INTEGRATION OF THE SEACEN ECONOMIES: ASSESSMENT AND POLICY ANALYSIS

Lim Choon Seng, Vincent

The South East Asian Central Banks (SEACEN)
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PREFACE

Following globalization and the success of the European Union, it is commonly believed that small open economies can be better served against external shocks by pooling resources and combining their markets. This has lead to the recognition that regional integration could bring numerous benefits. As such, this paper attempts to provide some background insights into some of the current issues regarding the integration of SEACEN economies.

Mr. Vincent Lim, senior economist of the SEACEN Centre undertakes this project. Mr. Lim would like to thank fellow colleagues in the Research Division, in particular Dr. Bambang. S. Wahyudi, Director of Research for his advice and support. In preparing this paper, Mr. Lim wishes to gratefully acknowledge helpful comments from Dr. Delano Villanueva, former advisor, International Monetary Fund and Visiting Professor of Economics of Singapore Management University. Mr. Lim would also like to thank Mrs. Nurulhuda Mohd. Hussein, economist at the Centre and the Publication Unit of The SEACEN Centre for helpful assistance.

However, the views as expressed in this paper are those of the author's and do not necessarily reflect those of the SEACEN Centre nor its constituent member banks and monetary Authorities.

Dr. Subarjo Joyosumarto
Executive Director
The SEACEN Centre
June 2006

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Summary

A large part of SEACEN economies is already de-facto integrated with respect to trade and foreign direct investment. However, trade is still very dependent on exports to countries outside the region, in particular the US. Compared to the European Union (EU), SEACEN's economic structure is far more heterogeneous, making the path taken by EU difficult to replicate.

Perhaps, the first step is to work towards forming some sort of a customs union among selected groups of SEACEN countries. This requires less effort, but cannot be easily achieved in the short run. These groups could then adopt the parallel currency approach of Mundell (2002) to issue some sort of a currency unit based on a weighted basket of members' currencies, with the US dollar used for invoicing and settling trade until a clearing and settlement system of the currency unit can be established. Accordingly, the motivation to adopt the single currency will then be driven by economics rather than politics (Eichengreen 2005). The second stage may involve further integration among these sub-groups.

However, it is not quite clear whether in the near future, a common currency or the adoption of a common currency-peg is desirable for the whole SEACEN region. History and pragmatism have dictated that partial integration among selected SEACEN countries will be the future trend for integration.

(1.0) Introduction

Despite some initial setbacks and outstanding issues, the economic integration of European countries (EU) could be considered as a success, at least at this early stage. This gives hope to the other regions that have similar aspirations. That such regional integration brings numerous benefits to the individual member economies is well recognized, especially for small open economies such as those in the SEACEN region. In an era of globalization, and the mushrooming of regional trade blocks, small economies will better protect themselves against external shocks by pooling resources and combining their markets. Such an economic alliance based on common interest and objectives, geographical proximity and similar socio-economic structure has emerged as an effective approach to meet the new challenges while reaping benefits from a volatile global environment.

While there have been discussions and proposals on possible economic integration in Asia, the focus has been more on trade as seen in the proliferation of trade agreements both at multilateral and bilateral levels. However, for a group of countries that share common borders or have been historically close such as those in the SEACEN group, the linkages could extend far beyond trade. As shown by the Asian financial crisis, the linkages were also seen in the financial realm, which gave rise to contagion problems from Thailand to as far as Korea. Consequently, it would be useful to access the stages off economic integration of the SEACEN countries and to suggest policies towards economic integration so that appropriate strategies can be adopted by members.

Objectives:

- To look at issues regarding economic integration, with reference to the SEACEN countries;
- To explore the feasibility of further economic integration of the SEACEN economies; and
- To suggest appropriate policies regarding economic integration of the SEACEN economies.

(2.0) Tracking Economic Integration

Economic integration refers to a process where different kinds of barriers between one or more countries are eliminated. Such barriers may include removal of trade restrictions as well as flows of factors of production. Economic integration can arise because of several reasons:

1) through voluntary agreements between authorities among group of economies;
2) formal agreements such as the preferential trade agreements (PTAs) which may result in mutual benefits, and;
3) geographical proximity, resulting in income and policy convergence and trade creation.[1]

The first formalized step toward economic integration is preferential free trade agreements often mutually agreed upon by authorities relating to common trade or services (Table 1). An earlier example of the PTA is the British Commonwealth PTA scheme established in 1932. The second stage is the establishment of the Free Trade Area (FTA). In the FTA, members of the FTA trade freely among themselves but they do not adopt a common trade barrier such as tariff/quota with non-member countries. Individual members decide and retain their own barriers with non-member countries. The third stage is the Custom Union (CU). Under the CU, members go one stage further by adopting a common system of tariffs and quotas with respect to non-member countries. The fourth stage is the formation of a Common Market where the notion of one common market is adopted by members, following the restriction of all barriers, including those that limit the movement of factors of production. The final stage of economic integration is the Economic Union where in addition to the common market, members adopt a common currency and unified monetary and fiscal policy stances.

1. Krugman (1991) also notes that "natural trading block" owing to geographical proximity could be both efficient and welfare increasing.

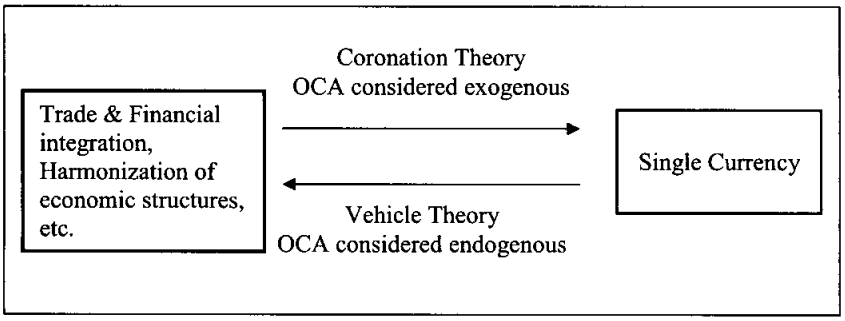
Table 1:
Stages of Economic Integration

Economic Integration	With members	With non-members
Preferential Trade Agreements (PTA)	Grant trade partial preferential to members	
Free Trade Area (FTA)	Trade without restriction	Individual members retain own retains tariff and quota system
Custom Union (CU)	All Restriction removed on mutual trade	A common system of tariffs and quota
Common Markets (CM)	CU + Remove restrictions on all movement of factors of production	Common trade barriers
Economic Union	Supranational authorities coordinate policies. It requires a single monetary system, a central bank, a unified fiscal system, and a common economic policy	Common restriction and trade barriers

(3.0) Sequencing of Integration

Two competing theories of sequencing have emerged since the seminal paper of Mundell (1961). Technically, the order of sequencing depends on whether optimum currency areas (OCA) are endogenous (Chart 1). According to Langhammer (2005), the coronation theory (i.e., the creation of a single currency, hence the 'Coronation') called for the introduction of a single currency after the convergence of various macroeconomic variables as shocks to the system would have been symmetric (hence the concept of OCA). This is the case of the EU, where monetary union came only after a successful integration of trade and factor markets, as well as harmonization of economic structures.

Chart 1:
Sequencing of Integration



This view notes that the greater the degree of similarity and integration in production and consumption structures, the lower the risks of asymmetric shocks or diverging developments that would necessitate a different monetary policy or changes in the exchange rate in order to avoid prolonged periods of unemployment. This is well sumarized by Eichengreen (1997):

> *'The theory of optimum currency areas, initiated by Robert Mundell (1961), is the organizing framework for the analysis. In Mundell's paradigm, policymakers balance the saving in transactions costs from the creation of a single money against the consequences of diminished policy autonomy. The diminution of autonomy follows from the loss of the exchange rate and of an independent monetary policy as instruments of adjustment. That loss will be more costly when macroeconomic shocks are more 'asymmetric'(for present purposes, more region- or country-specific), when monetary policy is a more powerful instrument for offsetting them, and when other adjustment mechanisms like relative wages and labor mobility are less effective'*(Eichengreen 1997, pp. 1–2, cited in McKinnon 2004).

The second proposal, known as Mundell II theory (Mundell, 1973, cited in McKinnon, 2004) argues that when expectations are not stationary and exchange rates are forward looking, countries adopting a single currency can mitigate the adverse effect of shocks through better reserve pooling, portfolio diversification, and risk sharing. For instance, losses can be shared among its members. Mundell (1973, cited in McKinnon 2004) notes:

> *'[a] harvest failure, strikes, or war, in one of the countries causes a loss of real income, but the use of a common currency (or foreign*

> *exchange reserves) allows the country to run down its currency holdings and cushion the impact of the loss, drawing on the resources of the other country until the cost of the adjustment has been efficiently spread over the future. If, on the other hand, the two countries use separate monies with flexible exchange rates, the whole loss has to be borne alone; the common currency cannot serve as a shock absorber for the nation as a whole except insofar as the dumping of inconvertible currencies on foreign markets attracts a speculative capital inflow in favor of the depreciating currency' (Mundell, 1973, p. 115).*

This theory also known as the 'Vehicle theory' (Langhammer 2005) or 'reverse integration" (Shin & Wang 2002) argues that monetary union can promote economic stability and real sector integration. In other words, a country may not join a monetary union *ex ante* but can do so *ex post facto* because of the possibility of lowered asymmetrical shocks (Shin & Wang 2002).

According to Wyplosz (2001),[2] Europe's integration has been successful because of a particular sequencing. It started from trade integration and fixed-but-adjustable exchange rates while keeping domestic and external financial markets under tight control. Then the financial markets were liberalized once the Common Market was fully developed. Exchange rate stability was then enshrined into the EMU. In this respect, Glick (2005) notes two significant differences regarding the sequencing order between the EU and East Asia. The first is that the EU has a strong formal agenda for trade liberalization, unlike that in East Asia where trade agreements are normally negotiated only between a small group of countries. The second difference is the timing of liberalizing the capital accounts. In East Asia, most countries have liberalized their financial markets well before they are considered well-developed but in the EU, the financial markets were only liberalized only after they well developed and the process of integration was well underway. Glick (2005) further argues that the 'wrong' timing of the liberalization of the capital accounts of East Asia is one reason for the region's vulnerability to capital flow reversals, thus making it different for the region to adopt a single currency peg or a common basket of currency peg.

2. Others have also noted the importance of sequencing of free-trade areas (FTAs). For instance, Igawa and Kim (2005) note that because of the market size, an FTA with ASEAN countries may not be beneficial for Korea and they suggest that Korea should form the KOREA-JAPAN FTA with Japan before considering other bilaterial FTAs.

(4) Prerequisites to further Integration

When forming bilateral or sub-regional groups, several critical design principles need to considered (see Table 2). Drake-Brockman & Drysdale (2002) note two additional requirements. The first is that the agreements must offer greater benefits than that could be achieved through the multilateral process in terms of welfare gains. Secondly, one also has to consider the speed of achieving those gains.

Table 2 :
Prerequisites to setting up Trade/Economic Integration

Transparent	Early notification to the WTO accompanied by provision of trade statistics; no further use of the enabling clause; maximum compatibility with the existing disciplines of GATT Articles XXIV and V.
Comprehensive	No exception of sensitive sectors (inclusion of all sectors, if necessary subject to different time frames).
Open-ended	Explicit provision for accession by other regional trading partners.
Minimal trade and investment diversion	Broadest possible interpretation of 'no new barriers', including simple transparent rules of origin; choice of partner countries must be based on proximity, complementarities and significance and rate of growth of bilateral trade and investment flows.
No undermining of WTO rights and obligations under way.	New bilateral dispute settlement, contingent and safeguard protection mechanisms should be avoided.
Beyond WTO's content	The RTA must be trail-blazing or template-setting for the WTO, without prejudging the outcome of any WTO negotiations
Multilateralisable	The RTA must be consistent with other RTAs and timetables.

Source: Table 1, Drake-Brockman & Drysdale (2002), with modification.

Should the economies integrate further, some operational requirements need to be considered,. These are (a) macroeconomic policy coordination, particularly exchange rate management, (b) surveillance and cooperation, and (c) political commitment.[3]

3. See Noyer (2001).

(4.1) Exchange Rate Coordination

A high level of economic integration does not automatically imply the adoption of a common currency or peg; however, it does call for some degree of harmonizing and coordinating of economic policies across participating countries. The greater the degree of the economic integration, the more coordinated macroeconomic policies, in particular, exchange rate policies The importance of exchange rate coordination in trading bloc arrangements is highlighted by Carsten (2005). Coordination of exchange rates is important because exchange rates affect profit-margins of firms and therefore affect trade and FDI flows. Without proper coordination, it is likely that when a particular member of a trading bloc loses competitiveness because of the exchange rate msalignments, that particular country may resort to protectionism by either raising tariffs with rest of the world, causing more trade aversion, or adopting less transparent non-tariff barriers with members. Carsten (2005) cited an example of the 1999 devaluation of the Brazilian real which resulted in a strained relationship between Argentina and Brazil. There have been many recommendations for economies that are closely integrated to adopt a common-basket-exchange rate peg (Williamson 1999 and Murase 2000, cited in de Brouwer 2002). The common peg would eliminate intra-regional competitiveness by reducing intra-regional exchange rate variability.

Hence, in an economic union-type arrangement (defined as economic integration sandwiched between an economic union and a common market) and without a common currency, it is clear that the choice of exchange rate regime has important implications. However, the general conclusion is that the chosen regime must ensure that the operational framework of the exchange rate mechanism is flexible enough to withstand episodes of tension such as changing economic and financial market conditions and unforeseen shocks. In the European experience, examples are provided by the US dollar misalignment in the 1980s and 1990s and the asymmetric shocks caused by German reunification in the early 1990s. In the European Monetary System (EMS)/ Exchange Rate Mechanism (ERM), flexibility of the system was ensured through allowing fluctuation bands around central exchange rates. In addition, the central rates may also be adjusted through "realignments" to be agreed by the ministers and governors of the participating member states. However, there seems to be no general consensus on the most optimal exchange rate management policies for the developing economies (Guinigundo 2005).

(4.2) Surveillance and Peer Pressure

While it is possible to achieve exchange rate and monetary cooperation among countries with different levels of economic development, surveillance mechanisms to monitor macroeconomic stabilization is important for economic integration to work. For example, in the EU, the Stability and Growth Pact, agreed in June 1997 was set up to monitor national fiscal policies and monetary and financial developments. In addition, there must be peer reviews of domestic policies and regular consultations among all parties. This serves three purposes. Firstly, to ensure member compliance with the policy recommendations and to accelerate the execution of agreed policy reforms. This will ensure that the member countries engaged in the catching-up process were committed to implementing the necessary structural reforms. Secondly, to provide mutual financial assistance if required for economic stabilization and thirdly, to prevent future financial crisis through appropriate policies.

(4.3) Political Commitment

As integration deepens, political will is critical to the adoption of a different policy stance than would be needed based upon purely domestic considerations. Members must be willing to take difficult policy measures to reform institutions, such as making central banks independent and accepting supranational directives on issues (such as factor mobility and competition policy). Questions have been asked regarding the political will of many countries to do so (Eichengreen and Bayoumi 1996, Eichengreen 1999 and Williamson 1999).

(5.0) Regional Economic Integration in Asia

According to Carstens (2005), nations pursue trade agreements and form trade blocks for obvious reasons, such as to enhance trade and FDI the flows and to increase welfare and market size. Rato (2005) notes that economic integration, particularly regional integration in Asia will benefit everyone (i.e., it is not a 'zero-sum games') through deepening of the financial markets, strengthening the resilience of economies to external shocks, and maximizing the efficient use of Asia's huge pool of savings for investment purposes. Others, such as Agarwala and Prakash (2002), see regional cooperation in the context of ensuring the improvement of the long-term efficiency of resource allocation, the reduction of output volatility and the prevention of prolonged recessions in regional economies.

One factor that leads to the increasing speed of economic integration in Asia is the 1997 financial crisis. In its wake, the Asian region has recognized the need to make the area more resilient (Mashor 2003). For countries that were affected by the crisis, they recognised not only the 'dynamic effects [of free trade] for revitalizing their economies' but also the need to take the opportunity to tap into China's economic dynamism by fostering closer cooperation (Yamazawa 2002). On the other side of the coin, with China emerging as a global economy, Asian countries must seek to integrate further to face greater competition especially in labour-intensive industries. By integrating their economies, Asian countries can gain economies of scales and force convergence toward regional 'best practices.' (Ramos 2005). Furthermore, Asian countries, being highly exported oriented economies, also see a need to organize themselves into PTAs and trading blocs in the wake of the little progress made by either the WTO or the APEC (Yamazawa 2002 and Mashor 2003). This is compounded by the fact that elsewhere, much integration has been achieved in the European community and the NAFTA.

Another important factor for wanting closer cooperation through forging bilateral and regional trade ties is the geopolitical and security considerations to ensure regional stability by promoting the economic development of participating countries (Carsten 2005). For example, this was the initial aim of the formation of ASEAN in Asia and MERCOSUR in Latin America. Ramos (2005) even suggests that Asia should move to a '*Pax Asia Pacificia*' in which Asian countries 'contribute to and share in the maintenance of Asia-pacific of security and stability'.

It is now well known that free trade does not always lead to welfare gains or economic efficiency as one has to examine the pros and cons of free trade from the point of view of trade creation and trade diversion. Trade creation happens when new trade is generated as a result of cooperation or due to the formation of a trading blocs, while trade diversion is when 'the volume of trade is diverted from low-cost outside exporters to higher-cost bloc-partner exporters' (Pugel 2005). Therefore, trade diversion is the protectionalist element of integration and trade creation the trade liberalization element. Hence, an organised trading bloc can be harmful to trade development if members do not pursue trade openness with non-members.

Another area of concern is the effect of a growing number of overlapping preferential trade agreements (PTAs) that has resulted in a 'spaghetti bowl' of trade relations. Market access among smaller countries has improved as a result

of improved networks. But this also implies a much more complex myriad of trade rules and procedures. These can be difficult to administer and that may actually hinder trade (The World Bank 2005). However, trade diversion has little evidence for its support and, if any, the effect is small and insignificant. Overall, most studies have pointed to the net benefits of economic integration (Table 3).

Table 3:
Findings of selected papers

Authors	Methodology	Major Findings
Kreinin and Plummer (1991)	Concepts of "natural trading Bloc"	East Asia integration likely to take place
Panagariya (1994)	Descriptive Analysis	Because of non-trade barriers, East Asia Integration unlikely
Lee and Park (2002)	Gravity Model	East Asia FTA is more feasible than China-Japan-Korea FTA
Martin, Petri mad Yanagishima (1994)	Global computational Equilibrium (CGE) Model	China and ASEAN will be the biggest winners under an East Asia FTA
Oh and Cheong(1997)	Global CGE Model	Japan and Korea can collect the highest gains from an East Asian FTA
Brown, Deaddoff and Stern (2001)	Global CGE Model	An East Asian FTA may have disruptive effects on sectoral employment in some regions
Park(2001)	Global CGE Model	North-South FTAs are more economically desirable than South-South or North-North FTAs in East Asia
Choi(1996)	Gravity Model	Free Trade Area including ASEAN, Japan And Korea will bring benefits and region's bargaining
Cheong (2004)	CGE approach	East Asia FTA will bring more economic benefits to all member compared to only China-Japan FTA

Source: Cheong (2002), Table 1 cited in Ahn, Baldwin & Cheong I (eds) (2005)

Economic integration in East Asia has been firmed but has not gone beyond the free-trade area arrangement. In many potential areas, Asia tends to like to use the concept of cooperation rather than integration. For instance, the Joint Statement issued by Association of Southeast Asian Nations (ASEAN, eight SEACEN economies are part of ASEAN and Korea is part of the ASEAN +3) in 1999 noted several areas of possible cooperation in East Asia (ASEAN Secretariat), such as strengthening coordination in monetary, financial, social and human resource developments and policies (see Table 4).

Table 4:
Areas of Cooperation

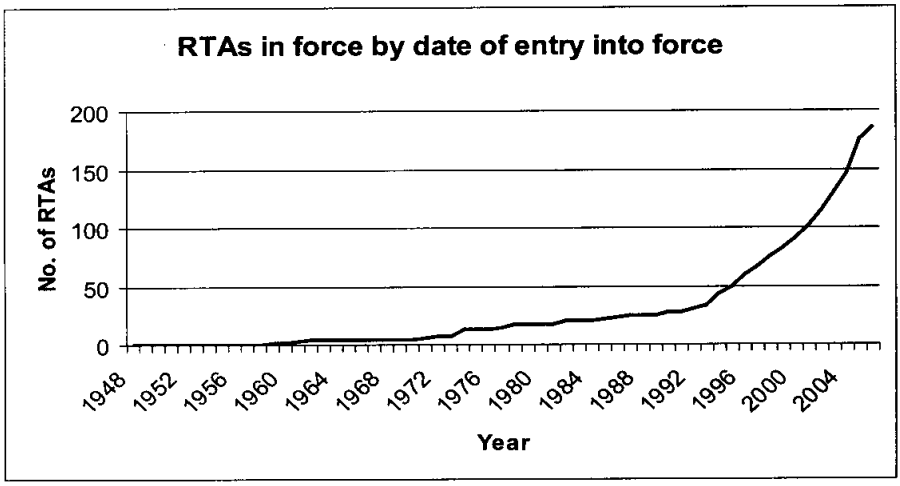
Economic/Social Fields	Agreed to strengthen efforts in accelerating trade, investments, technology transfer, encourage technical cooperation in information technology and e-commerce, promote industrial and agricultural cooperation, strengthen small and medium scale enterprises, promote tourism, encourage active participation in the development of growth areas in East Asia, including the Mekong River Basin, promote broader private sector participation in economic cooperation activities through networking initiatives, such as an East Asian Business Council and industry-specific business fora for major regional industries, and continue structural reform. Agreed to strengthen these areas of cooperation, since these are essential to sustained economic growth and are indispensable safeguards against the recurrence of economic crises in East Asia.
Monetary/Financial cooperation	Agreed to strengthen policy dialogue, coordination and collaboration on the financial, monetary and fiscal issues of common interest, focusing initially on issues related to macroeconomic risk management, enhancing corporate governance, monitoring regional capital flows, strengthening banking and financial systems, reforming the international financial architecture, and enhancing self-help and support mechanisms in East Asia through the ASEAN+3 Framework, including the ongoing dialogue and cooperation mechanism of the ASEAN+3 finance and central bank leaders and officials.
Social/Human Resources	Agreed on the importance of development of social and human resources for sustained growth of East Asia by alleviating economic and social disparities within and among East Asian countries. Agreed to enhance cooperative efforts in the implementation of the ASEAN HRD Initiative by establishing a Human Resource Development Fund and the ASEAN Action Plan on Social Safety Nets.

Scientific/Technical Development	Agreed to strengthen cooperation in the sciences and technology to enhance capacity-building for the promotion of economic development and sustained growth in East Asia.
Cultural/Information	Agreed to strengthen regional cooperation in projecting an Asian point of view to the rest of the world and in intensifying efforts at enhancing people-to-people contacts and in promoting cultural understanding, goodwill and peace, focusing on the strengths and virtues of East Asian cultures and building upon the recognition that the region partly derives its strength from its diversity.
Development cooperation	Agreed on the importance of generating and extending support for ASEAN efforts in the implementation of the Hanoi Plan of Action to advance economic and sustainable development, technical capability, and the standard of living of the people with the view to fulfilling long-term economic and political stability in the region.
Political/Other Fields	Agreed to continuing dialogue, coordination, and cooperation to increase mutual understanding and trust towards forging lasting peace and stability in East Asia.
Transnational issues	Agreed to strengthen cooperation in addressing common concerns in this area.

(5.1) Trade Arrangements and Agreements in Asia

In recent years, regional trade agreements have become a feature of world trade. There are now more than 200 regional trade agreements (RTAs) in force—a six fold increase in just two decades (The World Bank 2005, see Chart 2). RTAs are defined by the World Bank as "agreements among a group of countries that reduce barriers to trade on a reciprocal and preferential basis for those in the group."

Chart 2



Source: WTO.

Over forty years, SEACEN countries have played an active role in regional trade arrangements and cooperation with the recognition that formation of such 'unions' is the first step towards economic integration.[4] Several SEACEN countries are members of economic cooperation such as ASEAN+3, APEC (Asia-Pacific Economic Cooperation) and SAARC (South Asian Association for Regional Cooperation, see Table 5).

4. In the SEACEN region, in 2000-2003, the average percentage of intra-regional export to total exports is around 25% and the average percentage of intra-regional imports to total imports is 25.3%. However, in the same period, the US is the single largest SEACEN exports markets, around 19 percent of total SEACEN exports, which is larger than the rest of Asia excluding Japan. As for imports, Japan is the largest import market of SEACEN at 18 percent.

Table 5: Trade Agreements and Asia

Agreements	Members
AFTA ASEAN Free Trade Area	Brunei, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam
APEC Asia Pacific Economic Cooperation	Australia, Brunei, Canada, Chile, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, Mexico, New Zealand, Papua New Guinea, Peru, Philippines, Russia, Singapore, Taiwan, Thailand, United States, Vietnam
SAFTA[1] South Asian Free Trade Area **SAPTA** South Asian Preferential Trade Agreement	Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan Sri Lanka
PICTA Pacific Islands Countries Trade Agreement **PACER** The Pacific Agreement on Closer Economic Relations or **SPARTECA** The South Pacific Regional Trade and Economic Cooperation Agreement	Excludes New Zealand and Australia, is a free trade agreements among its member. 16 states of the Pacific forum, include Australia and New Zealand, deals with trade issues but itself is not a free trade agreement. The non-reciprocal agreement dating back to 1981 which provides for duty-free access of Pacific Island goods into the Australian and New Zealand markets.

Source: The World Bank, 2005 and Bilaterial.org website

Nine SEACEN countries are part of the ASEAN+3 grouping and APEC. APEC also includes much larger economies such as the United States, Japan, Canada, Russia, Australia and China. Nepal and Sri Lanka are part of SAARC which also include India. Four SEACEN countries namely Myanmar, Nepal Sri Lanka and Thailand are part of the BIMST-EC (Bangladesh-India-Myanmar-

5. The Agreement on South Asian Free Trade Area (SAFTA) was signed on 6 January 2004 during the Twelfth SAARC Summit in Islamabad. The Agreement is to enter into force on 1 January 2006. Currently, the Sensitive Lists of products, Rules of Origin, Technical Assistance as well as a Mechanism for Compensation of Revenue Loss for Least Developed Member States are under negotiation. The Trade Liberalization Programme is scheduled for completion by 2016 (SAARC website).

Sri Lanka-Thailand Economic Cooperation) formed in 1997. The main aim of the BIMST-EC is to 'serve as a bridge between the SAARC countries and ASEAN countries' to increase regional trade in the region of the Bay of Bengal and the Eastern coast of the Indian Ocean (BIMST-EC 2005). Other regional arrangements include PACER (The Pacific Agreement on Closer Economic Relations) and PICTA (Pacific Islands Countries Trade Agreement), which include two SEACEN members—Fiji and Papua New Guinea.

(5.11) Possible Conflicts between Regional Trade Arrangement and WTO

There are some arguments that regional trade integration would eventually impede and hamper the liberalization effect of the WTO as these regional blocs are actually 'inward looking.' Article XXIV of the GATT recognizes that although the de-facto integration has already been existence because of trade links, full integration under WTO is unrealistic because of the sheer number of WTO members. Hence, under the same Article and now the WTO, regional agreements are explicitly permitted and acknowledged as compatible with the multilateral trading system (Bergsten 1997).

However, ambiguities exist. Regional trade agreements (RTAs) are viewed as discriminatory since tariff concessions are not granted to every member of the WTO (Goto, 2002). However, the GATT Article allows such practices but subject to two conditions. Firstly, WTO members can go ahead and form RTAs provided that they aim for complete liberalization (normally not to exceed ten years from the start date) and the removal of barriers to traded products. Secondly, there should be no an increase in barriers against non-RTA member countries.

However, as Bhagawati (1993, cited in Goto 2002) argues, the term 'complete liberalization' is ambiguous because there is neither an economic nor a legal definition of it. In addition, Goto (2002) also notes that even though they may be no increase in barriers against non-members, their welfare can worsen (trade diversion) by the interaction of trade between member and non-members of the RTA.

Bergsten (1997) has suggested that one potential way to solve this conflict of interest between regional and global progress and to achieve compatibility between regional trade agreement and the global trading system embodied in the World Trade Organization is to adopt 'open regionalism' currently championed by APEC. While open regionalism is not precisely defined, Bergsten

(1997) notes that open regionalism can de defined in the context of adopting the *nonmutually exclusive four-part formula* which consists of (i) the maximum possible extent of unilateral liberalization (ii) a commitment to continue reducing its barriers to nonmember countries while it liberalizes internally on an MFN (most favoured-nations) basis; (iii) a willingness to extend its regional liberalization to nonmembers on a mutually reciprocal basis; and (iv) recognition that any individual APEC member can unilaterally extend its APEC liberalization to nonmembers on a conditional or unconditional basis.

(5.2) Financial Cooperation

A strong interconnection of trade and FDI is the argument in favour of financial cooperation between countries. But financial cooperation and integration need to be distinguished from financial openness, though in many instances, the latter is a prerequisite to financial cooperation. Rajan (2004) has defined financial cooperation as policy measures to remove obstacles to unrestricted cross-border trade and financial flows.

Therefore, financial cooperation can be in the form of information-sharing or through more sophisticated and complex arrangements of regime settings (Kuroda & Kawai 2002). In this context, there are several levels of financial cooperation (Rajan 2004). One can cooperate in terms of adopting and harmonizing regional financial markets and prudential measures and further adopting a common platform for intraregional payments and settlements. For instance, Yam (2005) has suggested that the first step is to link the financial infrastructure by integrating the trading, clearing, payments and settlement systems as the technology is current available for such linkages. Another area of financial cooperation is the monitoring and harmonization of prudential regulations (Anwar 2005), e.g., some form of surveillance and financial cooperation in exchange rate management.

SEACEN members have set up many regional fora for financial and monetary cooperation (see Table 6). Such efforts include the Executives' Meeting of East Asia and Pacific Central Banks (EMEAP), APEC Finance Ministers' Meeting (FMM), and the South East Asian Central banks (SEACEN). But there have not been any concrete regional surveillance facilities and early warning systems among SEACEN countries. However, steps are been taken by the SEACEN Expert Group (SEG) on Capital Flows. The SEG was established by the SEACEN Centre in May 2000, in response to the concern expressed by the SEACEN central bank Governors over the need to manage capital flows to ensure stability in regional financial markets. The SEG work has focused on

three main areas, namely developing a regional framework to promote the sharing of capital flows data; assessing the methods and systems of risk management among members; and capacity building. The SEG comprises 17 member central banks, viz. the 14 SEACEN member central banks, and 3 SEACEN observers, namely the Reserve Bank of Australia, Hong Kong Monetary Authority and Bank of Japan.

Table 6
Regional Forums for Finance Ministries and Central Banks

	Finance ministries and/or central banks					Central banks		
	ASEAN	ASEAN+3	MFG[a]	APEC	ASEM[b]	SEANZA	SEACEN	EMEAP
Year established	1967	1999	1997	1994	1997	1956	2006	1991
Fiji							#	
Japan		#	#	#	#	#		#
China		#	#	#	#	#		#
South Korea		#	#	#	#	#	#	#
Hong Kong			#	#		#		#
Taiwan				#			#	
Singapore	#	#	#	#	#	#	#	#
Brunei	#	#	#	#	#		#	
Cambodia	#	#					#	
Indonesia	#	#	#	#	#	#	#	#
Laos	#	#						
Malaysia	#	#	#	#	#	#	#	#
Myanmar	#	#					#	
Philippines	#	#	#	#	#	#	#	#
Thailand	#	#	#	#	#	#	#	#
Vietnam	#	#		#	#			
Mongolia						#	#	
Macao						#		
Papua New Guinea				#		#	#	
Australia, New Zealand			#	#		#		#
Nepal, Sri Lanka						#	#	
Bangladesh, India, Iran, Pakistan						#		
USA, Canada			#	#				
Chile, Mexico, Peru				#				
Rusia				#				
EU-15					#			

Notes: APEC = Asia-pasific Economic Cooperation; ASEAN = Association of Southeast Asian Nations; EMEAP = Executives Meeting of East Asia-Pasicfic Central Banks; MFG = Manila Framework Group; SEACEN = South East Asian Central Banks; SEANZA = South East Asia, New Zealand, Australia.

a Includes the International Monetary Fund, the World Bank, the Asian Development Bank and the Bank for International Settlements.

b Includes the European Commission.

Source: Table 2, Haruhiko Kuroda and Masahiro Kawai, Pacific Economic papers, October 2002, with modifications.

One of the most concerted efforts of regional financial cooperation among several SEACEN members is the bilateral swaps arrangement under the Chiang Mei initiative framework agreed upon by ASEAN + 3 in May 2001[6]. The Chiang Mai Initiative was the first step towards some sort of regional financing. The basic idea of the agreement is that members agree to take the initiative to supplement loans from the IMF and World Bank during time of crises. After the financial crisis, in September 1997, there was a proposal to set up the Asian Monetary Fund, a 'sister' fund to the IMF. However, the fund which was proposed by the then Deputy Finance Minister of Japan, Eisuke Sakakibara did not materialize as the proposal witnessed strong opposition from the US (Lewis 1999).[7] A year later in October 1998, Miyazawa the then finance minister of Japan launched the "New Miyazawa Initiative" a bilateral initiative intended to help Asian economies through the creation of a US$30 billion facility, comprising US$15 billion for long-term projects and US$15 billion for short-term stabilization (Ministry of foreign affairs, Japan 1998).

The setting up of the Asian Bond Fund is considered by many as one of the most important milestones in financial cooperation in Asia (Rajan 2004). There is a need for a regional bond market where funds available for borrowings in the domestic market are limited. A mature bond market can increase the efficient use of pool of savings for regional long-term investment, without going through financial intermediaries outside the region. Once a regional bond market becomes sufficiently liquid and deep, investors outside the region would want to invest in the regional currency-dominated bonds. In this respect, domestic banks and local firms can avoid facing balance-sheet vulnerabilities caused by fluctuations in exchange rates (the 'Original sin' as hypothesized by Eichengreen & Hausmann 1999, cited in Kuroda & Kawai 2002).

According to the EMAP press release,[8] the Asian Bond Fund (ABF) is an initiative developed by the EMEAP Group which aims at broadening and deepening the domestic and regional bond markets in Asia. In June 2003,

6. Earlier the then Prime Minister Mahathir Mohammad of Malaysia in December 1990 proposed the formation of the East Asian Economic Grouping (EAEG), and later renamed "East Asian Economic Caucus"(EAEC) at the ASEAN Fourth Summit in Singapore. Yamamzara (2005) notes that the Chiang Mai agreement gave the impression that the momentum of regional cooperation, although it came a bit late, shows the desire to advance greater financial corporation.

7. Another reason according to Kinukawa (2000) as to why the proposed Asian Monetary Fund (AMF) did not take off was because of lack of clarity regarding the mechanisms of the AMF.

8. Taken from EMEAP Press Statement, 2005.

EMEAP launched the first stage of ABF (ABF1), which invests in a basket of US dollar denominated bonds issued by Asian sovereign and quasi-sovereign issuers in EMEAP economies (excluding Australia, Japan and New Zealand). Building on the success of ABF1, the Group has worked to extend the ABF concept to bonds denominated in local currencies and has announced the launch of the second stage of ABF (ABF2) in December 2004. ABF2 comprises a Pan-Asian Bond Index Fund (PAIF) and eight Single-market Funds. The PAIF is a single bond fund investing in sovereign and quasi-sovereign local currency-denominated bonds issued in the eight EMEAP markets. The eight Single-market Funds will each invest in sovereign and quasi-sovereign local currency-denominated bonds issued in the respective EMEAP markets.

(6.0) Is the SEACEN region ready for a Single Currency?

The formation of European Union highlights the importance of optimum currency areas (OCA). Barro (2001, cited in Madhur 2002) notes that currency unions may have become more popular due to '(i) the increasing number of countries in the world; (ii) globalization; and (iii) the diminishing role of independent national monetary policies, especially for small countries.'

Adopting the coronation theory discussed above, the implementation of a single currency for SEACEN countries, if indeed it is desirable is dependent on many other factors, among them the flexibility of factor markets and the degree of economic convergence. In many SEACEN countries, since the crisis, exchange peg had been abandoned and therefore there is the possibility of increase volatility of bilateral exchange rates. In addition, macroeconomic variables have stabilized since the 1997 Asian financial crisis.

By the optimum currency area criteria, as noted by Mundell (1961) and McKinnon (1963), a prerequisite for advocating a single currency is that economies must experience symmetrical economic shocks. In the European Union, the asymmetrical disturbance was greatly reduced because the euro area economies shows high degree of similarities in consumption and financial structures that enable the transmission of monetary policy to the real economy very workable and predictable.[9]

9. This is debatable. Others have argued that EU is not an optimal currency area (Wagner, 1998). For instance, Trichet (2005) notes that though the EU has been highly integrated in terms of economic structures and financial areas, there are still significant differences in the national financial structures. For instance, there are differences in how long-term savings and pensions of households are structured and in the role of debt securities and private sector financing.

The degree of flexibility of the labour market is also an important consideration. In a currency union, if wages are inflexible downward, the economies may find it hard to reach an equilibrium and massive unemployment may occur. In some sense, the labour market is much more flexible in Asia than in Europe because of the lack of unions. It is worthwhile to note in many SEACEN countries such as Korea, Malaysia and Thailand, in period of recession, the labour market did exhibit some degree of downward *flexibility* as nominal wage cut and other measures (include cuts in bonuses, no adjustment in minimum wages, as in Thailand in 1998). As noted by the International Labour Organisation (2002), "[l]abour markets displayed a great deal of flexibility in the sense that even nominal wages in manufacturing in the Republic of Korea and Thailand fell in the wake of crisis, which helped to limit the incidence of unemployment."

Many SEACEN countries are in fact already been integrated through various regional groupings and through de-facto integration through trade and investments. The intensified trade link is one reason for a single currency arrangement (Kawai & Takagi 2000). Hence the debate is not whether SEACEN economies should adopt freer trade but whether the SEACEN region is ready for a single currency. In the next section, we examine whether shocks to SEACEN economies are symmetrical.

(6.1) Empirical Evidence

A structural VAR proposed by Blanchard and Quah (1989) is used to analyse the degree of economic convergence. Similar to Sato and et.al., (2003), five variables consisting of real economic growth of US (y_t^*), U.S. inflation (p_t^*), real domestic economic growth (y_t), domestic inflation (p_t), and growth of domestic monetary supply (m_t) are used.[10]

The structural model (equation 1) is given by

$$X_t = A(L)\varepsilon_t$$ [11]

10. Due to limited quarterly data, the estimations use yearly data from 1980-2004 (except for Nepal and Myanmar, from 1980-2003). We estimate using changes to avoid the issue of unit roots. Economic growth is measured by real GDP while money supply is measured by changes in M2. All variables are in log differences. Because of yearly data, we estimate with just one lag.

11. Since the variables are assumed to be stationary, there exists a VAR representation of the form $\Delta X_t = A(L)\,\Delta X_{t-1} + \upsilon_t$. It can be shown that the VAR residuals (υ_t) are composed of the structural shocks (ε_t). We estimate equation (1) to recover the structural shocks. We then correlate these structural shocks across the countries.

where A(L) is a 5x5 matrix of lag polynominals and ε_t is the matrix of disturbances.

$$X_{t=}\begin{bmatrix}\Delta y_t^* \\ \Delta p_t^* \\ \Delta y_t \\ \Delta p_t \\ \Delta m_t\end{bmatrix}, \quad A(L) = \begin{bmatrix} A_{11}(L) & A_{12}(L) & A_{13}(L) & A_{14}(L) & A_{15}(L) \\ A_{21}(L) & A_{22}(L) & A_{23}(L) & A_{24}(L) & A_{25}(L) \\ A_{31}(L) & A_{32}(L) & A_{33}(L) & A_{34}(L) & A_{35}(L) \\ A_{41}(L) & A_{42}(L) & A_{43}(L) & A_{44}(L) & A_{45}(L) \\ A_{51}(L) & A_{52}(L) & A_{53}(L) & A_{54}(L) & A_{55}(L) \end{bmatrix}, \quad \varepsilon_t = \begin{bmatrix}\varepsilon_s^* \\ \varepsilon_d^* \\ \varepsilon_s \\ \varepsilon_d \\ \varepsilon_m\end{bmatrix}$$

where ε_s = supply shocks åd = demand shocks and ε_m = monetary shocks.

As discussed by Sato and et.al.,(2003), the inclusion of the US variable is to identify supply and demand shocks conditioned on these respective shocks The long-run restriction is as follows:

Domestic shocks have no impacts on the US variable
$A_{13}(L) = A_{14}(L) = A_{15}(L) = A2_3(L) = A_{24}(L) = A_{25}(L) = 0$

S price shocks have no long-run impact on US economic growth
$A_{12}(L) = A_{34}(L) = A_{35}(L) = A_{45}(L) = 0$

Following Bayoumi and Eichengreen (1994), we estimate the size of the shocks by measuring the long-run impact of the respective shocks on economic growth, prices and money, respectively. The speed of adjustment is the ratio of the response after one year to the respective long-run impacts. According to Bayoumi and Eichgreen (1994), supply shocks are most likely to exclude the effects of policy measures and pure stochastic shocks. As can be seen in Table 7, looking at the correlations of the supply shocks, with the exception of Myanmar and Sri Lanka, the shocks appear to be correlated across the SEACEN countries.[12] The correlation is particularly strong for some ASEAN countries. Supply shocks of non ASEAN countries, particularly Korea and Taiwan also appear be correlated with some ASEAN countries. Looking at the demand shocks, they appear to be more positively correlated than supply shocks. However, as expected, monetary shocks are less correlated than both demand and supply shocks as monetary shocks represent domestic monetary disturbances.

12. Only positive shocks are considered; negative shocks are considered asymmetric. This result is consistent with that of Eichengreen and Bayoumi (1996); they found that certain pairs of East Asia countries achieve OCA scores comparable to those in Europe For instance, Singapore–Malaysia, Singapore–Thailand, and Singapore–Taiwan.

Table 7: Correlation of structural supply shocks among selected SEACEN countries

	Fiji	Indonesia	Korea	Malaysia	Myanmar	Nepal	Philippines	Papua	Singapore	Sri Lanka	Taiwan	Thailand
Fiji	1.00											
Indonesia	0.09	1.00										
Korea	0.19	-0.14	1.00									
Malaysia	-0.13	-0.23	0.51	1.00								
Myanmar	-0.12	-0.14	0.12	0.10	1.00							
Nepal	0.20	0.32	0.15	0.11	-0.16	1.00						
Philippines	0.12	0.29	0.26	-0.04	0.18	0.10	1.00					
Papua	0.32	0.24	-0.22	-0.36	0.04	0.14	0.21	1.00				
Singapore	0.04	-0.13	0.57	0.53	-0.11	0.26	0.02	-0.35	1.00			
Sri Lanka	0.02	-0.23	-0.13	-0.21	0.10	0.11	-0.03	0.18	-0.07	1.00		
Taiwan	0.42	-0.16	0.07	0.21	-0.43	0.32	0.14	-0.21	0.18	0.06	1.00	
Thailand	0.25	-0.12	0.42	0.29	0.05	-0.19	0.30	0.13	0.23	-0.16	0.27	1.00

Correlation of structural demand shocks among selected SEACEN countries

	Fiji	Indonesia	Korea	Malaysia	Myanmar	Nepal	Philippines	Papua	Singapore	Sri Lanka	Taiwan	Thailand
Fiji	1.00											
Indonesia	-0.10	1.00										
Korea	0.32	-0.21	1.00									
Malaysia	0.15	0.00	-0.05	1.00								
Myanmar	-0.06	0.40	-0.10	0.07	1.00							
Nepal	-0.08	-0.03	-0.03	-0.17	0.04	1.00						
Philippines	0.18	0.42	0.29	0.20	0.19	0.12	1.00					
Papua	-0.26	-0.23	0.22	-0.34	-0.11	0.69	-0.15	1.00				
Singapore	0.22	-0.10	-0.03	0.29	0.48	0.39	-0.08	0.23	1.00			
Sri Lanka	0.53	-0.14	0.31	0.32	-0.13	-0.14	0.28	-0.04	0.22	1.00		
Taiwan	-0.38	-0.03	-0.01	-0.53	0.09	0.46	-0.24	0.52	0.18	-0.24	1.00	
Thailand	0.08	-0.32	0.52	0.01	0.11	0.21	0.07	0.31	0.34	0.20	0.30	1.00

Correlation of structural monetary shocks among selected SEACEN countries

	Fiji	Indoneisa	Korea	Malaysia	Myanmar	Nepal	Philippines	Papua	Singapore	Sri Lanka	Taiwan	Thailand
Fiji	1.00											
Indoneisa	-0.12	1.00										
Korea	-0.02	0.05	1.00									
Malaysia	-0.04	-0.20	0.15	1.00								
Myanmar	-0.25	-0.01	0.03	0.16	1.00							
Nepal	-0.13	-0.19	-0.20	0.12	0.22	1.00						
Philippines	-0.06	0.20	-0.07	0.06	-0.24	0.11	1.00					
Papua	-0.46	-0.25	-0.34	-0.14	0.31	0.67	0.14	1.00				
Singapore	-0.07	0.43	0.45	0.12	-0.25	-0.28	-0.01	-0.46	1.00			
Sri Lanka	0.20	0.12	0.09	0.24	-0.15	-0.09	0.18	-0.08	0.06	1.00		
Taiwan	-0.05	0.10	0.04	0.29	-0.48	0.13	0.20	-0.31	0.33	0.02	1.00	
Thailand	0.12	0.20	0.27	0.28	-0.38	-0.09	0.40	-0.22	0.45	0.28	0.30	1.00

The shade area shows significant levels of correlations. Significant level is computed using the Fisher's variance-stabilising transformation of correlation r where z= 0.5*ln((1=r)/(1-r)), which has a normal distribution with mean equals zero and standard deviation qpproximately equals 1/square roots of (n-3), under the null hypothesis that the coefficients equals zero. See Sato and er.al (2003)

Comparing the size and speed of the shocks, on average across the region, supply shocks are much larger than demand shocks but the speed of adjustment to demand shocks is much faster than supply shocks (see Table 8). On the other hand, the speed of adjustment and the size of monetary shocks are relatively large. Looking at individual countries, with the exception of a few countries, the size of supply shocks appears to be similar but the speed of adjustment is more varied. Similar patterns are detected for both demand and monetary shocks.

Table 8: Size and Speed of Adjustment to Shocks

	Supply Shocks		Demand Shocks		Monetary Shocks	
	Size	Speed	Size	Speed	Size	Speed
Fiji	0.04	0.79	0.02	0.79	0.06	0.85
Indonesia	0.05	0.75	0.03	1.05	0.07	0.58
Korea	0.06	0.56	0.02	1.01	0.07	0.47
Malaysia	0.05	0.75	0.02	0.61	0.05	0.90
Myanmar	0.08	0.27	0.11	0.75	0.08	0.95
Nepal	0.02	0.86	0.05	0.76	0.03	1.09
Papua New Guinea	0.08	0.61	0.04	0.54	0.04	0.78
Philippines	0.04	0.34	0.03	0.27	0.07	0.63
Singapore	0.06	0.37	0.01	1.56	0.07	0.72
Sri Lanka	0.02	0.83	0.03	1.11	0.04	0.89
Taiwan	0.04	0.16	0.03	0.77	0.02	0.28
Thailand	0.08	0.44	0.02	0.66	0.07	0.44
Average	0.06	0.61	0.04	0.90	0.06	0.78
Standard Deviation	0.02	0.24	0.03	0.33	0.02	0.24

The results show that only some subsets of SEACEN countries are good candidates for a monetary union as demand shocks appears to be correlated.[13] However, it does appear that the size of the shocks and the speed of adjustment vary quite significantly across the countries. We would tend to agree that the empirical evidence does not seem to suggest that the SEACEN region as a whole is not an OCA. The results are hardly surprising as they simply endorse a known fact about the heterogeneity of the structure of the SEACEN economies.

A caveat to this kind of study is that it is important to recognize that an optimum currency area may not remain optimal. For instance, Eichengreen (1992) and Krugman (1991) recognize that as a region becomes more specialized in what they produced, the optimality of OCA may be questioned, i.e., *ex ante* OCA can be different from *ex post* OCA (McKinnon 2004). As such, the risk is that eventually, members may experience asymmetric shocks and not respond to counter-cyclical monetary policies. Another important consideration is that the OCA can be potentially endogenous to certain events (Frankel & Rose 1998).

(7.0) Possible Scenarios for Economic Integration

We envisage that there are several possible scenarios for further integration for the SEACEN economies. One possible scenario is to pursue further integration of all SEACEN economies only. The second option is to integrate SEACEN economies with China, Japan and India while the third option is to integrate SEACEN economies into various different groups.

(7.1) Further Integration of all SEACEN Economies only

As noted above, a large part of the SEACEN region can be considered as having *de-facto* trade-integrated, while the 1997 financial crisis highlighted the high degree of financial and macroeconomic interdependence. The question thus is: as many SEACEN countries are already part of many regional groupings, is further integration necessary? Unlike PTAs which require a diversified membership to exploit comparative advantage of economies of scale (Carsten 2005), further integration of the SEACEN economies calls for similar economic structures of its member countries. By the optimum currency area criteria, as

13. The result is similar to the OCA index of Eichengreen and Bayoumi (1996). They find that certain pairs of East Asia countries achieve scores comparable to those in Europe For instance, Singapore–Malaysia, Singapore–Thailand, Singapore–Hong Kong, Singapore–Taiwan, and Hong Kong–Taiwan.

the empirical evidence shows, full integration of all the SEACEN economies is not very feasible as the diverse economic background may pose heterogeneity problems in policy coordination. For instance, Korea, an oil importer, would respond differently in terms of monetary policy to a surge in oil prices, compared to an oil exporter such as Indonesia (Kwan 2001).

By examining other relevant indicators, one points to the same conclusion. For instance, there are vast differences in the levels of income and indebtedness among SEACEN countries. The trade structure is also very different. Some SEACEN countries have comparative advantage in the capital-intensive manufacturing products while others in agricultural products. Furthermore, in terms of global and business competitiveness indeces reported by World Economic Forum and Harvard University[14], there are also wide discrepancies among the rankings of the two indices in the SEACEN countries (see table 9 and 10).

Table 9: Competitiveness Index

Growth Competitiveness Index rankings 2004			BusinessCompetitiveness Index,			
Country	2005	2004	Country	BCI	Company operations and Strategy	Quality of the national business environment
Taiwan	5	4	Japan	8	3	1
Singapore	6	7	Singapore	10	12	8
Japan	12	9	Taiwan	17	12	20
Korea	17	29	Malaysia	23	28	23
Malaysia	24	31	Korea	24	21	28
Thailand	36	34	India	30	30	32
China	49	46	Indonesia	44	38	46
India	50	55	China	47	39	47
Indonesia	74	59	Sri Lanka	68	69	67
Philippines	77	76	Philippines	70	50	77
Mongolia	96	-				
Sri Lanka	98	73				

14. The GCI is composed of three "pillars," all of which are widely accepted as being critical to economic growth: the quality of the macroeconomic environment, the state of a country's public institutions, and, given the increasing importance of technology in the development process, a country's technological readiness. The Business Competitiveness Index (BCI) is a complement to the medium-term, macroeconomic approach of the Growth Competitiveness Index It evaluates factors for creating wealth (see Global Competitiveness Report 2005-2006).

However, one possible solution towards reconciliation of these diversities is to extend cooperation to include technical assistance and capacity building (Yamazawa (2002). For instance, with the objective of closing the development gap between members, ASEAN has adopted the Initiative for ASEAN Integration (IAI), focusing on human resource development, infrastructure (transport and energy), regional economic integration, and information technology. [15]

To enhance integration further, the roadmap to a full SEACEN economic integration needs to consider the following:

(7.11) The Issue of Liberalization and the Harmonization of Tariffs.

For SEACEN economies, because of the wide disparities in economic development, the implementation of a large number of arrangements for facilitation simultaneously, similar to the EU experience, is problematic. For instance in the SEACEN region, the all or nothing-the *acquis communitaire'* approach may pose problems to smaller countries (Elek 2003). In addition, markets that are very much segmented and fragmented will incur unnecessary costs incurred due to the need to harmonize customs procedures and standards (Mckinsey's report cited in Rajan 2005).[16]

A possible solution is to opt for flexibility where members are given the option to join later or at the same time but at a slower pace, depending on their level of development, preparedness and comfort This unique characteristic is the model adopted by ASEAN (Reyes 2004) There are also many 'soft' and sensitive areas that needed to be harmonized. For instance, these include complex issues such as anti-dumping subsidies, intellectual property rights, trade-related investment measures, subsidies, particularly agriculture and the removal of barriers to the flow of capital and labour. Taking ASEAN as a yardstick, it has already established the ASEAN Single Window (ASW) in December 2005.The ASW is the single most important initiative of customs that will ensure expeditious clearance of goods and reduce the cost of doing business in ASEAN. The ASW will facilitate the speedy clearance of imports through electronic processing of trade documents at national and regional level.

15. ASEAN Chairman's Statement of the 11th ASEAN Summit, 2005.

16. The proliferation of FTAs is one of the main causes of fragmented and segmented markets.

Table 10: Selected Key Indicators

HDI Rank		Human Development Index (HDI) value	Education Index	Primary Exports (% of merchandise exports)		Manufactured Exports (% of merchandise exports)		High-technology exports(% of merchandise exports)		Income group	Indebtedness
HDI Rank	**Countries**	2003	2003	1990	2003	1990	2003	1990	2003		
High Human Development											
10	USA	0.944	0.87								
11	Japan	0.943	0.95								
25	Singapore	0.907	0.91	27	12	72	85	40	59	High income	Debt not classified
28	Korea	0.901	0.97	6	7	94	93	18	32	High income	Debt not classified
33	Brunei	0.866	0.86	100	94	(.)	6	..	(.)	High income	Debt not classified
Medium Human Development											
61	Malaysia	0.796	0.83	46	22	54	77	38	58	Upper middle income	Moderately indebted
73	Thailand	0.778	0.86	36	22	63	75	21	30	Lower middle income	Less indebted
84	Philippines	0.758	0.89	31	10	38	90	..	74	Lower middle income	Moderately indebted
92	Fiji	0.752	0.86	63	55	36	44	12	1	Lower middle income	Less indebted
93	Sri Lanka	0.751	0.83	42	25	54	74	1	1	Lower middle income	Moderately indebted
110	Indonesia	0.697	0.81	65	48	35	52	1	14	Lower middle income	Severely indebted
114	Mongolia	0.679	0.9	..	62	..	38	..	..	..	..
129	Myanmar	0.578	0.76	..	..	..	..	..	..	Low income	Severely indebted
136	Nepal	0.526	0.53	..	..	83	..	..	..	Low income	Less indebted
137	Papua New Guinea	0.523	0.52	89	94	10	6	..	39	Low income	Moderately indebted

Sources: The World Bank and Human Development Index Report, 2005, UNDP

The Human development index (HDI) is a composite index measuring average achievement in three basic dimensions of human development— a long and healthy life, knowledge and a decent standard of living. Education index is one of the three indices on which the human development index is built. It is based on the adult literacy rate and the combined gross enrolment ratio for primary, secondary and tertiary schools. The larger both indices, the better.

(7.12) The Issue of Leadership

The third issue concerns the absence of a natural focus point and leadership. If SEACEN economies were to integrate fully there is the question of who is willing to assume leadership. Unlike in the EU, the Bundesbank Bank has acquired the reputation of delivering consistently low inflation and by virtual of the size of the German economy and therefore it is natural for Germany to lead. Another major obstacle is that in the SEACEN countries, there is no obvious candidate for a currency to act as a strong anchor for a cooperative exchange rate arrangement.

(7.13) The Issue of Political Commitment

For economic integration to be successful, members need a clear vision and therefore a strong commitment for longer-term cooperation. But because of political differences, the setting up of a supranational regional political organization with supranational laws may not be desirable or even possible (Promfret 2004 and Glick 2005). The depth of integration is defined by the strengthened role of these supernational institutions (Fossum 2001). As the loss of autonomy is a great concern, any proposal to integrate SEACEN economies is only likely to succeed if it does not infringe on sovereignty issues.[17] With regards to the possibility of a single currency for the whole SEACEN, greater financial cooperation is the first step towards more concrete coordination which ultimately may lead to independent supranational institutions with regulatory and supervisory oversight. Taking the Chiang Mai Initiative (CMI) as a yardstick, it is important to realize that a common currency region would requires greater commitment and a much greater pooling of reserves that is currently possible under the CMI (Madhur 2002).

(7.2) Integration of the SEACEN Economies with Japan, China and India

With China and India being the fastest growing economies, this is an interesting proposition. In some aspects, this has already taken place. For instance, in the context of ASEAN, China in 2002 through the Framework

17. It is now well known that the key disadvantage of adopting a common currency is the loss of autonomy in domestic policy making decisions. On this note, Madhur (2002) notes that the loss of autonomy may not be a concern for smaller countries with thin capital markets as, these economies are already facing constraints in pursuing monetary policy for counter-cyclical stabilization purposes. But the dilemma is that weakness in the financial sectors may prevent them to join a monetary union in the first place.

Agreement on Comprehensive Economic Cooperation signed to establish the ASEAN-China Free Trade Area (ACFTA) within ten years. India and ASEAN have also agreed to implement the ASEAN-India Free Trade Area (FTA) Agreement from 1 January 2007. As for Japan, it has concluded its first bilateral free trade agreement in 2000 with Singapore and is currently negotiating individual bilateral agreements with Korea, Malaysia, Thailand and the Philippines by 2005, as well as a separate FTA with ASEAN as a whole by 2010.[18]

It is envisaged that Japan could easily take the leadership role like Germany in the EU. But a SEACEN-Japan-China-India integration may pose several problems. Firstly, the financial markets in China are 'restricted and decoupled' from the international financial system (Langhammer 2005). The non-convertible Chinese yuan remains an issue, as does China's protectionalist agricultural policy. Secondly, the Japanese banking system has not shown any concrete recovery since the relatively poor growth performance during the nineties. Thirdly, there is the element of lack of trust among China, Japan and India. For instance, Zhang (2002) argues that that without the participation of China and Japan, East Asia cannot be properly integrated but its success is very much dependent on the 'real trust and cooperation between the two countries.' However, Korea, a SEACEN member can act as a buffer. Korea and Japan could form a firm FTA first before embracing on trade agreement with China (Cheong 2005). Cheong (2005) also notes that with Japan, China and Korea forming an FTA, issues such as the spaghetti bowl effects and hub-and-spoke dilemma can be amicably settled.

However, as the prospective area for regional currency gets larger, greater dissimilarities would arise, leading to increased difficulties in policy coordination. If SEACEN-China-Japan-India integration becomes a reality, smaller SEACEN countries may fear that the integration bloc may be dominated by a few countries or a single country. In a similar context, Agarwala and Prakash (2002) have argued for the case of East Asia integration. In addition, as Taiwan is a full member of SEACEN, a complication would arise with current the political tension between Taiwan and China

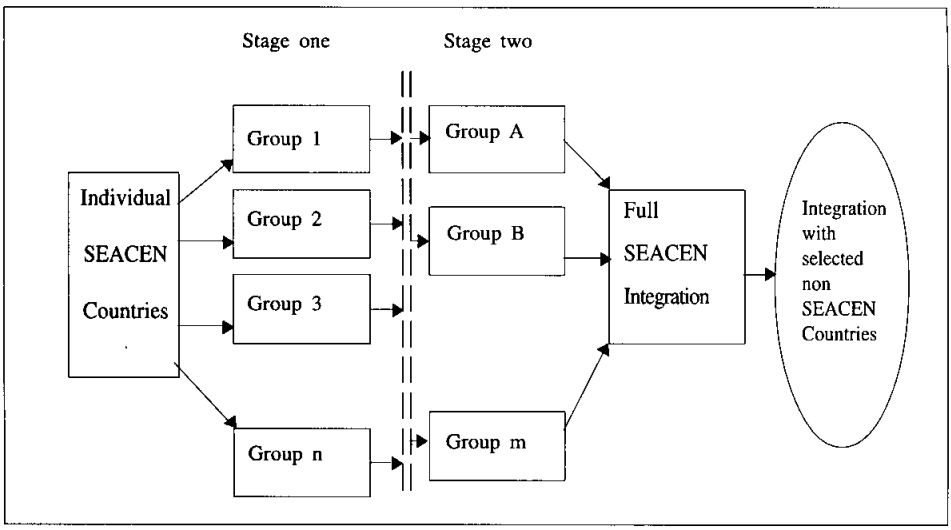
18 . Sourced from Bilaterals.org.

(7.3) Integration among selected SEACEN Countries

This option seems to be most feasible. With integration among selected SEACEN group of countries, the policy option is to take advantage of existing regional groupings among the SEACEN countries. For instance, integration of selected groups of SEACEN countries, based on geographical proximity such as ASEAN, Nepal and Sri Lanka on one hand and Fiji and Papua New Guinea on the other. Partial integration of selected countries will solve the problem of asymmetric shocks.

As far as sequencing is concerned, perhaps the first step may be to form a customs union. A selected group of SEACEN countries could then adopt the parallel currency approach of Mundell (2002) and issue some sort of a currency unit based on a weighted basket of members' currencies, with the US dollar used for invoicing and settling trade until a clearing and settlement system of the currency unit can be established. Accordingly, the motivation to adopt the single currency will then be driven by economics rather than politics (Eichengreen 2005). The second stage may involve further integration among these sub-groups (chart 3).

Chart 3: Stage Approach Integration Route



Where n>m. Selected SEACEN countries integrated into groups in stage one. In stage two, these sub-groups are further integrated.

But partial integration may lead to the route of bilateralism, the so called 'hub-and-spoke systems of bilateral treaties.' Also there is also the possibility that partial integration would lead to a rapid widening in income differences among different groups.

(8.0) Conclusion

Does the SEACEN region have the right political geometry? What about the economic criteria in terms of an optimum currency area? Should SEACEN economies continue to limit capital mobility for the sake of exchange-rate stability or should certain SEACEN countries form sub-groupings? The comparison with Europe begs the question of whether the SEACEN region satisfies the criteria of the optimal currency areas. Whether it is partial or full integration, SEACEN countries may need to consider the following five economic questions (HM Treasury 1997). These are:

(1) Are business cycles and economic structures compatible with interest rates on a permanent basis?

(2) If problems emerge, is there sufficient flexibility to deal with them?

(3) Would joining an integrated bloc create better conditions for firms making long-term decisions to invest in the countries?

(4) What impact would entry into integrated economies have on the competitive position of the country's financial services industry? and,

(5) In summary, will joining a bloc promote higher growth, stability and a lasting increase in jobs?

The SEACEN region, like the rest of Asia may not see the urgent need to integrate like Europe because they rely less on intra-trade within the region and more reliant on the US and EU markets, including Japan (Shin & Wang 2002, Kawai, 2001 and Ogawa & Ito 2000). It may be desirable to create a regional production network to satisfy the desire for integration but yet non-discriminatory as by principle, it allows outsiders to invest in them (Sakakibara & Yamakawa 2003). There is also less desire politically for economic integration, unlike that of the rest of Asia. In addition, it would be difficult to enforce the convergence criteria advocated by the EU. The EU has used the 'scoreboard' approach to track the stage of economic integration by comparing issues related to integration

with a pre-specified time-table to determine the extent to which each country has committed itself to integration. This may not be workable in the Asian context that emphasizes consensus than on confrontation (Dennis & Zainal 2003). Others, such as Lewis (1999), argue that to further integrate, members need to move beyond the principle of non-interference. It is also important that any proposed regional economic block needs a clear vision to identify the region's need for closer cooperation. For instance, clear objectives regarding the intention and conditionalities of the integration must be clearly spelled out.

As the long-term goal would be to contribute to the maintenance of peace, security, prosperity and progress in the region and beyond,[19] we have to recognize that any sort of integration in Asia (for that matter for SEACEN countries) must be for pragmatic reasons rather than an 'aggressive' one (Yamazawa 2002). Hence, history and pragmatism have dictated that partial integration among selected SEACEN countries will be the future trend for integration. Therefore, it is envisaged that integration of SEACEN countries would have to follow a much different path than that of Europe.

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