFTA (North America) has the greatest FDI intensity among the three regions shown; however, it is not intra-NAFTA but rather with Latin America, which is not surprising given the current planning for a Free Trade Agreement of the Americas (FTAA)<sup>62</sup> which is to be implemented in 2005. For the EU, the greatest intensity is intraregional, as well as increasingly with Central and Eastern Europe, which indicates expanded investment there by EU countries in anticipation of EU expansion. The high index with North America reflects the importance of the EU's investment relationship with the U.S.

Asia's intraregional intensity index (1.5) actually exceeded that of the EU (1.3) in 1999. (See above Figure 4.9.) Asia's highest FDI intensities are intraregional, as well as with North America, although the former increased in the 1990s as the latter declined. This is consistent with the findings presented in Table 4.8 (top 3 source countries), which show the U.S., Japan, Singapore and Taiwan as top investors in ASEAN and other East Asian countries.<sup>63</sup> Additionally, it is not inconsistent with Figure 4.5, which indicates a decline in intra-ASEAN investment as TNCs in Singapore, which were very active in 1999 and 2000, have focused their investments in Northeast Asia.<sup>64</sup> This trend has apparently continued in 2001 when Singapore doubled its outward investment, surpassing Hong Kong as the largest outward investor in the region, primarily through two major M&A deals, one in Hong Kong and the other in Australia.

The Asian region has been at the forefront of a movement that began in the 1980s when TNCs located in developing countries began to increase their outward investment, mostly to other developing countries. South, East and Southeast Asian firms have accounted for the major portion of these outflows; i.e., 66 percent of developing country outflows in 1997 and 84 percent in 2001. (See Table S.12 in appendix.) This can be attributed to the export-oriented growth in these countries, which led to the growth of their TNCs which then invested intraregionally as well as in developed countries.<sup>65</sup>

In summary, while FDI inflows to East Asia have risen markedly over the last decade, there has been a noticeable shift in flows away from the ASEAN countries to China. While the decline in investment in ASEAN is partly due to the effect of the Asian crisis, from which some have yet to recover, recently it is caused more by the increase in China's attractiveness as a host country, largely because of its highly skilled but lower-cost labor, as well as its increasingly liberalized trade and FDI environment. Despite the increase over the decade in the bias toward intraregional investment (FDI intensity index), the region is still highly dependent on investment from the U.S. and a few European countries, as these countries are home to the largest number of internationally integrated TNCs. Focusing on the intraregional/extraregional investment scenario should not deflect attention from the internal investment dynamics of the region, particularly where China is concerned. Not only Japan, but also other major regional investors, including Hong Kong, Singapore and Taiwan, are focusing on Northeast Asia as well.

## **Trade and FDI in East Asia – Some Conclusions**

Given the strong linkage between trade and FDI, it might be expected that changes in their patterns would follow a similar trajectory over time. It is true that the factors affecting one often also affect the other; e.g., the 1997-98 financial crisis, the prolonged stagnation of Japan's economy, the opening up of China, the downturn in the global (particularly the U.S.) economy beginning in 2000, and changes in the

international production system. However, although broadly consistent, precise similarities are not always evident. For example, while the bias, or intensity, in intraregional trade has been at a fairly high level but declining over the last two decades, intraregional FDI began at a fairly low level but has risen in recent years.

Some general observations, however, can be made concerning both trade and FDI patterns in the region:

- East Asia still does a great deal of trade with, and receives a large amount of direct investment from, the U.S. and some European countries.
- Although the U.S. and certain European countries are still Japan's primary trade and investment partners, there are signs of a shift in both trade and FDI from outside to inside the region (involving China particularly).
- While most countries have recovered well from the crisis in terms of trade and FDI, some have not, particularly Indonesia, which is still experiencing disinvestment.
- ASEAN's trade with Japan is declining while that with China and South Korea is rising and ASEAN is receiving less investment from Japan as well.
- The rise of China is having a major impact on the region's trade and FDI patterns as TNCs both inside and outside the region shift operations to that country, often from other countries within the region.

From these observations we can discern the continuation of the highly liberalized nature of East Asia's trade and direct investment and the importance of maintaining its extraregional relationships. At the same time, intraregional relationships are strengthening as individual countries struggle to find a way to prosper and grow in the shadow of a rising China. In the next section we will consider a role for regionalism in this dynamic environment.

## **A Role for Regionalism in Promoting Trade & FDI**

We have so far made three observations: (1) East Asia's trade and FDI patterns are global and, at the same time, intraregional, (2) the current trend in East Asia is to seek regional solutions for shared issues, and (3) it is welfare-enhancing to coordinate the formulation of trade and FDI policies. Consequently, it is worthwhile to explore possible regional approaches to the promotion of trade and FDI in East Asia. Presented in this section are two such approaches: regional agreements and regional production networks.

### **Regional Agreements**

There are several types of cooperative arrangements designed to promote trade and/or FDI. These can be narrow agreements, including only two countries and covering either trade or FDI, or they can be very broad agreements, including more than two countries and covering a wide range of activities. There are many cases where investment issues are being included under free trade agreements or under regional integration frameworks, such as NAFTA. In fact, these are the fastest growing in number of all regional agreements that address investment issues.<sup>66</sup>

Both trade agreements and investment agreements have the common goal of liberalization of trade/investment activities and non-discriminatory treatment of participants in the agreement. Investment agreements vary in their provisions as related

to performance requirements, breadth of investment promotional measures, inclusion of protection standards, and range of investment issues covered, such as competition, technology transfer, employment, environmental protection, incentives, illicit payments and conflicting requirements.<sup>67</sup> Trade agreements focus chiefly on the elimination of tariffs on goods. However, it has been suggested that more recent regional trade agreements may be notable more for their promotion of FDI than of trade and, for some, this could be the motivation for their formulation.<sup>68</sup>

Table G.4 in the appendix includes a list of primary regional instruments dealing with FDI (adopted between 1957 and 2002) and involving East Asian countries. The number of agreements for East Asia is only 11, out of a total of 105 worldwide, indicating the region as a newcomer to such arrangements.<sup>69</sup> Furthermore, the number of these that are also trade agreements (see Table G.3 in appendix), meaning they encompass both trade and investment issues in one agreement, are only two: the agreement between New Zealand and Singapore and that between Japan and Singapore [aside from AFTA, which covers trade, while investment is covered under a separate agreement, i.e., ASEAN Investment Area (AIA), and APEC which has its separate APEC Non-Binding Investment Principles].<sup>70</sup>

As trade agreements in general are concerned, these two are noteworthy in their recognition of the complementarity of trade and FDI. For example, the Japan-Singapore New-Age Economic Partnership Agreement (JSEPA) includes trade-related elements, such as the elimination of tariffs on goods and of non-tariff measures inconsistent with WTO, and addresses trade-related issues including rules of origin, customs procedures, paperless trading, and mutual recognition of tests and certifications. Important for promoting investment, it covers the liberalization of trade in services,<sup>71</sup> the facilitation of investments through promotion and protection, and the movement of natural persons between the two countries. Additionally it covers issues related to intellectual property, government procurement and competition, and enhances economic cooperation in financial services, information and communications technology, science and technology, human resource development, and others. Finally, it includes provisions for the settlement of disputes.<sup>72</sup>

The major drawback to JSEPA is its avoidance of the agriculture issue, partly because Singapore has virtually no agriculture but also because agriculture is a particularly sensitive area for Japan. This is why the agreement may be limited in its versatility as a prototype for other Asian countries where agriculture is of considerable importance. Aside from this, it is laudable in its broad coverage of elements important to the promotion of both trade and FDI.

A number of other FTAs are currently being negotiated in East Asia. These include a Japan-Korea FTA (in the study phase since 1998), which is expected to be quite broad in its coverage. It "would not aim merely at removing the tariffs and nontariff measures that still exist between the two countries; it would aim at a comprehensive framework encompassing an array of market-integration measures, such as investment promotion, trade facilitation, and harmonized trade and investment rules and standards."<sup>73</sup> Japan and Korea both place a high priority on finalization of this FTA. Korea would like to implement FTAs also with Singapore and Mexico in the short term.<sup>74</sup>

The FTA that has taken center stage in the region recently, however, is the ASEAN-China FTA (ACFTA), for which a framework agreement was signed in

Cambodia in November 2002, designating 2010 as the completion date for the FTA with an extension to 2015 for the newer ASEAN members. The goal of this agreement is to promote comprehensive economic cooperation through the elimination of tariff and non-tariff barriers on goods, the liberalization of services trade, and the establishment of an open, competitive investment regime. Cooperation would be strengthened in the areas of agriculture, ICT, human resource development, investment and the Mekong River basin development and extended to include the areas of banking and finance, transportation, telecommunications, industrial cooperation, forestry and fisheries, energy, and others. This framework agreement was accompanied by a so-called “early harvest” program which reduces the tariffs on certain agricultural items (e.g., live animals, meat, fish, dairy products, live trees, vegetables, fruits and nuts) within three years in an effort to accelerate trade liberalization of these items. Provision for the establishment of a dispute-settlement mechanism is included.

While some ASEAN members remain wary of China’s motives and doubtful of benefits accruing to ASEAN from the ACFTA, most in the region see this approach as preferable to adopting a defensive, protectionist stance against the challenge of China. From China’s perspective, while it may have some desire for leadership in the region, it can also benefit more from cooperation with, than alienation of, its neighbors as it needs a large market for its vast array of goods and resources for its industrial production. This FTA is indicative of the region’s recognition of the importance of cooperation and openness in a broad-based approach to the promotion of trade and investment.

Also in November 2002, Japan and ASEAN signed a joint declaration to draw up a framework for an FTA to be established within ten years; however, in this case, Japan may proceed by forming bilateral agreements with individual ASEAN countries first, followed by an FTA with ASEAN as a group. The ultimate package is envisaged as broad in coverage, including measures to promote and facilitate trade and investment in the areas of financial services, information and communications technology, human resource development, transportation, and others. At the same time, China, South Korea and Japan reached agreement to initiate next year (2003) a joint study on the subject of the economic effects of an FTA among those three nations.

As previously mentioned, ASEAN and APEC have separate trade and FDI agreements. APEC has contributed to the reduction of tariffs in the region through its Bogor Declaration and promotes free and open investment by encouraging its members to eliminate restrictions through the framework of the WTO Agreement and the APEC Non-Binding Investment Principles. AFTA has succeeded as a regional tariff reduction program but has done little beyond that, especially in the area of non-tariff barriers. APEC and AIA’s achievements in the area of investment promotion consist mainly of studies, training, dialogue, and the provision of information.<sup>75</sup>

There are a number of ways that trade and investment agreements can be mutually promoting. The reduction in import tariffs has implications for the location of FDI in that it lowers input costs for foreign affiliates making the host country more attractive for investment. Trade agreements also lead to wider market access. Those agreements covering a broader range of issues, for example incentives, can also lower production costs and risks which would induce more, probably export-oriented, FDI.<sup>76</sup>

The literature on the issue of regional trade agreements (RTAs)<sup>77</sup> and their economic effects is extensive,<sup>78</sup> although these do not encompass the implications of

investment (nor of services trade) because of a lack of data and the limitations of current modeling methodology.<sup>79</sup> The general debate has been whether trade blocs are “stumbling blocks” or “building blocks” to free trade.<sup>80</sup> The consensus of this literature overall is that multilateral arrangements, or free trade, as opposed to smaller regional or subregional arrangements, are preferable. The most extensive recent study on this topic (Scollay and Gilbert, 2001) concludes that RTAs (both bilateral and plurilateral) create a “spaghetti bowl” effect and, thus, reduce the efficiency of regional trade.<sup>81</sup> As a means of avoiding the negative effects of this phenomenon, the authors recommend arrangements of larger groupings, e.g., APEC. Most economists, including many who have specifically addressed the issue of RTA proliferation, believe that free trade (through its primary advocate, the WTO) is the best alternative for promoting international trade.<sup>82</sup> However, in the “first comprehensive empirical study of the effect of the postwar multilateral agreements on trade,” Rose (2002)<sup>83</sup> finds that “membership in the GATT/WTO is not associated with enhanced trade, once standard factors (such as the effect of income on trade) have been taken into account.”<sup>84</sup> On the other hand, he did find that trade is nearly doubled by the Generalized System of Preferences (GSP), which is a type of developed-country to developing-country preferential arrangement.<sup>85</sup> Other studies also attach some importance to the developed/developing country relationship, as discussed below.

Most studies that cover the mutually promoting benefits of the combined trade/FDI agreements focus on developed country regional integration agreements, such as NAFTA and the EU, while few focus on agreements among developing countries, such as MERCOSUR and AFTA/AIA. However, a study by Blomström and Kokko (1997) examined developed and developing country agreements<sup>86</sup> and found that, theoretically, the capability of a regional integration agreement for attracting FDI both internally and externally depends on a number of characteristics, including whether the agreements are between developed countries, developing countries or a combination of both, whether the countries are competitive or complementary, and the level of group integration at the outset. Furthermore, there may be a different impact on participating investors versus outside investors. For example, the implications of the findings in the South-South arrangement of MERCOSUR, which is similar to ASEAN, are that it does increase investment inflows but these are not likely to be equally distributed among the various members. Also, macroeconomic stability of the countries involved may have been a more important determinant than regional integration.

However, in the case of NAFTA (a North-South arrangement like ASEAN-Plus-Three), they found a profound effect on inflows to Mexico due to NAFTA’s enhancement of domestic reforms, thus contributing to significant, positive, and even permanent change in Mexico’s investment environment. Also, given Mexico’s locational advantages in labor-intensive industries relative to the U.S. and Canada, regional integration brought more commercial opportunities and increased investment to all three NAFTA members, particularly from outside the region. There are some general characteristics in NAFTA that could apply to other North-South agreements, particularly relative to “the potential for improved policy credibility and gains from guaranteed access to large northern markets.”<sup>87</sup>

The automotive industry is an example of how preferential tariffs under regional trade agreements among developing countries, such as AFTA, have led to an expansion of intra-industry trade and increases in FDI in the member countries.<sup>88</sup> This example

spans both the “regional agreement” approach and the “regional production network” approach that we are proposing in this chapter. It will therefore be explained in the next section on regional production networks.

Admittedly, as many regional agreements are still in the early stages of formulation, it is impossible to determine at this point whether the comprehensive nature (encompassing both trade and FDI) of their initial frameworks will in fact be realized in their final implementation. Nevertheless, the fact that this concept is incorporated in the early stages, and that such frameworks are increasing in number, indicates a recognition of the importance of linking trade and FDI in formulating agreements from which economic benefits are expected.<sup>89</sup> It also indicates that policymakers in many countries (both developed and developing) recognize that TNCs are moving away from the traditional linear internationalization sequence, which begins with exporting before progressing to FDI, to a more integrated approach to establishing an international production network.<sup>90</sup> Furthermore, policies liberalizing trade and investment often precede or accompany regional integration arrangements. These can lead to increased FDI flows.<sup>91</sup>

While there is no template for regional agreements that guarantees an increase in trade and FDI, it is evident that the selection of partners to the agreement, as well as the structure of the agreement itself, are important in whether or not it is successful in achieving this outcome. While larger groupings might be more welfare enhancing, a bilateral approach could be an initial step to a broader multilateral arrangement. In any event, the inclusion of both developed and developing countries in the agreement seems advisable. Above all, the more comprehensive the agreement, the better the chance that it will lead to the coordination of trade and FDI policies. Finally, the formation of preferential agreements should be seen as a temporary measure leading eventually to a multilateral approach.

## **Regional Production Networks**

The establishment of regional production networks (RPNs) is another way in which regionalism can play a role in promoting trade and FDI through their linkages. The establishment of RPNs is broader in concept than regional trade and investment agreements, and could be viewed as an extension of these. One of the host country economic determinants of efficiency-seeking FDI indicated by UNCTAD is “membership in a regional integration agreement conducive to the establishment of regional corporate networks.”<sup>92</sup> Accepting that the formulation of regional agreements is a temporary approach for the promotion of trade and FDI, regional production networks could be the next step, or even a concurrent step, for East Asia as it moves toward the ultimate goal of becoming a fully functioning member of the *global* production network. This is not to imply that a regional network should operate outside the international network. Rather, it should operate within it and as a part of it. Given that there is a multilateral aspect to East Asia’s trade and FDI, this could be considered essential for the region’s continued growth and development.

The EU and NAFTA play a major role in international production and are major providers and recipients of global FDI. These regions comprise mostly developed countries, and most large TNCs, which are central to the global production network, are found in developed countries. In East Asia, on the other hand, there is only one

developed country, plus four NIEs and ten developing economies. This raises the question of whether or not the region has a sufficient number of TNCs capable of contributing in a major way to production networks in the region. We will later examine some trade and FDI indicators that will help answer this question.

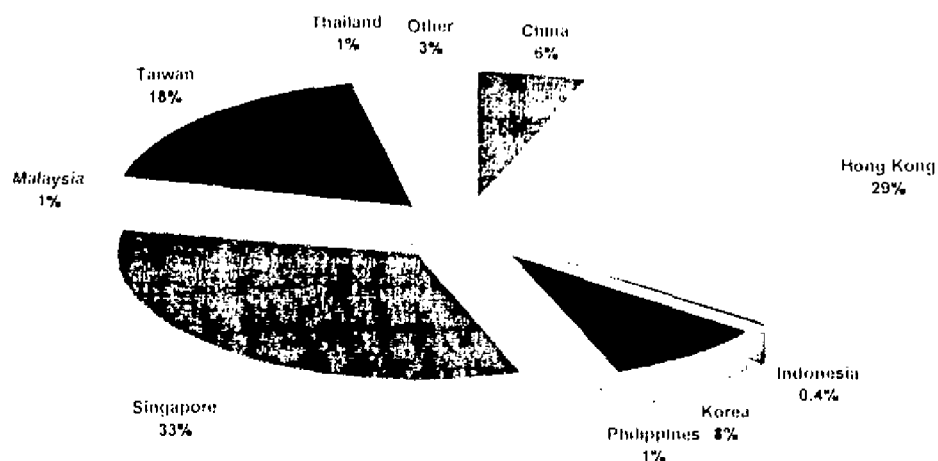
The beginnings of a regional production network, in fact, already exist in East Asia. Japan played the lead role in establishing this network through its “flying geese” model.<sup>93</sup> Japan’s lead was followed by the Asian NIEs (Singapore, Hong Kong, Taiwan and South Korea) and then by the ASEAN-4 (Malaysia, the Philippines, Indonesia and Thailand), by China, and now Vietnam. All are currently at different stages of industrial development, and the “flying geese” model is viewed by many to be no longer the predominant growth model for Asia; however, it helped establish the beginnings of a regional production network through the cross-border activities of TNCs, including trade, FDI, licensing and sub-contracting, and it had the effect of increasing integration in the region.<sup>94</sup>

Currently, Japan is included in the “Triad” (along with the EU and the U.S.), which accounts for the largest share of global inward and outward FDI.<sup>95</sup> In addition, among developing countries, South, East and Southeast Asian firms have accounted for the major portion of FDI outflows (i.e., 84 percent in 2001) and these firms invest both in developing countries within the region, as well as in developed countries around the world. Figure 4.10 shows which East Asian countries are the major providers of outward FDI.



Figure 4.10

Share of Asian FDI Outflows - 2001



Note In this figure Asia includes South, East and Southeast Asia.

Source Compiled from UNCTAD, World Investment Report 2002, Annex table B 2 , 307-309

Unsurprisingly, the largest share of the region's outward investment is from the NIEs. Contrarily, the ASEAN-4 countries provide very little of these outflows. However, China's share is significant – 6 percent, up from a share of only 1 percent in 2000.

On a global level, the region's (excluding Japan) share of FDI outflows was nearly 5 percent in 2001 with that of Singapore, Hong Kong and Taiwan (around 1.0 to 1.5 percent each) being the largest among individual countries (See Table S.12 in appendix.) While this may not appear to be much compared to the EU's 59 percent, it is very close indeed to Japan's 6 percent. Furthermore, while a small amount of FDI poured into an economy the size of the U.S. would not have much effect, if the same amount is invested in a country the size of Malaysia or Indonesia, it could have a significant impact on the local economy

Given that TNCs play such an important role in the international production network, a look at the number of East Asian TNCs and their share in total foreign assets will give some indication of the region's firm-level capacity for contributing to regional production networks. In addition, UNCTAD has developed an index called the "transnationality index" (TNI),<sup>96</sup> which gives some idea of the extent to which host countries and TNCs (separately calculated indices for each) are involved in international production. Table 4.9 shows these indicators for the largest 50 non-financial developing-country TNCs, based on their foreign assets

Table 4.9

Home Countries/Regions of the Top 50 Non-financial TNCs from Developing Economies									
Region/Country	Average Network Spread Index	Average TNI		Share in total foreign assets of top 50 (%)			Number of entries		
		2000	1999	2000	1999	1998	2000	1999	1998
West Asia	-	19.3	-	0.5	-	-	1	-	-
Latin America	-	28.2	48.3	21.8	22.0	28.3	12	10	9
Africa	-	41.4	46.0	4.4	5.9	6.3	4	4	3
South, East and Southeast Asia	-	32.4	39.1	73.3	72.0	65.7	33	36	38
China	2.9	28.5	-	3.9	-	8.8	3	-	3
Hong Kong	1.4	42.0	45.4	38.9	26.4	22.0	11	11	10
India	-	-	9.6	-	0.7	0.8	-	1	1
Korea	7.6	23.9	27.8	13.4	23.2	16.7	5	9	6
Malaysia	1.6	38.1	24.1	7.2	7.0	6.3	5	5	6
Philippines	5.0	28.1	25.0	1.1	1.1	1.5	1	1	1
Singapore	4.0	43.2	58.9	7.4	11.2	7.2	6	7	9
Taiwan	4.8	23.1	43.9	1.4	2.4	2.4	2	2	2
Average/total <sup>a</sup>	-	31.3	34.5	100.0	100.0	100.0	50	50	50
From Top 100 List for Comparison:									
U.S.		43.0		27.2			23		
EU		67.1		53.0			49		
Japan		35.9		10.7			16		

a Numbers may not add up exactly due to rounding.  
Note: List does not include countries from Central and Eastern Europe.  
Source: Compiled from UNCTAD, World Investment Report 2002, Table IV.16., 108 and Figure IV.8., 109.

South, East and Southeast Asia have the greatest number of companies (33) on the top 50 list and the largest share of total foreign assets (73 percent), as of 2000. Among these countries, the positions of Hong Kong, South Korea and Singapore are significant. While Hong Kong has largely maintained the same number of firms on the list since 1998 (11), the number for Singapore has declined since then (from 9 to 6). South Korea also lost some firms between 1999 and 2000, but this is reportedly due to a lack of data.

Furthermore, among the 11 newcomers to the top 50 list, seven were from East Asia, three of which were from China. The foreign expansion of Chinese firms has progressed rapidly. China's top 12 TNCs, which are mostly State-owned enterprises, controlled over \$30 billion in foreign assets, had over 20,000 foreign employees and reported foreign sales of \$33 billion in 2001. Non-State-owned enterprises, although mostly small and medium-sized TNCs, are following the same path and have investments in over 40 countries around the world, including Asia.<sup>97</sup>

These data indicate the prominence of East Asia's TNCs among those of developing countries. However, it is possible to see the potential for East Asian firms to become "global players" by looking at the top 100 "worldwide" list, which includes firms from both developed and developing countries. In 2000, among a record five firms from developing countries, three East Asian firms made it to this list: Hutchison Whampoa (Hong Kong), LG Electronics (South Korea) and Petronas (Malaysia), the latter two for the first time.

The ranking of the top 100 firms is generally related to their degree of participation in cross-border M&As<sup>98</sup> as that is the primary mode of entry for firms investing in developed countries. On the other hand, the mode of entry for developing countries is primarily greenfield investment – two-thirds of FDI flows to developing countries are greenfield investments and the share of developing countries in the value of M&As was only 10 percent in early 2000. This, however, is gradually changing. In Asia, for example, the share of FDI (inflows) that was in the form of M&As increased from 8 percent in 1987-89 to 20 percent in 1998-2000.<sup>99</sup> Furthermore, outward FDI from developing Asia has also shifted over the last two years from greenfield investments to M&As.<sup>100</sup>

The transnationality index (TNI) for host countries (country level, as opposed to firm-level; not included in the above table) indicates Hong Kong as the most transnational economy in the world, with Singapore being fourth and Malaysia, eighth. This is based on the production potential and results of their inward FDI.<sup>101</sup>

As for firm-level TNI (see Table 4.9 above), developing Asia's average of 32.4 (in 2000) is above Latin America's 28.2 and compares favorably with Japan's 35.9. Even more notable is Singapore's 43.2 and Hong Kong's 42, which are virtually the same as the United States' TNI of 43. Even for Malaysian firms, the average TNI is high at 38.1. In fact, Hong Kong and Singapore have traditionally had the most "transnationalized" companies among developing-countries.<sup>102</sup>

The Network Spread Index (also in Table 4.9 above) measures the number of countries in which a firm has foreign affiliates, thus giving an indication of the "degree of transnationalization of a company."<sup>103</sup> South Korean firms have the highest index on average among the top 50 developing-country firms – close to 8 percent. The firms of other countries have much lower indices on average with the next highest average index being for firms of the Philippines and Taiwan – around 5 percent for each. The firms of Singapore and Hong Kong have the lowest average index because their foreign operations are only in a few locations, particularly in China.

As would be expected, though, the transnationality of developing Asia's firms is below that of developed country firms. The average TNI for the top 100 firms in the world, of which all but five are developed country firms, is 55.7 versus 32.4 for developing Asia's firms, and the average Network Spread Index of the top 100 TNCs is about 14 percent versus about 3.5 percent for the top 50 developing country firms.<sup>104</sup> Firms in developing economies are smaller and do not have as extensive a geographical reach as do developed country TNCs, so it is difficult for them to explore developed country markets.<sup>105</sup> However, it would be easier for them to explore markets in their own region to which they are closer geographically and with which they have more familiarity.

Structural shifts in production caused by a number of factors, including new technologies, new demand patterns, and new production organization, are reflected in changing trade patterns.<sup>106</sup> Table 4.10 shows the trade structure for developing countries and gives an indication of how the region of East and Southeast Asia has progressed in export competitiveness over the last 15 years (to 2000). (See Table G.5 in appendix for description of product categories.) In fact, the region has made the greatest progress (among developing regions) in the evolution from exporting primary commodities to exporting manufactured goods and services.

Table 4.10

Structure of World Trade in Major Product Categories, By Region, 1985 and 2000 <sup>a</sup>														
Product <sup>c</sup>							Of which							
	Developed Countries <sup>b</sup>		CEE <sup>b</sup>		Developing Countries <sup>b</sup>		East & Southeast Asia <sup>d</sup>		Latin America & Caribbean		Middle East & North Africa		Sub-Saharan Africa	
	1985	2000	1985 <sup>e</sup>	2000	1985	2000	1985	2000	1985	2000	1985	2000	1985	2000
Primary products	38.0	40.4	0.8	3.6	61.2	56.0	10.4	9.5	12.5	13.2	21.4	20.9	5.4	4.3
Manufactures based on natural resources	68.7	68.2	1.4	5.2	29.8	26.6	8.4	11.7	7.0	6.5	4.9	3.9	1.7	1.3
Manufactures not based on natural resources	81.9	66.8	0.6	2.4	17.5	30.8	10.8	22.6	2.6	4.6	0.8	1.1	0.4	0.2
Low-technology	66.4	49.7	1.2	3.6	32.4	46.6	22.9	33.4	3.2	5.3	1.6	2.7	0.5	0.4
Medium-technology	89.2	78.6	0.5	2.6	10.4	18.8	4.7	11.7	2.5	5.0	0.5	0.8	0.3	0.3
High-technology	83.2	63.4	0.2	1.3	16.6	35.4	10.9	29.1	2.1	3.6	0.3	0.3	0.3	0.1
Other transactions	71.2	58.4	0.2	1.2	28.6	40.4	5.3	8.6	4.2	4.8	0.9	0.9	4.1	1.9
Total	68.9	63.5	0.8	2.9	30.3	33.8	10.1	18.7	5.8	6.0	6.3	4.0	1.8	1.0

<sup>a</sup> Based on a 3-year average for 1985 (1984-1986) and a 2-year average for 2000 (1999-2000).  
<sup>b</sup> These three regions add up to 100 percent for each export category.  
<sup>c</sup> Includes the ASEAN countries plus China, Hong Kong (China), Macau (China), Mongolia, North and South Korea, and Taiwan.  
<sup>d</sup> See Appendix for description of product categories.  
<sup>e</sup> The share of CEE (Central and Eastern Europe) in exports is understated for 1985 because data are lacking in a number of countries. This also overstates the relative gain in the group's market shares over time.

Source: UNCTAD, World Investment Report 2002, Table VI.1., p148.

A country/region that experiences an increase in market shares over time reveals its dynamic competitiveness and its ability "to keep up with changing technologies and trade patterns."<sup>107</sup> UNCTAD's list of economies that have raised their world market shares by at least 0.1 percent (so-called "export winners") between 1985 and 2000 reveals that China was at the top of the list (of developing countries) in all categories of exports, except resource-based manufactures in which it was third. Hong Kong is on the list in only resource-based manufactures while South Korea, Singapore and Taiwan are in the top 10 of several categories. Malaysia, Thailand and the Philippines are also prominent in the list for all sectors.<sup>108</sup>

Three industrial sectors that have in recent years figured largely in international production networks involving developing countries are clothing, electronics and automobiles.<sup>109</sup> In the clothing industry, production relocation has taken place largely through subcontracting. In East Asia, the NIEs were the first to be involved in this process. They began with the simple assembly of imported inputs and, after a short time, came to concentrate on skill-intensive activities at home while outsourcing the labor-intensive activities of production to lesser-developed East Asian countries having lower wages. End products would then be exported from there back to the home country or to third countries. In essence, there was a movement from "bilateral interregional trade flows to a more fully developed intraregional division of labour incorporating all phases of production and marketing."<sup>110</sup> There is reason to believe this type of regional networking will continue in the future, except that the players may change somewhat as competition increases from other East Asian countries, which will undoubtedly upgrade from assembly to full-package manufacturing.

The electronics industry is more globalized than the clothing industry and is driven by TNCs. Japan and the U.S. have played major roles as investors while East

Asian economies have been major host countries because of their low wages, highly skilled labor, good physical infrastructure and fewer restrictions on exports relative to Japan. Prior to the early 1990s, Japanese TNCs tended to import components from Japan rather than obtaining them from local suppliers.<sup>111</sup> Finished products would then be exported back to Japan or, in many cases, directly to third markets. This traditional pattern is beginning to change for higher level electronics, specifically computer products, as a result of not only tougher competition and the increasing importance of speed in getting products to market, but also because production capability is improving in local economies.<sup>112</sup>

While this bodes well for the future of regional production networks, it does not diminish the importance of the global element. In fact, this industry has come to be characterized by the emergence of a "new pattern of regional production sharing" that has given rise to "overlapping and competing international production networks." This has both positive and negative implications for East Asian economies in that it allows them to act as suppliers in a wide range of production networks, but it also gives buyers a wider selection of suppliers to choose from.<sup>113</sup>

The automotive sector in East Asia is one where trade (through regional trade agreements) and FDI linkages, as well as the global/regional element, are particularly evident. Investment in this industry from Japan, the U.S. and the EU has been drawn to ASEAN countries by AFTA's lowering of intraregional trade barriers and raising of import tariffs for non-members, which has benefited Malaysia and Indonesia in particular. In fact, intraregional trade in motor vehicles and their parts has risen significantly in the AFTA countries. Table 4.11 shows the growth rate in imports from member countries to be very high in the 1990-99 period (18.6 percent for motor vehicles and 20.8 percent for parts). The negative growth for imports from non-members, is primarily because of the Asian crisis, but also because of efforts by some countries to develop national industries.<sup>114</sup>

Table 4.11

Intraregional Imports of the Automobile Industry								
Region	\$ million	Share in total imports			Growth rate		Growth rate in extraregional imports	
		1990	1995	1999	(Percent)		1980-1989	1990-1999
AFTA								
Motor vehicles	175	1.1	1.0	5.4	9.4	18.6	1.5	-0.7
Parts of motor vehicles	195	1.1	2.9	9.5	17.3	20.8	14.2	-5.6
World								
Motor vehicles	365,672				10.7	6.6		
Parts of motor vehicles	138,406				10.2	6.4		

Note: Data in this table relates to SITC 781, 782, and 783 (motor vehicles), and to SITC 784 (parts of motor vehicles).  
Source: Compiled from UNCTAD, Trade and Development Report, 2002: Table 3.A5, 108.

After the mid-1980s, rapid economic growth in the region, plus the yen's appreciation and the formulation of RTAs, helped the automobile industry to develop

rapidly. Japanese automakers convinced their Japanese suppliers, whom they wanted to use for their production networks, to establish plants in ASEAN countries. In these countries there were preferential tariffs for companies having a minimum level of national equity. This benefited the automakers and strengthened the competitiveness of the auto industry, as well as improved the efficiency of the regional division of labor.<sup>115</sup> Thus, a regional production network in automobiles can allow, and has already allowed, this industry to develop in the region, whereas on a national level its development is constrained by the lack of necessary economies of scale.

From the foregoing discussion we see the potential for East Asian countries to build further on the regional production network that was started by Japan in the post-war period and that has evolved through the development of the region's clothing, electronics and automotive industries. TNCs in East Asia, although not as numerous or as large as developed-country TNCs, demonstrate an increasing level of transnationality and are prominent among developing-country TNCs.

Chinese enterprises, especially, have great potential to become major investors in the region. Since the mid-1980s, China has significantly expanded its FDI outward stock from only US\$131 million in 1985 to US\$28 billion in 2001.<sup>116</sup> In that year (2001), Prime Minister Zhu Rongji proposed that China implement a "going outside" strategy. While Chinese firms have been attracted to Latin America, North America and Europe, there is increasing interest in investing within Asia.<sup>117</sup> If the ASEAN-China FTA is successfully implemented as planned, China's share of investment in ASEAN could increase significantly. Further regional integration that includes China could bring FDI and trade-related benefits to both China and the countries of ASEAN.

It is not necessary for every firm to be a large TNC in order to participate in a regional production network. The segmentation of the production process allows many smaller firms to concentrate on a single component, or a few related components, that may be used by larger firms in a final product, such as computer chips that are components of a wide variety of products. Regional production sharing can bring benefits over producing the whole product at the national level, as is common in East Asia now.<sup>118</sup>

This type of production can take place in other industries as well, for example, the clothing industry, as described above.<sup>119</sup> It allows specialization at the firm level and yet allows firms to participate in a wider regional network. This may be easier as a starting point than trying to compete from the outset in a global network.

There are, of course, potential problems in trying to establish regional production networks. Large TNCs are able to locate the various stages of production anywhere in the world in order to take advantage of differences in factor prices and technologies. There is naturally a broader range of choices globally than regionally. Just as it is unlikely that one country will have absolute advantage in all products, it is unlikely one region will either. However, East Asia is highly diversified in its level of development, the capability of its work force, and its resources. It is possible through regional cooperation to take advantage of that diversification by bringing together the comparative advantages of individual countries so as to maximize the comparative advantage of the entire region.

Nonetheless, TNCs will always operate in their own self-interest and choose locations from that perspective. Although it is impossible to control all factors that might

influence that decision and equally impossible to force enterprises to choose intraregionally as opposed to extraregionally, it is possible through coordinated policymaking, technology sharing and capacity building to cultivate an environment appealing to TNCs. This would take some sophistication and considerable cooperation, particularly in the area of policymaking, but there are resources within the region, as well as in the international community, that could be drawn upon for this purpose.

Certain policies may need to be eliminated or changed so as not to obstruct cross-border production. Standardization of products and customs regulations could be needed to reduce costs and facilitate the flow of goods. As stated in Arndt (2001), "This task is clearly more complex than the traditional focus on the removal of trade barriers. The objective is not simply to free up the flow of goods, but to create an integrated regional production arena."<sup>120</sup> Sometimes there must be dramatic structural changes in the economy of the countries involved and it can mean a decline in the importance of manufacturing in a country's GDP or employment.<sup>121</sup> Ideally, a well developed regional production network would not only promote trade and investment intraregionally but also would make the region more attractive to partners from outside the region, as has been the case with the EU and NAFTA.<sup>122</sup>

A difficulty in East Asia is that individual countries, although cognizant of the value of regional cooperation, still tend to protect their own sovereignty and carry out policymaking, particularly for FDI, at the national level. A *regional* approach can be a stage between a *national* and a *global* approach. "The basic idea is to think of the region rather than the nation as the production base and to spread component production around the region in accordance with comparative advantage."<sup>123</sup>

The appeal of regional production networks for East Asia is that they satisfy the desire for dealing with issues through regional cooperation and yet are not entirely self-contained in that there is still latitude for countries outside the region to invest in, and trade with, countries of the region and vice versa. The goal is not to "keep out" extraregional investment or limit regional countries investing externally, nor should it be restricted to only imports from and exports to regional economies. It is merely a way of optimizing the comparative advantages of the region as a means of promoting complementarity in production and trade, as opposed to all countries focusing on the same goods and services.

This process should be dynamic, rather than static. It should be flexible regarding shifts of production within the region, as well as with other regions, remaining always open to being a part of the global production network. For to act otherwise would be a failure to acknowledge the current reality vis-à-vis globalization and, thus, potentially self-destructive.

## Concluding Remarks

The recognition of trade and FDI linkages has become more important in today's global environment characterized by an increasingly integrated international production network. TNCs, which are at the heart of this network, decide where to invest and from where to trade in pursuit of the most efficient organization of their production activities. Technology has facilitated this process through improved transportation and communication at a reduced cost. As a result, TNCs can locate their production activities anywhere in the world.

Contributing to the economic growth and development in East Asia over the last two decades has been a phenomenal rise in trade and FDI activity. This has been attributed in large part to the region's liberalization in these two areas. Our analysis has revealed the continued multilateral nature of the region's trade and FDI and the importance of its extraregional relationships. Thus, the willingness to remain open is essential for the region's continued development and the achievement of prosperity.

At the same time, we also see a very high level of intraregional trade and FDI with some shifts in trading and investment patterns both from outside to inside the region and within the region itself. East Asia is witnessing a shift in investment away from Southeast Asia (ASEAN) to the north in search of lower costs, and there is a foreboding of China eventually becoming the primary production center of the region with an absolute advantage in many types of products.

Because of the recognized need to forestall such an eventuality, as well as the desire for a strong regional identity and a lessening of dependency on the West, regional cooperation efforts are gathering momentum in East Asia. One outcome of this is the heightened interest in forming regional trade agreements (RTAs).

Trade and, particularly, FDI policies have traditionally been formulated at the national level in East Asia and generally with little coordination between the two. However, it is increasingly important that the development and implementation of these policies be coordinated and mutually supporting. In light of the East Asia's rising interest in pursuing regional solutions and the importance of policy coordination in the promotion of trade and FDI, we have suggested two approaches that combine these two elements: (1) the formulation of regional agreements and (2) the creation of regional production networks.

The first of these, the formation of regional agreements, should specifically encompass aspects of both trade and FDI with an appreciation of their interactive characteristics. As this type of broad trade/FDI agreement is relatively new, there are few empirical studies of its welfare-enhancing capabilities. Studies that do exist indicate that the inclusion of developed, along with developing, countries in the agreement could lead to potential advantages from improved policy credibility and guaranteed access to larger markets. As with regional trade agreements (RTAs), it appears that a larger grouping of countries is preferable. But Singapore is proceeding along the path of bilateral agreements in anticipation that they will serve as a prototype for other economies in the region. ASEAN and China are moving ahead with their plans for an ASEAN-China FTA in ten years, while Japan is pursuing bilateral agreements at the same time it is studying a broader agreement with ASEAN as a bloc.

There are those who are alarmed at the proliferation of bilateral and regional FTAs and who believe they will only complicate the multilateral negotiations of the WTO. It should be kept in mind, though, that most of these agreements are still under negotiation and far from finalization. So while it appears that a "spaghetti bowl" is indeed in the making in East Asia, it is conceivable that over the next ten years or so these disparate dialogues and negotiations could come together and, if some standardization and consistency is maintained, coalesce into a broader regional agreement in the long term. Working out agreements in smaller groups, or even bilaterally, could be easier and less daunting for the smaller, less developed countries of East Asia. There are, of course, certain difficulties that would need to be ironed out, not least of which is the



agriculture issue, but it is possible that resolving a troubling issue by one group can serve as an incentive to others for resolution. For example, China's "early-harvest" offer to open its agriculture sector is seen by some analysts as motivated by a desire to appear more accommodating than Japan and South Korea.<sup>124</sup> This could apply indirect pressure to the latter two countries to act likewise. At least, the process of negotiating regional agreements should lead to more interconnection and cooperation within the region.

A step beyond, and possible extension of, regional agreements is our proposal for a regional production network. While this has the appeal of being broader in context, it is a more complex approach which necessitates setting the stage for production networking by the elimination of restrictive policies and the creation of an enabling environment for cross-border transactions. The goal here is to maximize the comparative advantages of the region as a whole, which would require a shift in focus on the part of East Asian governments from the *national* to the *regional*. This approach would require a longer timeframe than the implementation of regional agreements but could be an extension of them, resulting in a broader approach that could involve the entire region as opposed to only a few countries. It is possible through these two approaches for East Asia to reach the ultimate goal of being a full-fledged participant in the global production network.

## **Chapter V – Financial and Monetary Integration**

Four areas of financial and monetary integration will be covered in this chapter. The first of these, the East Asian crisis, is of particular importance because of its detrimental effect on the regional and global economies at the time, as well as its role as a catalyst for the beginning of financial integration in the region. The second area deals with financial development in East Asia, including a review of financial structure and the development of financial markets. The last two areas deal with two related issues at the forefront of post-crisis discussion: capital account liberalization and a regional currency regime.

### **East Asian Crisis: Implications for Regional Cooperation**

The crisis of 1997-98 in East Asia was an event that captured worldwide attention not only because of the severity of its impact on the region's economy but also because of its far reaching effect on the global economy. Furthermore, the swiftness of its progression, taking the region from the status of "miracle" to that of "crisis" in less than a year, surprised all within the region, as well as those outside the region that were economically connected to it, including governments, investors, rating agencies, and international financial institutions.

While it is not the intent of this study to conduct an in-depth examination of the crisis itself, its relevance to the topic of regional integration cannot be overlooked. We will review the possible causes of this cataclysmic event in an effort to determine if, and how, it has hindered or furthered progression of cooperation in the region. In so doing, we will examine the causes of the crisis (and aggravating factors) as presented in the extensive literature on the topic. Out of the crisis there has arisen a call for reforms to the financial systems of these countries in an effort to promote growth and reduce the risk of another crisis. We will look at how these reforms are being carried out with a view to assessing the role of regionalism in the process.

The most notable aspect of the crisis was the sudden and swift reversal in 1997 of private short-term capital flows that Asian countries had attracted in large volume during the prior three years. Table 5.1 shows that net private capital flows into the five crisis countries (Indonesia, Korea, Malaysia, the Philippines, and Thailand) increased nearly two and a half times between 1993 and 1996 (from \$30.8 billion to \$74.3 billion). Then in 1997, the flow suddenly reversed and \$5.6 billion flowed out of these countries, with additional outflows of \$31.6 billion in 1998. In fact, these have continued with \$13.9 billion in 1999, \$15.7 billion in 2000, and \$16.2 billion in 2001. IMF projections are that outflows will continue through 2003 but gradually decline.

Table 5.1

Net Capital Flows <sup>1</sup> (billions of U S \$)											
	1993	1994	1995	1996	1997	1998	1999	2000	2001	Proj 2002	Proj 2003
Crisis Countries <sup>3</sup>											
Private Capital flows net <sup>2</sup>	30.8	33.4	56.8	74.3	-5.8	-31.8	-13.9	-15.7	-18.2	-8.4	-3.9
Private direct investment, net	8.7	8.5	10.3	11.7	10.2	11.5	14.6	14.3	8.3	10.3	10.6
Private portfolio investment, net	25.0	13.3	18.6	26.9	8.9	-8.0	11.8	7.0	3.2	5.1	1.5
Other private capital flows net	-0.8	15.6	27.9	35.7	24.7	-34.1	-40.4	-36.9	-27.7	-21.9	-16.0
Official flows net	3.2	0.7	8.8	-4.7	13.7	17.0	-2.2	8.6	0.6	1.4	3.3
Change in reserves <sup>3</sup>	-20.0	-6.5	-17.5	-4.8	40.6	-48.9	-38.2	-22.4	-11.7	-11.3	-12.1
Current account <sup>4</sup>	-13.5	-23.2	-39.8	-33.1	-25.5	69.7	62.7	47.1	32.8	23.1	17.9

<sup>1</sup> Net capital flows comprise net direct investment, net portfolio investment, and other long- and short-term net investments flows including official and private borrowing

<sup>2</sup> Because of data limitations "other net investment" may include some official flows

<sup>3</sup> A minus sign indicates an increase.

<sup>4</sup> The sum of the current account balance net private capital flows net official flows and change in reserves equals with the opposite sign, the sum of the capital account and errors and omissions

<sup>5</sup> Includes Indonesia, Korea, Malaysia, the Philippines and Thailand

Source: IMF World Economic Outlook, April 2002, Table 1.5.29

So devastating and extensive was this reversal that the crisis came to be identified as a "capital account crisis" This is in contrast to the more typical "current account crisis" which is characterized by poor macroeconomic fundamentals such as high inflation and large fiscal deficits The East Asian economies prior to the crisis did not suffer in general from unsound macroeconomic policies as they had for the most part high savings ratios, sound fiscal positions, low inflation and high growth It is widely agreed that poor macroeconomic policy was not a primary factor in the crisis Frankel (2000) points out that Thailand made some macro policy mistakes in 1997 and "excessive expansion led to excessive current account deficits and excessive indebtedness" But he goes on to say, "statistical evidence suggests that a large current account deficit or a high level of debt is not a highly significant predictor of crises"<sup>125</sup>

More important is the fact that capital inflows comprised primarily short-term foreign currency loans, which led to the double mismatch of maturity and currency as banks were lending long term and in local currency for nontradables (primarily real estate) This in turn led to twin crises in currency (resulting in devaluations) and in banking (resulting in banks becoming overburdened with non-performing loans causing many to eventually fail) Looking again at Table 5.1 above, we see that of the three types of capital flows, i.e., direct investment, portfolio investment, and other flows (which includes borrowing), the last of these had the largest inflows before the crisis and outflows afterwards

Many regional and international observers have speculated at length on the cause (or causes) of the crisis with no true consensus having been reached Some of these causes/vulnerabilities are listed in Table 5.2

Table 5.2

Source	Causes/Vulnerabilities
Radelet and Sachs (1999)	<ul style="list-style-type: none"> <li>▪ Weaknesses in the Asian economies, especially poor financial, industrial, and exchange rate policies.</li> <li>▪ Overinvestment in dubious activities resulting from the moral hazard of implicit guarantees, corruption, and anticipated bailouts.</li> <li>▪ Financial panic – what began as moderately sized capital withdrawals cascaded into a panic because of weaknesses in the structure of international capital markets and early mismanagement of the crisis.</li> <li>▪ Exchange rate devaluations in mid-1997 in Thailand (and late in the year in Korea) that may have plunged these countries into panic.</li> </ul>
Eichengreen (1999)	<p>Three sources of vulnerability:</p> <ul style="list-style-type: none"> <li>▪ Modest macroeconomic imbalances – appreciation of real exchange rates and current-account deficits.</li> <li>▪ Serious banking sector problems.</li> <li>▪ Mismanagement of the maturity structure of debt.</li> </ul>
Krugman (1998)	<ul style="list-style-type: none"> <li>▪ Crisis was only incidentally about currencies.</li> <li>▪ Mainly about bad banking and its consequences.</li> <li>▪ Some of the crisis is associated with unwise investments (office towers, auto plants) rather than with excessive investment per se.</li> <li>▪ "Herding" by investors plays some explanatory role as overinvestment and overvaluation of assets was not only the fault of domestic financial intermediaries but also private individuals and foreign institutional investors who bought stocks and real estate in the crisis economies.</li> </ul>
Kawai, Newfarmer and Schmukler (2001)	<ul style="list-style-type: none"> <li>▪ Burgeoning, global flow of private capital, esp. short term.</li> <li>▪ Macroeconomic policies that allowed large inflows of short-term, unhedged capital to fuel a domestic credit boom.</li> <li>▪ Newly liberalized but insufficiently regulated domestic financial markets with highly leveraged corporations.</li> <li>▪ Mounting political uncertainty in Thailand, Korea, and Indonesia.</li> </ul>

Source	Causes/Vulnerabilities
Lindgren et al (1999)	<ul style="list-style-type: none"> <li>▪ Financial and corporate sector weaknesses combined with macroeconomic vulnerabilities to spark the crisis.</li> <li>▪ Formal and informal currency pegs, which discouraged lenders and borrowers from hedging.</li> <li>▪ Capital inflows had helped fuel rapid credit expansion, which lowered the quality of credit and led to asset price inflation.</li> <li>▪ Inflated asset prices encouraged further capital inflows and lending, often by weakly supervised nonbank financial institutions.</li> <li>▪ Highly leveraged corporate sectors, especially in Korea and Thailand, and large unhedged short-term debt made the crisis countries vulnerable to changes in market sentiment in general, and to changes in exchange and interest rates in particular.</li> <li>▪ Weaknesses in bank and corporate governance and lack of market discipline allowed excessive risk taking, as prudential regulations were weak or poorly enforced.</li> <li>▪ Close relationships between governments, financial institutions, and borrowers worsened the problems, particularly in Indonesia and Korea.</li> <li>▪ Weak accounting standards, especially for loan valuation, and disclosure practices helped hide the growing weaknesses from policymakers, supervisors, market participants, and international financial institutions.</li> <li>▪ Inadequacies in assessing country risk on the part of the lenders.</li> </ul>
ADBI (Yoshitomi) <sup>126</sup>	<ul style="list-style-type: none"> <li>▪ Massive inflows of short-term capital aided by unsophisticated financial systems, financed excessive investments in real estate and some manufacturing industries.</li> <li>▪ Sudden reversal of capital flows coincided with cyclical downturn resulting in twin crises: currency crisis (depreciation) and banking crisis (credit contraction).</li> <li>▪ Twin crises led to deterioration in balance sheets of financial institutions and business enterprises.</li> </ul>

It is readily apparent from the literature referenced in the above table that there is no universal agreement as to the cause (or causes) of the crisis, although there is consensus in certain areas. Furthermore, while some of these may not have actually caused the crisis, they probably at least contributed to its worsening. What is important, however, is that the East Asian crisis was multifaceted with roots deep in the fundamental financial and economic (and in some cases even political) structure of the affected countries. In fact, there is general consensus that the financial, economic, and legal systems in these countries require reform and restructuring in order to prevent another crisis of such magnitude.

These studies, as well as others not mentioned here, make specific recommendations for reform perceived as necessary to prevent another crisis. Mishkin (2001) presents 12 basic areas of financial reform (described below) that summarize many of these recommendations. (Some of these reforms, and their implications for regional cooperation, will be discussed in more detail later in the paper.)

#### **Twelve Areas of Recommended Financial Reform:**

1. ***Prudential supervision*** – A banking crisis, arising out of the deterioration of banks' balance sheets, can increase the likelihood of a foreign exchange crisis and lead eventually to a full-blown financial crisis. This necessitates the need for governments to create and sustain a strong bank regulatory/supervisory system to reduce excessive risk-taking in their financial systems associated with moral hazard. These reforms take seven basic forms: prompt corrective action, risk management, limiting too-big-to-fail policies, adequate resources and statutory authority for prudential regulators/supervisors, independence of regulatory/supervisory agencies, accountability of supervisors, and restrictions on connected lending.
2. ***Accounting and disclosure requirements*** – These are often lacking for financial institutions in emerging market and transition countries and this makes it difficult for markets and supervisors to monitor institutions to deter excessive risk-taking.
3. ***Legal and judicial systems*** – These are needed to promote the efficient functioning of the financial system. Unclear or hard to enforce property rights can severely hamper the process of financial intermediation. An effective efficient bankruptcy process (often lacking or cumbersome in developing countries) can decrease asymmetric information in the marketplace.
4. ***Market-based discipline*** – Market discipline can discourage excessive risk taking by financial institutions. Thus market discipline should be enhanced through (1) disclosure requirements to provide more information to the markets so as to help them monitor financial institutions, (2) the implementation of credit ratings for financial institutions, and (3) the issuance of subordinated debt<sup>127</sup> (particularly with a ceiling on the spread between its interest rate and that of government securities), which a bank would be unable to sell if it has become overexposed to risk.
5. ***Entry of foreign banks*** – Entry of foreign banks can lead to a banking and financial system that is less fragile and less prone to crisis because they help insulate the banking system of an emerging market economy, which is often more volatile than that of an industrialized country, from domestic shocks.

6. **Capital controls** – Mishkin does not advocate the typical "exchange controls" that were adopted by Malaysia during the crisis since they may have the undesirable effect of blocking the entry of funds which would be used for productive investment opportunities. He suggests instead a type of "prudential control" that would, for example, restrict banks in how fast their borrowing could grow, which could substantially limit capital inflows. This would focus on improving bank regulation and supervision as a means of restricting capital inflows so they are less likely to produce a lending boom and excessive risk taking by banks. The issue of capital controls, however, is complex and has been the subject of many studies by economic and financial experts in the field particularly since the East Asian crisis. Therefore, the topic will be addressed in some depth later in this chapter.
7. **Reduction of the role of state-owned financial institutions** – This is proposed in the interest of promoting economic growth since in many emerging market countries the government intervenes through directed credit programs or state-owned banks resulting in moral hazard problems and lending to borrowers who do not have productive investment opportunities.
8. **Restrictions on foreign-denominated debt** – Emerging market countries tend to have a debt structure with substantial foreign-denominated debt, which can make the financial system more fragile and prone to financial crises triggered by currency crises and devaluations.
9. **Elimination of too-big-to-fail in the corporate sector** – Corporations that are considered to be too-big-to-fail (or too politically influential) by the government can lead to increased risk taking by lenders.
10. **Sequencing financial liberalization** – While deregulation and liberalization are not per se undesirable objectives, if not managed properly with a bank regulatory/supervisory structure, accounting and disclosure requirements, and well-functioning legal and judicial systems in place at the time liberalization is undertaken, there can be disastrous consequences.
11. **Monetary policy and price stability** – Monetary policy can play an important role in promoting financial stability. Price stability can lead to the reduction of an economy's dependence on foreign-denominated debt, thus enhancing financial stability. Countries with a past history of high inflation tend to have debt contracts denominated in foreign currencies which makes the financial system more fragile due to the possibility of currency depreciation triggering a financial crisis.
12. **Exchange rate regimes and foreign exchange reserves** – The view here is that, in general, a fixed or pegged exchange rate regime, while being one way to control inflation, can be a dangerous strategy for an emerging market country with a large amount of foreign-denominated debt. Also, low levels of international reserves relative to short-term foreign liabilities can increase vulnerability to crises. Exchange rate regimes and their suitability for East Asia are examined in detail later in this chapter.

Given the complex and comprehensive nature of these recommended reforms, it is clear that the task of carrying them out is daunting, particularly for emerging economies, which often lack the needed expertise and economic resources necessary for such an

undertaking. It is true that a number of the crisis-affected countries have taken steps at the national level and achieved some success in their reform efforts, but much remains to be done, as can be seen in Table 5.3.

Table 5.3

Crisis-affected Country	Progress at the National Level in Financial Sector Restructuring <sup>128</sup>
Indonesia	<ul style="list-style-type: none"> <li>• Indonesian Bank Restructuring Agency (IBRA) created to resolve problem banks, provide guarantees of credit lines and manage and dispose of frozen bank assets. Asset Management Unit (AMU) created to focus on debt recovery.</li> <li>• 64 banks and 2 joint venture banks closed between 1997 and 1999. 16 banks taken over between 1998 and 1999.</li> <li>• No foreign or domestic equity capital markets.</li> <li>• Has not recognized full extent of NPLs but performed comprehensive system-wide portfolio reviews.</li> <li>• New bankruptcy law, but not effective.</li> <li>• In theory can foreclose nonviable NPLs but this is not yet enforced in legal system.</li> <li>• No secondary market for bank NPLs (sale to financial investors).</li> </ul>
Korea	<ul style="list-style-type: none"> <li>• Korea Asset Management Corporation (KAMCO) reestablished to manage and dispose of NPLs. Financial Supervisory Commission (FSC) created to oversee financial and corporate restructuring. Financial Supervisory Service (FSS) established to supervise and regulate financial institutions.</li> <li>• Liquidated 16 of 30 merchant banks, 10 of 25 leasing companies, 28 of 231 mutual savings companies and 128 of 1,666 credit unions. No commercial bank liquidations.</li> <li>• W64 trillion allocated for recapitalization of viable banks of which W60 trillion already used. Cost could rise due to further corporate restructuring (Daewoo).</li> <li>• 5 banks successful in 1998 in domestic equity capital market.</li> </ul>



Crisis-affected Country	Progress at the National Level in Financial Sector Restructuring <sup>128</sup>
	<ul style="list-style-type: none"> <li>• Partially recognized extent of NPLs. A new 'forward-looking' system of loan classification introduced in 1999.</li> <li>• KAMCO has used W20 trillion to purchase W56 trillion (face value) of NPLs (7% of all bank loans).</li> </ul>
Malaysia	<ul style="list-style-type: none"> <li>• Danamodal created to recapitalize banks and fincos. Danaharta created to purchase, manage, and dispose of NPLs. Corporate Debt Restructuring Committee (CDRC) created to oversee voluntary corporate debt restructuring.</li> <li>• No bank liquidations. Malaysia opted instead for industry consolidation through mergers. 58 financial institutions in process of being consolidated into 10 core banking groups.</li> <li>• RM6.4 billion already injected into 10 financial institutions. Recapitalization cost initially estimated to be RM16 billion but injections eventually reduced to RM5.3 billion.</li> <li>• No foreign or domestic equity capital markets; banks encouraged to use Danamodal if need capital.</li> <li>• Recognition of full extent of NPLs in progress.</li> <li>• Incentives for NPL restructuring in place in the form of capital support and waiver of stamp duties.</li> <li>• Good framework to facilitate foreclosure of non-viable NPLs. Danaharta Act speeds foreclosures.</li> </ul>
Philippines	<ul style="list-style-type: none"> <li>• Central Bank Monetary Board decides on bank closures. Philippine Deposit Insurance Corp., established in 1963, responsible for receivership and liquidation of banks.</li> <li>• 1 commercial bank, 7 thrifts and 44 rural banks under receivership since 1997.</li> <li>• No viable banks recapitalized; incentives for mergers.</li> <li>• No banks obtained foreign or domestic equity capital but several commercial banks seeking additional capital via private placements and equity markets.</li> <li>• Recognized full extent of NPLs but for treatment of</li> </ul>

Crisis-affected Country	Progress at the National Level in Financial Sector Restructuring <sup>128</sup>
	restructured loans. <ul style="list-style-type: none"> <li>• Favorable loan loss provisioning treatment for restructuring NPLs.</li> <li>• No secondary market for bank NPLs.</li> </ul>
Thailand	<ul style="list-style-type: none"> <li>• Financial Restructuring Authority (FRA) and Asset Management Corporation (AMC) established in 1997 for resolution of 56 closed fincos and sale of their assets.</li> <li>• 57 out of 91 fincos, 1 out of 15 banks liquidated.</li> <li>• TB300 billion to recapitalize viable banks.</li> <li>• At least 8 banks have foreign equity; 3 banks have issued Tier-1 capital through a domestic innovative capital instrument (about TB80 billion).</li> <li>• Recognized full extent of NPLs with implementation of new loan classification rules in 1998.</li> <li>• Market-based guidelines and incentives put in place for restructuring of viable NPLs.</li> <li>• New bankruptcy and foreclosure law passed in 1999. Utilization low.</li> <li>• Auction process for US\$20 billion of shutdown fincos loans. No centralized mechanism for banks NPLs (only private sector-based).</li> </ul>
Source: Compiled from Kawai (2000, Table A13.1)	

While it is necessary that certain reforms be carried out at the national level, it is often the case that when individual countries pursue strategies and formulate policy based on their own self-interest, the benefits derived are often less than optimal for the country concerned and may even be detrimental to its neighbors (so-called “beggar-thy-neighbor” policies). On the other hand, benefits can often accrue to most countries in a region when mutual interests are taken into account and policy is set on a cooperative basis.

It is also true that a country may have little difficulty carrying out reforms in one area, but often policy changes or reforms in related areas are necessary to achieve the desired overall effect or to prevent undesirable consequences. A case in point is Chile’s capital controls in the 1990s. Eichengreen (1999) points out in his discussion of Chile’s capital controls that taxes on capital inflows are effective only when supplemented by

other policies to encourage hedging by banks and corporations and to strengthen the domestic financial system, which is a time-consuming, laborious process<sup>129</sup>. Cooperative efforts among countries in the establishment of standards and reform criteria can considerably alleviate the burden of this process on individual countries.

Such cooperative efforts could occur on a global or regional basis. It could be argued that an international approach is warranted because the causes of present-day crises have global ingredients and spillover effects. An example is the elemental capital inflows of the Asian crisis, which were largely from outside the region. Asian policies that reduced restrictions on borrowing abroad coincided with structural and macroeconomic changes elsewhere in the world (e.g., lower borrowing rates in the U.S. encouraged foreign investment in Asia).<sup>130</sup> The Asian crisis also provides an example of spillover effects where repercussions of the crisis spread quickly to other regions of the world (i.e., to Russia, Latin America and eventually even to the U.S. via the Long-Term Capital Management (LTCM) hedge fund which ended up being bailed out by the U.S. Federal Reserve.)

In the years immediately following the Asian crisis, there were innumerable calls to reform the “international financial architecture” (i.e., the international monetary and financial system). There were proposals by national governments, by international financial institutions (IFIs) and other international organizations, and by the private sector. They included the creation of a permanent Standing Committee for Global Financial Regulation bringing together the IMF, the World Bank, the Basle Committee, and other regulatory groups (Brown, 1998), creation of a public corporation to insure investors against debt defaults (Soros, 1997 and 1998), and enactment of legislation by countries receiving IMF assistance to impose an automatic reduction of the principal of interbank deposits extended to banks in their countries (Litan et al, 1998).<sup>131</sup> Some recent initiatives for improving the international financial architecture are outlined in Table 5.4.<sup>132</sup>

Table 5.4

<b>Global Initiatives to Improve the International Financial System</b>
<ul style="list-style-type: none"> <li>▪ Information and transparency: The World Bank and IMF among others have been working on new standards for disseminating data on reserves and external debt and on new codes of good practices in fiscal, monetary, and financial disclosure.</li> <li>▪ Banking and supervision: Work is ongoing to strengthen Basle core principles. The World Bank and IMF are conducting joint assessments of financial systems to ascertain compliance with new international norms and detect extant weaknesses.</li> <li>▪ Securities markets: The International Organization of Securities Commissions has prepared principles and standards for disclosure.</li> <li>▪ Accounting and auditing: The International Accounting Standards Committee is reviewing principles with the objective of having uniform standards by 2002.</li> <li>▪ Bankruptcy and governance: The U.N. Commission on International Trade Law has disseminated a new mode law of cross-border insolvency, and the Organization for Economic Cooperation and Development Task Force is working on internationally applicable principles of corporate governance.</li> <li>▪ Private sector involvement: The IMF and its Board, among others, have been working on general principles to elicit greater private participation in financing packages, in part because IMF resources are limited and in part to discourage the “moral hazard”</li> </ul>

<b>Global Initiatives to Improve the International Financial System</b>
that could be associated with bailouts.
Source: Kawai, Newfarmer, and Schmukler (2001: Box 2, 48)

While most of the literature has been focused on restructuring the financial architecture at the international level, some discussion and early-stage planning have occurred at the regional level. Even before the crisis, there were some financial arrangements in place although their accomplishments were few. (See Table 5.5.)

Table 5.5

Forum	Year Originated	Number of Members	Purpose/Objectives
Inter-ASEAN network of currency swap arrangements and repurchase agreements	1977	Originally 5; now 10 + 3	Purpose was to provide immediate short-term swap facilities to members with temporary international liquidity problems. Initially set at US\$100 mil. for 5 members with a maximum of \$40 mil. receivable per member. Total raised to US\$200 mil. in 1978 with a receivable of \$80 mil. per member. Total raised to US\$1 billion by Chiang Mai Initiative in May 2000.
EMEAP (Executives' Meeting of East Asia and Pacific Central Banks)	1991	11	Members are the Southeast Asian and Australasian members of SEANZA. Objectives include enhanced regional surveillance, exchange of views and information, and financial market development.
The Six Markets Group (also called G-6, or G-4 plus 2)	1994	Originally 4; now 6	Initially the four major Asian financial centers (Australia, Hong Kong SAR, Japan, Singapore). Recently, China and the U.S. invited to attend meetings. Objectives include stability of the region's financial and foreign exchange markets. Attended by vice ministers of finance and deputy governors of central banks.
APEC Finance Ministers Process	1994	21	Members are APEC economies. Provides a forum to exchange views and information among members on regional financial developments and to pursue cooperative programs to promote financial sector development and liberalization.

Forum	Year Originated	Number of Members	Purpose/Objectives
SEACEN (South East Asian Central Banks)	1980s	13	Initially a training and research organization; now substantive forum for discussion of central banking issues. Includes major Southeast Asian economies, as well as some smaller Asia-Pacific Countries.
SEANZA (South East Asia, New Zealand, Australia)	1956	17	Largest of the regional policy fora in terms of membership. Forum for exchange between central banks and a vehicle for training in central banking.

Source: IMF, APEC and ASEAN

### ASEAN's Response to the Crisis

Despite the fact that the ASEAN swap arrangement described above had been in place for 20 years prior to the crisis for the purpose of providing liquidity in the event of just such a crisis, ASEAN was surprised by the events of the crisis and failed to provide any meaningful assistance. Soesastro (1998) provides a bleak assessment of ASEAN's response to the crisis saying that the crisis-affected countries had to resort to the IMF or resolve the problem on their own (as did Malaysia) because ASEAN was "not in a position to do anything".<sup>133</sup> In fact, the ASEAN finance ministers met for the first time in March 1997 and voiced their expectation that the positive outlook for Asia would continue. Even after the crisis was in full swing, ASEAN's response was weak. The existing ASEAN swap arrangement was woefully inadequate (US\$200 million at the time) and was reportedly never used. The ASEAN finance ministers met again in December 1997 in Kuala Lumpur to discuss the crisis and possible responses but reportedly did not make any kind of financing arrangement to help ASEAN members.<sup>134</sup>

The official view of ASEAN's role in response to the crisis was summarized in 1998 by Rodolfo Severino, ASEAN Secretary-General, who outlined four levels of response by ASEAN members at that time:<sup>135</sup>

- **National Level** – Individual countries affected by the crisis were undertaking reforms, with varying degrees of success, related to closer supervision and tighter discipline of banks, greater transparency in financial transactions, promotion of more competition, enactment of bankruptcy laws and stronger commercial codes, and strengthening of the rule of law and the judiciary. (Some of these are described in detail in Table 5.3, "Progress at the National Level in Financial Sector Restructuring".)
- **Bilateral Level** – ASEAN's government leaders offered one another material and financial assistance and advice. For example, Thailand offered rice and the Philippines offered medicine, Singapore guaranteed letters of credit issued by Indonesian banks, and Malaysia extended to Indonesia a standby credit of US\$250 million with Singapore offering a similar facility.

- **International Level** – ASEAN called upon the developed countries to maintain open markets to, and trade financing for, Southeast Asian countries, to honor letters of credit issued by Indonesian banks, and to be accommodating in re-negotiating Indonesia’s debt. It also encouraged China not to devalue the renminbi.
- **ASEAN Organization Level** – ASEAN reaffirmed its commitment to regional economic integration and open regionalism. In their ASEAN Vision 2020 statement, government leaders pledged to maintain regional macroeconomic and financial stability through closer cooperation, to promote liberalization of the financial services sector, and to keep the ASEAN Free Trade Area on track and on schedule.

In ASEAN’s view, the origin of the crisis was global in nature. It therefore believed the best response would be to work with the IMF and other international forums in formulating a solution. Along this line, ASEAN called upon developing countries to work toward a resolution. ASEAN’s response was initially in the form of advice, recommendations, and general pledges for further cooperation; however, more concrete steps are being taken now. (This is discussed further under “Post-Crisis Initiatives”.)

## **APEC’s Response to the Crisis**

APEC was no quicker or more effective in its response to the crisis than was ASEAN, although in the case of APEC this was more understandable since its membership was less cohesive than that of ASEAN.<sup>136</sup> Action taken by APEC in response to the crisis primarily occurred after, rather than during, the crisis. Initially this was in the form of somewhat vague resolutions by the economic leaders to work together to support a sustained recovery and to strengthen their markets through greater transparency, enhanced competition, and improved regulation. More recently, however, the APEC Finance Ministers Process has reportedly led APEC’s response to the Asian financial crisis through the acceleration of its “collaborative initiatives to develop regional financial and capital markets and support freer and stable capital flows in Asia-Pacific.”<sup>137</sup> These initiatives are of a more concrete nature as evidenced by the list below:

<b>APEC Finance Ministers Process Collaborative Initiatives</b>
<ul style="list-style-type: none"> <li>▪ Strengthening financial market supervision through training of banking supervisors and securities regulators;</li> <li>▪ Assessing banking supervisory regimes;</li> <li>▪ Reform of pension systems;</li> <li>▪ Improving credit rating agencies’ ability to channel timely and accurate information to capital markets and strengthening financial disclosure</li> </ul>

standards;

- Developing domestic bond markets;
- Strengthening corporate governance;
- Designing a Voluntary Action Plan for Supporting Freer and Stable Capital Flows; and
- Endorsing the inaugural meeting of the APEC Privatization Forum, part of an initiative to support privatization efforts through institutional strengthening and investment promotion.

Source: APEC Secretariat, Finance Ministers Process, updated December 13, 2001

The fulfillment of these initiatives is being carried out through the use of seminars and training programs on such topics as pension fund reform, financial institution and product regulation, risk management, and credit analysis. Some seminars were held in 2000 and 2001.

## Post-Crisis Initiatives

The occurrence of the crisis strengthened appeals for regional cooperation in the financial area. As a result, a number of financial arrangements and initiatives have emerged since the crisis. These are described below.

**Asian Monetary Fund (AMF)** – The idea for an Asian Monetary Fund (AMF) was proposed in September 1997 by Japan to bring stability to Asian currencies and financial markets and work towards prevention of the recurrence of another crisis. In furtherance of this goal, it planned to raise US\$50-60 billion in contributions from participating countries and another US\$50 billion from the Japanese government.<sup>138</sup> It was to be independent of the IMF and function as a substitute for IMF activities such as regional surveillance. The original membership was to be Japan, Korea, China, Taiwan and Hong Kong.

The plan was abandoned, however, a few months later due to the opposition of the IMF and the U.S. Some objections were that it enhanced the moral hazard problem, created a double standard (IMF and AMF), and challenged IMF leadership. Another factor was the general nonsupport of China for the idea. In its place the Manila Framework Group was established in 1997, followed in 1998 by the implementation of the New Miyazawa Initiative.

The AMF proposal is not dead, however, and resurfaces from time to time from different quarters. Malaysia is one of the most frequent champions of this idea but others are supportive of the idea, even some of those who were originally opposed to it. The Chiang Mai Initiative (discussed below) is viewed by some as a precursor to an AMF.

**Manila Framework Group (MFG)** – In November 1997, finance and central bank deputies from the Asia-Pacific region<sup>139</sup> and high-level representatives from the IMF, World Bank and ADB met in Manila to create a new framework for regional cooperation to enhance the prospects for financial stability. The primary purpose of this

group was regional surveillance and it included the following initiatives: (1) a mechanism for regional surveillance to complement global surveillance by the IMF, (2) economic and technical cooperation to strengthen financial systems and regulatory capacities, (3) measures to strengthen the IMF's capacity to respond to financial crises, and (4) a cooperative financing arrangement that would supplement IMF resources.<sup>140</sup> Noteworthy in this Framework, as evidenced by these initiatives, is the recognition that the IMF has the central role in the international monetary system.

Although this group is still meeting today, it does not appear to be strongly influential in the region. Its eighth meeting in Beijing in March 2001 was attended by representatives from the original 14 countries and IFIs, plus the Bank for International Settlements (BIS). A summary of the discussions of that meeting reveal this group to be somewhat slow moving and functioning primarily as a forum for the exchange of views and experiences. Although the cooperative financing arrangement of the MFG was briefly mentioned, the focus was on improvements in financing facilities in the region through enhanced IMF facilities (e.g., Supplemental Reserve Facility (SRF), Contingency Credit Line (CCL), etc.). In the end they agreed to avoid duplication of activities of other regional groups. (The MFG reportedly met most recently in December 2001 to discuss money laundering and prevention of financial crises, but little other information is available about the meeting.)

*New Miyazawa Initiative (NMI)* – This arrangement, announced in October 1998, was implemented by Japan as a bilateral support mechanism “to assist Asian countries affected by the currency crisis in overcoming their economic difficulties and to contribute to the stability of international financial markets.”<sup>141</sup> The support package consists of US\$30 billion, of which US\$15 billion is available for Asian countries' medium- to long-term financial needs for economic recovery provided either as official development assistance (ODA) or untied loans.<sup>142</sup> The other US\$15 billion is for countries' short-term capital needs during the process of implementing economic reforms. Commitments under this initiative, as of February 2000<sup>143</sup>, totaled US\$21 billion with US\$13.5 billion of that amount being medium- to long-term support. (See Table 5.6).



Table 5.6

New Miyazawa Initiative (Financial support already indicated as of February 2000) (in millions of US\$)				
	Medium-to Long-term Financial Support		Short-term Financial Support	Total
	JBIC (OOF <sup>1</sup> account)	JBIC (ODA <sup>2</sup> account)		
Indonesia	1,500	1,430		2,930
Korea	3,350		5,000	8,350
Malaysia	900	950	2,500	4,350
Philippines	1,100	1,400		2,500
Thailand	1,350	1,520		2,870
Subtotal	8,200	5,300		
Total		13,500	7,500	21,000

<sup>1</sup> OOF = Other Official Flows  
<sup>2</sup> ODA = Official Development Assistance  
Source: Japan Ministry of Finance (<http://www.mof.go.jp/english/ifa/e1e042a.htm>)

According to the Japanese Ministry of Finance (MOF), these are not grants but mainly loans that will be repaid. The objectives of the initiative are to support corporate debt restructuring, strengthen the social safety net, stimulate the economy and facilitate trade finance and assistance to small- and medium-sized enterprises.

In the "Second Stage" of the NMI, Japan pledged its readiness to assist in the mobilization of up to 2 trillion yen of domestic and foreign private-sector funds for Asia through assistance in fundraising in international financial and capital markets (via JBIC and ADB credit guarantees and interest subsidies), and through assistance in investing in Asian private-sector enterprises via equity funds. Through this initiative Japan hopes to utilize its abundant savings and promote active use of the Tokyo market.

Although the NMI was implemented shortly after Japan's unsuccessful attempt to form an Asian Monetary Fund (AMF) in 1997, it differs from the originally conceived AMF, which was a multilateral scheme focused on the stabilization of currency as opposed to a bilateral initiative for recovery assistance. Also, the NMI is an arrangement separate from the Chiang Mai Initiative (discussed below), but there are some similarities in its short-term facility in that it consists of short-term swap arrangements. Two of these are currently in place (US\$2.5 billion with Malaysia and US\$5 billion with Korea). These are not tied to the IMF and are annually renewable.

**ASEAN Surveillance Process** – At the ASEAN Finance Ministers' Meeting (AFMM) in October 1998 in Washington, DC, the ASEAN Surveillance Process (ASP) was officially established based on the principles of peer review for all member states and complementarity with the global surveillance undertaken by the IMF. The objective of the process is to strengthen cooperation through an exchange of information, a peer review process, and recommendations for action at not only the regional, but also the national level. It is the last of these (i.e., recommendations by a regional body for action to be taken by an individual country) that Soesastro (2000b) views as a departure from

ASEAN's principle of non-intervention with the potential to transform the nature of ASEAN, if in fact it is actually carried out.<sup>144</sup>

As part of the ASP function, all ASEAN member states are to provide the ASEAN Surveillance Coordinating Unit with baseline data like that provided to the IMF under its Article IV consultation mission. Technical assistance and capacity building for this process are to come primarily from the Asian Development Bank (ADB).

As for ASEAN's peer reviews, little information beyond their mention in official meeting statements is available. In March 1999, at the Third AFMM in Hanoi, the ministers stated that they had conducted a "peer review of each other's economic situation"<sup>145</sup> and listed as positive results the stabilization of their economies, including a return to stability in the foreign exchange markets, build-up of reserves, decline in interest rates, recovery in stock markets, and others. The implication is that these results were the outcome, at least in part, of ASEAN's Surveillance Process; however, this is difficult to confirm. The Surveillance Process was not mentioned in the official statement of the May 2000 AFMM, but was referred to in a general way in the official statement of the April 2001 AFMM where it was stated that discussions of ways to enhance the ASP would proceed with the plus-three countries of China, Japan and Korea. There was only an oblique reference to the ASP in the Sixth AFMM in April 2002 related to ADB's confirmation of continued support for the process.

The precise nature of the complementarity between ASEAN's Surveillance Process and that of the IMF is unclear. As Soesastro (2000b) points out, one advantage of a regional mechanism is that a country might be less reluctant to accept advice from neighbors who can also be impacted by the economic condition of that country. This close connection gives a country's neighbors a legitimate interest in its policies and performance.<sup>146</sup>

Eichengreen (2001) argues the need for coordination between ASEAN's Surveillance Process and that of the IMF because of the potential for "inconsistent, incompatible assessments of performance and recommendations for action," which could undermine the credibility of each other's advice.<sup>147</sup> This he sees as a distinct possibility given there is no guarantee that both bodies will arrive at the same conclusion even if they receive the same information.

**AGRI** – In November 1998, the United States and Japan announced the Asian Growth and Recovery Initiative (AGRI) to stimulate economic recovery and growth. The participants in this initiative include the APEC economies, as well as officials from the ADB, IMF, and World Bank. The initiative has four key components: (1) accelerate bank and corporate restructuring, (2) facilitate the provision of trade and working capital finance, (3) mobilize the return of private sector capital, and (4) provide financial, legal, and accounting assistance for restructuring and market-based reforms.

**Chiang Mai Initiative (CMI)** – The CMI was established by the ASEAN Plus Three (ASEAN plus China, Japan and Korea) Finance Ministers at Chiang Mai, Thailand in May 2000 as a regional financing arrangement supplementary to existing international facilities. It is probably the most concrete and currently active of the regional financial arrangements to come out of the Asian crisis. The CMI has two parts:

- **ASEAN Swap Arrangement (ASA)** – This is the aforementioned swap arrangement originated by ASEAN in 1977 in an amount of US\$200

million. In November 2000, it was enlarged to US\$1 billion and expanded to include all ASEAN members.

- *Bilateral Swap Arrangement (BSA) and Repurchase Agreement* – The purpose of the *Bilateral Swap Arrangement* is to provide short-term financial assistance in the form of swaps to a country in need of balance-of-payment support or short-term liquidity support.<sup>148</sup> Up to 10 percent of the maximum amount of drawing can be provided for a short-term period without linkage to the IMF. The BSA essentially links the international reserves of the 10-member ASEAN countries with those of China, Japan and South Korea allowing the ASEAN countries to effectively borrow U.S. dollars to bolster their own reserves. Although not officially stated, the likely creditor nations are Japan, Korea and China. There can also be bilateral swap arrangements between the “plus-three” countries, as currently exists between Japan and China and between Japan and Korea. The timing of any disbursement would be tied to that of the imposition of IMF conditions.
- The purpose of the *Repurchase Agreement* is to provide temporary foreign exchange liquidity via the sale and buyback of appropriate securities to a country that is in need of foreign exchange liquidity support.

It would be nearly a year before any BSAs were put in place. Japan took the lead in the negotiation of agreements with ASEAN countries but China and South Korea are now included. There are currently nine BSAs for a combined total of \$18.5 billion that have been signed and several more are under negotiation. BSAs signed as of November 2002 are shown in Table 5.7.

Table 5.7

BSAs under the Chiang Mai Initiative		
Countries	Currencies	Amount (US\$ billions)
Japan/S. Korea	Dollar/Won	2.0
Japan/Malaysia	Dollar/Ringgit	1.0
Japan/Thailand	Dollar/Baht	3.0
Japan/Philippines	Dollar/Peso	3.0
Japan/China	Yen/Yuan	3.0
China/Thailand	Dollar/Baht	2.0
China/Malaysia	Dollar/Ringgit	1.5
S. Korea/China	Dollar/Won/Yuan	2.0
S. Korea/Thailand	Dollar/Baht	1.0
	<b>Total</b>	<b>18.5</b>
Source: Japan MOF < <a href="http://www.mof.go.jp/jouhou/kokkin/pcmie.htm">http://www.mof.go.jp/jouhou/kokkin/pcmie.htm</a> > and others		

Initially Malaysia, disturbed by the IMF's handling of the Asian crisis, objected to the linkage of the CMI with IMF conditionality and voiced a preference for monitoring

by an Asian agency more familiar with regional economies. Malaysia wanted to be able to draw on more than 10% of the line exclusive of IMF conditionality but was unable to gain support in this from other ASEAN countries and eventually agreed to enter into a BSA with Japan in the spring of 2001. The finance ministers' concession to Malaysia's objections relative to the IMF was to agree to review the CMI in three years.

As for Indonesia, it has been concerned more with domestic problems and working with the IMF since the crisis, but in May 2002, it began negotiations for a \$3 billion BSA with Japan. This was originally scheduled to be signed this past summer but has been delayed. The Philippines has been negotiating BSAs with China and South Korea but these are not yet ready to be signed. The plan of Asian policymakers as of this date is for all major BSAs to be signed by May 2003.<sup>149</sup> Singapore has so far not signed any BSAs although it has been in negotiations with Japan this past year. For the time being, Brunei and the newer members of ASEAN are excluded, with the latter being more interested in ODA than in short-term swap arrangements.

While the CMI swap arrangements themselves are bilateral in nature, there is a multilateral aspect to the CMI in that the creditor nations will coordinate the provision of funds when one or more of their partners are in need of short-term liquidity. This means, of course, that the more swaps that are in place, the more effective the arrangement will be. Major concerns relative to the CMI are its potential effectiveness and its risk. The concerns are focused in three areas: (1) its indications for moral hazard, (2) the level of risk for the countries involved, and (3) the amount of support available.

1. *Moral Hazard* – As revealed earlier in the review of the literature on causes of the crisis, one concern often voiced was that of moral hazard. While most of the discussion of this issue focused on the moral hazard engendered by the implied guarantees of support by governments for domestic financial institutions (and for some corporates as well), there were also suggestions that the IMF contributed to moral hazard by virtue of its emergency rescue packages. The same could be said of the CMI because of its commitment to support in the event of a liquidity crunch, the only difference being that in this case the support would be regional as opposed to national or international. The problem of moral hazard could be reduced by imposing conditionality and or by tying the financial support to some predetermined standards of macroeconomic and financial stability of member economies (Yoshitomi and Shirai, 2000).
2. *Credit Risk* – The BSA agreements being put in place provide U.S. dollars for local currencies which means the hard-currency providers (probably Japan, China and Korea) are taking real credit risk relative to their partner in the swap. By linking the swap to IMF conditionality, the risk may be reduced to some extent, as the country in difficulty would supposedly be required to take steps to correct conditions that led to the emergency.<sup>150</sup> Of course, there is no guarantee that the conditions imposed by the IMF would improve the situation. For example, it is widely contended that the IMF's requirements imposed on Thailand and other countries during the 1997 crisis may have worsened the crisis. There is also the concern that if IMF conditions need to be imposed, it may take some time to actually put them in place and that the disbursement of funds could be delayed as a result. This risk could be alleviated if predetermined standards are already in place and qualification for support is based on regular assessments from regional

surveillance (Yoshitomi and Shirai, 2000). Nonetheless, the potential creditor nations have indicated their preference for IMF linkage perhaps believing that even uncertain protection is better than none at all. The rating agency, Standard & Poor's, indicated that if the CMI does not involve IMF conditionality, credit ratings in the region could be negatively impacted <sup>151</sup>

- 3 *Sufficiency of support* – Given that the aggregate official foreign reserves of the ASEAN-Plus-Three countries was around US\$900 billion in 2001 with US\$700 billion of that amount held by the Plus-Three countries (China, Japan and Korea) alone, the potential support amount seems enormous – over 10 times that of the U S (around US\$70 billion in 2001) <sup>152</sup> However, swap lines to individual countries are very small (US\$1-3 billion), especially when compared to amounts traded in the global currency market where daily volume can be as much as \$1 3 trillion <sup>153</sup> Even more revealing is to look at the amount of emergency assistance committed and disbursed to the crisis-affected countries in response to the 1997-98 crisis (See Table 5 8)

Table 5 8

Commitments and Disbursements of the International Community in Response to the Asian Crisis (in billions of U S dollars)							
	Commitments				Disbursements (as of 5/30/2000)		
Country	IMF	Multilateral <sup>1</sup>	Bilateral	Total	IMF	Other <sup>4</sup>	Total
Indonesia <sup>2</sup>	15.0	10.0	24.7	49.7	11.6	10.3	21.9
Korea <sup>3</sup>	21.1	14.2	23.1	58.4	19.8	10.6	30.4
Thailand	4.0	2.7	10.5	17.2	3.4	10.9	14.3
<b>Total</b>	<b>40.1</b>	<b>26.9</b>	<b>58.3</b>	<b>125.3</b>	<b>34.8</b>	<b>31.8</b>	<b>66.6</b>

<sup>1</sup> World Bank and ADB  
<sup>2</sup> Includes augmentations since July 1998  
<sup>3</sup> Korea has repaid US\$13 billion of the financing provided by the IMF as of end-May 2000  
<sup>4</sup> Combined multilateral and bilateral disbursements  
Source: IMF (2000c Table 1)

This table shows that a total of US\$125.3 billion was committed by IFIs and individual countries in support of the three countries most affected by the crisis – Indonesia, Korea, and Thailand. When compared to this amount, the CMI's current US\$18.5 billion in BSAs, the US\$1 billion under its ASA, and the \$7.5 billion under the NMI seem small indeed. The amount committed in response to the crisis was nearly five times this amount.

There are those who are of the opinion that the Chiang Mai Initiative is not what Asia needs at this time because circumstances have changed in the region since the 1997 crisis. For one thing, most of the region's currencies are no longer pegged so there is no target for central banks to defend and thus little incentive for speculators to attack. <sup>154</sup>

However, the CMI's bilateral swap arrangements themselves could trigger this event if they involve a target exchange rate to be defended before swaps can be called upon.

It could also be argued that the focus and energy of the ASEAN countries might be more effective in preventing another crisis if directed towards needed reforms in the financial and corporate sectors rather than on short-term fixes. As revealed earlier in Table 5.3, which shows progress in financial sector restructuring at the national level, progress has been made in this area, but much remains to be done. As mentioned, the ASEAN Surveillance Process and the initiatives of the APEC Finance Ministers Process are making some moves in this direction as well, but more concrete efforts are needed.

The significance of the Chiang Mai Initiative is not really in its size, but rather in its implications for regional cooperation. If the CMI attains its goal of forming a financial network connecting the economies of East Asia, its value will be enhanced as it becomes more than just a few bilateral arrangements for emergency purposes. In this respect it takes on considerable importance as a potential vehicle for future monetary cooperation. It can also be viewed as a statement intended to show the world that Asian countries can work together and be self-reliant.

The IMF's view on the issue of regional monetary cooperation has changed over the last several years. Vehemently opposed to the possibility of an Asian Monetary Fund (AMF) when the idea was first floated in 1997, the Fund has become more open to possibilities in the area of monetary cooperation. In January 2001, Horst Köhler, Managing Director of the IMF, commented on the implementation of the CMI saying that he welcomed the initiative and encouraged the ASEAN+3 countries to make it operative. He added, however, that he understood it to be a complement to the IMF's financial assistance for members in the region.<sup>155</sup> The U.S. as well has expressed its general concurrence with the CMI and efforts towards monetary cooperation in general. More significant, however, is the response of China, which was originally opposed to the idea of an AMF, but has since become more accepting of the regional efforts towards monetary cooperation and has even signed two BSAs, one with Thailand and one with Japan.

Looking at the Chiang Mai Initiative as a step towards further integration rather than an end in itself would seem to be appropriate at this time. While at the present time it adds a degree of financial security to the region, its real significance lies in its implications for future monetary cooperation in the region. Some even see a natural progression from the Chiang Mai Initiative leading to the renewal of an old idea: an Asian Monetary Fund (AMF). While establishment of an AMF could be some time in coming to fruition, the idea has not disappeared and suggestions for its implementation resurface not infrequently.

### **National, Regional or Global Approach: Which is Best?**

Opinions vary as to where the primary responsibility should lie for the prevention and cure of crises although most promote a sharing of responsibility between the global and regional with the actual reforms being carried out at the national level. Nellor (2000) argues that the primary surveillance function must be a global activity as stipulated by an integrated global economy. In support of this opinion, he refers to the many global economic interactions; for example, the fact that developments in Latin American

financial markets affect financing costs of capital in Asian emerging markets. As for surveillance, he claims that the part of surveillance related to the assessment of policy interactions must be handled globally because of the integrated nature of the global economy. However, the second aspect of surveillance (i.e., encouraging countries to adopt desirable policies) could involve regional groups that can strengthen the process through building mutual support and 'peer pressure.' He refers to the effect of shared 'culture' in a region as a further strengthening factor.<sup>156</sup>

Nobel and Ravenhill (2000) emphasize the globally integrated nature of the financial system as a potential hindrance to the effectiveness of regional action. They raise the issue of the most appropriate geographical definition of the region emphasizing the imprudence of excluding Australia and New Zealand, as well as Taiwan, which they see as a potential contributor of funds but which could not be included in a grouping of which China is a member. On the issue of a regional monetary fund, they question the enforceability of conditionality on a borrower by its neighbors because of the potential for political embarrassment. Their conclusion is that the most feasible regional collaboration on financial issues would be in the form of systematic monitoring of conditions since neighbors are well placed to observe conditions across their borders and have the incentive to apply peer pressure to reduce the risk of contagion.<sup>157</sup>

Kawai, Newfarmer and Schmukler (2001) promote a sharing of responsibility for policy reforms at all three levels (international, regional and national). One of their "nine lessons from the East Asian crisis and contagion" is that improvements undertaken at the regional level should be consistent with those in the global framework because economic contagion begins with a geographical focus but spreads globally. Their framework for regional financial coordination covers three areas:<sup>158</sup>

1. Regional consultation and economic surveillance/monitoring for crisis/contagion prevention – Exchanges of macroeconomic policies and structural information such as fiscal positions, monetary and exchange rate policies, capital flows, external debts, financial system conditions, and corporate sector development. Peer pressure would provide the incentive to pursue policies leading to stability of accounts and currencies.
2. A regional financing facility to augment international liquidity in times of crisis – This should be consistent with, and complementary to, a global facility to promote synergy, international coherence and involve private creditors who are often financial institutions outside the region.
3. Programs to assist in the resolution of the systemic impact of the crisis and accelerate recovery – Regionally concerted action to mobilize fiscal resources from core regional countries is needed to recapitalize weak banks, facilitate corporate debt restructuring and increase social safety net spending.

Given the region's already fairly high degree of financial openness but, at the same time, its preference for noninterference in the domestic concerns of neighbors, it could be argued that the most logical and workable approach for crisis prevention and resolution in East Asia would be one that encompasses all three levels (national, regional and global). The CMI is an example of this in the fact that it is made up of regional swap arrangements but still linked to IMF conditionality. This issue will be addressed again later in this chapter.

## **Summary**

The Asian crisis of 1997-98 was a turning point for the region. It brought an end to the fantastic growth (particularly of the Asian Tigers) of the 1980s and early 1990s, which few believe will ever return. However, it also brought an awareness of the need for financial cooperation in the region. This is in part because of disappointment at what is perceived as failures on the part of international financial institutions (i.e., the IMF) and developed Western countries (i.e., the U.S.) in resolving the crisis.

The primary focus in the region since the crisis has naturally been on their prevention and resolution. As previously mentioned, this has led to a call for reform in a number of areas, including financial regulation and supervision, information disclosure, and legal system changes, as well as discussion of whether a national, regional or international approach is best. In the following sections, we will take a closer look at three areas that have in recent years become the focus of intense discussion because of their potential role in crisis prevention: financial development, capital account liberalization, and regional currency regimes.



## Financial Development in East Asia

Arising out of the Asian financial crisis is the consensus that restructuring and strengthening East Asia's financial sector is one essential element of a program for preventing another crisis. Beyond this, achieving a sound and stable financial sector is an important step toward overall economic development.

In this section we will review the development of financial markets across the region. In conjunction with this, financial structure will be examined in an effort to determine its effect, if any, on this development. The importance to this process of the legal, regulatory and macroeconomic environments will also be considered. Finally, we will evaluate the various approaches under consideration for achieving the level of financial development necessary to foster growth in the region.

There is ample literature<sup>159</sup> dating back to the late 19<sup>th</sup> century that attests to the importance of financial development for economic growth. Ross Levine (1997) in his review of this body of literature<sup>160</sup> points out that it is characterized by a wide variety of often-conflicting opinions on the topic. However, the conclusion to his own analysis, although "stated hesitantly and with ample qualifications," is that the "preponderance of theoretical reasoning and empirical evidence suggests a positive, first-order relationship between financial development and economic growth."<sup>161</sup> Dominic Wilson in a more recent paper states, "The past few years have seen more concerted attempts to argue that these links [between financial development and growth] are both empirically valid and of practical importance, a task that has probably become easier since the recent financial crises."<sup>162</sup> Recent research also shows that the poorer segments of society benefit directly from financial development, and income distribution is also improved.<sup>163</sup>

The importance of financial market structure to financial development has also been debated but with more tentative conclusions. Financial structure is variously defined, but the most common definition is that the financial structure of an economy is the degree to which it has a bank-based or market-based financial system. In bank-based systems, banks provide the major portion of credit to the economy, and in market-based systems, firms obtain financing primarily in capital markets (bond and equity markets). However, in most countries both sectors co-exist and have important roles to play in financing within the economy. "There is no empirical support for policies that artificially constrain one in favor of the other. Indeed, the development of each sector seems to strengthen the performance of the other by maintaining the competitive edge of individual financial firms."<sup>164</sup>

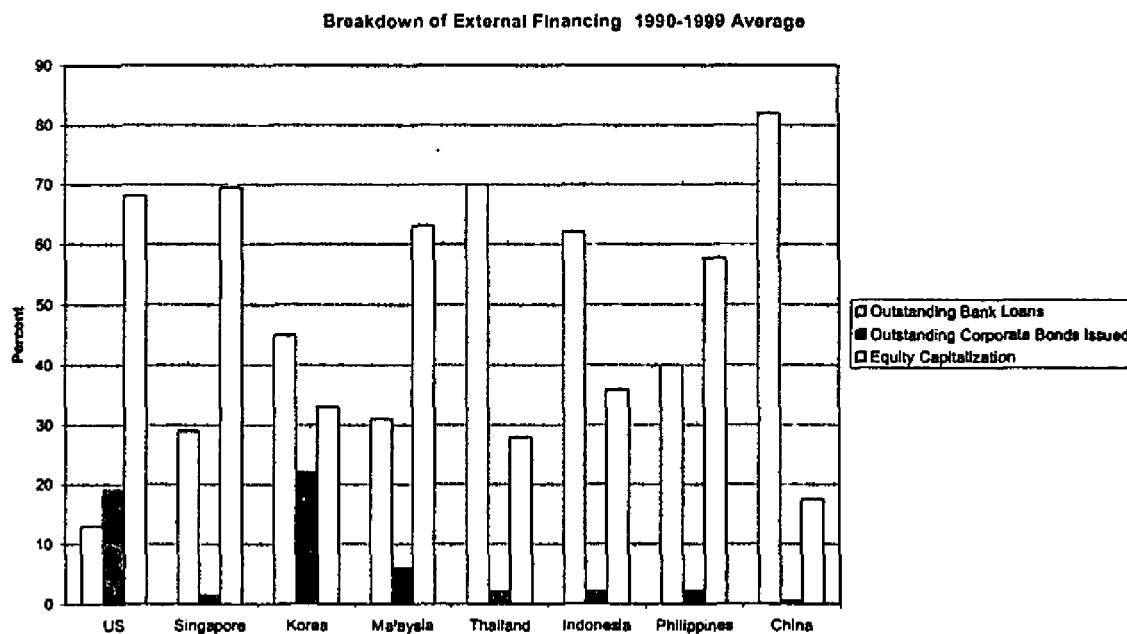
René Stulz (2001) defines financial structure more broadly than just bank-based or market-based systems. In his words, it comprises "the institutions, financial technology, and rules of the game that specify how financial activity is organized at a point in time."<sup>165</sup> He acknowledges that bank-based economies and market-based economies have different financial structures; however, he believes that other characteristics matter a great deal in how the financial system performs its functions. Both the narrow and broad definitions of financial structure will be relevant to our discussion of financial development in East Asia.

## Financial Structure in East Asia

Before commencing a discussion of recent thinking on how best to promote financial development in East Asia, we will look at the region's current financial structure. Developing economies are generally more dependent upon bank lending than on capital markets for financing. This is largely true for the developing economies of East Asia as well.

Figure 5.1 below shows the breakdown of total external finance by source (i.e., bank loans, equities and corporate bonds) for selected East Asian countries and the U.S. for 1990 to 1999. It is obvious that among the lesser-developed economies bank loans and equities are a much greater source of external financing than are corporate bonds. In the case of Thailand, Indonesia and China, bank loans are the largest source while Singapore, Malaysia and the Philippines are more reliant on the equities markets. In Korea, bank loans are the most important source although equities also play a significant role. However, when compared with the U.S., for which bank loans make up only about 13 percent of external financing, the heavy reliance on bank lending by the other countries shown (from around 30 percent for Singapore and Malaysia to over 80 percent for China) becomes obvious.

Figure 5.1



Source: Adapted from Shirai (2001b, Chart 2c, 15)

Table 5.9 presents a different perspective of financial structure (and includes some countries not shown above), but the implications are the essentially same. Financing source as a percentage of GDP<sup>166</sup> (1998) for the developing countries similarly reveals a heavy reliance on bank loans. Among these countries Indonesia, Korea,

Malaysia and Thailand have the highest level of reliance on bank lending. In Malaysia's case, however, there is greater reliance on equities (137 percent of GDP, which is not much below the percentages for the U.S. and some European countries.)

Corporate bond markets, on the other hand, are very poorly developed across the region although Korea's market is considerably larger than that of the others (except for Japan's). Japan's financing source profile (in terms of loans, equities and corporate bonds) is more characteristic of other Asian countries and some European countries (especially Germany) than it is of the U.S.<sup>167</sup> In fact, there is a well-recognized difference between the bank-centered model, of which Germany and Japan<sup>168</sup> are representative, and the Anglo-Saxon model, of which the Great Britain and the United States are representative.<sup>169</sup>

Table 5.9

Financing Sources for Specified Countries 1998 (% of GDP)					
Country	Bank Claims on Private Sector <sup>1</sup>	Total Equities	Total Bonds <sup>2</sup>	Govt. Bonds	Corporate Bonds
Indonesia	68.9	24.0	1.8	0.0	1.1
Korea	82.5	35.7	86.5	55.6	30.9
Malaysia	104.1	136.9	52.5	27.4	21.0
Philippines	50.3	54.3	14.2	12.1	1.9
Thailand	127.8	30.9	18.6	8.6	3.1
Japan	133.3	65.9	137.7	97.7	40.0
France	77.1	68.1	83.2	50.3	32.9
Germany	125.9	51.5	94.5	40.8	53.7
Italy	62.4	48.0	133.2	102.5	30.7
The Netherlands	124.0	159.6	64.4	52.8	11.7
UK	120.8	169.7	61.0	33.2	27.8
USA	63.6	158.0	164.2	94.0	70.2

<sup>1</sup> Bank claims are the closest available proxy for bank loans, although claims could also include other claims, such as equity securities. Claims on the private sector, therefore, should approximate to loans to the private sector.

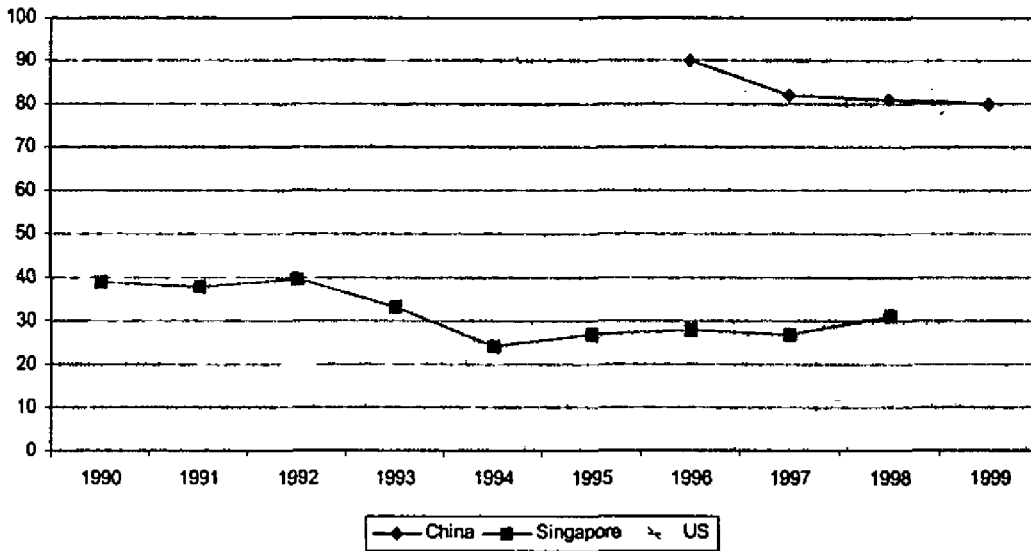
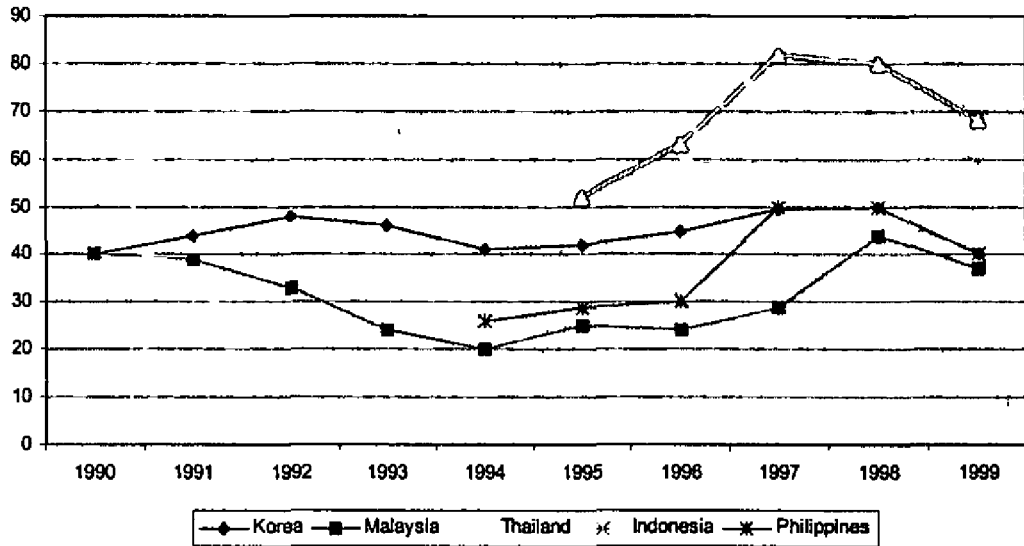
<sup>2</sup> Bond figures for the developing countries include only debt securities with initial maturities of at least one year. Bond figures for developed countries are debt securities of all maturities, not just bonds.

Source: Compiled from Endo (2001: Table 5, 245)

Financial structure in the region has changed over time as illustrated in the figures below, which show bank loans and corporate bonds, respectively, as a percentage of total external finance for eight selected countries for the years 1990 to 1999. With the decline in bank lending after the crisis came a rise in corporate bond issuance in the crisis countries from \$68 billion in 1997 to \$130 billion in 2000<sup>170</sup>, mostly in Korea, but also to a lesser extent in Malaysia and Thailand.<sup>171</sup> After the banking sector problems of the crisis, capital markets grew in importance for most of the crisis-affected countries.

Figure 5 2

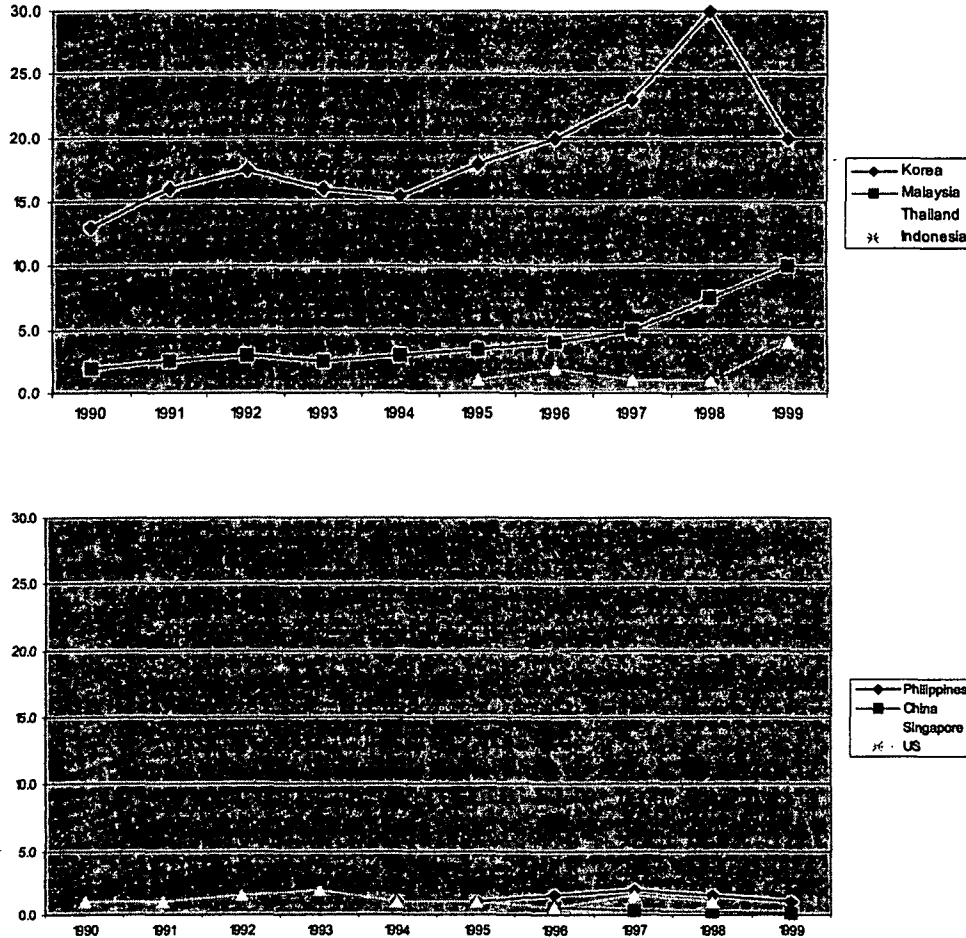
Outstanding Bank Loans as Percent of Total External Finance: 1990-1999 Time Series



Note External finance is defined as the sum of outstanding bank loans, outstanding corporate bonds issued and equity market capitalization  
 Source Shirai (2001b Chart 1d, 9)

Figure 5.3

Outstanding Corporate Bonds Issued (Percent of Total External Finance): 1990-1999  
Time Series



Source: Shirai (2001b: Chart 2d, 16)

The Asian Policy Forum (under the ADB Institute) labels the financial system in Asia an “intermediate financial market structure,”<sup>172</sup> which is between a bank-centered system and a full-fledged capital market; commercial banks not only provide traditional banking services but also are active in the corporate bond market as major issuers, investors, underwriters, dealers/brokers and guarantors.<sup>173</sup>

A somewhat different approach to the assessment of the financial structure and development of East Asian economies is presented in a recent study by Demirgüç-Kunt and Levine (2001a)<sup>174</sup>, where selected economies are classified according to their status

as developed or underdeveloped and their structure as bank-based or market-based. (See Table 5.10.)

Table 5.10

Country Classification of Financial Structure (Based on data collected in the 1990s)			
Financially underdeveloped economies		Financially developed economies	
Country name	Structure index	Country name	Structure index
<b>Bank-based economies:</b>		<b>Bank-based economies:</b>	
Indonesia	-0.50	Austria	-0.73
Argentina	-0.25	Belgium	-0.66
India	-0.14	Italy	-0.57
Ireland	-0.06	Finland	-0.53
		Norway	-0.33
		New Zealand	-0.29
<b>Market-based economies:</b>		<b>Market-based economies:</b>	
Denmark	0.15	Japan	-0.19
Chile	0.25	France	-0.17
Philippines	0.71	Germany	-0.10
		<b>Market-based economies:</b>	
		Netherlands	0.11
		Thailand	0.39
		Canada	0.41
		Australia	0.50
		Korea	0.89
		Sweden	0.91
		Great Britain	0.92
		Singapore	1.18
		United States	1.96
		Switzerland	2.03
		Hong Kong	2.10
		Malaysia	2.93
Notes:			
(1) A country is defined as having an underdeveloped financial system if both of the following hold: (1) <i>Claims of deposit money banks on the private sector/GDP</i> is less than the sample mean and (2) <i>Total value traded as a share of GDP</i> is less than the sample mean. (See Table S.16 in Statistical Appendix.) Thus, a country's financial system is classified as underdeveloped only if it has poorly developed banks and markets.			
(2) Countries are ranked along the spectrum from bank-based to market-based, where higher values of <i>Structure</i> indicate higher levels of stock market development relative to banking-sector development. Countries that have above the mean values of <i>Structure</i> are then classified as market-based. Countries that have below the mean values of <i>Structure</i> are classified as bank-based.			
<b>Source: Demirgüç-Kunt and Levine (2001a: Table 3.12, 121)</b>			

Demirgüç-Kunt and Levine developed a conglomerate index of financial structure that is based on measures of size, activity, and efficiency. These measures when combined into a "Structure Index" (see above table) identify a country's place on a market-based versus bank-based spectrum. Countries are also distinguished between

those that have underdeveloped financial systems and those that have developed systems.<sup>175</sup> This is done to avoid classifying two countries in the same bank-based (or market-based) category if one has poorly developed banks (or capital markets) and the other has highly developed banks (or capital markets) by international standards. (See “Notes” at bottom of Table 5.10 above for classification criteria.)

According to this classification, there are more East Asian economies that are market-based (i.e., the Philippines, Thailand, Australia, Korea, Singapore, Hong Kong, and Malaysia) than bank-based (i.e., Indonesia and Japan). In fact, Hong Kong and Malaysia have higher Structure Indices (2.10 and 2.93, respectively) than that of the U.S. and Switzerland (1.96 and 2.03, respectively).<sup>176</sup> The Hong Kong and Malaysian stock markets are quite large and active; however, their high Structure Indices mean that their stock market development is high relative to their own banking-sector development, but not relative to the level of stock market development in other countries. In another example, the Philippines is classified as market-based because its banks are small and underdeveloped, not because its stock market is very well developed.

When viewed in this way, the classification for most countries (in Table 5.10) is consistent with the information provided in the prior tables where it was revealed that a number of East Asian economies had a larger proportion of equity financing than bank financing (e.g., Singapore, Malaysia and the Philippines). On the other hand, Thailand and Korea are shown in the earlier figure to have a larger proportion of bank-sector financing whereas Demirgüç-Kunt and Levine classify them as market-based. The Demirgüç-Kunt and Levine classification, however, adds another dimension through its representation of the relationship between stock market and bank sector development based on a number of ratios,<sup>177</sup> as opposed to a simple proportionate breakdown of financing sources.

In the case of Korea, the authors point out that although it is usually viewed as large-bank dominated, it is classified in their study as having a market-based financial system. They explain that this is not only because Korea has a very active and efficient equity market (based on *Turnover* and *Total value traded/GDP* ratios – see Table S.13 in the Statistical Appendix) but also because nonbanks play a role as substantial as that of banks in Korea and this is reflected in the ratios.<sup>178</sup>

The Demirgüç-Kunt and Levine structure classifications incorporate data for banks and stock markets but not for bond markets.<sup>179</sup> However, the charts appearing earlier in this section reveal that the corporate bond markets in East Asian economies are not at all well developed.

## **Developing Financial Markets in East Asia**

Recommendations for the best course of action to reach the goal of “well-developed financial markets” in East Asia have generally focused on two approaches. One approach is to look at financial market structure and assess whether a bank-based financial system or a market-based system is more advantageous for emerging economies. Since the Asian crisis, discussion of this approach has intensified, particularly surrounding the issue of developing local-currency corporate bond markets as a means of lessening the chance of another crisis.

The second approach advocates a focus on improving the legal and regulatory environment in order to set the stage for the natural evolution of financial structure, which is believed to change gradually through the process of economic development. According to this approach attempts to quickly change financial structure directly, without first having in place well-developed legal, information, and enforcement mechanisms, are rarely successful.

In fact, both these approaches have essentially the same ultimate goal (i.e., sound and stable financial markets) and recommend some of the same steps in the accomplishment of this goal. Even those who advocate the approach of changing the financial market structure do not suggest that this can be accomplished as merely a technical infrastructure-building exercise with some regulations, an exchange, and a clearing system.<sup>180</sup> In addition to an appropriate legal and regulatory system, there is the need for an environment that will attract participants, and this environment requires legal, information, and enforcement mechanisms. These two approaches to financial market development in East Asia are discussed further below.

## **Financial Market Development Via Change in Financial Structure**

With the banking sector having been the recipient of considerable blame for its role in the Asian crisis, attention has shifted to the development of capital markets (equity and bond markets) in Asia as an alternative to the heavy reliance on banks. Wilson (2002) believes that post-crisis models<sup>181</sup> show that with access to several sources of financing, firms can balance debt and equity to maintain a manageable degree of leverage and reduce the impact of shocks specific to a particular form of financing. Kawai (2002), in his review of bank and corporate restructuring, places importance on the development of local capital markets. He believes that an active corporate bond market can function as a warning mechanism as well as an exit mechanism while equity financing can provide a cushion against currency and interest rate shocks.

### **Corporate Bond Markets**

The primary focus of financial structure change has recently been on improving corporate bond markets as an effective and feasible way to minimize the chances of crisis like that of 1997-98. The reason for this is that local-currency bonds lock in interest rates and local-currency funding which can have a dampening effect on crises caused by international capital flows.

Beyond crisis prevention, there are other reasons to encourage the development of local-currency corporate bond markets. Some of these are (1) improvement of resource allocation efficiency through market-determined interest rates, (2) provision of financing for longer-term, larger-scale projects than banks are able to handle because of their focus on quality improvement, (3) enhancement of financial institution transparency through information disclosure, and (4) creation of competition with banks leading to lower interest rates.<sup>182</sup>

The difficulty in achieving well-developed corporate bond markets, however, should not be underestimated. The process is complex and takes considerable time to accomplish as evidenced by the list of requirements for a well-functioning corporate bond



market that appears in Table G.6 in the General Appendix.<sup>183</sup> It should also be realized that for some developing countries, success might prove to be impossible.

This process is further complicated by the involvement of “attitudes, cultures, and politics. Developing new attitudes and behavior is a main reason why developing markets take so long. People need to learn new ways of thinking about how and with whom they do business. New cultures need to be created – for taking and managing risk, disclosing information, and maintaining quality operations and accounts, among other areas.”<sup>184</sup>

The corporate bond markets in East Asian countries in general are not well developed<sup>185</sup> as is revealed by the following description of their main characteristics.<sup>186</sup>

1. Government bond markets are underdeveloped because (a) the size of issues is small with diverse types of official bonds and the issuing time is irregular, (b) secondary markets are highly illiquid, and (c) the maturity is narrowly spread.
2. Corporate bond markets are largely underdeveloped for a number of reasons:
  - a) Poorly developed government bond markets make it difficult to establish benchmark yield curves that are necessary for the pricing of corporate bonds. Although some governments in Asia have been able to establish benchmark yield curves as a result of their post-crisis increase in bond issuance to finance expansionary policy, bank recapitalization and social safety nets, there is uncertainty as to the extent this will continue once fiscal deficits are no longer so large.
  - b) Some governments have adopted low interest rates and transaction taxes that discourage investors from transacting bonds in the secondary market.
  - c) The issuer base is narrow with few large, reputable non-financial firms and the size of issues is small with maturities concentrated on the short- to medium-term.
  - d) The investor base is narrow and limited with individual investors preferring safe, liquid bank deposits. Corporations prefer stock markets and bank loans to bond markets as the former two financing sources are more convenient than bond issuance because of strict rules and regulations for listing and issuing, as well as high fees.
  - e) Institutional investors are generally underdeveloped and concentrated.
  - f) Secondary markets are largely illiquid.
  - g) Corporate bonds are primarily guaranteed or privately placed (especially before the crisis).
  - h) The market infrastructure in Asia is poor. Some countries still use paper-based bookkeeping and lack systems for electronic clearing and funds transfer while there is no regional clearinghouse for payment and settlement transactions.
  - i) Some central banks in Asian countries are not in favor of developing domestic bond markets because of the fear it will weaken their power over monetary policy.
3. Commercial banks play a key role in the corporate bond market in that they are at the same time major investors, guarantors, underwriters and issuers of corporate bonds.

A particular problem in Asian bond markets is the limited institutional investor base. This is due to a number of factors, including low income per capita and poor wealth accumulation in regional economies. In addition, there is a lack of investor confidence because of inadequate information about issuing firms and poor legal and judicial infrastructure, which if improved could serve to assure debt repayment, penalize the dissemination of false information, and prohibit insider trading.<sup>187</sup>

In Indonesia, Korea, and Thailand, the major institutional investors are financial institutions. In Malaysia there is a single institutional investor (i.e., the Employees Provident Fund) that dominates the investor base with the second major investor being the banking sector. Financial institutions in some countries tend to hold their bonds until maturity because of reserve and liquidity requirements that are imposed on them. This buy-and-hold strategy not only reduces the liquidity of the secondary market but is also one reason why financial institutions dominate the investor base since little is left over for retail investors. An inactive and undiversified investor base leads to pricing inefficiencies.<sup>188</sup>

In recent years, particularly since the crisis, individual countries have taken steps to develop their bond markets with varying degrees of success. Due to the constraints of time and space, an in-depth assessment of the level of development of each country's market will not be undertaken here but Park Yoon-Shik (2001) reports that Korea, Malaysia and Thailand in particular have made progress in this area through the strengthening of market infrastructure, the establishment of benchmark yield curves and the opening of their markets to foreign participants. The result has been a gradual diversification away from excessive reliance on the banking sector to an expanded use of bonds. He cautions, however, that more needs to be done particularly in the areas of corporate governance, bankruptcy and workout procedures, disclosure, and commercial laws. Also, secondary market liquidity remains a problem.<sup>189</sup>

Finally, not everyone agrees that bond market development is the answer to the financial system problems in East Asia. In the words of Dr. Julia Turner, Managing Director of Moody's Asia Pacific, "[...] bond market reforms alone are inadequate to spur capital market development. [...] as long as borrowers have the option to borrow at uneconomic rates from their bankers, without disclosing the true state of their financial health, not even the most enlightened reform of capital market regulation will be sufficient to motivate them to borrow in the public debt markets."<sup>190</sup> In view of the fact that the banking sector still plays an essential role in the financial markets, Moody's espouses the "Basel Committee's Proposal" for bank reform<sup>191</sup> as a key contributor to capital market reform and development, provided it is "sensibly implemented."<sup>192</sup>

A regional forum that also believes the banking sector plays, and will continue to play, an essential role in the region is the Asian Policy Forum/ADB Institute. Its proposal for financial development targets both the banking sector and bond market in combination as described in the following section.

### **Bank Involvement in Bond Market Development**

In East Asia, the banking sector already plays a significant role in its underdeveloped bond markets.<sup>193</sup> Table 5.11 reveals the scope of this involvement for four East Asian countries.

Table 5.11

Role of the Banking Sector in Asia				
Banks as:	Thailand	Indonesia	Korea	Malaysia
Issuers	X	X	X	
Underwriters	X			X
Investors	X	X	X	X
Guarantors		X	X (before the crisis)	X (before the crisis)
Note: Listed in the left-hand column are areas where the banking sector plays a crucial role.				
Source: Shirai (2001b: Table 3, 19)				

The Asian Policy Forum (APF)/ADB Institute<sup>194</sup> views commercial bank involvement in the development of bond markets (its so-called *intermediate stage* of financial development) as logical and desirable as an interim step in the long-term evolution of financial market development in Asia. The rationale for this view is related to the particular difficulties that Asian countries face in their financial environment, including severe information asymmetry between issuing companies and public investors, the lack of companies sufficiently large, mature and reputable for their information to be credible, and the necessity to establish the legal and regulatory framework needed for sound capital markets. These difficulties hamper the development of bond markets in the region. This group also expects the bank-based system to continue its dominance in Asia and believes a sound capital market cannot be developed to replace it in a short period of time.<sup>195</sup>

The APF argues that banks already have certain advantages related to the nature of their existing business that would make them natural intermediaries in underdeveloped bond markets. They could serve as investors (relying on their previously collected household savings and information on issuing companies) and as issuers (relying on their large size and already established reputation). In addition, they can make use of information they already possess on borrowers to underwrite bonds, which would lead to lower costs relative to investment banks. In an *intermediate financial market structure*, “commercial banks continue to provide traditional banking services while becoming major issuers, investors, underwriters, dealers/brokers, and guarantors in the corporate bond market. Thus, banks actively engage in securities and related business, such as derivatives.”<sup>196</sup> [See Table G.7 in the General Appendix and Shirai (2001a: 34-46) for a detailed assessment of the advantages of this structure.]

While the aforementioned concept may be logical, the risks inherent in bank involvement in the securities business should not be underestimated. Some of these are indicated in Table G.7. In a financial system, banks are the most fragile part because of the “demandable” nature of their liabilities. Even a small triggering event can lead to a run on a bank.<sup>197</sup>

The APF does caution that certain disadvantages could arise in the *intermediate financial market structure*. These include a higher default ratio on bank loans as the more reputable firms would prefer lower cost bond issuance leaving less reputable firms

to choose bank loans. Also, it could result in hindrances to the development of bond markets if particularly powerful banks tend to substitute bank loans for bond finance or if they emphasize cost-saving at the expense of product innovation.<sup>198</sup>

The perceived complementarity between banks and bond markets leads the APF to propose that the development of bond markets can be fostered through strengthening the banking sector. To accomplish this, it makes nine proposals in two areas.<sup>199</sup>

- A) Proposed steps for strengthening the banking sector:
  - 1) Reducing government interference in banks' financing operations and eliminating the abuses of connected lending.
  - 2) Strengthening prudential and supervisory regulations on banks in a manner suitable for local conditions. Not all countries have the same level of institutional infrastructure and arrangements for universal prudential regulations. Also, developed country soundness indicators are not always effective for emerging economies.
  - 3) Determining the appropriate corporate structure for banking organizations so as to reduce the risks associated with banks engaging in securities activities. This can be either separate banking and securities subsidiaries under one holding company or different departments in one entity.
- B) Proposed steps for the development of corporate bond markets:
  - 4) Planning, prioritizing and pacing the sequenced development of bond markets with governments assuming a primary role.
  - 5) Regular issuance of government bonds with a well-spaced maturities mix (not disregarding fiscal prudence) and adoption of a comprehensive market-based pricing system.
  - 6) Stimulating demand and supply of corporate bonds through the establishment of legal, regulatory, and information infrastructure for bond markets and the introduction of tax incentives in the early stage.
  - 7) Establishing related financial markets, in particular, derivatives markets to improve risk management and enhance liquidity.
  - 8) Improving clearing and settlement systems.
  - 9) Preparing for establishing an Asian regional bond market.

The weaknesses in the structure of the financial and corporate sectors of East Asian economies (particularly before the crisis) are by now well known. In his examination of the financial and corporate sector issues related to the crisis, Kawai (2002) describes them thus: "The list of fundamental structural deficiencies in East Asia's financial and corporate sectors is long. It includes a lack of prudent risk management on the part of commercial banks, ineffective banking regulation and supervision, poor accounting, auditing and disclosure practices, and weak governance of corporations. The close relationship between corporations and banks, coupled with their influence over governments and legislatures, undermined even the weak prudential safeguards that did exist. Ineffective legal and court systems contributed to inadequate protection of minority shareholders."<sup>200</sup> As is apparent, these issues have implications not only for the banking sector but also for the capital markets in these countries.

Since the crisis, efforts have been made to remedy many of these deficiencies with varying degrees of progress in countries throughout the region. Details of this

progress were provided earlier in this chapter and a very thorough review of bank and corporate restructuring can be found in Kawai (2002).<sup>201</sup>

Accomplishing the APF's proposals (strengthening the banking sector and developing corporate bond markets) would require strong political will and commitment as well as financially sophisticated human resources with particular expertise in the credit area. While prudential and supervisory regulations have been in place in developed countries for a long time and would seemingly serve as examples for developing economies, they may not always be appropriate or feasible for emerging markets.

### **A Regional Bond Market**

In recent years, interest in the establishment of a regional bond market in Asia has surfaced.<sup>202</sup> A regional bond market is seen as having the economies of scale to be more cost-effective than local bond markets in numerous small economies. It could also provide diversification for corporate financing and utilize abundant financial resources (i.e., large pool of savings), which would be able to flow freely across borders.

The New Miyazawa Initiative (NMI)<sup>203</sup>, of which the second stage places particular priority on the development of bond markets, is perceived as the precursor to the development of regional bond market activities in East Asia. The relevant measures are:<sup>204</sup>

- Acquisition of sovereign bonds issued by Asian countries by the JEXIM (now Japan Bank for International Cooperation - JBIC).
- Supporting Asian countries in raising funds from international financial markets through the use of guarantee mechanisms and/or interest rate subsidies.
- Possible establishment of an international guarantee institution with a prime focus on Asian countries.

It is believed that Japan's decision to guarantee Asian sovereign debt issues (under the NMI) has prompted improvement of bond markets in the region.<sup>205</sup> However, progress toward development of a regional bond market has been slow to proceed from the momentum of the NMI. In fact, the major markets in the region (Hong Kong, Singapore, Sydney and Tokyo) have reportedly gained no significant momentum from the NMI.<sup>206</sup>

In fact, the difficulties of developing an Asian bond market are not that different from those of developing local bond markets. Requirements include the following:<sup>207</sup>

- A regional credit rating agency
- A regional clearing and settlement system
- Mechanism for cross-border borrowing and lending of securities
- Harmonization of tax treatment
- Regional trading mechanisms
- Fuller dissemination of information concerning creditworthy Asian companies
- Greater credit enhancement for potential bond issuers
- Increased communication between the public and private sectors
- A dominant Asian currency to serve as a key international currency
- A regional bond-trading center. The APF sees Tokyo as the most likely candidate for this because of its developed economy and business activity but perceives it to be hampered because of the insufficient internationalization of

the yen and its weak institutional infrastructure for JGBs (Japanese Government Bonds) and low presence of foreign institutions.

Individual countries would need to assess the costs and benefits to participation in an Asian regional bond market. The benefits would include pricing advantages and accessibility to regional financial resources while costs would be potential currency mismatches and “internationalization” of local currencies associated with using a “regional” currency.<sup>208</sup> There is also rivalry among certain financial centers (e.g., Hong Kong, Singapore, Bangkok) that want to be regional hubs. This has resulted in only sporadic cooperation when it comes to any kind of link-up<sup>209</sup> of bond settlement systems for cross-border transactions.<sup>210</sup>

### **Developing Equity Markets**

The development of equity markets is also being propounded as part of capital market development in the region. It is argued that developing equity markets can be less complicated than developing bond markets. Among other things, bond markets require supporting pricing infrastructure and bond issuers must be able to manage their cash flow so as to service and repay their bonds. Also, bond markets cannot grow as fast as equity markets.<sup>211</sup>

In Southeast Asia, there are equity markets in Bangkok, Jakarta, Kuala Lumpur, Manila and Singapore. The Northeast Asia equity markets are in Taipei, Seoul, Tokyo and Hong Kong. The major markets in East Asia as a whole are Hong Kong, Singapore and Tokyo.<sup>212</sup>

As has been the case for corporate bond markets, equity markets in the region have also come under scrutiny since the Asian crisis. While the five Southeast Asian markets performed largely in line with the Dow Jones Composite, NYSE Composite and S&P 500 indices during the first half of the 1990s, they fell substantially behind the U.S. markets in the period following the crisis.<sup>213</sup> Although bank loans were the most affected by the sharp flow reversals during the crisis, portfolio investments were also subject to volatility and suffered outflows, albeit to a lesser degree.<sup>214</sup> (See Table 5.12.)

Table 5 12

Net Capital Flows <sup>1</sup> (billions of U.S.\$)													
	1983	1984	1985	1986	1987	1988	1989	1990	1991	2000	2001	Proj. 2002	Proj. 2003
<b>DEVELOPING ASIA<sup>4</sup></b>													
<b>Crisis Countries<sup>5</sup></b>													
Private Capital flows net <sup>2</sup>	30.8	35.4	58.6	74.3	-5.6	-31.6	-13.9	15.7	-16.2	-6.4	-3.9		
Private direct investment, net	6.7	6.5	10.3	11.7	10.2	11.5	14.6	14.3	8.3	10.3	10.6		
Private portfolio investment, net	25.0	13.3	19.8	26.9	8.9	-9.0	11.6	7.0	3.2	5.1	1.5		
Other private capital flows, net	-0.8	15.6	27.9	35.7	-24.7	-34.1	-40.4	36.9	-27.7	21.9	-16.0		
Official flows, net	3.2	0.7	8.6	-4.7	13.7	17.0	2.2	6.6	0.6	1.4	3.3		
Change in reserves <sup>3</sup>	-20.0	-6.5	17.5	-4.8	40.6	-46.9	-36.2	-22.4	-11.7	-11.3	12.1		
Current account <sup>4</sup>	-13.5	-23.2	-39.6	-53.1	-25.5	66.7	62.7	47.1	32.6	23.1	17.9		
<b>Other Asian emerging markets</b>													
Private Capital flows net <sup>2</sup>	22.5	34.9	40.7	46.0	19.6	-15.4	15.2	0.2	35.4	15.9	9.5		
Private direct investment, net	26.4	38.2	44.1	43.9	47.3	48.3	47.3	40.1	45.2	49.2	50.1		
Private portfolio investment, net	0.9	7.5	2.1	3.3	2.1	-9.2	2.4	-2.6	-17.6	-4.3	-5.9		
Other private capital flows, net	-4.7	-10.8	-5.4	-1.2	-25.6	-54.4	-34.6	37.3	7.8	29.1	-34.7		
Official flows, net	8.2	2.5	-3.3	-7.3	-6.6	3.1	3.8	-2.1	-2.0	4.0	4.8		
Change in reserves <sup>3</sup>	-16.6	-51.4	25.4	-41.7	-46.8	-16.6	-38.6	-26.2	-80.7	-42.8	-34.4		
Current account <sup>4</sup>	7.2	18.3	8.5	14.7	51.4	41.0	32.7	35.8	54.7	42.1	36.8		
<b>Developing Asia Total</b>													
Private Capital flows net <sup>2</sup>	53.3	70.3	87.5	120.3	14.0	-47.0	1.3	-15.5	19.2	9.5	5.6		
Private direct investment, net	33.1	44.7	54.4	55.6	57.5	59.8	61.9	54.4	53.5	59.5	60.7		
Private portfolio investment, net	25.9	20.8	20.7	30.2	6.6	-18.2	14.2	4.4	14.4	0.8	-4.4		
Other private capital flows, net	-5.5	4.6	22.6	34.5	50.3	-68.5	75.0	-74.2	-19.9	-51.0	-50.7		
Official flows, net	11.4	3.2	5.5	-12.0	7.1	20.1	1.8	4.5	-1.4	5.4	8.1		
Change in reserves <sup>3</sup>	-36.8	-57.9	-42.9	-46.5	-6.2	-63.5	76.8	-48.6	-92.4	-54.1	-46.5		
Current account <sup>4</sup>	-20.7	-4.9	-31.3	-38.4	25.9	110.7	95.4	62.9	87.3	65.2	54.8		
<b>Hong Kong SAR</b>													
Private Capital flows net <sup>2</sup>		7.3	-7.2	-9.4	11.7	-8.5	1.0	4.2	-5.1	-9.9	-10.4		
1 Net capital flows comprise net direct investment, net portfolio investment, and other long- and short-term net investments flows including official and private borrowing.													
2 Because of data limitations, "other net investment" may include some official flows.													
3 A minus sign indicates an increase.													
4 The sum of the current account balance, net private capital flows, net official flows, and change in reserves equals with the opposite sign, the sum of the capital account and errors and omissions.													
5 Includes Korea, Singapore, and Taiwan Province of China.													
6 Includes Indonesia, Korea, Malaysia, the Philippines, and Thailand.													
Source: IMF World Economic Outlook, April 2002, Table 1.5.29													

The above table shows that private portfolio investment recovered quite significantly in 1999 after the crisis but not to anything near pre-crisis levels. In fact, investment fell again in both 2000 and 2001. This could be attributed to the world economic slowdown following the bursting of the dot-com bubble in the U.S. and the September 11<sup>th</sup> terrorist attack in the U.S. A small recovery is expected in 2002 as recovery of the U.S. economy appears to be gaining momentum.<sup>215</sup>

The capitalization and trading volume of these equity markets is extremely small compared to that of some major stock markets, particularly those in the U.S. (See Table 5 13 for some comparisons.)

Table 5.13

Stock Market Capitalizations						
(US\$ billion)						
Market	1995	1996	1997	1998	1999	2000
New York (Dow Jones Industrial)	5,950	7,210	8,900	9,654	13,400	16,755
Tokyo (Nikkei)	3,440	3,150	2,285	2,375	3,560	3,795
London (FT100)	1,380	1,410	1,780	2,070	2,750	2,665
Hong Kong (Hang Seng)	301	428	384	353	509	515
Taipei (Weighted Price)	176	287	313	264	300	417
Seoul (Composite)	198	144	53	75	272	252
Singapore (STI Ind Index)	169	184	127	110	207	173
Kuala Lumpur (Composite)	214	302	97	92	140	159
Manila (Composite)	56	80	35	31	37	19
Bangkok (SET)	139	105	25	32	52	40
Jakarta (Composite)	66	93	36	17	29	41
<b>Total Southeast Asia</b>	<b>644</b>	<b>764</b>	<b>320</b>	<b>282</b>	<b>465</b>	<b>432</b>
SE Asia as percent of Dow Jones	10.8	10.6	3.6	2.9	3.5	2.6
SE Asia as percent of HKSE	214.0	178.5	83.3	79.9	91.4	83.9

Source: Freeman (2000: Table I, 4)

The above table shows that as of June 2000, the aggregate capitalization of Southeast Asia's five stock markets was US\$432 billion, which was only about 3 percent of the Dow Jones, 16 percent of the London Stock Exchange, and 3.6 percent larger than the exchange in Taipei.<sup>216</sup>

Table 5.14

Stock Market Capitalization			
(percent of GDP)			
	Jan. 1990	Jan. 1995	Jul. 2000
Indonesia	n.a.	22.8	33.8
Malaysia	n.a.	248.8	165.0
Thailand	n.a.	85.6	40.3
Singapore	122.9	236.3	261.9
Korea	54.8	41.2	66.4
China	n.a.	n.a.	8.1
Taiwan	154.8	84.3	119.9
Hong Kong	110.1	218.1	336.7
Australia	45.9	61.8	35.6
U.S.	50.6	62.5	184.5

Source: Wilson (2002, Table 2.3, 26)

Table 5.14 puts the capitalization level into perspective (showing stock market capitalization as a percent of GDP) and also shows changes over time. The degree of capitalization has increased and Wilson (2002) attributes this to a greater degree of



‘equitisation’ of (i.e., entry of new firms into) the economy as opposed to the result of a rapid index growth.<sup>217</sup> He suggests that the latter would be the explanation for the growth of capitalization in the U.S., which is related to the stock market boom of the latter half of the 1990s.

Table 5.15

Stock Market Liquidity*		
	Average (1990-95)	Average (1995-00)
Indonesia	3.7	3.7
Hong Kong	4.1	5.2
NYSE	4.1	5.8
Malaysia	3.8	4.1
Korea	0.6	1.5
China	n.a.	6.7
Taiwan	25.1	23.8
Thailand	8.4	4.9
Singapore	n.a.	3.1

\* monthly market turnover as a percentage of stock relative to market capitalization  
Source: Wilson (2002: Table 2.4, 26)

Stock market liquidity (shown in Table 5.15) has increased in several countries of the region in the latter half of the 1990s but in most cases remains lower than that in the U.S. Taiwan, which has a high level of turnover,<sup>218</sup> is a notable exception.

Freeman and Bartels (2000) assert that stock markets are of primary importance to Southeast Asia’s post-crisis recovery, which they view as primarily, although not exclusively, involving corporate sector debt restructuring, particularly for Indonesia and Thailand. With bank lending still constrained and development of a regional bond market a long-term possibility, they see the equity markets of the region as important for obtaining necessary capital, some of which must come from abroad.

In a review of the five Southeast Asian equity markets, Freeman (2000) identifies several weaknesses in the region’s equity markets including low capitalization and trading volume, as well as sectoral bias. This bias refers to the overrepresentation in the equity markets of banks and finance companies (with their high levels of non-performing loans) and property development companies (with their high leverage and vacant buildings). On the other hand, high tech companies (electronics, computer-related, telecommunications, media, etc.) are underrepresented – even though these are of more interest to institutional investors.<sup>219</sup> Singapore is an exception with only 19.6 percent (April 2000) of total market capitalization in the finance sector compared to 42 percent for Manila and 34 percent for Jakarta.<sup>220</sup> There are also problems with the stocks underlying the markets as the well-documented need for improved corporate governance attests.

Yang and Siregar (2001) found, based on a review of the literature and their own empirical work, that the financial liberalization of Asian economies in the 1980s and early 1990s enhanced interaction and integration among the stock markets in the Asia-Pacific region. However, in the period following the crisis, there appeared to be no long-run relationship among the returns of these markets, but a strong short-run relationship was found, which suggests to the authors that the movement in these stock markets is unrelated to changes in fundamental economic conditions. This implies that “stock markets in the Asia-Pacific region do not satisfy the criteria for full information efficiency and this may be evidence that Asia-Pacific stock markets are subject to speculative bubbles.”<sup>221</sup>

Freeman (2000) acknowledges there are steps that could be taken on a national basis to improve the functioning of individual markets and these include:<sup>222</sup>

- Improving the regulatory environment that pertains to the equity markets
- Ending the use of distinctions between foreign and local share, and/or ceilings on cumulative foreign holdings of stocks
- Making strides to improve levels of corporate disclosure by listed firms
- Liberalizing the listing requirements
- ‘Spring cleaning’ the indices of stocks that have been unable to recover from the impact of the Asian financial crisis.

However, he makes another, more comprehensive, proposal and that is the formation of a regional equity market through the consolidation or merger of existing major markets and involving interested ASEAN countries<sup>223</sup>

### **A Regional Equity Market**

Freeman (2000) views the proposal for a regional equity market as the “portfolio investment equivalent” of the ASEAN Investment Area (AIA), which is designed to attract FDI into the region. Although the combined capitalization level (see Table 5.13) would still be small by global standards, it would be enough, in his opinion, to keep these markets from being dismissed altogether by institutional investors. It would raise liquidity levels that could lessen the chances of capital flows actually driving market performance, which is now the case. It might also reduce the problem of sectoral imbalance although would probably not eliminate it altogether. The presence of Singapore’s more balanced SGX in the aggregation could help to reduce sectoral skewing.

He identifies several problems of a political and logistical nature in this proposal. From a political perspective, there is the view that a country’s equity market is a sign of modernity and a strategic asset that should not be strongly influenced by foreigners. There is also the issue that the larger markets (e.g., Singapore) might perceive a regional market as potentially diluting to their existing strength. From a logistical perspective, there would need to be consistency among the five markets in terms of trading systems, settlement and payment systems, membership structure, listing requirements, fee structure, et cetera.

In order to mitigate potential political issues, he suggests that the pan-regional entity might be newly created, rather than being derived from an already existing equity market. Although it would need to have a minimal physical presence somewhere in the region (Singapore being the most likely location, in his opinion), it could function on a virtual basis.

Solving logistical issues would be somewhat more involved although his examination of one area (i.e., listing requirements) across the five markets revealed that despite many differences, there are broad consistencies for primary criteria. Furthermore, he suggests that needed logistical changes could be carried out incrementally in a manner similar to the process for AFTA and the AIA. He also sees the possibility of building a regional corporate bond market in conjunction with a regional equity market.

Freeman sees the development of a regional equity market as part and parcel of the move toward regional cooperation, which so far has been concentrated on trade and FDI. In his view, it is essential to attract foreign institutional investors back to the region's markets through improved corporate disclosure and more protection of the rights of minority shareholders, among other things. He places the onus for accomplishing this on regional authorities.

There is, however, considerable ambivalence in the region toward foreign investors. Given the limited number of institutional investors in the region and the tendency of individual investors to prefer less risky investments (e.g., bank deposits), regional authorities can readily see the need to attract foreign investors. On the other hand, because of their perceived negative role in the crisis, there is still considerable distrust where foreign investors are concerned.<sup>224</sup> Rajan and Siregar (2002) express this dilemma as follows, "The challenge for regional policymakers is to facilitate the ongoing recovery in foreign capital inflows while ensuring that the economies' vulnerabilities to sudden reversals in capital flows do not increase in tandem."<sup>225</sup> This, of course, underlies much of the discussion on this issue. A definitive regional solution has not been found, although certain countries have had some success with specific national policies (e.g., Malaysia's capital controls).

Although well argued, it is uncertain whether formation of a regional equity market would signal foreign investors that ASEAN is serious about creating a regional environment conducive to business and generate a higher benchmark of performance across Southeast Asia, as Freeman suggests. What cannot be disputed is that underlying the creation of a regional equity (or corporate bond) market is the need for improved corporate governance and financial market reform. Furthermore, there are those who argue that focusing on financial reform will lead naturally to well-developed capital markets and the appropriate financial structure will emerge at each stage of development.

## **Focusing on Financial Development Rather Than Financial Structure**

A slightly different perspective on the relationship between financial development/financial structure and economic growth is presented in a recent volume of work edited by Demirgüç-Kunt and Levine. The studies and analyses in this volume find, "Overall financial development matters for economic success, but financial structure per se does not seem to matter much."<sup>226</sup> The editors suggest that it would be more beneficial if policymakers focused on legal, regulatory and policy reforms in order to improve the functioning of both markets and banks rather than being concerned about the extent to which their financial system is bank-based or market-based.

Demirgüç-Kunt and Levine (2001a) found in their own analysis that at higher levels of income, financial sector development overall for bank-based and market-based

institutions is greater. In other words, both banks and stock markets are larger, more active and more efficient in richer countries. Also, stock markets (relative to banks) become more active and efficient in higher-income countries. Finally, the authors examined financial structure relative to legal, regulatory, tax, and macroeconomic determinants and found that countries having a "Common Law tradition"<sup>227</sup>, strong protection for shareholder rights, good accounting standards, low levels of corruption, and no explicit deposit insurance tend to be more market-based, even after controlling for income. On the other hand, countries with a French Civil Law tradition, poor protection of shareholder and creditor rights, poor contract enforcement, high levels of corruption, poor accounting standards, heavily restricted banking systems, and high inflation tend to have underdeveloped financial systems in general, even after controlling for income."<sup>228</sup>

Some of these findings are presented in Table 5.16 below for selected countries.

Table 5.16

Indicators of Financial Development, Financial Structure and the Legal System across Countries						
Country	Finance-activity	Structure-activity	Anti-director	Creditor	Rule of law	Legal origin
India	-4.35	-1.61	5	4	2.50	E
Japan	-0.43	-1.00	4	2	5.39	G
Malaysia	-1.08	-0.32	4	4	4.07	E
Philippines	-4.17	-1.47	3	0	1.64	F
Thailand	-1.98	-0.92	2	3	3.75	E
Australia	-2.14	-1.18	4	1	6.00	E
New Zealand	-3.14	-1.64	4	3	6.00	E
Denmark	-3.63	-1.87	2	3	6.00	S
France	-2.57	-2.28	3	0	5.39	F
Germany	-1.76	-1.52	1	3	5.54	G
Italy	-3.89	-2.52	1	2	5.00	F
Switzerland	0.55	-0.39	2	1	6.00	G
United Kingdom	-1.33	-0.74	5	4	5.14	E
United States	-0.80	-0.64	5	1	6.00	E

NOTES:  
 Finance-activity = Indicator of financial development; a measure of overall activity of financial intermediaries and markets.  
 Structure-activity = Indicator of financial structure; a measure of the activity of stock markets relative to the activity of banks.  
 Creditor = Index of degree to which legal codes of a country protect claims of secured creditors in case of reorganization or liquidation of a company. Ranges from 0 to 4 with 0 being lowest.  
 Anti-director = Index of degree to which legal codes of a country protect minority shareholder rights. Ranges from 0 to 6 with 0 lowest.  
 Rule of law = Assessment of law and order tradition of a country. Ranges from 10 (strong law & order tradition) to 1 (weak tradition)  
 Legal origin: E = British, F = French, G = German, S = Scandinavian  
 Source: Beck, Demirguc-Kunt, Levine, and Maksimovic (2001: Table 5A.1, Appendix 5.1, 234-236)

In financial development<sup>229</sup> (represented by the indicator 'Finance-activity' in the above table), Switzerland has the highest value and India, the lowest. Although too few countries are included to make an overall assessment of the Asian region, the results are as might be expected in that Japan's financial development is highest among those listed while India and the Philippines are at the low end with Malaysia and Thailand in between.

'Structure-activity' gives an indication of a country's financial system being more market-based or bank-based relative to other countries in the sample.<sup>230</sup> The remaining

indicators provide information regarding legal and regulatory differences with three indicators ('Creditor', 'Anti-director', and 'Rule of law') reflecting the rights of outside investors and the degree to which they are protected while 'Legal Origin' refers to the classification of a country's legal system.<sup>231</sup> The protection of secured creditors ('Creditor') and minority shareholders ('Anti-director') are fairly strong in India and Malaysia but weaker in the Philippines and Thailand with Japan being weak in the former but strong in the latter.<sup>232</sup> It is interesting to note that in terms of secured creditor protection Japan is at about the same level as other countries with a German-originated legal system (e.g., Germany and Switzerland).<sup>233</sup> However, Japan's protection of minority shareholders is considerably stronger than that of these two countries.<sup>234</sup>

The secondary importance of financial structure (bank-based or market-based) is further supported by the findings of Schmukler and Vesperoni (2001) in their analysis of cross-country microeconomic data. Their results suggest that for emerging markets, whether they are bank-based or market-based is less important than the fact that they are emerging markets. They also found that integration with world capital markets has similar effects on firms whether they operate in a bank-based or market-based system. They conclude, "[...] the financial sector of emerging markets (either bank-based or market-based) needs further development and can potentially benefit from integration with international markets."<sup>235</sup>

The Demirgüç-Kunt and Levine studies reveal that as a country undergoes the development process its financial structure will tend to change "because banks and markets have different requirements concerning information and contract enforcement in order to function effectively."<sup>236</sup> Thus, based on this research, it appears advisable for policymakers to focus on financial development through the reformation of the legal and regulatory environment allowing the financial structure to evolve naturally from that. Again, we come back to financial market reform as the focus recommended for policymakers.

## **Conclusion: How to Achieve the Goal**

The goal, as stated at the beginning of this section, is to develop the region's financial sector to a level of soundness and stability that would not only reduce the chances of another crisis but also promote economic growth in the region. We have presented basically two approaches for the achievement of this goal: (1) focusing on changing financial structure so as to move away from the currently dominant bank-based system to a more market-based system and (2) focusing on reforming the regulatory, legal and macroeconomic environment which will lead naturally to a move away from a bank-based to a market-based system. These approaches appear at first glance to be opposites. However, upon closer examination it can be seen that the ultimate outcome is the same – although approached from different directions.

In the first approach, developing corporate bond markets is proposed as an alternative method of financing for firms that have traditionally relied on the banking sector. However, corporate bond markets in the region are now significantly underdeveloped with a narrow issuer base and limited investors (particularly institutional investors), among other problems. While some progress in developing corporate bond markets has been made in individual countries, a great deal of work remains to be done. It will be a costly and lengthy process requiring years, even decades, to complete.

Because of this, as well as a sense of urgency since the Asian crisis, an interim plan has been proposed whereby banks would play a major role in the development of bond markets. Although banks already figure prominently as investors and issuers in the region's bond markets and there are a number of advantages to pursuing this path, there are also well-recognized risks associated with banks' involvement in the securities business. Given the weaknesses that already exist in the region's banking sector, these risks cannot be dismissed lightly. Thus, an important part of this proposal is the strengthening of the banking sector. Preferably, this would be carried out prior to increasing or formalizing its bond market activities. In conjunction with this, the need for improving corporate governance cannot be overlooked.

Another path to bond market development has also been proposed. The creation of a regional bond market is seen as potentially more cost effective than developing individual country markets given the small size of the individual economies in the region. Although the creation of a regional bond market would not necessarily require the participation of every country in the region, there would need to be a high level of cooperation and compromise among those that do choose to participate. The process would be complex and also extremely time consuming to carry out. It would thus be a long-term endeavor rather than a possibility for the near future.

A regional equity market, although less often mentioned in the discussion of regional capital market development, has also been proposed. A number of individual equity markets already exist in the region with some of these being fairly well capitalized (e.g., Hong Kong, Singapore, Taipei and Tokyo). In addition, there is ample evidence that some countries utilize a high level of equity financing. While some efforts have been made to link exchanges in the region, the creation of a regional equity market (as for a bond market) would entail a high level of cooperation and the need to overcome a number of political and logistical problems.

Underlying the above-mentioned proposals is the necessity to restructure the banking and corporate sectors of the region. Even though the development of bond and equity markets is seen by many as an essential part of financial development in the region, there is recognition that this must be accomplished in conjunction with strengthening of these sectors. The second approach described in this section starts with financial restructuring and allows the development process to bring about changes in financial structure that are appropriate at each level of development.

Regardless which of the above approaches is chosen as the route to financial development in the region, it is apparent that the process will be complex and lengthy. This raises the question of how the process should be undertaken and at what level (or levels) – national, regional or international – it should be pursued. Should it be controlled, guided or overseen by regional institutions or through regional cooperation, or should it be led by national governments. What, if any, should be the role of international institutions?

Of course, a variety of opinions and recommendations abound. There are those who believe the process should be handled entirely at the national level, those who think that regional institutions can help, and those who believe that international institutions and developed countries, who have extensive experience in this area, should be involved. Most believe it cannot be accomplished without involvement of the private sector.

Nam et al (2001) indicates that one obvious and desirable policy direction in the post-crisis period (for those wanting to take best advantage of liberalized capital markets) is to move away from the pre-crisis relationship-based system, accompanied by weak corporate governance and inadequate financial supervision, towards a market-based system with strengthened corporate governance and supervisory institutions. In order to successfully carry out this endeavor the authors believe a third party is required to change the rules and to provide leadership in the move to this “new, better equilibrium”. In their opinion a “natural candidate” for this role is the national government, albeit in cooperation with international organizations and other governments and with significant involvement of the private sector. They reason that involvement at the national and international levels is necessary because there is no incentive for any individual player to take on the role unilaterally.<sup>237</sup>

The aforementioned proposal of the Asian Policy Forum (APF) regarding the strengthening of banks in conjunction with the development of bond markets comprises both regional and national elements. Guidelines and suggestions are being made at the regional level (through the APF, which includes participants from all over Asia) but this entity has no enforcement power so that compliance would be up to each individual country.

Eichengreen (2001) suggests that regional cooperation could be effective in the promotion of financial stability and development in the region. Costs could be lower at the regional level than at the international level and agreement could be facilitated by the sharing of common problems by regional governments. Specifically he recommends establishment of a new forum, an “Asian Financial Institute” (AFI) based on the ASEAN+3 platform.

He foresees the responsibilities and activities of such an institution including the provision of technical assistance on prudential supervision and regulation to national agencies, the administration of training programs for inspectors, supervisors and accountants, the provision of central banking services (e.g., clearing and settlement) to member central banks, and the negotiation of distinct financial standards for the region, among others. He sees an AFI as accepting input from national regulators and authorities but having considerable power in monitoring compliance and imposing penalties. A major stipulation of this proposal (one that could very well mean its nonacceptance in the region) is the abandonment of “ASEAN’s consensual approach to surveillance and presumption of nonintervention in national affairs for a more forceful approach.” Without this, “a meaningful regional arrangement to promote financial stability and development [...] would not be possible.”<sup>238</sup> Eichengreen does not view an AFI working in isolation but rather in cooperation with international fora so as to ensure consistency in financial standards and financial development strategies.

At the international level, of course, standards for capital markets already exist and could conceivably be adopted by developing countries. However, despite the benefits that could be derived from their adoption, such as the reduction of information problems and the improvement of access for developing countries to the international financial system, these standards generally reflect conditions in developed countries so that they may not in all cases be appropriate for developing countries. The setting and implementation of international standards has to date been carried out primarily by industrialized countries. Developing countries naturally want to be a part of the standard

setting process if they are to adopt those standards into their national regulatory and supervisory regimes.

There is also some disagreement regarding implementation of international standards. Developed economies, represented by the G-7, are seeking rapid and complete compliance even suggesting that it become part of IMF conditionality while developing countries (represented by the G-24) prefer adoption to be voluntary and gradual.<sup>239</sup> Haruhiko Kuroda, Vice Minister for International Affairs for Japan, in referring to the Basel Committee on Banking Supervision (BCBS) as the established international organization for supervising banks whose members are all from industrialized countries says, "If the IMF were to force emerging economies to abide by the rules decreed by the Basel Committee, such a move might be resisted."<sup>240</sup>

Of course, developed countries and international institutions certainly have the experience and knowledge to provide adequate advice in this area; however, while cognizant of that, the current politico-economic mood in the region might limit the extensive involvement of these entities. Since the Asian crisis, and its perceived mishandling by the IMF and lack of assistance from the U.S., calls for regional solutions have increased. Also, recent events (i.e., the collapse of energy trader Enron<sup>241</sup> in the U.S. and the heavy losses incurred by a forex trader at Allfirst, U.S. subsidiary of Allied Irish Bank<sup>242</sup>) have cast serious doubts on the transparency and managerial competence of the financial services industry in the U.S. and Europe. The claims of superiority in the areas of corporate governance by the developed countries might now be conceivably met with skepticism in Asia.

Even setting standards at the regional level could be difficult. Differences in the level of financial market development among the countries of the region imply different needs in terms of markets and financing sources. For example, a bank-based system can be advantageous in a country where legal and accounting systems are weak or contract enforcement is poor since strong banks can apply pressure to firms to obtain information and payment of debt.<sup>243</sup> The standard-setting process would be complex and require a high level of cooperation, communication and preparedness. It is not clear that currently existing regional institutions in East Asia are at a stage where they could undertake such an endeavor, and to establish new institutions to undertake the project (as suggested by Eichengreen) seems redundant.

A look at the EU's experience puts into perspective how difficult it would be to develop regional markets and standards. The EU has achieved a currency union but is still in the early stages of creating a single market for financial services.<sup>244</sup> "At present, investors who want to trade in shares in more than one EU country have to contend with such a baffling array of regulations, red tape and languages that few bother trying."<sup>245</sup> A recent study by the European Financial Services Round Table, which is a forum of banks and insurers, found that the creation of a Europe-wide market for financial products, which at present does not exist, would increase competition and wider choice, and thus save consumers and investors as much as €15 billion a year.<sup>246</sup>

Given the realities of the politico-economic situation in East Asia, it is most likely that the national authorities will have the primary role in directing the process. This observation is borne out by the recent comments of Rodolfo Severino, secretary-general of ASEAN, on the related topic of a common currency for the region. He said that ASEAN members desire to control their own economic destinies and are reluctant to give



up decisionmaking power where their own economies are concerned.<sup>247</sup> Nonetheless, it would be most likely that they would not operate in a vacuum but would be open to some involvement by regional and international players as well.

## Capital Account Liberalization

It is widely acknowledged that the sudden withdrawal of capital from Asia played a primary role in the 1997-98 crisis. This followed a huge inflow of capital into the region in the years leading up to the crisis, resulting from a relatively significant degree of capital account liberalization in the crisis-affected countries in the early 1990s. (See Table 5.1 earlier in this chapter.) It was widely believed that financial liberalization in general, and capital account liberalization in particular, were essential stepping stones on the path to economic growth. It was thus recommended (some say by the Washington Consensus) that developing countries open their capital accounts, and these countries embraced the idea wholeheartedly. The East Asian crisis (and its aftermath) has altered that thinking to a great extent. Wyplosz (2001b) even declares, “A silver lining of the recent crises is that the liberalization activism of the 1990s is now *passé*.”<sup>248</sup> Nonetheless, financial liberalization as an ultimate goal is not dead and the way to proceed towards its achievement has engendered considerable debate.

Academic studies over the last decade have found the relationship between capital account liberalization and growth to be generally positive, but not strong. Ten of these studies conducted between 1994 and 2001 were reviewed by IMF staff who found the conclusions to be about evenly split between a finding of a “positive” relationship and that of “no effect”.<sup>249</sup> Those studies with a finding of “positive” were conducted more recently (2000-2001). One study was reported as having a “mixed” result. This study was conducted by Arteta, Eichengreen and Wyplosz (2001) who found “somewhat more evidence of a correlation between capital account liberalization and growth when we allow the effect to vary with other dimensions of openness.”<sup>250</sup> The authors go on to explain that sequencing of reforms plays a role in the effect of capital account liberalization (although they found this to be more robust in the 1980s than in the 1970s or 1990s), but macroeconomic imbalances are potentially more harmful than the lack of trade openness under capital account liberalization.

The review of these studies (plus the results of the IMF’s own study of 38 developing countries for the period 1980 to 1999) found that the channels through which capital account liberalization can positively impact growth include the following:<sup>251</sup>

- For developing countries, all forms of capital inflows can increase investment. In the case of domestic investment specifically, liberalization does have a positive effect in raising that as well.
- Capital account liberalization (particularly FDI) can bring technology spillovers but primarily in countries that have a highly educated workforce, which enables it to exploit such spillovers.
- Capital account liberalization can lead to a deepening of domestic financial markets (more so in the case of portfolio flows than FDI); however, it can also result in severe financial difficulties if the appropriate institutional framework is not in place.

While most regions of the world have been opening their capital accounts throughout the 1980s and 1990s, there are differences in degree of opening within developing countries across regions. The developing economies of Asia have been trending toward openness since the 1970s – in FDI as well as in portfolio and bank flows,

which rose significantly in the early 1990s. Among developing countries, Asian countries are the largest users of FDI flows (average for 1970-2000), while Latin American countries constitute the largest users of portfolio flows. This can be attributed to a history of larger fiscal deficits in Latin America relative to Asia, which led to more floating of government bonds and the earlier development of capital markets in some Latin American countries.<sup>252</sup>

The events associated with the East Asian and other crises have clearly demonstrated that the road to financial liberalization is fraught with risk. Wyplosz (2001b) studies the effect of domestic and external financial liberalization on both developing and developed countries. Among his findings are the following: (1) capital account liberalization is the “most sensitive step” of the financial liberalization process, (2) the capital inflow problem associated with liberalization is greater for developing countries than for developed countries, (3) while liberalization reduces foreign exchange pressure in the long term, initially it causes instability that can last for several years, and (4) immediately after capital account liberalization, developing countries experience a boom (nearly 15 percent of GDP), but this is followed by a sharp contraction.

Capital controls have been used by some countries in response to the large inflows that follow capital account liberalization or the large outflows associated with a crisis. Controls on cross-border capital flows are generally of two types: (1) administrative (direct controls), which are prohibitions, that are either outright or involve an approval procedure, on capital account transactions and (2) market-based (indirect controls), which discourage cross-border flows by making them more costly, e.g., through the use of taxes or other price-based measures.

Controls on inflows are more commonly used in the event of a speculative bubble and are becoming increasingly accepted as a short-term prudential measure for preventing the accumulation of short-term foreign liabilities, especially by lower-income economies while improving their financial supervisory systems.<sup>253</sup> Controls on outflows, however, are often implemented during a currency crisis associated with a speculative attack and are less widely endorsed although acknowledged to have been successful in some cases where they were used. Controls are generally imposed on short-term flows because of their potentially speculative nature and destabilizing effect. Short-term, rather than long-term, flows were the core of the problem during the East Asian crisis.

Controls on short-term capital inflows were used on several occasions during the 1990s, specifically by Brazil (1993-97), Chile (1991-98), Colombia (1993-98), Malaysia (1994), and Thailand (1995-97). In all five cases, the controls were put in place because of concerns over the negative effects of large capital inflows into developing economies in the 1990s. The principle motivation in all cases was to maintain an interest rate differential between domestic and foreign interest rates while at the same time reducing pressure on the exchange rate. While initially effective, they did not result in the achievement of both of these objectives. There is evidence that they were partly effective in Malaysia and Thailand in controlling the level and maturity of inflows and allowing the reduction in the use of sterilization operations. In Colombia, and possibly in Chile, they were effective in maintaining a differential between domestic and foreign interest rates. In the case of Brazil, the controls were largely ineffective.<sup>254</sup>

Instances where controls on capital outflows have been used include Malaysia (1998-2001)<sup>255</sup>, Spain (1992), and Thailand (1997-98). In the case of Malaysia and

Thailand, controls were imposed in response to the East Asian crisis to stop the flow of capital out of the country and counteract downward pressure on their exchange rates. At the time, Thailand had a pegged exchange rate regime and Malaysia had a managed float but later fixed the ringgit to the U.S. dollar when it imposed its capital controls. The goal of each was to curtail speculation and stabilize their currencies by restricting access to domestic currencies by nonresidents.

The effectiveness of these controls was mixed. In Malaysia, capital outflows were largely contained by the elimination of the offshore ringgit market (through the restriction on access to the currency by nonresidents), by restrictions on the repatriation of portfolio capital by nonresidents, and on the outward investments of residents. The currency was stabilized and has remained so. In Thailand, the controls were initially effective and speculative attacks temporarily halted. However, the offshore market was still active and large return differentials and expectations that the baht would be depreciated undermined the effectiveness of the controls. Thailand eventually floated the baht.<sup>256</sup>

At the time Malaysia imposed its capital controls (September 1998) the international prognosis was generally negative with predictions of loss of investor confidence and a decline in investment (FDI inflows), which were particularly important to Malaysia. This was despite the fact that Malaysian authorities took steps to exempt FDI and current account transactions from the controls. While there is now widespread agreement as to the success of Malaysia's controls (even by the IMF), there is less agreement as to the reason for this. The conventional view is that timing played a significant role and that Malaysia was about to recover from the crisis anyway particularly in light of the recovery of Korea and Thailand at the same time with no imposition of capital controls. Kaplan and Rodrik (2001) analyze the effectiveness of Malaysia's capital controls in its recovery relative to the recovery of Korea and Thailand, both of which utilized the IMF program. They conclude that the controls were effective in stabilizing the financial markets, which allowed authorities greater monetary and fiscal autonomy. They also conclude that the controls permitted a faster recovery than would have been possible under the IMF program.<sup>257</sup> In fact, the IMF has since indicated its agreement with the former of these findings; i.e., that the capital controls "appear to have provided some breathing space in which to implement more fundamental policy reforms [ . . . ]." However, it tempers this acknowledgement by stating that this was "at the cost of weakening the confidence of international investors, thereby increasing the cost of funding from abroad, weakening FDI flows somewhat, and producing large administrative costs."<sup>258</sup> On the other hand, Malaysia was not left with high debt levels to international lending institutions as were Korea and Thailand. In the IMF's view, the effectiveness of Malaysia's controls was enhanced by factors such as "macroeconomic and structural adjustments," as well as the "authorities' strong enforcement capacity and favorable exchange rate developments."<sup>259</sup> In fact, the effectiveness of Malaysia's capital controls, versus the long-term ineffectiveness of Thailand's controls, has been attributed in part to the fact that they were so comprehensive and succeeded in effectively eliminating the offshore ringgit market whereas leakages occurred in Thailand's case. IMF staff,<sup>260</sup> however, have hypothesized that the capital controls implemented by Thailand earlier in the crisis (and which failed) may have worsened the situation in that country by delaying its implementation of the structural reform and stabilization package.

The previous discussion has focused on the use of capital controls (on outflows) as a means to control international flows in a crisis situation. Capital controls, however, can also be effective in risk management associated with international capital flows in non-crisis situations. High risks are associated with capital account liberalization in the absence of well-developed financial supervisory and regulatory systems. Prudential policies applied to financial institutions can limit the vulnerability of the economy to the risk of excessive international capital flows by strengthening the financial system, thus enabling it to deal with market volatility and may even, in some cases, reduce the volatility of flows through financial institutions.<sup>261</sup> Prudential regulation and supervision could therefore be considered as an alternative to the imposition of capital controls.<sup>262</sup>

On the other hand, under circumstances where prudential policies are not well developed (or where nonfinancial firms play a significant role), capital controls can be useful in the management of some risks associated with international capital flows. It should be emphasized, however, that no single type of capital control is appropriate for every country in all situations, and they can be complex, difficult to administer and generally require strong enforcement capability. Direct controls are generally easier to administer than indirect controls but they can be distortionary in the prevention of sound, as well as risky, flows. Nonetheless, capital controls may be useful particularly in countries that lack well-functioning prudential policies; i.e., market discipline, transparency and internal controls in financial institutions.<sup>263</sup>

Wyplosz (2001b) recommends the following for minimizing the problems associated with capital account liberalization for developing countries.

- Wait until a proper economic, and possibly political, infrastructure can be built in order to reduce the possibility of pressure on exchange rates and boom-bust cycles.
- Prepare in advance for liberalization by implementing adequate welfare systems and build up public savings via fiscal policy so as to have financial reserves on hand in the event of a bust.
- While acknowledging that the debate on “fixed versus floating” and “extremes versus the soft middle” is ongoing, some form of exchange rate flexibility (i.e., floating or the ability and willingness to realign pegs) is essential during liberalization so that a temporary revaluation in the capital inflow stage and devaluation in the event of outflows could prevent a speculative attack and ensuing crisis.
- Sequence liberalization over several years starting with the domestic goods market, then trade, then the domestic financial market, and finally the capital account (long-term, then short-term).
- Banking regulation and supervision should be developed and financial institutions should function properly. Goods markets should be free and open.

Several of these recommendations are echoed by the IMF, including the sequencing of policies relative to “country-specific circumstances.” Emphasis is placed on sound and sustainable macroeconomic policies and financial sector reform as two of the most important for opening of the capital account. The former is designated as a precondition to financial and capital account liberalization as a means of defusing its linkage with instability. The latter is advised for implementation during liberalization (if not preexisting). The IMF recommends early stage attention to domestic financial

liberalization through market-based monetary arrangements and central bank reforms with gradual phasing in of prudential regulation and supervision, and financial restructuring policies. Transparency and data disclosure are also deemed important. Social and regional considerations should be taken into account in determining the pace, timing and sequencing of liberalization.<sup>264</sup>

An alternative to “sequencing”<sup>265</sup> is presented in Fan (2002) who describes China’s opening and reform process as “compatible opening.” Although in this case it is applied particularly to China, the concept is theoretical and could be applied to market liberalization for emerging economies generally. In discussing the problems that China faces in further financial market opening, Fan says, “these problems do not mean further opening is not the right thing to do, but they do show that domestic reform should be the main priority and that liberalization is helpful only when compatible with domestic development.”<sup>266</sup> In fact, he proposes, “reform and market opening should go hand in hand, progressing neither too fast nor too slow, so that they can promote and facilitate each other.”<sup>267</sup> He faults the prevailing “sequencing” theory as not being politically realistic because in reality, “policymakers just do what the situation allows.”<sup>268</sup> Furthermore, developing countries are often pushed by those in favor of sequencing to liberalize as fast as possible.<sup>269</sup>

Some may criticize the “compatible opening” theory as being a “half-way” solution, but Fan responds that domestic reform itself is only half completed. “One of the lessons of the East Asian crisis is not that closed markets create instability, but that the crisis was caused by ‘complete opening’ before ‘complete reform’.”<sup>270</sup> The downside to this approach is that it is government managed which could lead to unfair competition rent seeking. It could also be slower but does not necessarily need to be depending on the pace of domestic reform, with which liberalization should coincide.

Since the 1997-98 crisis, Asian countries have, to varying degrees, taken major steps towards restructuring their financial systems and strengthening their macroeconomic policies. (Some of these are outlined in Table 5.3 earlier in this chapter.) However, as is the case for China’s domestic reform, East Asian countries still have considerable work to do in order to attain the level of financial and structural development that would minimize the risks associated with capital account liberalization. It is obvious that a task of this magnitude can not be accomplished in the short, or even medium, term and has been estimated to take decades.

In his assessment of globalization, Fan Gang points out that developing economies are hampered in their ability to compete globally in part because of their vulnerability to the risks associated with the international market. In order to prosper, these countries must have more than the foreign capital and technology brought by globalization or the cheap labor that is in plentiful supply at home. They further need “competitive economic structures, strong institutions, the experience to manage markets and basic education [ . . . ].”<sup>271</sup> In his view, globalization does not bring these to developing countries, or at least not as completely or as quickly as it does capital and technology. He points out that their acquisition or development requires considerable time to complete – as much as 10, 20, or even 50 years, which is still not as long as it took industrialized countries to develop their market systems.

## Summary

Capital account liberalization is desirable in the long run but is associated with considerable risk in the process, particularly if macroeconomic policies are not sound and financial supervision and regulation is weak. While sequencing of the opening of the capital account is often recommended, there is no single formula for this process, just as there is no simple rule for the use of capital controls. “Compatible opening” where the progress of domestic reforms coincides with that of market liberalization is also an alternative. Both “sequencing” and “compatible opening” can, if handled properly, be geared toward the specific circumstances of financial development in individual countries. Many factors related to an individual country’s stage of development and current level of involvement in global capital markets need to be considered in setting realistic goals and objectives in this area.

## A Regional Currency Regime

Arising out of the Asian crisis and related to the issue of financial system reform,<sup>272</sup> is an ongoing debate on the appropriate currency regime for East Asian economies, extending as far as a discussion of the suitability of a regional monetary arrangement for East Asia.<sup>273</sup> Prior to the crisis, currencies of the crisis-affected countries were “effectively” pegged to the U.S. dollar.<sup>274</sup> (See Table 5.17 below for “official” pre-crisis exchange rate regimes for the crisis-affected countries.)<sup>275</sup> Large capital inflows into these countries caused rapid appreciation of their exchange rates, especially after 1994. When the dollar appreciated against the yen beginning in 1995, the currencies became overvalued. The eventual reversal of capital flows in mid-1997 put downward pressure on these currencies, which were vigorously defended by their respective central banks. In the end, after their foreign exchange reserves were depleted (Thailand and Korea), the currencies could no longer be defended and were allowed to float and, thus, depreciate. This depreciation, combined with rising interest rates, negatively impacted banks. Their nonperforming loans increased as borrowers (particularly real estate developers)<sup>276</sup> went into bankruptcy, and they suffered direct balance sheet losses (to the extent they were net dollar borrowers).<sup>277</sup> The only exception was Malaysia, which switched from a managed float to a conventional fixed peg and imposed capital controls.

Table 5.17

<b>Crisis Country</b>	<b>Pre-Crisis Exchange Rate Regime* (12/31/91)</b>
Indonesia	Crawling Peg
Korea	Managed float with no pre-announced exchange rate path
Malaysia	Pegged rate in horizontal band
Philippines	Managed float with no pre-announced exchange rate path
Thailand	Other Conventional Fixed Peg
* See Appendix for description of exchange rate regimes.	
Source: IMF Annual Report 2000 and Fischer (2001: Tables 2, 3, and 4)	

Radelet and Sachs (1999) believe that if Thailand had switched to a float earlier in 1997 and moderately tightened monetary and fiscal policies, foreign exchange reserves



would not have been exhausted and the crisis “could have been largely avoided”.<sup>278</sup> For the same reason, Corden (2000) also suggests that Thailand could have resorted to an earlier float but believes there might still have been a sudden depreciation as lenders and the foreign exchange market realized that the boom was ending soon.

## **Bipolar or “Two-Corner Solution”**

Because of their perceived negative role in the crisis, the pre-crisis “soft pegs” fell out of favor as a prescribed regime for emerging market countries. As an alternative to (and reaction against) this regime, many experts advocated a bipolar or two-corner solution for East Asia. This solution involves a choice of either absolutely fixed exchange rates (e.g., currency board, monetary union, dollarization), or freely floating rates.<sup>279</sup> The theory associated with this solution is that if countries have hard pegs or free floats, then speculative attacks will no longer be a threat and currency crises will cease to be a problem.<sup>280</sup>

Advocates of the two-corner solution point to the so-called “impossible trinity” to support their view. The essence of this principle is that the following three goals cannot co-exist:

- Fixed exchange rate (i.e., exchange rate stability)
- Free flow of capital (i.e., financial market integration)
- Independence of monetary policy

Frankel, Fajnzylber, Schmukler and Servén (2000) suggest this does not mean that a country must give up one of the three entirely but could instead choose a halfway approach on two of the goals; e.g. half-stability and half-independence, such as would be the case if a country adopted a “target zone of moderate width.” They go on to explain that a government could pursue “a managed float in which half of every fluctuation in demand for its currency is accommodated by intervention and half is allowed to be reflected in the exchange rate.”<sup>281</sup> McCauley (2001) points out a similar suggestion by Yi Gang and Tang Xian (2001), which is that “an independent monetary policy (1) might be combined with semi-fixity of the exchange rate (1/2) and a halfway open capital account (1/2).”<sup>282</sup>

In an attempt to offer a possible theoretical rationale for the favored two-corner proposition<sup>283</sup>, Frankel, Fajnzylber, Schmukler and Servén (2000) examine ease of verifiability of exchange rate regimes. Their reasoning is that verifiability (i.e., the ability of the market to determine from available data that the official exchange rate regime of a country is in fact in operation) contributes to “transparency,” which has become a major focus for post-crisis reform and figures prominently in discussions of the new international financial architecture. They focus on exchange rate bands<sup>284</sup> as one type of “intermediate” (non-corner) regime and attempt to assess the degree to which it is verifiable from observed data. They conclude that on the whole, a wider bandwidth, multiple instead of simple basket pegs, and frequent parity realignments all make it more difficult to statistically verify the announced regime. Credibility is an essential element in maintaining foreign exchange stability and the ability to verify an announced regime would understandably contribute to that credibility. They reason that if this is indeed the case, then a more easily verifiable corner regime might be preferable to investors. Credibility is a major goal of emerging market countries and a primary reason for their pursuit of exchange rate stability.

There are a number of reasons to question the suitability of the two-corner solution for East Asian countries. A floating rate would adjust as needed to maintain internal and external balance but has drawbacks for the emerging economies of Asia. In this case, there are two problems in particular with a freely floating regime.<sup>285</sup>

- 1) **Short-term volatility** – The narrow and shallow capital markets of Asian economies make them vulnerable to the manipulations of a few large players in the international capital market, which can result in extreme volatility that can be magnified by the effects of “herding”. This high volatility, and its attendant high risk, can lead to an increase in interest rates, which in turn can slow economic growth. The situation is worsened by the limited and costly hedging opportunities in Asia. Another problem is that exchange rate volatility causes fluctuation in the real value of domestic assets and this can prompt domestic investors to seek stable investments abroad.
- 2) **Medium-term exchange rate misalignment** – Capital inflows will cause a currency to appreciate, attract more inflows and further appreciate until a persistent misalignment occurs in the medium term. This can result in the distortion of domestic resource allocation between tradables and non-tradables.

At the other corner is a fixed exchange rate, such as a currency board. A currency board provides a high level of stability (and credibility, provided there is certainty the peg will not be abandoned), but a country must give up monetary policy independence, which few countries are willing to do. Also, the rate cannot be adjusted if the country wants to attain certain targets of internal and external balance. If a real devaluation is needed, it can only be brought about through declines in domestic prices and wages. In addition, the lack of a lender of last resort can be problematic in an environment of liberalized financial markets.

Larrain and Velasco (1999)<sup>286</sup> have identified certain conditions they believe necessary for a country planning to adopt an exchange rate anchored to another currency:

- Small, as opposed to large, countries and countries that have symmetric shocks with the anchor country are better candidates as there is less need for such countries to have an independent monetary policy and flexible exchange rate than if they had to deal with asymmetric shocks on their own.
- Most of an adopting country’s trade should take place with the anchor country to minimize the negative effects of exchange rate fluctuations on trade competitiveness.
- An adopting country’s inflation preferences must be broadly similar to those of the anchor country. This is generally easier to accomplish for countries that have a history of high inflation as they are often willing to endure considerable hardship to achieve price stability.
- The adopting country should have flexible labor markets so as to reduce the reliance on other policy measures, such as monetary policy, for dealing with economic shocks.
- A strong, well-capitalized and well-regulated banking sector is needed to reduce the need for a lender of last resort.

- High-quality institutions and a rule of law should be in place as they make it easier to adhere to the strict rules concerning monetary policy that come with anchoring the currency.

Among Asian countries, only Hong Kong SAR has a currency board, which was adopted in 1983 and has been highly successful. Eichengreen (1999) attributes this success to its internationalized banking system, openness to trade, flexible labor markets and the monetary authority's insulation from political pressures. These characteristics do not come together in most other East Asian countries.

## A Floating Regime or an Implicit Dollar Peg?

As previously noted, most of the crisis-affected countries switched to a floating rate regime during the crisis. Current exchange rate regimes for East Asian countries (along with their monetary policy frameworks) are listed in Table 5.18.<sup>287</sup>

Table 5.18

Exchange Rate Arrangements and Anchors of Monetary Policy (As of December 31, 2000)		
Country	Exchange Rate Regime	Monetary Policy Framework
Australia	Independently floating	Inflation targeting framework
Brunei Darussalam	Currency board	Exchange rate anchor
Cambodia	Managed floating with no preannounced path for exchange rate	Fund-supported or other monetary program
China	De facto peg arrangement under a formally announced policy of managed or independent floating (against dollar)	Two nominal anchors: (1) Exchange rate anchor (2) Monetary aggregate target
Hong Kong SAR	Currency board (dollar)	Exchange rate anchor
Indonesia	Independently floating	Fund-supported or other monetary program
Japan	Independently floating	Has no explicitly stated nominal anchor, but rather monitors various indicators in conducting monetary policy.
Lao PDR	Managed floating with no preannounced path for exchange rate	Has no explicitly stated nominal anchor, but rather monitors various indicators in conducting monetary policy.
Malaysia	Other conventional fixed peg arrangement (against dollar)	Exchange rate anchor

Exchange Rate Arrangements and Anchors of Monetary Policy (As of December 31, 2000)		
Country	Exchange Rate Regime	Monetary Policy Framework
Myanmar	Other conventional fixed peg arrangement (against a composite)	Exchange rate anchor
New Zealand	Independently floating	Inflation targeting framework
Philippines	Independently floating	Two nominal anchors: (1) Monetary aggregate target (2) Fund-supported or other monetary program
Singapore	Managed floating with no preannounced path for exchange rate (Singapore describes its regime as a basket, band, and crawl (BBC) with undisclosed parameters.) <sup>288</sup>	Other (not specified)
South Korea	Independently floating	Other (not specified)
Taiwan	Managed floating <sup>289</sup>	N.A.
Thailand	Independently floating	Inflation targeting framework
Vietnam	Pegged exchange rate within horizontal band (0.1% daily movement, one-sided) (De facto arrangement under a formally announced policy of managed or independent floating.)	Exchange rate anchor
NOTE: Taiwan is not included in the IMF listing. Source: IMF, International Financial Statistics, July 2001		

There is, however, some controversy about the true nature of these countries' announced regimes, which for most are indicated as independently floating. Several recent studies<sup>290</sup> are reviewed in Branson (2001). These studies examine variability in exchange rates, international reserves and interest rates of certain "floater" countries relative to the variability in these indicators for the U.S., Japan and Germany. They find that, for the most part, countries are neither adopting a hard fix nor are they actually freely floating but rather are managing their exchange rates against the dollar, yen or

DM/euro, or against a basket. (These studies cover a number of “floater” countries including some, but not all, East Asian countries that float.)

McKinnon (2001) is more specific in claiming that although having officially switched to a floating rate regime during the crisis, many East Asian countries in fact returned to pegging against the dollar after the crisis. McCauley (2001), on the other hand, disputes this claim with his findings that in 1999-2000 (relative to 1995-1996) “exchange rates have become more volatile not only absolutely but also in relation to interest rates in Indonesia, Korea, the Philippines, Taiwan and Thailand. In addition, exchange-rate volatility has risen relative to interest-rate volatility marginally in Singapore and substantially in Taiwan.”<sup>291</sup> He does, however, acknowledge that countries in East Asia have the capacity, in the form of international reserves, and the willingness to intervene in order to support their currencies. He also finds a willingness to limit exchange rate volatility by restricting financial transactions involving non-residents. (See Table G.11 in General Appendix.)

De Brouwer (2001) also questions the claims that East Asian floaters are implicitly dollar pegging and goes further to say that even if there were stability against the dollar for these currencies in the past few years, it could have been the result of the efforts of the crisis-affected economies to build up their foreign exchange reserves. Currency movement against the dollar would have been limited as these countries bought dollars when cheap and refrained from buying when expensive, but he emphasizes this is not implicit dollar targeting. He also points out that stability against the dollar could in fact be stability against the yen since it is not clear whether these economies were targeting the dollar or the yen. The exchange rate between the two has been stable in recent years.<sup>292</sup>

Calvo and Reinhart (2000) argue that emerging market countries have a tendency to stay away from a pure float because of a fear of large exchange rate swings – what they call “fear of floating”. The reasons the authors give for this fear (or conversely, why exchange rate stability is highly sought after) are as follows:

- Exchange rate volatility can be an indication of the monetary authority’s lack of credibility,
- Exchange rate volatility can cause debt servicing difficulties and defaults since liabilities are often foreign-currency denominated,
- Exchange rate volatility appears to be more damaging to trade in emerging markets which may be because trade is predominantly invoiced in U.S. dollars and hedging opportunities are more limited, and
- The passthrough from exchange rate swings to inflation is higher in emerging markets than in developed economies.

For these reasons, the authors believe that although emerging market countries might indicate an “intention” to float, they in fact do not allow their currencies to do so. Branson (2001) concurs with the “fear of floating” theory and believes that developing countries’ fear of unstable financial markets is justified since these markets are not well integrated into the international system, unlike those of large developed economies which can float without concern. He concludes that developing countries do not, and should not, adopt either of the corner solutions.

## **“Intermediate” or “Middle” Regime Alternatives**

If the two-corner solution is not the answer, what are the alternatives? There are a number of options between the two extremes of a hard peg and a free float, often referred to as “intermediate” or “middle” regimes. Kwan (2001) lists these in descending order of commitment to maintain a fixed rate: “monetary union, currency board, adjustable peg, crawling peg, basket peg, target zone or band, managed floating, and free floating.”<sup>293</sup> The third through sixth of these are identified as intermediate regimes and the two on each end as polar regimes. Some consider the intermediate regimes as reversions to the soft pegs of the pre-crisis era; however, Frankel (1999b) is of the opinion that the recommendation to avoid middle regimes in favor of a hard fix or free float is not appropriate because their rejection is no more than “a rejection of where most countries have been, with no reasonable expectation that the sanctuaries of monetary union or free-floating will, in fact, be any better.”<sup>294</sup> Kwan (2001) believes it is preferable “to improve the intermediate regimes with explicit exchange rate targets so as to make them less vulnerable to currency speculation.”<sup>295</sup>

The first question that must be asked is whether or not East Asia is ready for a common currency arrangement. Bayoumi, Eichengreen and Mauro (2000) assess the level of preparedness of Asia (ASEAN in particular) for monetary union by looking at trade patterns, economic shocks, factor mobility, and the monetary transmission mechanism. They determine that “in terms of the economic prerequisites for monetary integration, ASEAN is not in a significantly worse position than the EU was a few years prior to its signing the Maastricht Treaty.”<sup>296</sup> They emphasize, however, that ASEAN lacks the political commitment to put economic integration ahead of loss of sovereignty, which was instrumental in the EMU’s success. In their estimation this lack of commitment would make monetary integration very difficult for ASEAN to achieve in the foreseeable future.

In fact, most agree that monetary union is a long-term prospect for East Asia. However, there is an ongoing search for some type of common currency arrangement that would benefit the region in the short- to medium-term. The determination of a common currency regime for East Asia, however, is complicated by the heterogeneity of the region’s economic and financial characteristics. (Many of these were discussed earlier in this study.) The extent and importance of this diversity as it relates to monetary integration becomes evident in light of the IMF’s list of “Considerations in the Choice of Exchange Rate Regime” appearing in Table G.12 in the General Appendix. This list indicates the desired degree of exchange rate flexibility for particular economic characteristics. Depending upon which countries are to be included in an optimal currency area in East Asia, there is diversity among countries in potentially every area included in this list.

A number of studies have been carried out in the 1990s to assess East Asia’s status as an optimal currency area (OCA). Kawai and Takagi (2000) review the literature<sup>297</sup> on this topic and arrive at the conclusion that based on various economic criteria (such as those in Table G.12), “East Asia is no less ready for a regional monetary arrangement than Europe was before EMU.” They also acknowledge (due to the endogenous nature of OCA criteria), “the very act of forming a regional monetary arrangement will enhance the suitability of East Asia for such an arrangement.”<sup>298</sup>

There have been many efforts since the Asian crisis to define a common currency arrangement that would be suitable for the region. The proposed arrangements have tended to be in the form of intermediate regimes with a "common basket peg" being a prominent feature. The recommendations have been that countries in the region peg their currencies to a basket comprising the yen, dollar and euro, as these are the most reflective of East Asia's trade and investment activities.<sup>299</sup> Some proponents recommend that the weights in the basket be based on the respective country's trade shares with Japan, the U.S. and the EU, while others believe they should be based on an average of trade shares with these three countries.

The common basket peg is recommended because it is viewed as one that will provide exchange rate stability, which is generally believed to be essential for the promotion of trade, FDI and economic growth in the region,<sup>300</sup> and at the same time allows for some flexibility against the three major currencies (yen, dollar, and euro).<sup>301</sup> Including the yen in the basket, however, could be problematical if a currency union is the eventual goal. It would in effect treat the yen asymmetrically whereas the yen, yuan and won should be treated symmetrically as the yen becomes a non-special currency in the region.

One often discussed type of common basket peg is the basket-band-crawl or BBC.<sup>302</sup> A band would be placed around a parity (center of the band) that would be periodically adjusted in small steps so as to track the underlying fundamental equilibrium exchange rate (FEER). The parity would be defined in terms of a basket of currencies and would comprise trade-weighted currencies of a country's principal trading partners. This is chosen over a single currency for countries with diversified trade (no dominant trading partner) in that a basket would stabilize the effective exchange rate<sup>303</sup>. The band would be publicly announced and would function as a guide to the equilibrium rate for the market. Its function would be to stabilize market expectations, thus reducing the risks of volatility and misalignment. The exchange rate would fluctuate within the band, but the central bank would intervene at the edges of the band to keep the rate from moving outside the band.<sup>304</sup>

The band is recommended to be wide in order to (1) eliminate the need to defend a disequilibrium exchange rate, (2) allow adjustment of the parity, in line with fundamentals, without causing expectations of discrete changes that would be destabilizing, (3) allow for some monetary policy independence when a country's cycle is out of sync with the world norm, and (4) to help cope with strong temporary capital inflows. The crawl is part of the formula to neutralize differential inflation; however, the goal is to do this in such a way as to maintain competitiveness.<sup>305</sup>

Williamson (2001) believes it is rational to have an exchange rate policy rather than leaving rates to the market in order to prevent rates from moving too far from the rate that makes sense in terms of the fundamentals (i.e., the FEER). In his opinion, it is rational to seek continuous internal balance, but acceptable to secure external balance in the medium term. This is the exchange rate objective in the BBC regime. He suggests that the use of monetary policy, sterilized intervention, and capital controls are three options for preventing the exchange rate from becoming misaligned.

Williamson recommends weights of about one-third each on the dollar, the euro and the yen, which could be created as an Asian currency unit (ACU).<sup>306</sup> He foresees a market in the ACU being established and, once functioning, the ACU could be used as

the “common reference point” for all exchange rates in the region, whether they be pegged, managed or floating exchange rates. He notes several problems with this scheme. Some countries may consider an ACU peg too complicated to be credible, at least in comparison to a dollar peg. There could be resistance to disclosure of the contents of the basket and the parity, which he views as important. Also, agreement on reference rates for currencies that had been floating would require cooperation among partners, as these could not be unilateral decisions.

Kawai and Takagi (2000) consider a common currency basket as preferable to what they see as the “current de facto dollar peg policy” in that it would ensure exchange rate stability in the region. They agree that the common basket could serve as the reference anchor in conducting exchange rate policy but that each country could choose its own formal exchange rate arrangement. It would be a “pragmatic policy option for East Asia until greater political and institutional developments create an environment conducive to a more robust framework of monetary and exchange rate cooperation.”<sup>307</sup> In their opinion, more needs to be done to build institutions for surveillance and consultation, which could be comparable to the European Monetary Cooperative Fund (EMCF) and the European Monetary Institute (EMI), which were important in the monetary integration of Europe.

Despite the significant support for the common basket peg regime, it does have its detractors. De Brouwer (2002) does not dispute the importance of intraregional currency stability given that nearly half of East Asian countries’ trade is intraregional.<sup>308</sup> Nor does he disagree that Japan, the U.S. and the EU are important trading partners for countries within the region, which implies that pegging to a single currency would not bring stability to the effective exchange rate. Nonetheless, he argues several points against the common basket peg as a common currency arrangement for East Asia. Some of his arguments are as follows:

- a) He suggests that it might be more appropriate to use a country’s own trade weights rather than common trade weights because trade patterns vary significantly among countries within the region. He points to Cambodia, Lao PDR and Vietnam in particular as being “outliers” in that they trade more with other countries in the region than they do with the U.S., EU or Japan.<sup>309</sup> For this reason a basket based on common weights would be less stabilizing than one with each country’s own weights. Some countries could become less competitive against others depending upon which currencies in the basket move, and how they move.
- b) Using an export similarity index, he determines that the region’s export structure is increasingly similar to that of industrialized countries so that only the lesser developed countries in East Asia still have intraregional trade that is more similar than extraregional trade. In view of this finding, the common basket peg may not be appropriate for the region since it implies that stabilizing intraregional exchange rates is more important than stabilizing exchange rates with Japan, the U.S. and the EU.
- c) Switching to a common basket peg would mean, for most countries in the region, changing from a floating rate regime to which they have already become adapted.



- d) A common basket peg presumes that exchange rate volatility adversely affects trade and economic performance but he finds a lack of evidence for this in East Asia.
- e) Pegging forces changes in the real exchange rate through the price level rather than the nominal exchange rate, which in a situation of persistent inflation, is inefficient.

Wyplosz (2001a) sees the merit of a common basket peg in that it would stabilize exchange rates within the region as well as with major trading partners outside the region. He points out the disadvantage, however, that decisionmaking would be carried out by individual countries without institutional support. He suggests that the Chiang Mai Initiative (CMI) in association with common basket bands might serve the purpose as an EMS-type arrangement. However, he identifies two problems with this: (1) whereas support of the bilateral pegs of the ERM (exchange rate mechanism) of the EMS (European Monetary System) was automatic and unlimited, the CMI amounts are limited relative to what the markets could mobilize and (2) the dollar and euro would be included in the basket but are not part of the CMI arrangement eliminating the possibility of concerted intervention, which made the EMS arrangement so successful. Therefore, in his opinion, this combination would not stand up to a speculative attack. He also suggests the alternative of stabilizing bilateral rates and managing the common rate against the dollar and euro but notes that an institution would be needed to provide a coordinating mechanism in this case.

As an alternative to the common basket peg, Williamson (2001) suggests (and later dismisses) a system of mutual pegging among currencies in the region similar to the European snake<sup>310</sup> and ERM. However, he points to what he sees as obstacles to this alternative. In his view there is no economic power dominant enough to anchor the system and dismisses Japan in that role because of what he refers to as the “vagaries of the yen.” He also sees difficulties with Hong Kong switching from its currency board, and political issues for China and Taiwan relative to their bilateral exchange rate.

Wyplosz (2001a) believes that while there are many types of soft pegs, the differences among them are less important than the implementation of procedures to enforce and verify the arrangements. He emphasizes the importance of the support provided by adequate institutions if the adoption of a peg is part of a regional agreement.<sup>311</sup> Kawai and Akiyama (2000) emphasize the importance of coordinated action by East Asian countries in any attempted move to a new exchange rate arrangement where the relative weights are shifted away from the dollar toward the yen and euro. In their opinion, such a move would be difficult for a country on a unilateral basis if neighboring countries do not make a similar shift.

## Concluding Remarks

During the crisis, most East Asian countries switched from their “effective” dollar pegs to a floating rate regime (with some notable exceptions including Malaysia and Hong Kong). Although it is still disputed as to whether or not these countries have since returned to implicit dollar pegging, there is evidence of more volatility in Asian exchange rates after the crisis than there was before. While the two-corner solution of a hard fix on the one hand or a pure float on the other is recommended by some as the most

appropriate exchange regime for East Asian economies, most in the region favor some type of intermediate regime. A common basket peg has been widely discussed and has many supporters, particularly in Japan; however, there is sufficient disagreement with this suggestion in the region to allow for the consideration of alternatives in the area of monetary cooperation. Most agree that a currency union is a long-term proposition for East Asia, but there are possibilities short of this proposal that are feasible for Asia in the short- or medium-term. This paper's recommendations in this area are presented in Chapter VII.

## **Chapter VI – Conclusion: Observations on Integration**

We began this study of East Asian regional integration with a review of the region's economic history extending back hundreds of years. During that time Asia was the source of a wide variety of both primary and manufactured goods that were highly desired throughout the world. This was made possible by the region's richness in primary resources as well as its large and highly civilized population whose skills were technologically sophisticated for that time. As a result, Asia enjoyed a very high level of GDP and per capita income, which during some periods surpassed even that of Europe.

Historically, Asia played a central role in not only intraregional trade, but also in global trade. Its complex pattern of trade covered a wide area encompassing East, West, South and Southeast Asia as well as Europe, Africa and the Americas, throughout which a wide variety of goods were exchanged, facilitated by the use of precious metals as currency. The region weakened during the latter part of the millennium as the Industrial Revolution gained momentum in Europe and colonialism expanded in Asia. The negative effects of the latter event are still evident today as East Asia struggles to return to its past strength and prominence.

Two historical factors will have a significant impact on the way East Asia proceeds toward regional integration in the future. One is that Asia has been an open region fully involved in the world economic system and has played a central role in worldwide trade and the global division of labor. The second is that intraregional trade has a long history in the region and was very well developed in the past.

Another characteristic of equal importance in its effect on East Asia's progress toward integration is the diversity of its social, economic and political structures. East Asia is expansive in terms of territory and number of countries, extending over 15 million square kilometers and including as many as 15 nations with wide differences between the largest and the smallest. By comparison, the EU is compact (3 million Km<sup>2</sup> and 15 countries) and NAFTA is long and narrow (21 million Km<sup>2</sup> but with only 3 countries, of which two are of much larger size than the third.) In population (representing both a market and source of labor), East Asia is enormous encompassing nearly 2 billion people (again with wide differences between the largest and smallest countries) compared to about 400,000 each for the EU and NAFTA.

The countries of East Asia are much more heterogeneous than are the countries of the EU or NAFTA in terms of ethnicity, religion, culture, and political systems, both within the individual countries themselves and between countries of the region. There is also considerable diversity among East Asian countries in economic and financial development with Japan at the high end as a developed country and the newer ASEAN members at a lesser-developed stage. While the EU also has some economic diversity (e.g., Germany and Greece) and differences will undoubtedly increase as the EU enlarges, the gap is much narrower than that between, for example, Japan or Singapore and Vietnam.

Differences exist not only in GDP but also in industrial development as well. Japan, of course, is highly industrialized, and Singapore and Taiwan are leaders in high-tech industries, but Vietnam, Cambodia and Lao PDR export primarily low-tech products. Also, the financial markets of Singapore, Hong Kong and Japan are very

advanced whereas those of the newer ASEAN members are virtually undeveloped. These differences have significant implications for both trade and monetary integration.

In view of this heterogeneity, we examined the characteristics of various regional groupings (e.g., ASEAN and APEC) in an effort to determine if one or another of these institutions brings greater benefit to the region and the economies therein. It can be argued that a group comprising developmentally similar economies would be a more workable arrangement in which smaller members would have more influence, but there is a slightly more compelling argument in favor of agreements between industrial and developing economies in that they can bring significant benefits to the developing partners.

Regional institutions have been slow to develop in East Asia in part because that was never a defined goal of regional cooperation in the region. This, however, is beginning to change. As cooperation among the nations of the region becomes a higher priority, attention is increasingly directed toward the formation of more dynamic, effective regional institutions having greater capability for the promotion of trade, investment, finance and security in the region. These efforts have been complicated by the region's diversity, historical political tensions between certain countries, the desire to protect national interests and specific industries, and the region's already established openness in trade and FDI including its long-standing relationships with the U.S. and the EU. The result has been the formation of a variety of regional groups encompassing a wide range of member nations.

The most prominent among these are ASEAN (and its extension ASEAN-Plus-Three) and APEC. The defining characteristic of ASEAN is its so-called "ASEAN Way," which emphasizes consensus, non-intervention and minimal institutionalization. As opposed to using treaties and binding obligations, ASEAN prefers non-binding plans and guidelines. Its secretariat has few powers and limited authority and is thus characterized as a "soft" secretariat. National interests, therefore, tend to take precedence. These characteristics make regional decisionmaking difficult and slow. The ASEAN way is often contrasted with the more formal and legalistic "Brussels way". "Institution building" has been identified as the second ingredient (after pragmatism) of Europe's successful integration progress.<sup>312</sup> Unlike the EU, however, ASEAN has been unwilling to move in the direction of establishing a supranational body and has instead maintained its commitment to preserving national sovereignty.<sup>313</sup> Whereas the EU is structured and treaty-based, ASEAN is flexible and ambiguous.

APEC is primarily recognized for its policy of "open regionalism" or "concerted voluntarism" of which the goal is the pursuit of free and open trade and investment and a commitment to nondiscrimination toward nonmembers. This is contrary to the concept of preferential treatment and discrimination against nonmembers, which is characteristic of regionalism in the EU and NAFTA.<sup>314</sup> There is some question, however, whether "open regionalism" will continue to characterize regional cooperation in East Asia, particularly in light of the increasing number of FTAs now being proposed and formulated there.

Both ASEAN and APEC are viewed by many as weak and ineffective institutions and are often criticized for the vague and noncommittal outcomes of their frequent meetings. There is also the issue of membership. ASEAN is viewed as too small and not fully representative of the entire region as certain major players (Japan, China and Korea,

as well as Hong Kong and Taiwan) are not included. On the other hand, APEC is not considered to be a "true" regional grouping because of the inclusion of countries on the other side of the Pacific.

A third group that seems to hold more promise is ASEAN-Plus-Three which is more representative of the region in terms of its membership, although it also does not include Hong Kong and Taiwan. However, it is not an official or fully functioning regional institution but operates on the sidelines of ASEAN. Furthermore, its focus until recently has been primarily on the financial/monetary aspects of cooperation, with its Chiang Mai Initiative, to the exclusion of trade and investment. The focus of this group, however, seems to be changing now with progress being made in the formulation of the ASEAN-China FTA and the interest this has sparked in the other two Plus-Three countries of South Korea and Japan.

The liberalization of trade and FDI in East Asia has contributed significantly to the region's at times phenomenal economic growth and development over the last two decades. Our analysis reveals the continued multilateral nature of East Asia's trade and FDI and the importance of its extraregional relationships. At the same time, there is a very significant intraregional component with some recent shifts in trading and investment patterns both from outside to inside the region and within the region itself. One example of this is the apparent shift in investment away from Southeast Asia (ASEAN) to the North (China) in search of lower costs, among other things.

In light of East Asia's rising interest in pursuing regional solutions to common problems and the importance of policy coordination in the promotion of trade and FDI, we propose two approaches that combine these two elements: (1) the formulation of regional agreements and (2) the creation of regional production networks. In the case of the former, agreements should encompass aspects of both trade and FDI with an appreciation of their interactive characteristics. Additionally, including both developed and developing countries as partners in the agreement has been shown to bring greater benefits. While larger groupings may be more welfare enhancing, a bilateral approach could be an initial step to a broader multilateral arrangement.

The second approach, the creation of regional production networks, is a step beyond, and a possible extension of, regional agreements. East Asia has the potential to build such networks on the foundation established by Japanese TNCs in the post-war period. TNCs in East Asia, although not as numerous or as large as those of developed countries, demonstrate an increasing level of transnationality and have risen to the top among developing country TNCs in this respect. The TNCs of the Asian NIEs have already demonstrated their potential in this respect, and China's enterprises are likely to catch up quickly. Regional production networks are appealing in that they satisfy the desire for regional solutions and yet are not entirely self-contained as they are non-discriminatory, thus allowing countries outside the region to invest in, and trade with, countries of the region, and vice versa. This approach would require a longer timeframe to implement than would the regional-agreement approach, but it would be broader in context and could involve the entire region as opposed to only a few countries. Through these two approaches East Asia could attain the ultimate goal of participating fully in the global production network.

Prior to the 1997-98 crisis, regional integration efforts on the economic side in East Asia tended to focus on trade and direct investment. The crisis aroused an

awareness of the need for financial cooperation in the region to prevent another such occurrence. Although a number of proposals for such cooperation were made at the time, the Chiang Mai Initiative (CMI) of bilateral swap arrangements has made the most progress with six BSAs signed and eight under negotiation. Although many complain that the CMI amounts are too small to be effective in a major crisis, the process itself is important in its coordinating and cooperative effect on the economies of the region. At the same time, it is not exclusively regional in that it includes a global element through its link with IMF conditionality.

The crisis also brought calls for financial sector restructuring and reform but efforts so far have been carried out primarily at the national level. Many observers, however, believe that a coordinated effort at the national, regional and international levels is necessary because of the regional and global nature of recent crises.

Discussions have focused on the best way to develop the region's financial sector to a level of soundness and stability that would not only reduce the chances of another crisis but also promote economic growth in the region. Many believe a move away from a bank-based system to a market-based system is desirable. We have presented two approaches currently under discussion for the achievement of this goal. One focuses on changing financial structure so as to move away from the currently dominant bank-based system to a more market-based system, and the second focuses on reforming the regulatory, legal and macroeconomic environment, which should lead naturally to a move away from a bank-based to a market-based system. The ultimate outcomes of these two approaches are the same (i.e., a market-based system), but they are reached from different directions.

Still, there are those who are of the opinion that a bank-based system is appropriate for some economies under certain circumstances and others who believe that developing capital markets is not the answer for East Asia. Some also expect that bank-based systems will remain prominent in East Asia even with the eventual development of capital markets. In any event, strengthening the banking system is essential. It is not clear, however, whether this should be undertaken at the national, regional or international level, or possibly at all three levels.

Another topic of debate that came out of the crisis is capital account liberalization which, while desirable in the long run, is associated with considerable risk, particularly if macroeconomic policies are not sound and financial supervision and regulation is weak. While the issue of capital controls has been controversial, a "sequencing" or "compatible opening" approach may be desirable for most emerging economies.

In the area of monetary integration, a currency union, although possibly desirable for East Asia, would not really be feasible in the region for decades. In the interim, many favor an intermediate currency regime that could be some type of adjustable peg or band, with a basket peg (including the yen, euro and dollar) being the most often mentioned. Some believe this to be appropriate for the region because of its trade and investment patterns. Others, however, disagree, citing significant variation in trade patterns between some countries in the region that can disadvantage them relative to other countries when the yen or euro fluctuates against the dollar. Other possibilities for monetary cooperation exist, including the recommendation of this paper which is for some type of foreign exchange policy coordination that would lead eventually to monetary integration. This is discussed in Chapter VII.

This study has raised a number of issues for the regional integration process in East Asia. In contrast to Europe and North America, East Asian countries have a tendency to change politically and economically, sometimes quite dramatically. For example, China until recently had been closed but is now opening up with the potential for remarkable consequences, both negative and positive depending upon how this is dealt with in the region. Also, Japan's economy rose to a high level after World War II but in the last ten years has faltered and shows little sign of near-term recovery. This has jeopardized the country's position and influence in the region. The ASEAN-5 countries experienced astronomical growth in the 1980s and early 1990s, then suffered a nearly complete turnaround in 1997-98 as a result of the crisis and will probably never return to those heights again. Also before the crisis, Indonesia played a leadership role in regional integration, but since then has been struggling simply to survive and has not been able to resume this role.

These examples evidence the potential for great change in East Asia and provide some understanding of the trial and error nature of regional integration in the region. In fact, it is often implied that the process of European integration is a well-thought-out strategy; however, it is rather characterized, in the words of Charles Wyplosz, as a "process of muddling-through, two steps forward and one step backward, with deep and lingering divergences as to what the end objective is."<sup>315</sup> In this respect, Asia's own non-strategic, somewhat sporadic progression towards integration is not dissimilar from that of the EU. However, the EU's well-developed institutions have assumed the role of transforming projects into reality when opportunities are presented.<sup>316</sup> There is little evidence that East Asia's institutions are capable of doing the same.

It could be said the motivation for regional cooperation was similar, yet different, for ASEAN and the EU. Politics played the primary role in both cases. In Europe's case, economic interdependence was thought to be the most effective force for promoting the political cooperation that was considered to be highly desirable in the region in the post-war period. This was the case in the formation of the European Coal and Steel Community and the EEC. In ASEAN's case, political cooperation was also the motivating factor with economic cooperation following from there. Thus, politics played the main role in both regions but the approach was from different directions.<sup>317</sup>

In fact, there have been various motivators for East Asian integration. As just mentioned, the initial motivation for ASEAN's formation in the 1960s was political. Then in the early 1990s, progress in European and North American integration acted as a catalyst for Asia's emphasis on economic integration with the formation of AFTA and APEC's Bogor Declaration. The financial crisis of 1997-98 was the motivation in the latter half of the 1990s, this time in the area of financial cooperation. At the same time, Japan's economic situation has been an indirect motivating factor as it has affected the country's patterns of trade, investment and ODA in the region. The uncertainty surrounding its economy makes it difficult to predict what will be Japan's future role in East Asia. There is now a new motivating factor for cooperation emerging – and that is the opening up of China. As China seeks cooperation with its neighbors in the region, this will decrease suspicion and distrust and could lead to even higher levels of integration in all areas – political, economic and financial/monetary.

East Asia's institutions are often criticized for being "talk shops". While institutional effectiveness is certainly desirable, the importance of dialogue and

discussion should not be underestimated. This is particularly true given the social and cultural environment in Asia where the emphasis is on consensus and noninterference. Furthermore, bringing China into the dialogue is essential.

The general consensus is that regional integration in East Asia will not (and in many respects, should not) proceed in the same way as has integration in Europe or North America. That is not to say East Asian countries will never achieve a high level of integration, but they will undoubtedly follow a different path to get there, and the end result will most likely be different as well. In the final chapter we look ahead to the future to see where this path might lead.



## Chapter VII - Looking Ahead

There seems to be little doubt that Asia was the center of the world economy in the pre-modern and early modern eras. Unlike Britain after the Industrial Revolution or the United States after World War II, Asian countries, including India, China and some Islamic empires, had not been hegemonic but had been dominant both in size and influence. These Asian empires engaged in complex patterns of global trade involving many routes. Their activities, however, were largely commercial and trade-centered and did not involve much direct investment, as was the case for Britain. Global, as well as intraregional, trade had thrived for centuries until the period of colonization by the West.

As Asia regained independence and started to engage in global economic activities after World War II, the historical legacy of centuries of global trading were quite important in that both hard and soft infrastructures, such as ports and a merchant class, were well developed. Indeed, Asia, particularly East Asia, had benefited significantly from a legacy of openness in trade. Its trade and economic transactions are broadly spread over all the regions of the world, much more so than those of Europe and the U.S. Given the level of development, Asia, particularly East Asia, is also quite open in trade, FDI and finance. Its dynamism during most of the past decades has been the result of this openness and the global nature of the region. East Asia has functioned as a major manufacturing base for the globalized world economy. As such, East Asian economies have had a very high export-GDP ratio, some of them even exceeding 100 percent.

Reflecting the open and global nature of trade and other economic transactions, regional economic cooperation has been relatively weak in East Asia. ASEAN started as a political organization and still espouses the "ASEAN way", emphasizing consensus, non-intervention and minimal institutions. APEC's "open regionalism" is patterned after ASEAN's "concerted voluntarism" and has served to supplement global liberalization rounds by WTO-GATT very effectively.

It might be reasonable to say that Asian regional organizations have not been regional in the true sense of the word but have been quite different from genuine regional organizations like the European Union and NAFTA. Given the open and global nature of the Asian region and given the enormous diversity that exists among the countries of the region, this has been somewhat natural and has served the region well. Asia has been the greatest beneficiary of global liberalization in trade and FDI, and an organization like APEC has served the region well by effectively supporting global liberalization. So far so good, and if we believe that global capitalism continues to evolve smoothly as in the past, one would support "open regionalism", or the lack of genuine regional organizations. Many economists trained in the neoclassical tradition support such propositions and conclude that APEC or the WTO is the organization that should be supported by Asian countries and that the formation of genuine regional organizations should be avoided. If their assumption of perfect competition is satisfied or if global institutions exist to rectify imperfections in the global market, their position is not unreasonable.

However, the reality of the globalized world is far from ideal. There is no global lender of last resort; neither do we have a global supervisory agency nor a global anti-

trust agency. Referring to the lack of a global lender of last resort, Mervyn King (1999) argued the two “purist” solutions to the problem; namely, the creation of a global lender of last resort and reinstatement of permanent capital controls are neither feasible nor desirable under the current international political regime. The middle way, or muddling through, is the only politically feasible solution and King refers to the creation of a “do-it-yourself” lender of last resort including establishing a regional lender of last resort as one of the middle-way solutions.

The East Asian crisis of 1997-98 has given rise to the recognition of the imperfections, or lack of governance, of globalized markets. The Asian miracle, to a significant degree a result of the open and global nature of this region, suddenly turned into the Asian crisis. Not only global institutions like the IMF and the World Bank, but also regional institutions like ASEAN and APEC, were unable to perform any useful function to stop the contagion of the crisis. Also, initial prescriptions by the IMF may have aggravated the crisis rather than stopping it. It is not only the policy recommendations made during the crisis, but also those made before the crisis, that need to be reexamined. The strong pressure to deregulate, particularly in international finance, without comparable strengthening of financial supervision had exposed many countries in the region to a degree of risk unmanageable by national governments. International organizations could not substitute for national governments in managing these new market risks. What is necessary is not to substitute market for government but to redefine the role of government in view of the rapidly changing international environment. Joseph Stiglitz<sup>318</sup> correctly points out what needs to be done in the future as follows:

“Just as before they were misled by the chimera of deregulation – they should have asked instead what is the *right* regulatory structure for their current situation – so too in the future, they will have to resist accepting without question the current mantras of the global marketplace of ideas. There will have to be *strengthened* regulation of securities markets and an improved overall legal environment, especially in areas such as corporate governance and bankruptcy. The legal structures will have to comport with international standards, yet be adapted to their own special situations; wholesale borrowing will not work.”

Policy efforts have to be largely national. However, the question here, in relation to regional cooperation, is whether genuine regional institutions like the EU would help national governments to accelerate their efforts in the right direction. Or should we leave these matters to international organizations such as the IMF and the WTO.

We endorse the establishment of a genuine regional institution in Asia, or at least in East Asia, on several grounds. First, existing global institutions are strongly biased toward market fundamentalism or the neoclassical paradigm, and their past records in international capital and finance are very poor. The establishment of a genuine regional institution could provide a countervailing force and would contribute to reforming international institutions. Indeed, global institutions are necessary, but healthy competition among global and regional institutions would help improve their performance.

Second, international institutions, politically dominated by Western countries and staffed largely by Western economists, often lack sufficient knowledge of regional values, culture and history and tend to impose their own views or try to “Westernize” the

country in question. Indeed, international standards need to be adhered to but standards should reflect existing cultural and institutional diversity. Regional organizations can supplement global ones effectively in such areas.

Third, as in the case of the EU, necessary structural reforms such as the ones mentioned by Stiglitz, can be more smoothly and willingly implemented if such reforms are deemed essential for regional integration. There has been increasing resistance to externally imposed reforms. Regional cooperation or integration (even slow integration) is a more effective way to internalize these reforms.

Fourth, the lack of global governance, such as the lack of a global lender of last resort or global financial regulation, is expected to continue for the foreseeable future. Rather than completely relying on national governance, there seems to be some room for regional governance. In a region like Asia where the diversity is enormous, regional governance is more difficult than in Europe, for example. However, more flexible and softer cooperation could be developed.

Fifth, regional integration has been proceeding quickly in Europe and, to a lesser degree, in the Americas although there are recent signs of increasing acceleration there as well. Is it politically feasible or desirable for Asia to be as open and global as in the past? Might not Asia be victimized by these two predatory empires in the future, as it was in the 19<sup>th</sup> and 20<sup>th</sup> centuries? This is a rather defensive position but has been a major driving force for the recent moves toward more regional cooperation.

If we are to establish a genuine regional organization, what kind of organization should it be and what kind of regional cooperation should be its focus? One obvious question that needs to be answered in the context of regional cooperation is what new type of division of labor is possible with the rapid emergence of China as a manufacturing giant in the region? The division of labor that has existed in East Asia, namely the “flying geese formation” led by Japan and the NIES, needs to adapt to this new environment. In fact, it is currently under rapid transformation and will eventually evolve into one that includes China as the key player. The precise characteristics of this new division of labor are not yet certain but one thing is clear – China cannot be dominant in every single manufacturing sector that currently exists in the rest of Asia. Strategic concentration in key areas of technological or other areas of advantage for a country should allow it to coexist with China and the rest of Asia. Japan, for one, can climb higher on the technology ladder, developing its own technological skill base while using China as its key manufacturing base. ASEAN countries could specialize in areas of manufacturing where they possess a skill advantage.

In many countries industrial reorganization could become necessary and involve a potentially large number of mergers and acquisitions. If an FTA between China and ASEAN, or among the members of ASEAN-Plus-Three (APT), were to be concluded and monitored by a genuine regional institution, Asia-wide industrial reorganization would become a major policy initiative for the region. Although the process would, and should, be essentially market driven, institutional involvement would be desirable since policy coordination among the countries involved would be a key element of success.

Regional trade agreements (RTAs) within APT, nevertheless, can proceed simultaneously with the Doha process. Positive feedback and sound competition between the two processes should accelerate liberalization, thus benefiting all countries concerned. By pursuing RTAs, Asian countries can gain a bargaining position vis-à-vis the U.S. and

Europe to channel WTO discussions in their favor. There has been criticism, particularly among developing countries, that the WTO process has benefited only developed countries, the U.S. above all. A two-track strategy (RTAs and WTO) would give leverage to Asian developing countries to counterbalance this bias.

China and the ASEAN countries have recently agreed to form an FTA by 2010, with some allowance for preferential treatment for less developed ASEAN countries. Korea and Japan could potentially join this arrangement to make it an APT FTA agreement. Given the diverse nature of the participating countries, the FTA should have initially some preferential treatment and exceptions for the less developed countries, but in general the FTA will accelerate integration, eventually eliminating preferences and exceptions. A pragmatic, rather than a purist, approach is required here. Parallel and reciprocal FDI agreements should proceed simultaneously with trade liberalization.

In the area of international finance, various ideas concerning regional monetary and financial cooperation have emerged since the financial crisis of 1997-98. The crisis, it has been generally agreed, was capital-account driven, rather than current-account driven as were many crises in the past. Furthermore, a dual mismatch in currencies and maturities was one of the major causes of the crisis. Thus, it is only natural that discussions and suggestions for crisis prevention are focused on the areas of exchange rate regime and financial market regulation.

Reviewing these recent developments, Eichengreen (2001) argues, "Cooperation to stabilize exchange rates would be a diversion at best and a costly mistake at worst." He believes "cooperation in strengthening banking systems and promoting the development of bond markets, on the other hand, would go a long way toward creating a zone of economic and financial stability."<sup>319</sup> These are the grounds upon which he advocates the creation of an "Asian Financial Institute" on the platform of ASEAN-Plus-Three.

We think quite the opposite is the case for the following reasons. First, given the major differences in the stage of development of financial markets among APT countries, say between Japan and Laos, it is not at all realistic to come up with common guidelines for the prudential supervision of banking systems or capital markets. Second, as he himself admits, whether regional standards for prudential financial supervision apart from global standards are necessary or not is quite doubtful. Each country can have its own policy adhering to global prudential rule depending upon its stage of development or its politico-economic system. However, there is no "Asian" or cultural commonality in financial regulation around which to form regional standards as such. As has often been pointed out, Asia is very diverse culturally, racially or ethnically. While there is some common ground for the formation of a standard apart from the global standard, diversity should be respected over and above any monolithic adherence to a uniform standard.

In contrast to cooperation in prudential financial supervision, exchange rate cooperation or cooperation on forex/capital account policies can be effective among countries of different developmental states. Just as less advanced countries in Central and East Europe peg their rates to the Euro, late starters in ASEAN could fix their rates to the currencies of advanced countries possibly with some capital controls. Also, variations in the micro or structural aspects of financial systems can be maintained in exchange rate cooperation as long as some coordination in macro policies is possible. This distinction between macro and micro, or macro and structure, is very important if

diversity is to be respected. Countries could coordinate exchange rate or monetary policies while maintaining different political and economic systems.

The issue then is what kind of forex cooperation is possible among Asian countries? Eichengreen (2001) reviews various types of foreign exchange regimes including an EMS-type snake, a currency-board-type peg to the dollar, the yen or a dollar-yen-euro basket, and a monetary union. However, he concludes that monetary cooperation is either infeasible or premature. True, its ultimate success is a long shot as it is in the case of FTAs. Difficulties in creating a currency union are at least as great as those in forming FTAs. It is also true there is a strong fear of floating among Asian countries, including Korea<sup>320</sup>, and the extent of currency management has not been insignificant. Furthermore, Chinese- and Malaysian-type partial capital controls can be implemented in countries where the IMF does not have a dominant role.

Indeed, cooperation needs to be pursued in a gradual and orderly manner but setting the target of currency union, along with FTAs, in the distant future, say ten years from now, is not inconsistent with gradualism. A common currency peg as advocated by Kawai and Takagi (2000) or Williamson (1999, 2000, 2001) may be a step toward currency union but inclusion of the yen in a basket is a problem if an eventual move to currency union is desired. The formal adoption of a common currency peg with appropriate weights is difficult enough politically. The more ambitious long-term goal of forming a currency union along with FTAs would seem more likely to be successful if it were combined with a pragmatic and feasible forex coordination policy in the short term.

Given the widespread fear of floating in Asia, it seems appropriate to coordinate the management of floating rates among authorities. In other words, interventions in forex markets by authorities and the asset allocation of foreign reserves can be coordinated to avoid mutually inconsistent actions. Specific bands need not be agreed upon but authorities can consult with one another and coordinate their policies, if necessary, to stabilize intraregional exchange rates. Countries like Korea, China, Japan and the advanced ASEAN countries can regularly meet and constantly communicate with one another to exchange respective views on forex developments and to try to stabilize their intraregional exchange rates by coordinating macro and intervention policies. There is no need to have formal agreements but an APT version of G7, so to speak, on macro and forex policies alone would contribute a lot to stabilization.

Eventually, forex cooperation should develop into the formation of an Asian currency unit (ACU) with a flexible snake around the central value, as in the case of the ECU and the snake. That is, the joint floating of Asian currencies vis-à-vis the U.S. dollar and euro with a relatively wide band around the central rate. Although the creation of a common currency à la the euro may not be feasible even in the long run, a soft and flexible form of currency union with an ACU could be a long-term possibility. It would enhance and accelerate integration through trade and FDI, and vice versa.

Speculative attacks are realistic possibilities, but with a wide and flexible band Asian countries should be able to fend off such speculation using their huge amount of combined foreign reserves if effective coordination of macro policies accompanies joint foreign exchange interventions. The need to jointly defend an ACU with a wide band logically leads to the idea of extending the Chiang Mai Initiative to an Asian Monetary Fund (AMF), which would pool a portion of the foreign reserves of the participating countries and conduct macroeconomic surveillance. Participating countries could

conduct joint intervention and coordination of macro policies with the AMF as the secretariat. Articles of the AMF could provide the modality and modus operandi of coordination and intervention.

In conclusion, let us emphasize that the concrete proposal outlined here is just one example, and the process of forming a genuine regional organization should be gradual and pragmatic. As in the case of Chinese national policy, structural reform needs to proceed simultaneously with opening or liberalization. The moves also need to be gradual and simultaneous on all fronts.

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<sup>1</sup> In several UNCTAD reports, including the *World Investment Report* series; the WTO's Working Group on the Relationship between Trade and Investment, which can be found at <[http://www.wto.org/wto/english/tratop\\_e/invest\\_e/invest\\_e.htm](http://www.wto.org/wto/english/tratop_e/invest_e/invest_e.htm)>; and OECD (2002). Smaller studies include Urata (2001), Markusen and Venables (1998), Hanson (2001), Goldberg and Klein (1997), Brainard (1997), Feenstra and Hanson (1996), Kleinert (2000), and Fukasaku and Kimura (2002); among others. Some of these are reviewed in OECD (2002).

<sup>2</sup> Japan represents a good case of how outward FDI can change the structure of both exports and imports of both host and home countries through international production. Over the course of about ten years (through 1999), "reverse imports" (imports from Japan's affiliates abroad) as a share of total imports have risen from 4 percent to 15 percent and these are increasing faster than the exports of parent firms. Also, the composition of Japan's imports is changing such that the share of machinery and equipment imports, mostly electrical and electronics machinery, has risen from 17 percent to 31 percent over the same time period. (UNCTAD (2002c: 46.)

<sup>3</sup> UNCTAD (1996c: Chapter III), UNCTAD (2001: 58), and UNCTAD (1999a: Section II).

<sup>4</sup> UNCTAD (1996c: xxiv)

<sup>5</sup> UNCTAD (2002c: xv)

<sup>6</sup> This is also referred to as fragmentation. See Arndt and Kierzkowski (2001) for discussion of this topic.

<sup>7</sup> UNCTAD (1996c: Chapter IV) and UNCTAD (2002c: Chapter V)

<sup>8</sup> UNCTAD (2002c: Chapter VI)

<sup>9</sup> UNCTAD (2002c: xx-xxi) and UNCTAD (1999a: 18)

<sup>10</sup> See UNCTAD (2002c: 152-153) for further discussion of these and other possible negative consequences of FDI.

<sup>11</sup> UNCTAD (2002c: 4) During 1971-2000, the correlation between the FDI and GDP growth rates was 0.3. Similarly, a simple regression of FDI inflows against GDP during the same period is as follows: FDI inflows = -190.9 + 0.0251 (GDP).  $R^2 = 0.75$ , adjusted  $R^2 = 0.55$ , t-value of GDP coefficients = 6.0. (UNCTAD (2002c: 22).

<sup>12</sup> This refers to 16 recent empirical studies that examined the effect of FDI on growth of income and productivity and that are reviewed and discussed in OECD (2002: Chapter III). This literature review focuses primarily on four questions: "[. . .] 1) Does FDI significantly affect the rate of growth of income or productivity? 2) Does FDI 'crowd out' or 'crowd in' domestic investment? 3) Do technology and knowledge spillovers take place in the domestic economy? and 4) Are there any necessary preconditions (e.g., human capital, technological or financial market development) for these positive effects to materialise?" (66) The studies covered, the specific questions addressed by each, their estimation techniques and major findings are presented in Table III.1. on pages 70-74 of the OECD's report.

<sup>13</sup> See Urata (2001) for more on this point.

<sup>14</sup> OECD (2002: 68)

<sup>15</sup> OECD (2002: 27-32)

<sup>16</sup> UNCTAD (1996c: 73)

<sup>17</sup> Export-processing zones (EPZs) constitute one example of consistent trade and FDI policies at the national level. [EPZs include "free-trade zones, duty-free zones, free-investment zones, [and] offshore zones [. . .]."] Activities performed in EPZs include "bonded warehousing, export processing, assembling, border or port trade and financial services. However, despite these variations, export-oriented manufacturing has been the main focus of most zones." UNCTAD (2002c: 214).

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<sup>18</sup> OECD (2002: 35)

<sup>19</sup> Data source is IMF's Direction of Trade Statistics. Taiwan not included.

<sup>20</sup> Table numbers beginning with "S" are located in the Statistical Appendix; those beginning with "G" are in the General Appendix.

<sup>21</sup> Includes the ASEAN countries plus China, Japan and South Korea.

<sup>22</sup> These three were selected because: (1) ASEAN is the most prominent official all-East-Asian group, (2) Japan is the only developed country in the region and has played a major role in trade in the region for the last two decades, and (3) China has recently entered the WTO and has experienced the most rapid growth in the region in recent years.

<sup>23</sup> Some caution, however, is advised in interpreting this data to mean that ASEAN is trading more intraregionally than externally with the U.S. and the EU. Given the shortcomings of the trade share measure, we will reserve judgment on this until after a look at the trade intensity index.

<sup>24</sup> Petri (1993) refers to these two measures as the "absolute" and "relative" measures, respectively, of regional interdependence. Frankel (1997: Chapter 2) also discusses these measures.

<sup>25</sup> The one exception (among the years included in the table) was in 1996 when "All East Asia's" share surpassed that of NAFTA, reflecting the rapid growth period in the region at that time.

<sup>26</sup> Since data has been calculated back to 1970 on the basis of current group membership, these increases would not reflect the actual addition of members.

<sup>27</sup> This is clearly reflected in Tables 3 and 4 where APEC with its 21 members and large-volume traders, such as Hong Kong, Singapore, Japan and the U.S., has a larger share in both world and its own trade than does NAFTA, which includes only three members of which one is the U.S., or ASEAN with 10 relatively small traders.

<sup>28</sup> For example, referring back to Table 2, Hong Kong's trade with ASEAN is only 8 percent of its total trade (average for 1998 to 2000) but its trade with APEC is over 82 percent, which does not necessarily mean that it trades more intensively with the countries of APEC than with the countries of ASEAN but rather that there are more and larger trading countries in the APEC group than there are in ASEAN. [See Frankel (1997) for further discussion of this topic.]

<sup>29</sup> See Drysdale and Garnaut (1993) for even more in-depth analysis of trade using other indices including the complementarity and bias indices.

<sup>30</sup> This is done by adjusting the trade shares of a country/group through some measure of that country's/group's importance in world trade. More specifically, it is the "ratio of the share of a country's exports with another country to the share of that other country in world imports. A number greater than one indicates that a country exports to another country at a greater level than the other is importing from the rest of the world, and a more 'intense' bilateral trading relationship." (DeBrouwer 2002: 290 and 292) There are a number of variations of this index including the "double-relative" measure of Petri (1993) and the "corrected concentration ratio" of Frankel (1997). The ratio used here is that presented in Drysdale and Garnaut (1993), Anderson and Norheim (1993), and DeBrouwer (2002). There are others who have also used similar versions of the index; e.g., Yamazawa, Hirata, and Yokota (1991), Goto and Hamada (1994), and Goto and Kawai (2001). Rajan and Sen (2002) also calculate this ratio for imports, in addition to exports.

<sup>31</sup> The same formula was used to calculate the index in both tables but there may be slight differences in raw data used in the calculations as they were drawn from somewhat different sources. The results, however, are largely comparable.

<sup>32</sup> For example, China's index with Japan in 1995-97 was 2.8 and this remained unchanged in 1998-2000; however, Japan was in second position as a partner for China in the earlier period but in third position in the latter period.

<sup>33</sup> That analysis showed that from 1990 (from at least 1980 in the case of exports) to the end of the decade ASEAN's trade with Japan as a share of ASEAN's total trade had declined. (See Figure 1.)

<sup>34</sup> Excluding Myanmar and Brunei, which were not included in the 1995-97 study.

<sup>35</sup> These findings are generally confirmed by other studies, some covering different timeframes. For example, see Frankel (1997: 29) and Goto and Kawai (2001: 7). Urata (2002) concurs based on his analysis of the "absolute", "relative", and "double-relative" (which is calculated differently than the intensity index used in this paper but is still comparable) measures.

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<sup>36</sup> Exports to the EU are actually less than might be expected based the EU's imports from the rest of the world (i.e., trade intensity index is less than 1.0).

<sup>37</sup> UNCTAD (2002c: 55)

<sup>38</sup> Not including the category of "Others" which comprises fairly large investments from unspecified countries and unclassified sources, the latter of which is the banking sector. Although not specified, it may be related to investment in the banking sector of Thailand in the post-crisis period.

<sup>39</sup> ASEM is an informal process of dialogue and cooperation bringing together the 15 EU member states and the European Commission with ten Asian countries (Brunei Darussalam, China, Indonesia, Japan South Korea, Malaysia, the Philippines, Singapore, Thailand and Vietnam). IPAP's aim is to contribute to an enhancement of two-way investment flows between Asia and Europe by sharing experience and best practices on investment promotion and policy issues.

<sup>40</sup> There were also disinvestments in Indonesia in previous years beginning in 1997 (during the crisis) when the U.S. was the only major investor to withdraw. Other source countries withdrew investment beginning in 1998, except the EU which began in 1999. The U.S. invested again in 1999, but disinvested in 2000.

<sup>41</sup> See Urata (2001: 430-31) on this point.

<sup>42</sup> The inclusion of the Virgin Islands and Bermuda among the top three originating countries for China and Hong Kong is related to their practice of "round tripping" and "tax haven routing" whereby capital inflows and outflows in the form of FDI move via tax haven economies into and out of Hong Kong. These economies account for large levels of inflows and outflows of Hong Kong-related FDI. Although more than half of Hong Kong's outward FDI goes to offshore financial centers (e.g., the Virgin Islands and the Cayman Islands), these funds actually are destined to eventually go elsewhere, including to mainland China.

<sup>43</sup> Brunei Darussalam, Indonesia, Malaysia, the Philippines, and Thailand.

<sup>44</sup> UNCTAD (2002c: 37)

<sup>45</sup> Indonesia, Malaysia, the Philippines, and Thailand.

<sup>46</sup> UNCTAD (2002c: Box III.2., 44)

<sup>47</sup> JBIC (2002). The survey was conducted in July 2001 and covered 792 manufacturing companies that have three or more foreign affiliates, including at least one manufacturing base as of October 2000. There were 501 valid responses for an effective response rate of 63.3 percent.

<sup>48</sup> UNCTAD 2002c: Box III.2., 44)

<sup>49</sup> Lardy (2002: 135-136)

<sup>50</sup> The possibility for increased Japanese investment in China is further supported by a survey conducted by Japan External Trade Organization (JETRO) in October 2001 which revealed that 21 percent of respondents (based on 645 responses among the 720 Japanese TNCs surveyed) indicated plans to relocate production sites to China with 67.5 percent of these likely to be moved from Japan, 9 percent from Hong Kong, 7.8 percent from ASEAN-5, 6.6 percent from Taiwan, and 1.2 percent from South Korea. In the same survey, respondents indicated that most aspects of the investment climate in Malaysia and Thailand were better than in China with concerns about China's investment climate centered on its establishment rules, transparency of investment rules and its tax system. However, respondents felt that market growth, production costs and labor supply were better in China. (UNCTAD (2002c: Box III.2., 45).

<sup>51</sup> ASEAN (2000: 6)

<sup>52</sup> See B. Low (2002) and Eckholm and Kahn (2002).

<sup>53</sup> In 1992, 38 percent of Malaysia's total FDI stock was concentrated in the electrical and electronic equipment sector. The percentage of fixed assets in this industry that were foreign owned rose from 68 percent in 1970 to over 90 percent in 1990 with Japan being the single largest investor in this sector. [UNCTAD (2000: 54)] Malaysia exported 200 billion ringgit (US\$52.6 billion) in electronic goods in 2001, almost three-quarters of its total manufacturing exports. [B. Low (2002)]

<sup>54</sup> B. Low (2002)

<sup>55</sup> UNCTAD (2002c: 162 and Table VI.7., 166)

<sup>56</sup> UNCTAD (2002c: 40).

<sup>57</sup> USTR (2002a).

<sup>58</sup> UNCTAD (1999a: 12).

<sup>59</sup> UNCTAD (2002c: 82 and 266).

<sup>60</sup> FDI intensity is measured by the ratio of the share of partner "b" in FDI stock of region "a" to the share of the region "b" in world FDI stock. [See UNCTAD (2001: 57) for equation.]



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<sup>61</sup> For this index, the region of “Asia” includes China, Japan, Malaysia, Pakistan, Republic of Korea, Singapore, Taiwan and Thailand and “SE Asia” includes the developing countries of South, East and Southeast Asia (i.e., excludes Japan).

<sup>62</sup> See Table S.3 in appendix for list of member countries.

<sup>63</sup> Hong Kong is also included as a top investor in that table but is not included in the definition of “Asia” for the intensity index calculation.

<sup>64</sup> UNCTAD (2001: 24).

<sup>65</sup> UNCTAD (1999a: 14).

<sup>66</sup> UNCTAD (2002a: 9).

<sup>67</sup> UNCTAD (2002a: 9).

<sup>68</sup> Scollay and Gilbert (2001: 19) and Ethier (1998).

<sup>69</sup> A complete list of all such agreements worldwide can be found in the source document indicated at the bottom of this appendix table.

<sup>70</sup> Table A.6 shows only signed and adopted agreements and Table A.7 shows only agreements since 1995.

<sup>71</sup> Services, e.g., transportation and communications, are increasingly important today as they link the various segments of production networks worldwide. [See Jones and Kierzkowski (2001) for a discussion of this issue.]

<sup>72</sup> “Agreement Between the Republic of Singapore and Japan for a New-Age Economic Partnership,” January 2002; Rajan and Sen (2002).

<sup>73</sup> Yamazawa (2001: 20).

<sup>74</sup> According to Senior Secretary to the President for Economic Affairs Hyun Jung-Taik, these three countries (Japan, Singapore and Mexico) cause the least concern in terms of agricultural issues for South Korea. [Speech at Seoul National University in November 2002 (Kim, 2002).]

<sup>75</sup> The achievements of AIA are mainly in the area of global missions to promote the region, establishment of a database of part and component manufacturers, provision of access to investment/business information on the region, convening regular fora with business organizations, capacity building through training workshops, and others (ASEAN 2000a). Completed projects under APEC’s Collective Action Plan on Investment (for 1996-2000) include publication of an investment guidebook, compilation of a compendium of initiatives and strategies of FDI stakeholders, organization of investment symposia, establishment of policy dialogues to review various investment regimes and investment aspects of FTAs, studies of investment liberalization, and the conduct of several training programs and seminars (Austria 2001).

<sup>76</sup> The degree to which incentives affect investment decisions is uncertain.; however, they have been important in the investment strategies of some developing countries, particularly in attracting export-oriented FDI. [See UNCTAD (2002c: 204-208).]

<sup>77</sup> See Table G.2 in the General Appendix for a description of various types of trade arrangements and Table G.3 for a list of recent RTAs in the Asia-Pacific region.

<sup>78</sup> See Drysdale (2001), Frankel (1997), Scollay and Gilbert (2001), Panagariya (1999), Low (2001), and Mistry (2000).

<sup>79</sup> Scollay and Gilbert (2001: 19-20)

<sup>80</sup> Phrasing that was first coined by Bhagwati (1991: 77) and popularized by others.

<sup>81</sup> RTAs can overlap and adopt complex and inconsistent rules of origin that add cost and result in inefficiencies. This phenomenon was first described by Bhagwati, Greenaway, and Panagariya (1998).

<sup>82</sup> See Panagariya (1999), Drysdale (2001) and Scollay and Gilbert (2001).

<sup>83</sup> Rose uses a standard “gravity” model of bilateral merchandise trade and a large panel data set covering over 50 years and 175 countries.

<sup>84</sup> Rose (2002: 1)

<sup>85</sup> GSP (Generalized System of Preferences) is a system used by many developed countries to help developing nations improve their financial or economic condition through exports. In effect, it provides for the duty-free importation of a wide range of products that would otherwise be subject to customs duty if imported from non-GSP-status countries. <[http://www.customs.ustreas.gov/travel/gsp.htm#What is GSP](http://www.customs.ustreas.gov/travel/gsp.htm#What%20is%20GSP)>

<sup>86</sup> In addition to a theoretical discussion of the effects of RIAs on FDI decisions, the study examines three specific cases of North-North (Canada-U.S. Free Trade Agreement), North-South (Mexico within NAFTA) and South-South (MERCOSUR) integration.

<sup>87</sup> Blomström and Kokko (1997: 41)

<sup>88</sup> UNCTAD (2002b: 65)

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- <sup>89</sup> The coordination of policymaking for trade and FDI is not entirely new. In fact, it has probably occurred more among developing countries, than among developed countries. See UNCTAD (1996c: 116-118).
- <sup>90</sup> An example is Honda's network of operations in motorcycles. Rather than starting its entry into Europe with exports, which was its conventional method, it used FDI very early on and integrated its EU operations by taking advantage of the increasingly liberalized framework there. (UNCTAD (1996c: 101).
- <sup>91</sup> Balasubramanyam (2002: 191)
- <sup>92</sup> UNCTAD (2002c: 24) and (1998: 91)
- <sup>93</sup> Originally conceptualized by Kaname Akamatsu in the 1930s.
- <sup>94</sup> See Ozawa (1999) for a detailed discussion of the "flying geese" paradigm and how it led to the development of East Asia.
- <sup>95</sup> "During 1998-2000, the Triad accounted for three-quarters of global FDI inflows and 85 percent of outflows, and for 59 per cent of inward and 78 per cent of outward FDI stocks." [UNCTAD (2001: 9)]
- <sup>96</sup> UNCTAD's "transnationality index" for a country is based on two FDI variables (i.e., FDI inflows as a percentage of gross fixed capital formation and FDI inward stock as a percentage of GDP) and two variables related to foreign firms' operations in a host country (i.e., value added by foreign affiliates as a percentage of GDP and employment by foreign affiliates as a percentage of total employment.) The index is also applied to individual firms and in this case is the average of three ratios: foreign assets/total assets, foreign sales/total sales and foreign employment/total employment. [See UNCTAD (2002c) for further details.]
- <sup>97</sup> UNCTAD (2002c: 61-62)
- <sup>98</sup> "The largest 20 companies most actively involved in cross-border M&As accounted for one-fifth of the total value of cross-border M&A deals during the past 15 years: 1987 – 2001." UNCTAD (2002c: 89).
- <sup>99</sup> OECD (2002: 50)
- <sup>100</sup> UNCTAD (2002c: 60-61)
- <sup>101</sup> UNCTAD (2002c: 20-21)
- <sup>102</sup> UNCTAD (2002c: 102)
- <sup>103</sup> This index is "calculated as the ratio of the number of foreign countries (N) in which a TNC operates wholly-owned affiliates to the number of foreign countries (N\*) in which it could potentially operate. The latter number is calculated for the countries (excluding the home country) which had a positive FDI stock in 2001, defining them as potential locations for FDI. All in all, this covered 187 countries." [UNCTAD (2002c: 109)]
- <sup>104</sup> See Table IV.2. on page 89 and Figure IV.9. on page 110 of UNCTAD (2002c).
- <sup>105</sup> UNCTAD (2002c: 109-10)
- <sup>106</sup> UNCTAD (2002c: 143)
- <sup>107</sup> UNCTAD (2002c: 149)
- <sup>108</sup> UNCTAD (2002c: 149-150)
- <sup>109</sup> A brief summary of these three industries, taken from UNCTAD (2002b: Annex 3 to Chapter III, 99-111), is presented here. See original publication for further details.
- <sup>110</sup> UNCTAD (2002b: 100)
- <sup>111</sup> This was in part because of their centralized management structure, the long time required in establishing local supplier relationships and their preference for in-house component design.
- <sup>112</sup> UNCTAD (2002b: 103-4)
- <sup>113</sup> UNCTAD (2002b: 105)
- <sup>114</sup> UNCTAD (2002b: 108)
- <sup>115</sup> Romijn, Van Assouw and Mortimore (2000: 139)
- <sup>116</sup> UNCTAD (2002c: Annex table B.4., p316-317)
- <sup>117</sup> Lawrence (2002)
- <sup>118</sup> See Arndt (2001: 26)
- <sup>119</sup> See also Jones and Kierzkowski (2001: 32-33).
- <sup>120</sup> Arndt (2001: 32)
- <sup>121</sup> See Cheng, Qiu and Tan (2001: 182-185)
- <sup>122</sup> See section on Regional Agreements above.
- <sup>123</sup> Arndt (2001: 26)
- <sup>124</sup> Wain (2002)
- <sup>125</sup> Frankel (2000: 20)

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- <sup>126</sup> ADB Institute (2000: 2)
- <sup>127</sup> Uninsured debt that is junior to insured deposits but senior to equity.
- <sup>128</sup> This table includes some completed, and yet to be completed, reforms. For a complete and detailed discussion of progress by individual crisis-affected countries in financial sector and corporate sector restructuring see Kawai (2000).
- <sup>129</sup> Eichengreen (1999: 52).
- <sup>130</sup> See Eichengreen (1999: Appendix C) for further discussion of the coincident nature of events in the Asian crisis.
- <sup>131</sup> Eichengreen (1999: Appendix A.)
- <sup>132</sup> Proposals and developments in the setting of financial standards are also reviewed in Eichengreen (1999: Chapter 3) and in Nellor (2000: Table 14.1).
- <sup>133</sup> See Soesastro (1998: 375)
- <sup>134</sup> Soesastro (1998)
- <sup>135</sup> Severino (1998)
- <sup>136</sup> Soesastro (1998)
- <sup>137</sup> APEC Finance Ministers Process, updated May 9, 2001. <[http://www.apsec.org.sg/fora/activity...nister\\_process/finance\\_process\\_upd.htm](http://www.apsec.org.sg/fora/activity...nister_process/finance_process_upd.htm)>.
- <sup>138</sup> Yoshitomi and Shirai (2000: 68).
- <sup>139</sup> Most, although not all, of the APEC countries were represented: Australia, Brunei Darussalam, Canada, China, Hong Kong SAR, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore, Thailand and the United States.
- <sup>140</sup> "A New Framework for Enhanced Asian Regional Cooperation to Promote Financial Stability," Meeting of Asian Finance and Central Bank Deputies, Agreed Summary of Discussions, Manila, Philippines, 18-19 November 1997.
- <sup>141</sup> Japan, Ministry of Finance (2002), <<http://www.mof.go.jp/English/qa/my001.htm>>
- <sup>142</sup> The US\$15 billion of medium- and long-term support under the New Miyazawa Initiative is handled through the Japan Bank for International Cooperation (JBIC), which is the merged entity of the former Export-Import Bank of Japan (JEXIM) and the Overseas Economic Cooperation Fund (OECF).
- <sup>143</sup> Data were obtained from Japan Ministry of Finance, <<http://www.mof.go.jp/English/if/e1e042.htm>> and are dated February 2000, but amounts remain unchanged today.
- <sup>144</sup> See Soesastro (2000b: 141)
- <sup>145</sup> ASEAN (1999)
- <sup>146</sup> Soesastro (2000b: 140)
- <sup>147</sup> Eichengreen (2001: 45)
- <sup>148</sup> The BSA is similar to a currency swap the U.S. Treasury extended to Mexico in the mid-1990s when the peso was in danger of collapsing. Mexico swapped its pesos for dollars to build its hard currency reserves, and later returned the dollars with interest. (Alan Yonan, Jr., Iain McDonald, and Alastair McIndoe, "Japan/Swaps Deal -2: To Insulate Asian Economies," Emerging Markets Report, 10 May 2001. <<http://www.djinteractive.com>>.
- <sup>149</sup> Wheatley (2002)
- <sup>150</sup> Not all of the swap arrangements will involve linkage to the IMF (e.g., the Japan/China swap), but so far most are linked.
- <sup>151</sup> "S&P says Asia swap deals could threaten ratings," Reuters English News Service, 10 May 2001. <<http://www.djinteractive.com>>.
- <sup>152</sup> IMF (2002a)
- <sup>153</sup> Alan Yonan, Jr., Iain McDonald, and Alastair McIndoe, "Japan/Swaps Deal -2: To Insulate Asian Economies," Emerging Markets Report, 10 May 2001, <<http://www.djinteractive.com>>.
- <sup>154</sup> Alan Yonan, Jr., Iain McDonald, and Alastair McIndoe, "Japan/Swaps Deal -2: To Insulate Asian Economies," Emerging Markets Report, 10 May 2001, <<http://www.djinteractive.com>>.
- <sup>155</sup> Horst Köhler, "New Challenges for Exchange Rate Policy," Remarks made at the Asia-Europe (ASEM) Meeting of Finance Ministers, Kobe, 13 January 2001.
- <sup>156</sup> Nellor (2000: 341-342)
- <sup>157</sup> Noble and Ravenhill (2000: 30-32)
- <sup>158</sup> Kawai, Newfarmer and Schmukler (2001: 44-47)

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<sup>159</sup> Other studies supporting this view, in addition to those mentioned in this paragraph, include Demirgüç-Kunt and Maksimovic (1998), Rajan and Zingales (1998), Wurgler (2000), Levine and Zervos (1998), and Beck, Levine, and Loayza (2000).

<sup>160</sup> Including Bagehot (1873), Hicks (1969), Schumpeter (1912), Robinson (1952), Lucas (1988), Chandavarkar (1992), Meir and Seers (1984), and Stern (1989).

<sup>161</sup> Levine (1997: 688)

<sup>162</sup> Wilson (2002: 17)

<sup>163</sup> World Bank (2002b) and Li, Squire, and Zou (1997)

<sup>164</sup> World Bank (2001: 6-7)

<sup>165</sup> Stulz (2001: 146-147)

<sup>166</sup> Percentages in this table are not directly comparable to those of other sources (e.g., Shirai 2001b). They may vary for some countries, which might be due to data being obtained from different sources. The results, however, are broadly consistent.

<sup>167</sup> Japan's percent of GDP for equities was undoubtedly higher during the bubble era.

<sup>168</sup> Japan has become less bank-centered in recent years.

<sup>169</sup> Stulz (2001) refers to Thurow (1992) in comparing the Anglo-Saxon system of maximizing shareholder influence to the German/Japan system of minimizing shareholder influence. Dore (2000) examines this subject in detail in his book, Stock Market Capitalism: Welfare Capitalism, which covers the labor, productivity, financial, cultural and social aspects of these two systems.

<sup>170</sup> IMF (2001b: 214)

<sup>171</sup> Including government bonds, the total outstanding amounts of local currency-denominated long-term bonds in these countries increased from \$181 billion at the end of 1997 to \$422 billion at the end of 2000. This was because of the large quantities of bonds issued by governments in domestic markets to fund the purchase of NPLs and to recapitalize local banks. (IMF, 2001c: 214)

<sup>172</sup> Asian Policy Forum (2001) and Shirai (2001a)

<sup>173</sup> The APF recognizes three stages in the development of financial markets: Stage I – bank dominant, Stage II – intermediate, and Stage III – full-fledged capital-market based.

<sup>174</sup> This study is based on recent cross-country data from almost 150 countries on banks, insurance companies, pension and mutual funds, finance companies, and stock and bond markets. It also includes information on each country's political, economic, and social environment.

<sup>175</sup> The classifications are based on the level of "financial development" as defined by the authors (see note at the bottom of Table 5.10). This may differ from a country's level of economic development. In other words, a country may be a "developing economy" but at the same time be classified as "financially developed" in this study (e.g., Thailand and Malaysia). Or it may be a "developed economy" but classified in this study as "financially underdeveloped" (e.g., Denmark).

<sup>176</sup> The higher the Structure Index, the higher the level of stock market development relative to banking-sector development.

<sup>177</sup> The authors point out that their study uses a database that "draws on a wider array of sources and constructs indicators of the size, activity, and efficiency of a much broader set of financial institutions and markets" than have been used in previous studies of this nature. (Beck, Demirgüç-Kunt, and Levine, 2001: 17-18)

<sup>178</sup> Demirgüç-Kunt and Levine (2001a: 120)

<sup>179</sup> Although their original database includes indicators for both equity and bond markets, it appears that the Structure Index shown here incorporates only equities (and not bonds) in the capital markets indicators.

<sup>180</sup> Some have tried to establish stock markets in this way but were unsuccessful. Harwood (2000: 5-6)

<sup>181</sup> For example, Krugman (1999)

<sup>182</sup> Harwood (2000)

<sup>183</sup> This list presumes that infrastructure, including regulations and regulators, exchanges, and trading and clearing systems, is already in place.

<sup>184</sup> Harwood (2000: 8)

<sup>185</sup> However, it should be noted that there is some diversity in the level of development of bond markets among the various countries of the region.

<sup>186</sup> Asian Policy Forum (2001), Shirai (2001b), Park (2001), and World Bank (2002b).

<sup>187</sup> Shirai (2001b: 1)

<sup>188</sup> IMF (2001b: 215)

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- <sup>189</sup> Park (2001: 66)
- <sup>190</sup> Turner (2001: 337)
- <sup>191</sup> Although not specifically stated, presumably this is a reference to the Basel Committee's multi-track effort to revise the Basel Capital Accord, which included a proposal for an internal-ratings based approach ("IRB approach") to regulatory capital. See Web site at <<http://www.bis.org/publ/bcbsca.htm>> for recent update.
- <sup>192</sup> Turner (2001: 339)
- <sup>193</sup> As of 1998, China was the only country (out of 51 industrial and emerging countries surveyed by the Institute of International Bankers) that had a completely "pure" separate banking system, meaning that banks are not permitted to engage in any type of securities activity. [Claessens and Klingebiel (2001: 26)]
- <sup>194</sup> Asian Policy Forum (2001), Yoshitomi and Shirai (2001), and Shirai (2001a)
- <sup>195</sup> Yoshitomi and Shirai (2001: 69)
- <sup>196</sup> Shirai (2001a: 34)
- <sup>197</sup> World Bank (2002b: 79)
- <sup>198</sup> See Shirai (2001a: 46-55) for further details.
- <sup>199</sup> ADB Institute (2001) and Asian Policy Forum (2001)
- <sup>200</sup> Kawai (2002: 86-87)
- <sup>201</sup> A complete review of bank restructuring in Indonesia is presented in Pangestu and Habir (2002).
- <sup>202</sup> See Kuroda (2001), Kobayashi (2001), Sakakibara (2001), and Asian Policy Forum (2001).
- <sup>203</sup> See Chapter V of this paper for description of NMI.
- <sup>204</sup> Asian Policy Forum (2001: 23) and <<http://www.mof.go.jp/English/if/e1e042.htm>>.
- <sup>205</sup> Park (2001: 58)
- <sup>206</sup> Asian Policy Forum (2001: 22)
- <sup>207</sup> Asian Policy Forum (2001: 23) and Kuroda (2001: 77)
- <sup>208</sup> Asian Policy Forum (2001: 22-23)
- <sup>209</sup> Australia and Hong Kong already have a link-up in place for their securities clearing systems.
- <sup>210</sup> Park (2001: 59)
- <sup>211</sup> Harwood (2000: 9)
- <sup>212</sup> Sydney would also be in this category if Australia is included in the region.
- <sup>213</sup> Freeman and Bartels (2000: 1-2)
- <sup>214</sup> Although the primary outflows were bank-lending flows, there were considerable portfolio (equity) outflows as well. According to Rajan and Siregar (2002), these outflows "played an important 'supporting role' in the regional crisis" (62).
- <sup>215</sup> IMF (2002b: 17)
- <sup>216</sup> Freeman (2000: 10)
- <sup>217</sup> Wilson (2002: 25) cautions against becoming overly distracted by downward valuation changes related to financial crisis when assessing the long-term progress in financial development and market sophistication because prices do not provide sufficient information about the underlying efficiency of the market.
- <sup>218</sup> Wilson (2002: 25)
- <sup>219</sup> Freeman's analysis is based on data prior to July 2000. In view of the subsequent decline in tech stocks worldwide, this may have altered somewhat. However, Freeman later implies that the sectoral bias is fairly well entrenched in the region.
- <sup>220</sup> Freeman (2000: 6)
- <sup>221</sup> Yang and Siregar (2001: 24)
- <sup>222</sup> Freeman (2000: 8 and 22)
- <sup>223</sup> Freeman acknowledges that he is not the first to make such a proposal. The Bank of Thailand Governor Chatumongol Sonakul proposed a joint venture between the equity markets in Bangkok, Kuala Lumpur and Singapore in May 2000.
- <sup>224</sup> Freeman claims that the role of foreign institutional investors in the crisis was exaggerated and that their guilt was less than that of foreign commercial bank lenders.
- <sup>225</sup> Rajan and Siregar (2002: 74)
- <sup>226</sup> Demirgüç-Kunt and Levine (2001b: 12)
- <sup>227</sup> Legal systems having European origin include English Common Law and the French, German, and Scandinavian Civil Law. English Common Law differs from civil law in that laws were formed primarily

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- by judges trying to resolve particular cases. [See Beck, Demirgüç-Kunt, Levine, and Maksimovic (2001: 204-205) for a detailed explanation of these systems.]
- <sup>228</sup> Demirgüç-Kunt and Levine (2001a: 132)
- <sup>229</sup> The authors define financial development as applied in this study as an assessment of the “efficiency with which financial intermediaries and markets (1) assess new projects and firms, (2) exert corporate control, (3) ease risk management and (4) mobilize savings. [Beck, Demirgüç-Kunt, Levine and Maksimovic (2001: 195)]
- <sup>230</sup> This is not an absolute measure.
- <sup>231</sup> Detailed descriptions of what the variables in these indicators represent are presented in Table G.8 in the General Appendix.
- <sup>232</sup> Traditionally, creditors such as banks and insurance companies were key shareholders of corporations in Japan. However, the ownership structure of Japanese firms has shifted so that cross-shareholdings have been reduced and foreign investors have increased. Furthermore, shareholders are exercising their rights actively. [Yasui (2001)]
- <sup>233</sup> Dore (2000) describes in detail the similarities between Japan’s and Germany’s forms of capitalism (i.e., Rhenish capitalism) versus the Anglo-Saxon version that is espoused by the US and UK.
- <sup>234</sup> Japan’s Commercial Code, which provides protection for minority shareholders, was amended in 1993 strengthening that protection. [Yasui (2001)]
- <sup>235</sup> Schumkler and Vesperoni (2001: 372)
- <sup>236</sup> World Bank (2002b: 78)
- <sup>237</sup> Nam et al (2001: 87-88)
- <sup>238</sup> Eichengreen (2001: 39)
- <sup>239</sup> Lamberte (2001: 137-139)
- <sup>240</sup> Kuroda (2001: 76)
- <sup>241</sup> Enron, an energy-trading company in Texas, declared bankruptcy in December 2001. Surrounding the bankruptcy are accusations of incompetence, conflict of interest and even corruption. This has led to calls for reforms to accounting standards, the auditing system, and corporate governance in the U.S.
- <sup>242</sup> In January 2002, a foreign exchange trader at Allfirst was accused of being instrumental in the loss of \$750 million to the bank. This occurrence added to the calls for investigations into and reform of the financial services industry, particularly the accounting industry, in the U.S. and Europe.
- <sup>243</sup> Demirgüç-Kunt and Levine (2001b)
- <sup>244</sup> At the beginning of 2002, a compromise was reached on the implementation of the Lamfalussy proposals which are a series of reforms for the harmonization of the regulation of European securities markets through “fast-track” legislation [Saltmarsh (2002: B4)].
- <sup>245</sup> Saltmarsh (2002: B4)
- <sup>246</sup> Saltmarsh (2002: B4)
- <sup>247</sup> Michael Richardson, “Asia Looks To Zones of Free Trade Region Unlikely to Push For a Monetary Union,” *International Herald Tribune* 03 Jan. 2002: 9, 08 Jan. 2002 <<http://www.djinteractive.com>>.
- <sup>248</sup> Wyplosz (2001b: 21)
- <sup>249</sup> Some of the more recent studies included in this review are: Rodrik (1998), Klein and Olivei (2000), Chanda (2000), Arteta, Eichengreen, and Wyplosz (2001), Bekaert, Harvey, and Lundblad (2001), and Edwards (2001).
- <sup>250</sup> Arteta et al (2001: 26-27)
- <sup>251</sup> IMF (2001d: 155-163)
- <sup>252</sup> IMF (2001d: 151)
- <sup>253</sup> Kaplan and Rodrik (2001: 1)
- <sup>254</sup> Ariyoshi et al (2000)
- <sup>255</sup> Malaysia’s controls were relaxed significantly in February 1999. [Asian Policy Forum (2000: 3)]
- <sup>256</sup> Ariyoshi et al (2000)
- <sup>257</sup> Kaplan and Rodrik (2001: 32)
- <sup>258</sup> IMF (2001d: 164)
- <sup>259</sup> IMF (2001d: 164)
- <sup>260</sup> Ariyoshi et al (2000: 28)
- <sup>261</sup> Ariyoshi et al (2000: 38)

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- <sup>262</sup> However, the distinction between prudential policies and capital controls is not always clear [Ariyoshi et al (2000: 32)].
- <sup>263</sup> Ariyoshi et al (2000: 39-40)
- <sup>264</sup> IMF (2001d: 167-169)
- <sup>265</sup> Fan (2002: 166) claims, "there has never been a real case of sequencing, except for some technical preparations for a certain step of market liberalisation."
- <sup>266</sup> Fan (2002: 165)
- <sup>267</sup> Fan (2002: 165)
- <sup>268</sup> Fan (2002: 166)
- <sup>269</sup> Another problem with sequencing is that it is difficult to determine at what point a step has been completed so that the next step can be taken. In compatible opening it is difficult to know which policies are compatible, but it requires no "check points," only that small steps be taken in all areas from which achievements will accumulate. It could thus be more chaotic than sequencing. [Fan (2002: 166)]
- <sup>270</sup> Fan (2002: 167)
- <sup>271</sup> Fan (2002: 158)
- <sup>272</sup> While this is the view of many in the region, there are those who disagree. Eichengreen (2001) views monetary cooperation (to stabilize exchange rates) and financial cooperation (to strengthen banking systems) as separate and distinct with the latter being of a higher priority than the former.
- <sup>273</sup> Descriptions of common currency regimes (as identified by the IMF) are presented in the General Appendix.
- <sup>274</sup> They were actually "soft" pegs to baskets composed of the U.S. dollar, Japanese yen, German mark and other European currencies, but the weight of the U.S. dollar was dominant (Yamazawa, 1998).
- <sup>275</sup> See Table G.9 in appendix for descriptions of common exchange rate regimes.
- <sup>276</sup> Real estate developers had borrowed in dollars (unhedged) from domestic banks to finance real estate projects.
- <sup>277</sup> Radelet and Sachs (2000: 115)
- <sup>278</sup> Radelet and Sachs (2000: 137)
- <sup>279</sup> No country uses a completely free floating exchange rate. Countries that are considered to be free floaters (such as the U.S. and Japan) will on occasion intervene with modest smoothing when absolutely necessary.
- <sup>280</sup> Calvo and Reinhart (2000: 26)
- <sup>281</sup> Frankel, Fajnzylber, Schmukler, and Servén (2000: 8)
- <sup>282</sup> McCauley (2001: 9)
- <sup>283</sup> The authors argue that a theoretical rationale for the two-corner proposition is lacking and they reject other possible explanations (i.e., the impossible trinity, the dangers of unhedged foreign liabilities, and government reluctance to abandon ship in time) as not convincing. [See Frankel, Fajnzylber, Schmukler, and Servén (2000) for a detailed discussion.]
- <sup>284</sup> A pegged exchange rate within a horizontal band – the value of the currency is maintained within margins of fluctuation around a formal or de facto fixed peg that are wider than plus or minus 1 percent around a central rate (parity). There is some limited degree of monetary policy discretion, with the degree of discretion depending on the bandwidth.
- <sup>285</sup> Asian Policy Forum (2000: 4)
- <sup>286</sup> Larraín and Velasco (1999: 11-12) and Glick (2002: 202-203)
- <sup>287</sup> See Table G. 9 and G.10 in the General Appendix for descriptions of exchange rate regimes and monetary policy frameworks, respectively.
- <sup>288</sup> Williamson (2001: 97)
- <sup>289</sup> Williamson (2001: 97)
- <sup>290</sup> Calvo and Reinhart (2000), Frankel, Schmukler and Servén (2000), and Bénassy-Queré and Cœuré (2000)
- <sup>291</sup> McCauley (2001: 25). The author reconciles the findings of McKinnon (2000) with his own contrary findings in his Appendix A, page 46.
- <sup>292</sup> De Brouwer (2001: 58)
- <sup>293</sup> Kwan (2001: 75) with categories based on Eichengreen (1994) and Frankel (1999b).
- <sup>294</sup> Frankel (1999b: 6)
- <sup>295</sup> Kwan (2001: 77-78)

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- <sup>296</sup> Bayoumi, Eichengreen and Mauro (2000: 147)
- <sup>297</sup> Goto and Hamada (1994), Eichengreen and Bayoumi (1999), Bénassy-Queré (1999), Kawai and Akiyama (2000), and Bayoumi, Eichengreen and Mauro (2000).
- <sup>298</sup> Kawai and Takagi (2000: 25)
- <sup>299</sup> Some advocates of this regime are Dornbusch and Park (1999), Murase (2000), Williamson (1999, 2000, 2001), Ogawa and Ito (2000), and Kawai and Takagi (2000).
- <sup>300</sup> De Brouwer (2002: 299) says that the evidence is mixed concerning the adverse effect of currency volatility on economic performance.
- <sup>301</sup> Kawai and Takagi (2000)
- <sup>302</sup> Favored by Dornbusch and Park (1999) and Williamson (1996, 2000, and 2001), among others.
- <sup>303</sup> "The 'effective exchange rate' is the weighted-average exchange rate against all currencies, where the weights are generally chosen to reflect the pattern of trade. (An alternative weighting system, based on trade elasticities, recognizes that countries are also important competitors, rather than just trade partners.) A 'real effective exchange rate' corrects for changes in relative inflation so that the index does not change if prices increase as much at home as the weighted average of the country's trading partners." (Williamson, 2001: 97)
- <sup>304</sup> Kwan (2001) and Williamson (2001)
- <sup>305</sup> Williamson (2001: 98)
- <sup>306</sup> Ogawa and Ito (2000) suggest that publishing a "typical currency basket unit" (or ACU) for the region could be helpful to each country in calculating its own basket.
- <sup>307</sup> Kawai and Takagi (2000: 25-26)
- <sup>308</sup> De Brouwer (2002: 292). The author bases his analysis on trade data for 1995-97. In terms of intraregional trade share for 1998-2000, as presented earlier in this study, the proportion has dropped slightly but is still close to half.
- <sup>309</sup> Again, de Brouwer bases his analysis on trade data for 1995-97. Our data for 1998-2000 reflects some changes in trade patterns for East Asian countries. Although it is still the case that Cambodia, Lao PDR and Vietnam trade more with other countries in the region than with the U.S., Japan and EU, compared to the earlier period Cambodia now exports more to the U.S. than the EU but still little to Japan, Lao PDR's share of exports to the EU has halved while that to Japan is nearly five times greater, and Vietnam's share of exports to Japan has dropped considerably while trade shares with the U.S. and EU are relatively unchanged.
- <sup>310</sup> The EC signed the Basle Agreement in 1972 which reduced the bilateral fluctuation margins of its member nations' currencies to +/-2.25 percent (the snake) against the wider world of 4.5 percent (the tunnel). This became known as the 'snake in the tunnel' (or European Common Margins Agreement). While the European currencies would continue to fluctuate against the dollar and other currencies within the wider band, intra-European fluctuations would be decreased. The tunnel disappeared a year later when the dollar was floated. This left the "snake" as a joint float. Aldcroft and Oliver (1998: 146-150) and Rehman (1997: 14-17)
- <sup>311</sup> Wyplosz (2001a: 130)
- <sup>312</sup> Wyplosz (2001a) identifies the European Commission and the ECB (European Central Bank) as the two main institutions today. He does not downplay the shortcomings of these institutions and the many difficulties they face in carrying out their functions, but states that their existence has been "crucial" and "they embody the principle of a common good and common aims which transcend national interests and objectives." Wyplosz (2001a: 140)
- <sup>313</sup> Tay (2000b: 159-60) and Soesastro (2000a: 192)
- <sup>314</sup> Urata (1998)
- <sup>315</sup> Wyplosz (2001a: 140)
- <sup>316</sup> Wyplosz (2001a: 140)
- <sup>317</sup> Kartadjoemena (2001: 210-211)
- <sup>318</sup> Stiglitz (2001a: 523)
- <sup>319</sup> Eichengreen (2001: 43)
- <sup>320</sup> Park et al (2001)



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