

# **Regional Cooperation towards Greater Global Stability: A Medium-Term Agenda**

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# The motivation

- The impact of the global financial crisis has been relatively limited in Asia
- This likely reflects the limited financial integration of Asia with the world
- But is the policy of relative financial isolation and underdevelopment sustainable for Asia, just to mitigate the impact of a global crisis?

# The purpose

- Focus on medium-term issues (because institution building takes time—though the global crisis can be used to jump start the process)
- To argue that promoting financial integration can contribute to greater stability, both within Asia and in the world

# Outline

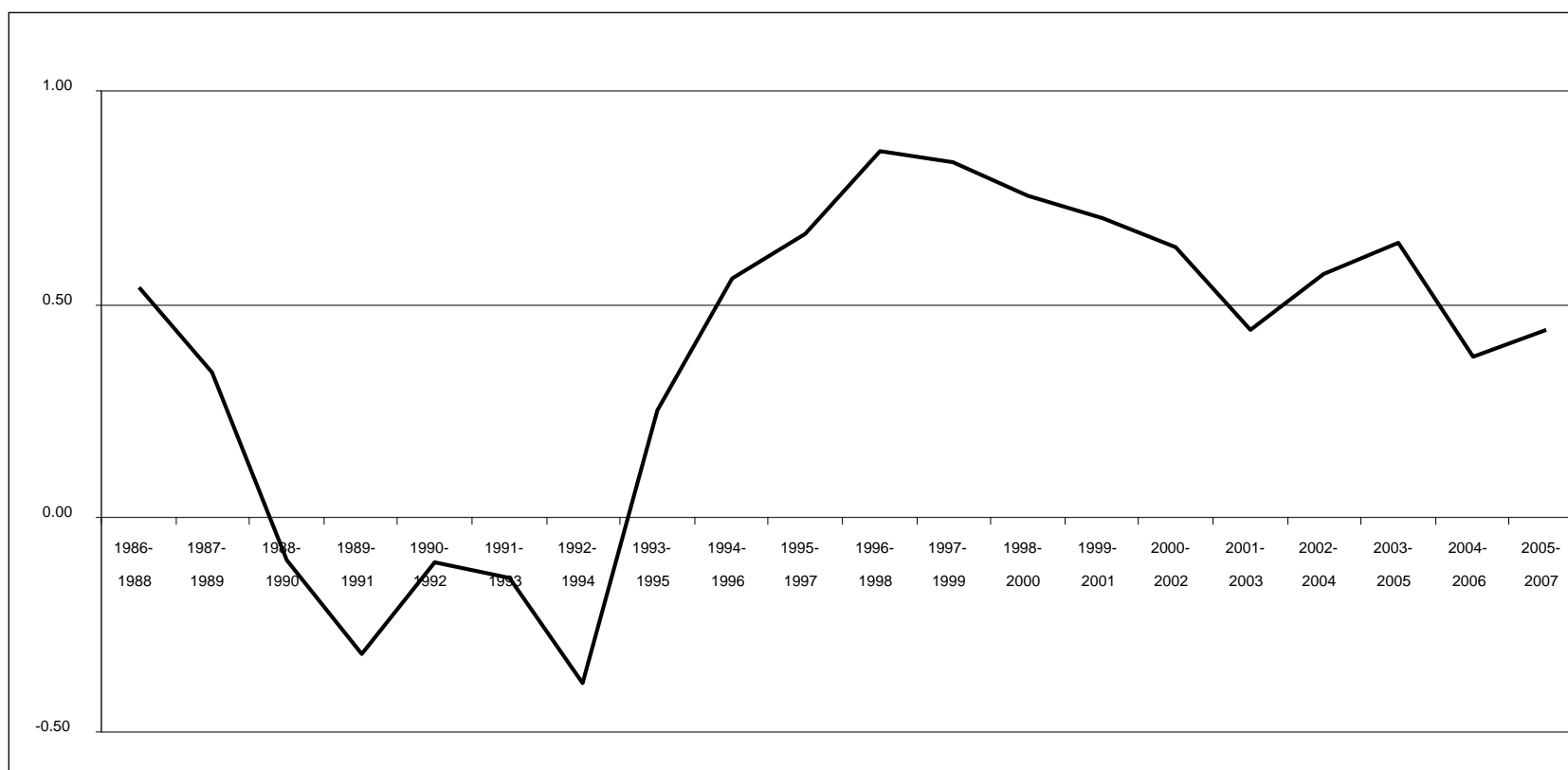
- I. Real integration
- II. Financial integration
- III. Should Asia promote financial integration?
- IV. Conclusion

# I. Real Integration

Empirical studies are almost unanimous in concluding that *output correlation in Asia has increased* significantly, reflecting strengthening intra-regional trade links.

# Asia's Output Correlations with Itself, 1986-2007

(Source: Adapted from ADB 2008, Figure 5.1 )

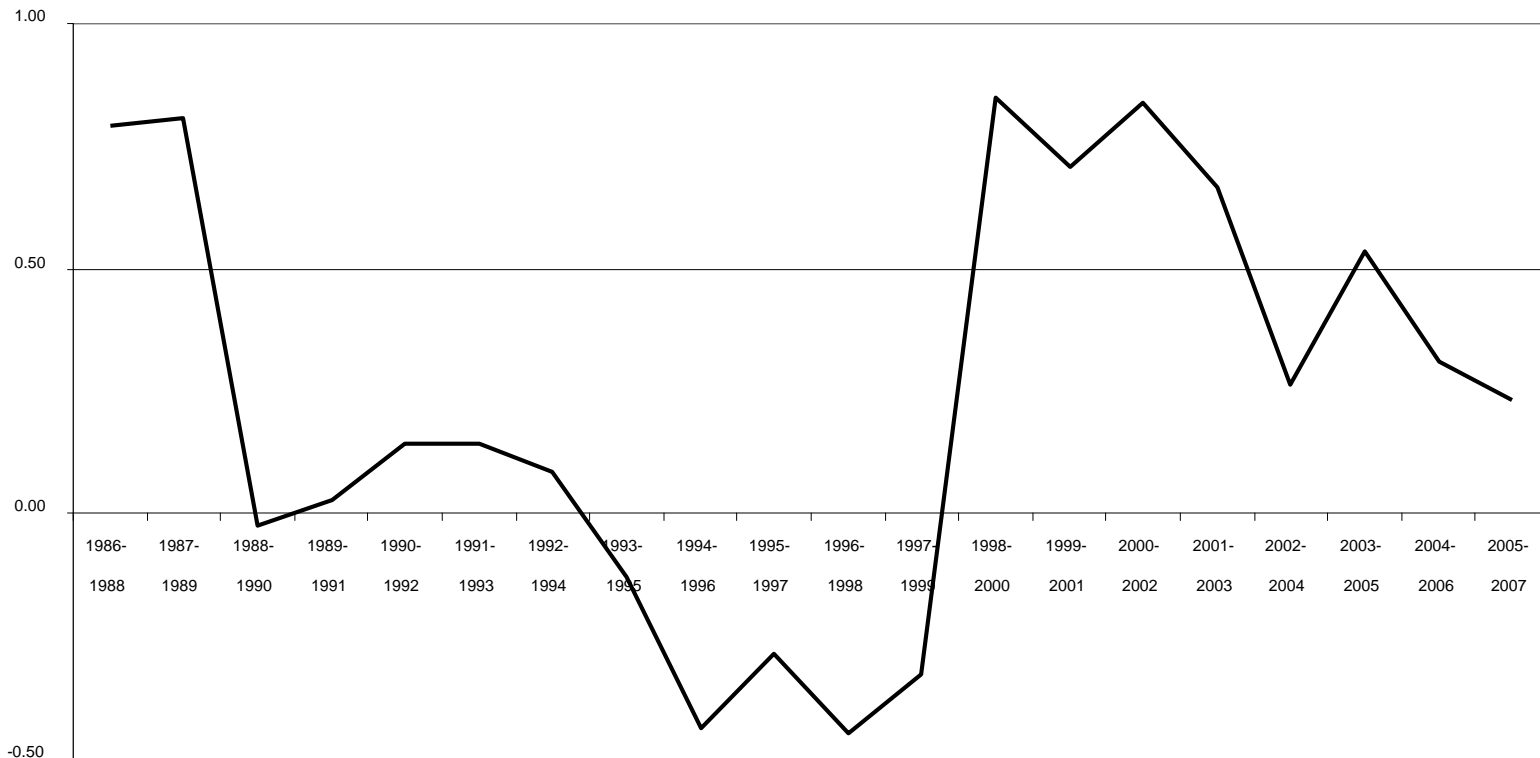


# Real integration (continued)

- There is less consensus that Asia has more de-coupled from the rest of the world, mainly the U.S. and the EU.
- But a number of studies suggest that Asia's links with the world has also strengthened, along with the intra-regional links.
- The current global crisis is a reminder that the world economy is closely linked.

# Asia's Output Correlation with ROW, 1986-2007

(Source: Adapted from ADB 2008, Figure 5.1 )



## II. Financial Integration

- A number of studies show that Asia's financial integration—as well as financial openness—is low relative to other regions.
- For example, estimate  $b$  from the following regression for different regions:

$$(\text{investment/GDP}) = a + b (\text{saving/GDP}) + e$$

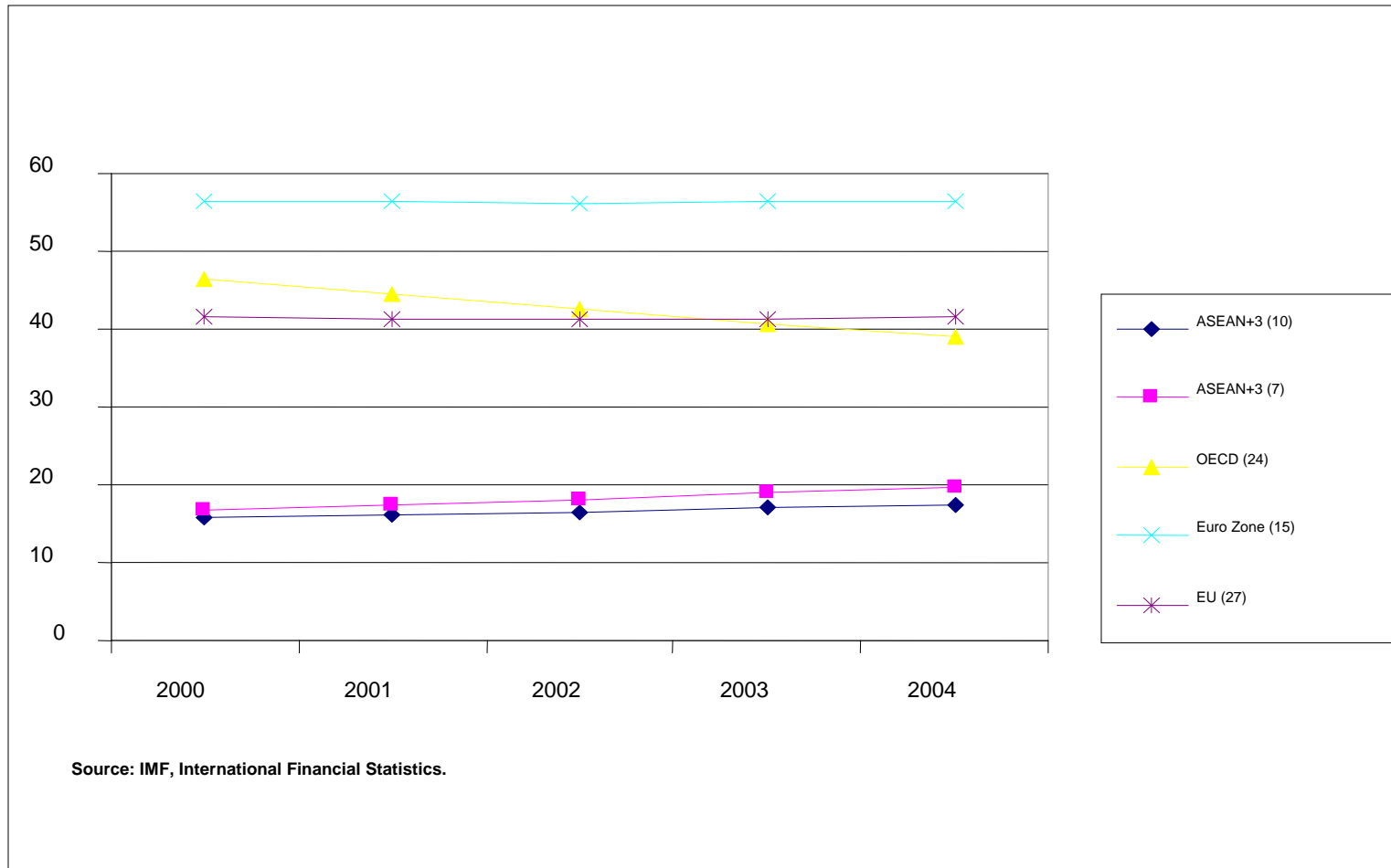
# Estimates of $\rho$ (saving-investment correlation), 1990-2006

Regions or country groups	1990-1999	2000-2006
Asia-Pacific: <u>2</u> /		
ASEAN+3 (10)	0.534 (0.067)	0.349 (0.169)
ASEAN+3 (7)	0.470 (0.103)	0.223 (0.162)
Europe:		
EU (27)	0.109 (0.141)	0.080 (0.078)
Euro Zone (15)	-0.131 (0.178)	0.049 (0.075)
Other parts of the world:		
MERCOSOUR (10)	0.229 (0.201)	0.284 (0.134)
Africa (38)	-0.063 (0.144)	0.092 (0.064)
CFA Franc Zone (12)	0.524 (0.375)	0.255 (0.080)
Other groupings:		
OECD (24)	0.152 (0.146)	0.020 (0.070)
G7 (7)	0.808 (0.141)	0.329 (0.168)

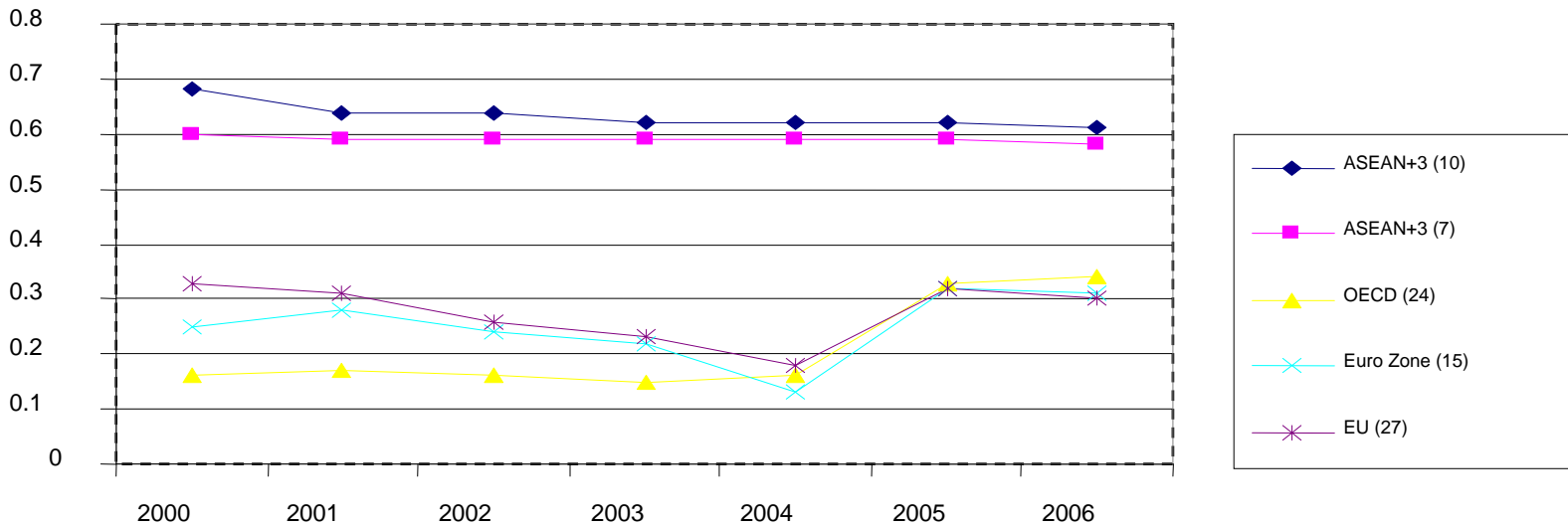
# What accounts for Asia's limited financial integration?

- Most financial flows are linked to trade—limited autonomous capital flows
- Capital controls are still in place in many countries
- Relative underdevelopment of financial systems—markets and institutions
- Financial links, if any, are thus stronger with world financial centers

# Trend Gross Capital Flows, 2000-04 (in percent of GDP )



# De Jure Exchange and Capital Controls, 2000-06 (% of controlled transactions)



Source: IMF, Annual Report on Exchange Arrangements and Exchange Restrictions.

# Should Asia promote financial integration?

- Asia has reaped the benefits of real integration without a commensurate increase in financial integration.
- Asia's relative financial isolation has allowed it to limit its exposure to the fallout of the current global financial crisis.
- Asia does not seem to have suffered too much by relying on world financial centers to intermediate its rather limited flow of financial resources.

## But the policy of relative financial isolation cannot be sustainable

- Asian countries need efficient financial systems for their own sake.
- Financial transactions will inevitably increase if financial systems improve.
- The question is how to manage financial integration—not how to prevent financial integration.

# From passive to active

Financial integration should be actively promoted, and not to be left as an outcome of financial system development, because it brings its own benefits.

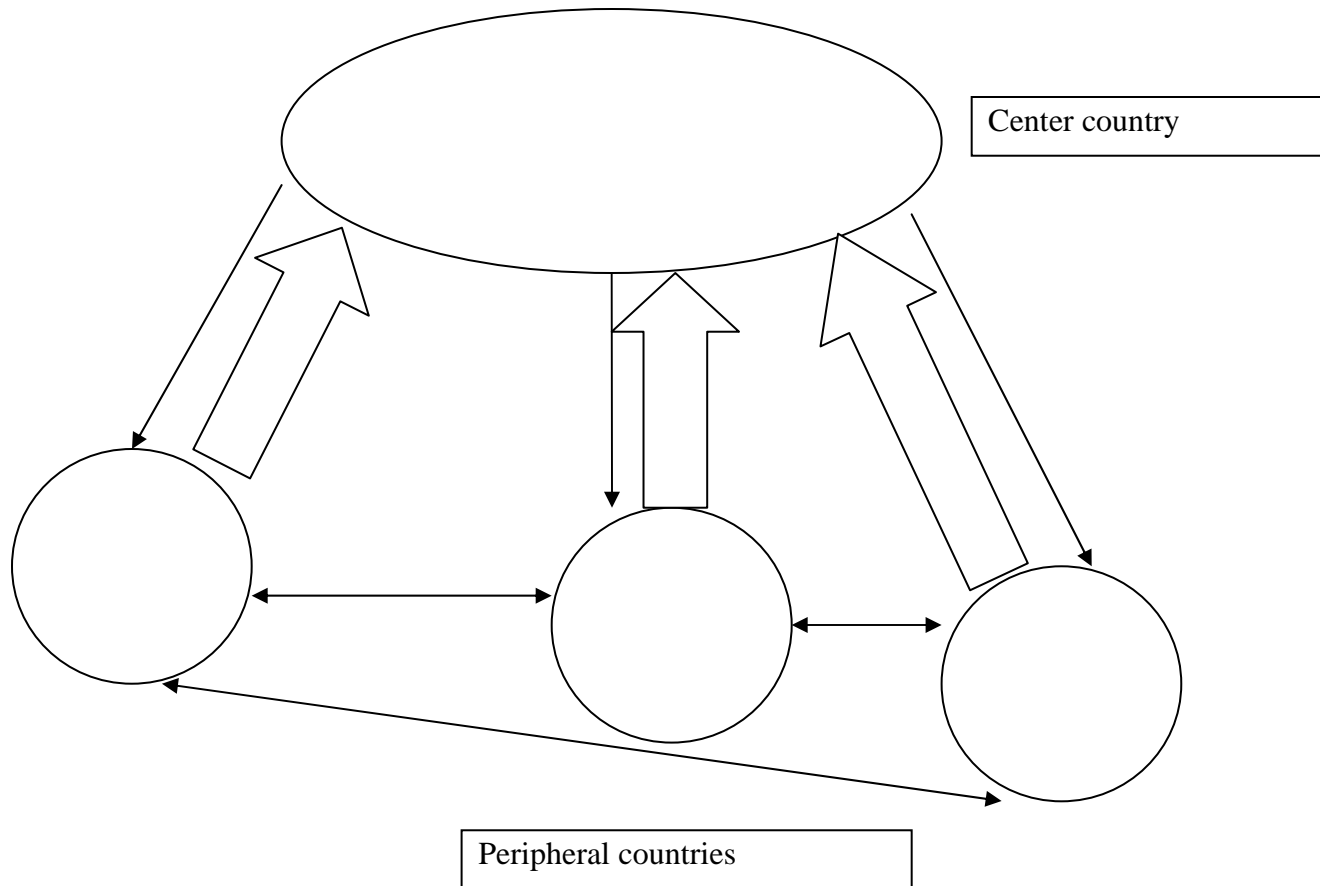
Promotion of financial integration should encourage regional financial integration proportionately more

Although financial system development does not discriminate between regional and global integration, given information asymmetry, it should bias towards regional financial integration—a “region” bias (even if offset to some extent by more efficient world financial centers).

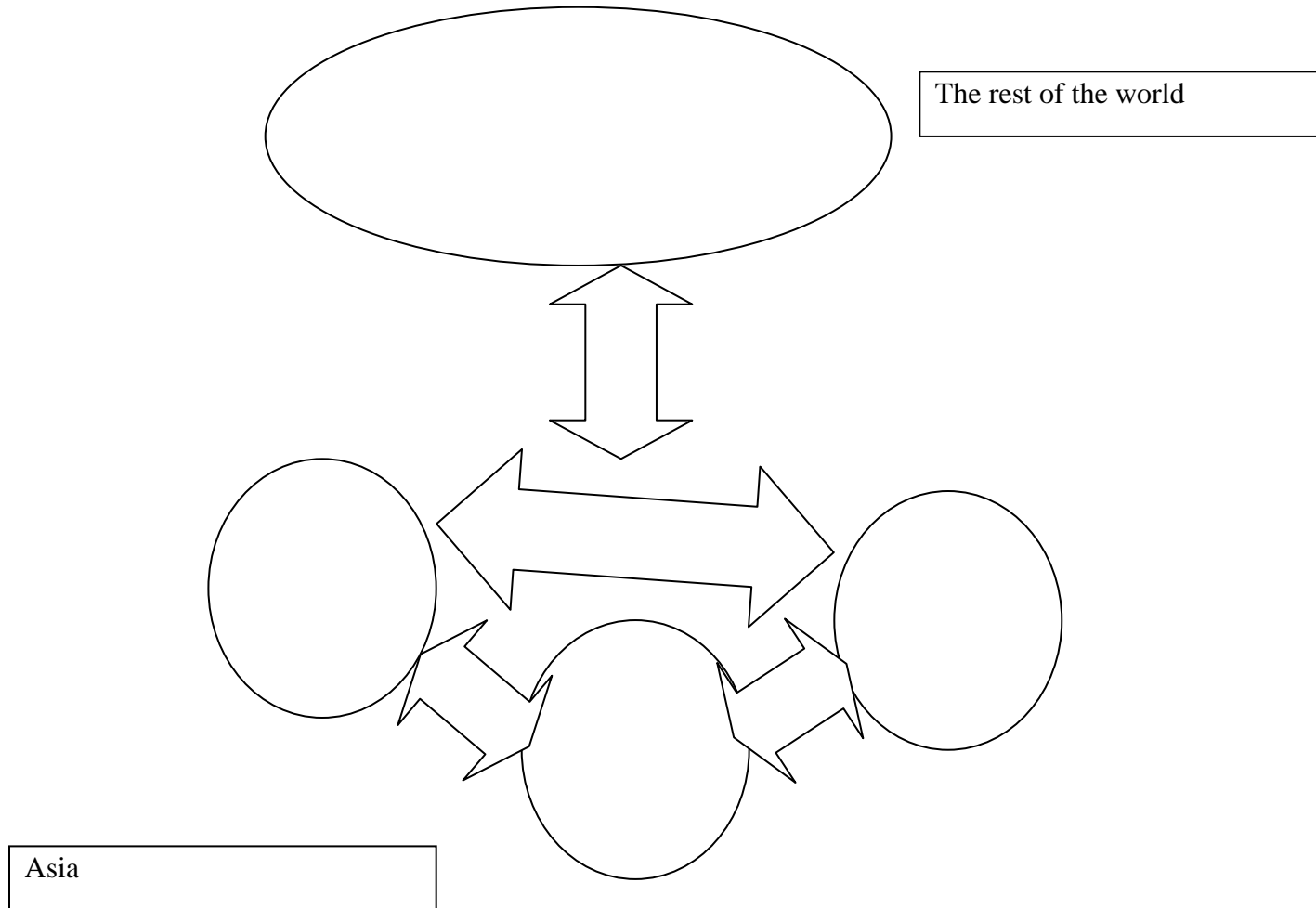
# Benefits of regional financial integration

- Promotion of greater real integration within Asia (Imbs 2006), by creating new opportunities and by lowering transactions costs.
- A more closely linked Asia would be a greater source of demand for final goods from both within and outside the region.
- Less reliance on center countries both for final demand and in intermediating financial resources.

# The Hub-and-Spoke Structure of World Trade and Finance



# The Pluralistic Structure of World Trade and Finance



# Conclusion

- Asia cannot remain a region whose financial integration has not kept pace with real integration.
- Promoting financial integration can lead to greater global economic stability, both by creating more final demand within the region and by spreading financial risks more widely.
- This would facilitate a transition of the current hub-and-spoke structure of world trade and finance, which has been the source of instability, to a more pluralistic structure.

# Conclusion II

- To make the paradigm shift, Asian policymakers must begin by making concerted efforts to develop a deep, efficient, and well-supervised financial system, and liberalizing a substantial portion of restrictions on capital transactions.
- Regional cooperation is essential, not only to push the process forward but to give additional confidence to the authorities.

Thank you.