I. Crisis reinforces need for stronger trade and financial integration in Asia and the Pacific

By Mia Mikic and Ravi Ratnayake

Introduction

The Asian economies have become an epitome of "trade as an engine of growth" during the past several decades as they have been expanding economic and human development, using trade as a ladder. Most of the economies have become highly integrated into the world economy, either through direct export and import or by becoming an important link in the global supply chain. However, when demand for their production and exports plunged suddenly and sharply in the last quarter of 2008, a sharp contraction in trade flows put their growth and social security under serious threat. On such occasions, issues of dependency on external markets, foreign exchange, foreign direct investment (FDI) and technology rise to the surface and chosen development strategies get reviewed. In Asia and the Pacific, this is accompanied by the concerns about the inability of the region's economies to enhance and deepen their regional integration. Expectedly, the latest crisis has accentuated the concerns about low levels of existing intraregional trade and investments as well as underdeveloped financial integration in Asia and the Pacific.

This e-book brings together chapters that explore various aspects of trade and financial integration in Asia and the Pacific, the reasons for the lack of it, and potential benefits of strengthening such integration. The book focuses on the exploration of challenges and opportunities that exist in intraregional trade in goods, integration in services trade, availability of trade finance as well as inflows of portfolio investments. The papers have been written by researchers who have applied their extensive expertise and analytical skills to studying the impacts of regional trade liberalization and motivations for financial flows.

A. Asia and the Pacific: A highly heterogeneous region…

For the purpose of this e-book, the Asian and Pacific region comprises 58 regional members and associate members of the Economic and Social Commission for Asia and the Pacific (ESCAP).[1] Ranging from Turkey in the west to Pacific island States in the east, and from the Russian Federation in the north to New Zealand in the south, it can be expected that the region includes extremes on all ends. In terms of population size, the three most populous nations (China, India and Indonesia) share the concerns of regional integration with Niue, Nauru and Tuvalu that together have less than 25,000 inhabitants.

[1] For the full list of economies included see the ESCAP website at www.unescap.org/about/member.asp.

The region encompasses the nations that belong to the “rich club” with a gross domestic product (GDP) per capita of more than US$ 50,000[2] as well as nations whose per capita GDP hardly reaches US$ 200. In terms of size of trade, there are mini-sized trading nations with less than US$ 10 million of merchandise exports and nations that are contributing sizeable shares to world exports, e.g., China at 9.3 per cent, Japan at 5 per cent and the Russian Federation at 3 per cent (table 1). In terms of import and export dependence, Asia-Pacific averages 27.5 per cent for merchandise import dependence and 29.5 per cent for export dependence, making the region more trade dependent than the world average. This average hides the very high values of merchandise trade dependence for small open economies such as Maldives (only on the import side), Nauru, Singapore and Hong Kong, China, or relatively low values for economies with large domestic markets, such as Australia, Indonesia, Japan and the Russian Federation (table 2).

Table 1. Ranking of Asia-Pacific economies, based on their world market shares, 2008

Rank	Economy	Import share	Rank	Economy	Export share
Top five economies (percentage share in world)					
1	China	7.10	1	China	9.23
2	Japan	4.78	2	Japan	5.05
3	Republic of Korea	2.73	3	Russian Federation	3.02
4	Hong Kong, China	2.46	4	Republic of Korea	2.73
5	Singapore	2.01	5	Hong Kong, China	2.39
Bottom five economies (percentage share in world)					
44	Micronesia (F.S.)*	0.00056	42	Palau	0.00019
45	Palau	0.00037	43	Vanuatu	0.00019
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47	Niue	0.00019	45	Niue	0.00006
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Memo items					
	Asia and the Pacific	**30.53**		**Asia and the Pacific**	**33.73**
	East and North-East Asia	**17.15**		East and North-East Asia	**19.44**
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B. …But most economies follow the 'outward-oriented' strategies

Notwithstanding these large differences between the economies in the region, most of them have, over a longer period, consistently relied on export (trade) to power their growth; Japan was followed by newly-industrialized economies (Republic of Korea, Singapore, Hong Kong, China and Taiwan Province of China) and newly emerging economies (Indonesia, Malaysia, Philippines and Thailand). Their economic vitality and successes in maintaining high economic growth rates, together with improving levels of inequalities and poverty reduction, have offered an excellent argument in favour of outward-oriented development strategies based on liberal trade and investment regimes as well as high reliance on trade and FDI (World Bank, 1993).

While the Asian financial crisis of 1997/98 brought some corrections in terms of management of capital account openness, the ability of the then crisis-hit economies to "export themselves out of the crisis" only enforced the importance of trade and current account openness for their development. Despite the weakening of the Washington consensus conditionalities after the Asian financial crisis, most Asian and Pacific economies continued to pursue outward-oriented strategies with two additional twists.

First, those affected by the financial crisis understood the value of sound current accounts, robust foreign exchange reserves, and appropriate capital account controls and foreign exchange rate management. In the decade after the Asian financial crisis, Asian economies increased their holdings of foreign exchange reserves by five times, and some of them became extremely important sources for financing the spending-savings gap in the United States and some economies in the European Union. At the same time, pressure on several Asian economies to appreciate their currencies in terms of the United States dollar and the euro prior to 2008 did cause some movements in the exchange rates, but relative competitiveness among the Asian economies has been preserved by managing these movements carefully. Most of the economies maintain de facto regimes of adjustable pegs and are not shy of using reserves to defend their currency values aligned with their national goals.

Since the late 1990s, most economies, especially those that were hurt badly by the financial crisis, have reduced their exposure to short-term debt; nevertheless, some economies did experience increased exposure just before the onset of the new global crisis (e.g., Kazakhstan, the Republic of Korea and the Russian Federation). However, while improvements have been made at the national level, the lack of progress in financial market integration in Asia and the Pacific is still very obvious.[3] The key reasons for this relative failure are (a) the absence of any linkage between jurisdictions of financial infrastructure, and (b) very weak cooperation in financial market development, including standards, supervision and intermediation (Bank of International Settlement, 2008).

Second, most economies developed strong enthusiasm for preferential trade agreements. Of 114 trade agreements that have been put into force and notified to the World Trade Organization (WTO) since 2000, 51 had at least one party from the Asia-Pacific region (figure 1).[4] The region also has 11 plurilateral trade agreements that connect countries in the same geographical region; these agreements more or less overlap with subregions such as Central Asia, South Asia, South-East Asia, the Pacific etc.[5] Most of these bilateral and regional agreements seek improvement of market access over and above the ones secured through multilateral trading agreements.[6] It is thus somewhat disappointing that while the intraregional trade by Asia-Pacific economies has been steadily increasing in United States dollar terms, as a share of their total trade it has been lingering at around 50 per cent since the end of 2003, up from 45 per cent in 1998.

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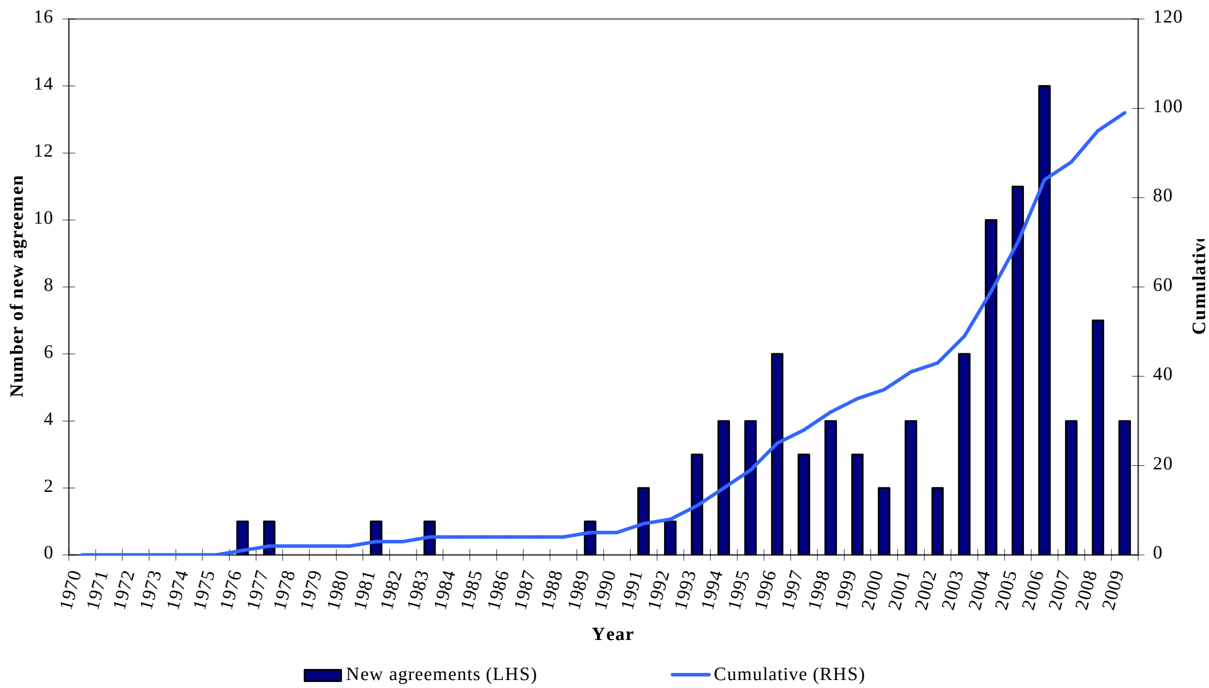
Compared with the 70-plus per cent achieved among the European Union economies, or the 55-plus per cent among the North American Free Trade Agreement economies, intraregional trade of Asia-Pacific would be considered as low **if** these economies had an agreement similar to what has been linking European or North American economies. Instead, the Asia-Pacific region economies form a "noodle bowl".[7]

Figure 1. Proliferation of regional trade agreements in Asia and the Pacific



Source: Asia-Pacific Trade and Investment Agreement Database.

C. Crisis and 'revival' of the efforts to reach regional integration

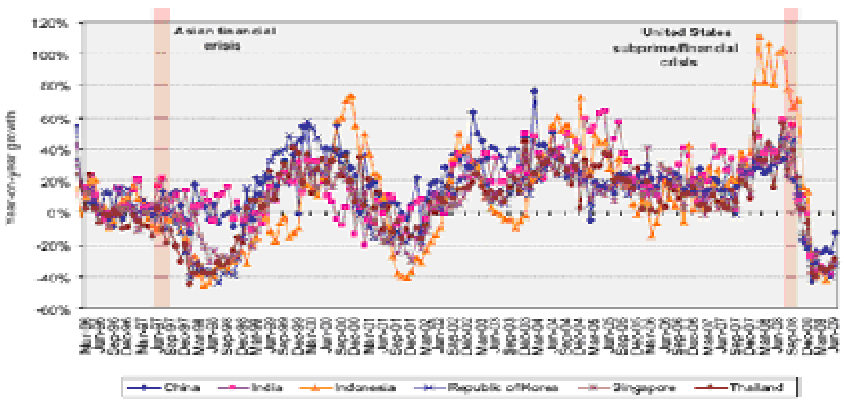
As stated above, exports and imports dwindled as the recession took hold in the major importing developed markets in the latter part of 2008 and early 2009. Figure 2 tracks year-on-year changes of monthly values of imports by selected Asian economies since 1996 in order to compare three episodes of import contraction: 1997/98, 2001 and 2008/09. The recent contraction of imports (measured by the year-on-year changes), which happened suddenly, was synchronized over all economies.[8] The magnitude of the imports contraction, at between 20 per cent and 40 per cent, in the current crisis is larger than the contraction recorded in the Asian financial crisis in 1997/98 and certainly deeper than in the dot.com crisis.

[7] This term is frequently used in the Asia-Pacific context to describe the "spaghetti bowl" phenomenon of the tangle of relationships created by multiple overlapping preferential trading arrangements. The term "spaghetti bowl" was introduced by Jagdish Bhagwati in the early 1990s.

[8] Exports behaved in the same way. See ESCAP, 2009 (part I).

Since June 2009, there have been signs of a rebound of exports and imports as well as a return to positive changes in real GDP and industrial production in a number of countries in the region, including China and India. These positive changes should not, however, be taken as an indication of a return of dynamic economic and trade growth as experienced during 2006-2008; it is more likely that the recovery of the global economy will take a much slower route. Furthermore, there is a growing consensus that pre-crisis trade and macroeconomic imbalances contributed to the crises and can cause another one if not talked in a more systematic way. This means that the sources of growth for the outward-oriented economies need to be modified and balanced instead of relying only on the demand in the developed markets. Since some of the economies in the region have really small internal markets, the only option for them is intraregional trade.

Figure 2. Import trends for selected Asian economies (monthly values, year-on-year changes, February 1996 to June 2009



Source: ESCAP, 2009.

The fact that intraregional trade in the Asian and Pacific region is perceived as low (given the efforts at liberalizing trade flows within the region), is seen by analysts and policymakers both as a part of the problem and a part of the solution in this current crisis. The low level of intraregional trade has been interpreted as a sign of high exposure to external risks (i.e., a contraction of the aggregate in developed markets). To a large degree, this is correct – trade contraction has indeed been caused by the disappearance of external demand in the developed markets (Baldwin, ed., 2009). The low share of intraregional trade is also seen as a solution. Expansion of demand for products originating in the region – that is, an increase in intraregional trade – can substitute for the lack of demand in the developed markets, which may take some time to recover after the crisis. While at the start of the downward cycle in 2008 some analysts believed that

Asia was "decoupled" from the developed country markets and would not be affected by the financial crisis in the United States and Europe, a consensus has now (almost) been reached that full "decoupling" is not possible, and is even undesirable, and that enhancing intraregional trade and investment should play a complementary role in the integration of the Asian and the Pacific region into the global economy (ESCAP, 2009).

D. Impacts of further trade liberalization on Asia and the Pacific

Among the obstacles that limit faster growth of the share of Asian and Pacific region countries in intraregional trade are obviously the ones that matter in times of crisis and which are linked to the man-made obstacles in terms of barriers to trade. Trade is influenced by both demand behaviour and supply capacity, but these typically take longer to correct. Therefore, the focus in the short term should be on boosting intraregional trade by eliminating the barriers that still exist, despite numerous preferential trade agreements among Asian economies.

Two chapters in this publication explore the impacts of liberalizing intraregional trade. Strutt (chapter II) uses the Global Trade Analysis Project model to consider how beneficial greater intraregional trade in Asia-Pacific would be. Several different trade liberalization scenarios are modelled, including a pan-Asia-Pacific tariff elimination, ASEAN+6 tariff elimination and multilateral WTO trade liberalization. The scenarios have been designed to explore some of the potential gains of switching from the Asian "noodle bowl" type of intraregional trade arrangements to one driven by a single tariff-reducing/eliminating trade agreement. It was not surprising to discover that an increase in exports is proportional to the level of ambition for liberalization among all economies in the region. However, such an export increase does not boost the welfare of the largest economies in the region by as much as the WTO level of liberalization does, due to the terms of trade effects being more favourable for them when liberalization is global.

Wadhwa (chapter III) examines some of the important aspects of intraregional trade in South Asia as countries of that subregion are members of multiple preferential regional and bilateral trade agreements. The paper tracks the trends and patterns in South Asian intraregional trade, the comparative advantages of major countries in the subregion, trade complementarity between those countries, and the levels and product coverage of intra-industry trade over the past decade. The paper shows that trade complementarities among the South Asian countries, although still low, have improved over time. In addition, the levels of intra-industry trade in this subregion are not yet significant. Nonetheless, the analysis of marginal intra-industry trade indicates that there are a few product categories that have contributed significantly to the new trade flows over the past decade. The region does have the potential for enhancing intraregional trade in at least some sectors through vertical intra-industry trade among the member countries, with India taking the lead in this regard.

While trade agreements focus on the creation of additional market access (in addition to the one obtained through WTO and unilateral preferential schemes), the byproduct is also generation of trade diversion for countries not involved in the agreements. Raihan (chapter IV) investigates the impact of trade liberalization between India and the European Union on low-income countries that currently enjoy preferences in the European Union market relative to India. All the low-income economies under consideration would experience a loss in welfare, and the welfare losses for the South Asian countries would be much higher than for the other low-income economies in Asia and Africa. Bangladesh appears to experience the largest loss in welfare in absolute value, whereas the rest of South Asia would incur the largest loss in terms of share in GDP. The welfare losses of these low-income economies are mainly driven by the loss in terms of trade. However, in general, the extent of welfare loss in terms of share in GDP for most of these countries is not very high. Most of these low-income countries would also experience losses in real GDP and exports. The policy issue to be considered here is whether rules of origin that exist in agreements between India and (most of the considered) low-income countries, and between India and the European Union, could be designed in such a way as to prevent these adverse terms of trade shocks.

While most of the trade growth for dynamic Asian economies has occurred in the merchandise and manufacturing sectors, services is an important sector; however, the latter sector is often overlooked as the driver of growth. Traditionally, services have been seen as a low productivity growth sector; however, with the recent advancement of information and communication technology (ITC) as a medium for delivering services, the services sector is playing a dominant role in increasing productivity of other sectors, services and goods alike. Another special feature of services trade is the type of barriers used. In contrast to trade in goods, services trade is regulated mostly by "behind the border" measures that belong to regulatory and liberalization frameworks and it is complicated to implement these measures on a discriminatory basis.

Nevertheless, as an increasing number of bilateral and regional trade agreements include concessions in the services sector, Dee (chapter V) explores what behind-the-border reforms in services and investment are best done through trade agreements. One way to answer this question is to think of trade agreements as being exercises in piecemeal reform, in the sense that they provide opportunities for reform, but in a constrained, partial manner. The key policy question is whether countries should unreservedly take advantage of these opportunities, despite the constraints, or whether the nature of the constraints should temper the way in which the countries go about the reforms. Chapter IV first compares trade agreements, as exercises in piecemeal reform, with other modes of liberalization, and then considers which particular reforms should be included in trade agreements. It develops two key principles of piecemeal reform in services and investment. The first is to look for sectors where trade barriers tend to add to real resource costs. The second is to take a broader view than that of just removing discrimination against foreign providers. The paper concludes with some general guidance for trade negotiators and trade ministers.

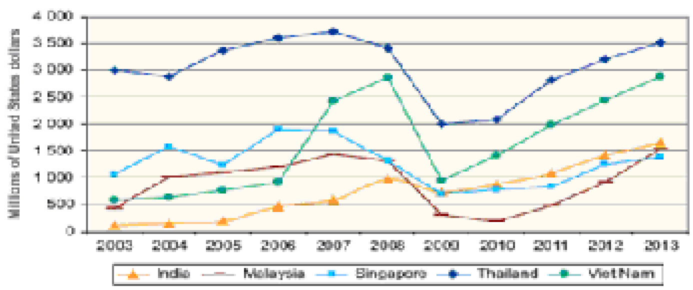
E. Some aspects of regional financial integration in Asia and the Pacific

In examining the key factors leading to the collapse of trade with the last crisis in 2008, Baldwin (ed., 2009) finds that "global trade finance has not had a major impact on trade flows". The freezing of trade finance did not happen in all regions and, in general, where it did occur it was only a “moderate freeze”, according to the authors of that volume. In contrast, Duval and Liu (chapter VII) found that the threat of the higher costs and limited availability of trade finance to some economies in the Asia-Pacific region was significant. In fact, in their other recent empirical analysis (Liu and Duval, 2009), they suggested that a 10 per cent decline in trade finance could lead to a US$ 129 billion drop in total trade in developing Asia, representing 3.6 per cent of their total trade. To overcome the adverse impact of the lack of trade finance, the authors suggested improvements in the establishment of related institutions in many of the less developed countries of Asia, together with more serious consideration being given to the options for regional cooperation in order to reduce the trade finance capacity gap between countries of the region.

It has been argued that financial integration in Asia is probably the weakest of all the components of regional integration (goods, services, labour and capital). While the goods, services and labour components could be larger and tighter, there is no denying that they have already strengthened. It is also true that data on those aspects of regional integration are more readily available than data on financial integration, including bilateral FDI flows.

ESCAP, 2009 (part I) discusses the intraregional flows of FDI based on available data. FDI inflows to Asia are expected to recover quickly following the current global crisis (figure 3), and most FDI destined for Thailand and Viet Nam is expected to come from other Asian countries. In turn, Thailand and Viet Nam, similar to China and Hong Kong, China are becoming valuable sources of FDI for neighbouring countries such as the Lao People’s Democratic Republic and Cambodia. FDI among Asian countries accounts for almost half of the region’s total FDI inflows, with intra-Association of Southeast Asian Nations (ASEAN) FDI particularly showing a rising trend. South-East Asia remains the main destination for Asian outward FDI (UNCTAD, 2008). Within South-East Asia, Singapore is the largest source of outward FDI, flowing mainly to other ASEAN countries, and particularly Indonesia, Malaysia and Thailand.

Figure 3. FDI inflows from Asia to selected developing countries



Source: For 2009 onwards, projections by the Economist Intelligence Unit online database, as cited in ESCAP, 2009**.**

The intraregional FDI flows appear to be rising, but their absolute level is still relatively low. This is even truer for the intraregional movements of portfolio capital (see, for example, Garcia-Herrero, Yang and Wooldridge, 2008). Most of the private traders

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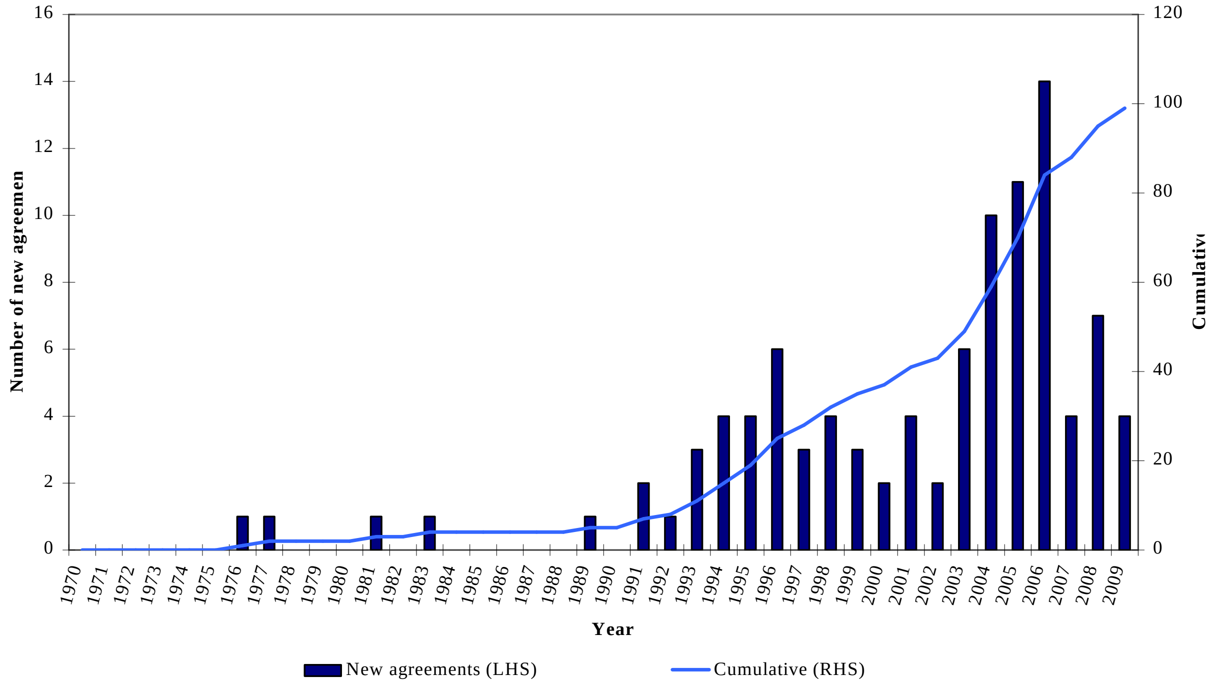
[5] Africa is home to seven regional trade and financial integrations.

[6] Obviously, a number of agreements also pursue other economic and non-economic objectives.

Compared with the 70-plus per cent achieved among the European Union economies, or the 55-plus per cent among the North American Free Trade Agreement economies, intraregional trade of Asia-Pacific would be considered as low **if** these economies had an agreement similar to what has been linking European or North American economies. Instead, the Asia-Pacific region economies form a "noodle bowl".[7]

Figure 1. Proliferation of regional trade agreements in Asia and the Pacific



Source: Asia-Pacific Trade and Investment Agreement Database.

C. Crisis and 'revival' of the efforts to reach regional integration

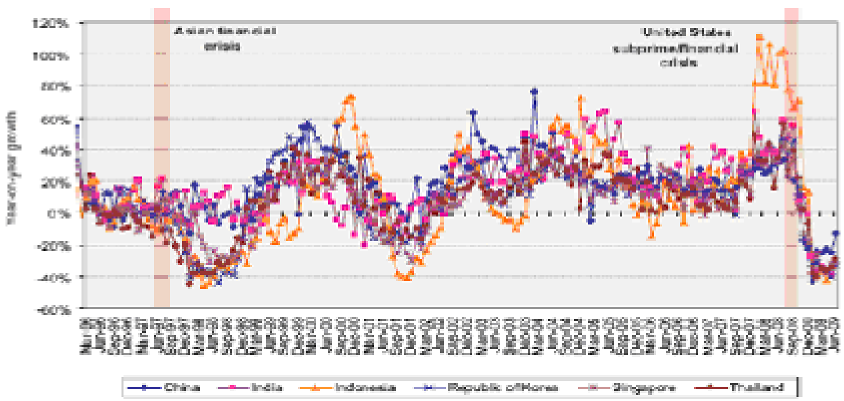
As stated above, exports and imports dwindled as the recession took hold in the major importing developed markets in the latter part of 2008 and early 2009. Figure 2 tracks year-on-year changes of monthly values of imports by selected Asian economies since 1996 in order to compare three episodes of import contraction: 1997/98, 2001 and 2008/09. The recent contraction of imports (measured by the year-on-year changes), which happened suddenly, was synchronized over all economies.[8] The magnitude of the imports contraction, at between 20 per cent and 40 per cent, in the current crisis is larger than the contraction recorded in the Asian financial crisis in 1997/98 and certainly deeper than in the dot.com crisis.

[7] This term is frequently used in the Asia-Pacific context to describe the "spaghetti bowl" phenomenon of the tangle of relationships created by multiple overlapping preferential trading arrangements. The term "spaghetti bowl" was introduced by Jagdish Bhagwati in the early 1990s.

[8] Exports behaved in the same way. See ESCAP, 2009 (part I).

Since June 2009, there have been signs of a rebound of exports and imports as well as a return to positive changes in real GDP and industrial production in a number of countries in the region, including China and India. These positive changes should not, however, be taken as an indication of a return of dynamic economic and trade growth as experienced during 2006-2008; it is more likely that the recovery of the global economy will take a much slower route. Furthermore, there is a growing consensus that pre-crisis trade and macroeconomic imbalances contributed to the crises and can cause another one if not talked in a more systematic way. This means that the sources of growth for the outward-oriented economies need to be modified and balanced instead of relying only on the demand in the developed markets. Since some of the economies in the region have really small internal markets, the only option for them is intraregional trade.

Figure 2. Import trends for selected Asian economies (monthly values, year-on-year changes, February 1996 to June 2009



Source: ESCAP, 2009.

The fact that intraregional trade in the Asian and Pacific region is perceived as low (given the efforts at liberalizing trade flows within the region), is seen by analysts and policymakers both as a part of the problem and a part of the solution in this current crisis. The low level of intraregional trade has been interpreted as a sign of high exposure to external risks (i.e., a contraction of the aggregate in developed markets). To a large degree, this is correct – trade contraction has indeed been caused by the disappearance of external demand in the developed markets (Baldwin, ed., 2009). The low share of intraregional trade is also seen as a solution. Expansion of demand for products originating in the region – that is, an increase in intraregional trade – can substitute for the lack of demand in the developed markets, which may take some time to recover after the crisis. While at the start of the downward cycle in 2008 some analysts believed that

Asia was “decoupled” from the developed country markets and would not be affected by the financial crisis in the United States and Europe, a consensus has now (almost) been reached that full “decoupling” is not possible, and is even undesirable, and that enhancing intraregional trade and investment should play a complementary role in the integration of the Asian and the Pacific region into the global economy (ESCAP, 2009).

D. Impacts of further trade liberalization on Asia and the Pacific

Among the obstacles that limit faster growth of the share of Asian and Pacific region countries in intraregional trade are obviously the ones that matter in times of crisis and which are linked to the man-made obstacles in terms of barriers to trade. Trade is influenced by both demand behaviour and supply capacity, but these typically take longer to correct. Therefore, the focus in the short term should be on boosting intraregional trade by eliminating the barriers that still exist, despite numerous preferential trade agreements among Asian economies.

Two chapters in this publication explore the impacts of liberalizing intraregional trade. Strutt (chapter II) uses the Global Trade Analysis Project model to consider how beneficial greater intraregional trade in Asia-Pacific would be. Several different trade liberalization scenarios are modelled, including a pan-Asia-Pacific tariff elimination, ASEAN+6 tariff elimination and multilateral WTO trade liberalization. The scenarios have been designed to explore some of the potential gains of switching from the Asian “noodle bowl” type of intraregional trade arrangements to one driven by a single tariff-reducing/eliminating trade agreement. It was not surprising to discover that an increase in exports is proportional to the level of ambition for liberalization among all economies in the region. However, such an export increase does not boost the welfare of the largest economies in the region by as much as the WTO level of liberalization does, due to the terms of trade effects being more favourable for them when liberalization is global.

Wadhwa (chapter III) examines some of the important aspects of intraregional trade in South Asia as countries of that subregion are members of multiple preferential regional and bilateral trade agreements. The paper tracks the trends and patterns in South Asian intraregional trade, the comparative advantages of major countries in the subregion, trade complementarity between those countries, and the levels and product coverage of intra-industry trade over the past decade. The paper shows that trade complementarities among the South Asian countries, although still low, have improved over time. In addition, the levels of intra-industry trade in this subregion are not yet significant. Nonetheless, the analysis of marginal intra-industry trade indicates that there are a few product categories that have contributed significantly to the new trade flows over the past decade. The region does have the potential for enhancing intraregional trade in at least some sectors through vertical intra-industry trade among the member countries, with India taking the lead in this regard.

While trade agreements focus on the creation of additional market access (in addition to the one obtained through WTO and unilateral preferential schemes), the byproduct is also generation of trade diversion for countries not involved in the agreements. Raihan (chapter IV) investigates the impact of trade liberalization between India and the European Union on low-income countries that currently enjoy preferences in the European Union market relative to India. All the low-income economies under consideration would experience a loss in welfare, and the welfare losses for the South Asian countries would be much higher than for the other low-income economies in Asia and Africa. Bangladesh appears to experience the largest loss in welfare in absolute value, whereas the rest of South Asia would incur the largest loss in terms of share in GDP. The welfare losses of these low-income economies are mainly driven by the loss in terms of trade. However, in general, the extent of welfare loss in terms of share in GDP for most of these countries is not very high. Most of these low-income countries would also experience losses in real GDP and exports. The policy issue to be considered here is whether rules of origin that exist in agreements between India and (most of the considered) low-income countries, and between India and the European Union, could be designed in such a way as to prevent these adverse terms of trade shocks.

While most of the trade growth for dynamic Asian economies has occurred in the merchandise and manufacturing sectors, services is an important sector; however, the latter sector is often overlooked as the driver of growth. Traditionally, services have been seen as a low productivity growth sector; however, with the recent advancement of information and communication technology (ITC) as a medium for delivering services, the services sector is playing a dominant role in increasing productivity of other sectors, services and goods alike. Another special feature of services trade is the type of barriers used. In contrast to trade in goods, services trade is regulated mostly by “behind the border” measures that belong to regulatory and liberalization frameworks and it is complicated to implement these measures on a discriminatory basis.

Nevertheless, as an increasing number of bilateral and regional trade agreements include concessions in the services sector, Dee (chapter V) explores what behind-the-border reforms in services and investment are best done through trade agreements. One way to answer this question is to think of trade agreements as being exercises in piecemeal reform, in the sense that they provide opportunities for reform, but in a constrained, partial manner. The key policy question is whether countries should unreservedly take advantage of these opportunities, despite the constraints, or whether the nature of the constraints should temper the way in which the countries go about the reforms. Chapter IV first compares trade agreements, as exercises in piecemeal reform, with other modes of liberalization, and then considers which particular reforms should be included in trade agreements. It develops two key principles of piecemeal reform in services and investment. The first is to look for sectors where trade barriers tend to add to real resource costs. The second is to take a broader view than that of just removing discrimination against foreign providers. The paper concludes with some general guidance for trade negotiators and trade ministers.

E. Some aspects of regional financial integration in Asia and the Pacific

In examining the key factors leading to the collapse of trade with the last crisis in 2008, Baldwin (ed., 2009) finds that “global trade finance has not had a major impact on trade flows”. The freezing of trade finance did not happen in all regions and, in general, from the region tend to invest in markets outside Asia, and some commentators argue that this weak linkage between financial markets in the United States/Europe and Asia has saved Asia from the adverse effects of the sub-prime mortgage crisis. While the low level of integration with the global financial markets might serve as insurance in circumstances such as this latest crisis, economies in Asia and the Pacific still need to improve their financial markets by connecting them both with the world and intraregionally.

Two chapters in this volume look at different aspects of portfolio investments. Daly and Mishra (chapter VII) analyse the linkage between the geographical patterns of trade and portfolio investment. They do so by studying the case of Australia. They use the International Monetary Fund’s coordinated Portfolio Investment Survey dataset. After finding that the pattern of Australia’s capital flows does not match that of its trade flows, they investigate the possible reasons for the mismatch, including the role of cultural informational factors as well as the role of regulatory and legal variables. Their results suggest that the major determinants of Australia’s geographical allocation of portfolio investment indicate a broad correspondence between stock market capitalization of destination countries and the allocation of Australian financial investments – although with some deviations from the baseline, where the deviations are correlated with Australian trade patterns. Australia’s disproportionate investment flows with their concentration on a few countries, in contrast to that country’s pattern of trade flows, can be attributable to an extension of the home bias puzzle that has been observed by many researchers.

Donnelly and Tower (chapter VIII) attempt to see which practices might have acted, or remain, as additional barriers to enhancing intra-Asian financial integration as well as integration between Asia and the most developed markets of United States and Europe. Historically, United States mutual funds have often calculated their asset values for international mutual funds using stale prices, because some fund components finish trading before the market close, thus causing daily fund returns to be predictable. This, in turn, allows an arbitrage opportunity for investors who move their money at the end of the trading day in the United States to capture the next-day change in Asian and European equities. This acts as a tax on other investors in mutual funds that hold non-United States assets. The paper quantitatively traces the history of this phenomenon, known as time-zone arbitrage, in various mutual funds, both before and after the phenomenon became well known. The opportunity for time-zone arbitrage has diminished but not disappeared. This shrinkage, together with the advent of Exchange-Traded Funds, which are not subject to time-zone arbitrage, make investment in Asia and Europe more profitable for American mutual fund investors. This should increase United States investment in Asia and Europe and enhance the integration of these markets.

F. Implications

It appears that after the initial dramatic reaction to the recent crisis, trade flows of Asia-Pacific economies have stabilized and turned towards recovery. While the recovery of trade has been faster than initially predicted, policymakers should not become complacent about the situation. It is obvious that corrections need to be made in the global imbalances in trade, savings and investments. This, in turn, will require repositioning by the Asia-Pacific region in terms of growth strategies. A complementary source of growth to demand in the developed country markets must be found; for many countries, domestic aggregate demand will not be strong enough to support the continuation of high growth rates over the longer period needed for a sustained fight against poverty.

From the analysis provided in this volume's chapters, efforts to improve trade and financial liberalization in the Asian and Pacific region must be strengthened. Trade liberalization, so far pursued through multiple preferential trade agreements, should be tackled in a more systematic way in order to prevent adverse "noodle bowl" effects. Even so, not all countries in the region will necessarily benefit if trade integration is just left to the elimination of tariffs. Deeper integration that enables formation of regional production networks is necessary. This will not be possible without improving the mobility of capital and labour in the region and creating greater transparency of "behind the border" barriers. Integration in real sectors must be balanced with financial integration. While movements in FDI have become more synchronized with trade flows, portfolio capital movements and development of bond markets are lagging behind. Improving the flow of goods, services, capital and people within the Asian and the Pacific region will produce benefits but should not be done at the cost of severing links between Asia-Pacific and the rest of the world.

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