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Specific Features of Economic and Currency Integration in Asia

Innessa N. Efremenko*
Rostov State Economic University «RINH»
69 B Sadovay st., Rostov-on-Don, 344002 Russia [1]

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Integration processes taking place in Central-Asian region are caused by global trends in the system of international relation connected with internationalization of social life and growing necessity of the states involved to strengthen national statehood, security and taking up global challenges of modern life. Having chosen integration the Central-Asian region is able to turn into an independent subject of modern geopolicy and to take a worthy place on the political map.

Keywords: economic integration; financial integration; national financial systems; globalization; Asian Bank of Development; Association of Southeast Asian Nations).

Point of view

The final aim of regional integration is the creation of common economic space among countries involved. Studying of optimal forms of economic, financial and currency integration is the main task for monetary powers of a number of states in the context of developing and implementing the strategy to adjust to the process of financial and economic globalization. Complexity of modern development of certain regions and world economy in general manifest the variety of integration processes. This fact proves the necessity and topicality of theoretical processing of the issues discussed. However at present some regions while developing and introducing integration mechanisms look for the model of integration which differs from the European one and whose final aim is not the transition to common currency, but the realization of the policy of interstate economic convergence.

Regional economic and currency integration development is based on stable trade links and, what is more important, on historic and cultural contacts of the countries of the given region. Transition from nominal to real convergence in the region brings about harmonization of macroeconomic policy, legal issues and institutional architecture.

Creation of a currency union means serious measures and great efforts connected with coordination of the monetary policy of the member states. Eventually these measures are to stimulate expansion and diversification of the financial market, to promote interregional trade and to strengthen economic power of the member countries of the union. The positive aspect of the implementation of the coordinated monetary policy together with synchronization of economic development of the countries of the union are: the possibility to meet several objectives with limited number of tools for monetary

* Corresponding author E-mail address: rinh_ff_2009@mail.ru

regulation available as well as the possibility of internalization of external effects. It is especially important for the developing countries in the region under consideration. Besides such form of financial-economic integration enables monetary authorities to manipulate with monetary tools in the situations either of instability and uncertainty or turbulence on the financial markets and to make independent decisions as well. All these meet the requirements of the current economic development of the countries of Asian and African regions. Asian countries are playing more and more prominent role in global economy consequently the question of the creation and development of the new section of the world financial architecture – regional economic and exchange union of these countries – are becoming more and more topical and are of great scientific interest.

Economic and financial potential of the Asian countries has grown dramatically for the last decades. This group is becoming the new locomotive for the growth in world economy. Financial relations of these countries are getting deeper and deeper every year and are becoming more organized, and the authorities are making efforts to strengthen them even better. The fact that such powerful financial centers as Hong Kong and Singapore are located in this region makes the processes of financial integration more active.

However in spite of the visible results integration process in the given region is not homogeneous. It should be mentioned that the development on the integration model is rather distorted: currency integration prevails over other stages of the integration which should be in front of the former. For example, full-scale free trade zone and customs union have not been established. Besides the growth of export to the developing countries in ASEAN countries in comparison with their GDP growth is still much higher than the growth of trade within the block. Being export-orientated to the developing countries ASEAN countries differ from other regional unions. For ASEAN countries the aggregated turnover growth with the developing countries for five years after the unification has increased by 1,9 % GDP more than the turnover within the block. In spite of the fact that the present level of trading interconnection of Asian countries is rather high (according to The Asian Bank of Development the share of mutual trading in the region is a less higher than 50 %), but it does not stimulate neither the development of formal integration processes in the trading sphere nor bringing together separate national financial systems of the Asian countries.

The process is specific due to the following subjective factors: big territory of the region, uneven levels of economic development of the countries (first of all industrial), economic potential, the number of population, different political orientation, historical and cultural background. That is why the degree of integration in the region is still low.

Three key factors are to deepen integration processes:

1. changes in behavior and preferences of the local and foreign market participants. In particular, investors are more focused on foreign markets due to technological and telecommunication advance and better information access;

2. national authorities' efforts to reduce/remove restrictions on capital flow and implementing of structural reforms;

3. concentration of efforts of the whole region.

For this decade international society has realized that it is necessary to develop and adopt common standards, and many countries took active steps for coordinating and harmonization their own legal and methodological complexes in accordance with international standards.

Besides, consolidation of financial contacts was accompanied by intense trading and conducting of investment agreements. This very fact stimulates the processes of regional economic integration; The European Union is a graphic example. Ten ASEAN countries strive for closer integration to create regional economic union in the future (by 2015).

Theoretically expansion of integration processes of regional financial integration is (determined) by opening of regional financial systems for foreign capital and by removing limits on placing residents' capital abroad as well as by recognition and adaptation of international standards and codes.

Some steps of political financial liberalization were taken in some Eastern-Asian countries in 1980s, which became more dynamic in the last decade of the XX century. Opening of the financial market meant introducing of market interest rates, allowing foreign financial service providers to render more services on the local market, reducing of reserve requirements, liquidation of credit control, gradual opening of capital market. It concerned, first of all, short-term capital operations while capital operations with balance of payment remained to be controlled.

Let us analyze how far the process of financial integration in Asia has proceeded and how strong are financial links in this region.

Example

Financial markets are known to be totally integrated when the law of the unified price is true, i.e. prices for assets with identical risks and profit rates are to be approximately the same in different countries. When the level of financial integration is high the capital flows to the places where the possibilities for profit are the highest, but gradually profit rates are equalizing.

Thus, index of financial integration – absence of connection between savings and investments within the country. It is expressed: (Feldstein, Horioka, 1980)

$$\left(\frac{INV}{GDP}\right)_{t,t} = \alpha + \beta\left(\frac{SAV}{GDP}\right)_{t,t} + \varepsilon_{t,t}$$

where i – country, t – period of time.

Coefficient β shows the ratio of changing of the rate of the domestic savings in the country with investment financing.

The experts of International Bank of Development (García-Herrero, Wooldridge, 2007) analyze the data reflecting changes of the coefficient β in 26 countries with the developing markets (9 Asian countries, 10 European countries, and 7 from Latin America) from 1982 to 2006 (Fig. 1).

Speaking about the countries with developing markets it should be mentioned that coefficient of savings was very significant in the 1980-s. It reflected the reducing mobility of the capital flows on the developing markets after the long debt crisis in 1982. In the course of 1990-s its significance dropped sharply (from 0,92 in 1987-91 to 0,37 in 1997-2001) and dropped even more (to 0,25) in 2001-06.

The assessment of the last period manifests the growing importance of coefficient of savings for the countries with mature economy (i.e. not zero), it means that both countries the developing markets and mature economies are not integrated in the global financial market. Among the countries with developing markets the coefficient of savings is the lowest in Latin America it is nearly zero in the period under consideration; in European countries it is 0,4 and in Asian countries – 0,5.

As it has been mentioned above the difference in prices for financial assets among the markets of the region is an important index for the financial integration. Consolidation of economic and financial contacts makes diversification of financial assets portfolios easier to low risks which

Fig.1. Ration of savings to investments (García-Herrero, Wooldridge Ph, 2007)

are to promote price balancing. The analysis of the data of the US, European and other developed countries' stock markets for the period of 1980-s demonstrates that the possibilities for profit gaining depend on the country's specificity. However later on – late 1990-s and the early 2000-s – this difference was reducing, which means the growing financial integration. But the possibilities for profit gaining now are influenced by the factors connected with sectors of investments. The countries with developing markets vice verse do not demonstrate any progress in financial integration, and country's specificity is still very important for the possibilities of profit gaining. At the same time the impact of the country's specificity on the prices for financial assets is not as strong in Latin American countries as in Asian countries. It might be connected with fact that quite a big number of the companies in Latin America are listed in different stock markets in the first run in the USA.

The law of unified price appears though not to full extend in the financial market sectors with the fixed revenues. It means the difference in the interest rates between to currencies is equal to the difference between forward operation rates and spot operations. Correspondence of interest rates is observed in the countries which joined the European Union in 2004, at least on money market. However it does not happen in Latin America as there are barriers for investors to participate in arbitration between domestic and foreign markets.

Substantial difference in interest rates is observed in the Latin American countries depending on the country where the capital is placed. Besides at present in the Latin American countries there are a great number of restrictions on capital transactions. These data confirm again that the level financial integration in the Asian region is still very low.

It testifies that not only integration of the countries with the developing markets (Asia) within the region but their integration into the international financial system is lagging behind the regional integration of the countries with developed economy. Consequently the Asian countries are integrated into the international financial system at greater extend than between each other.

Opening national financial systems for non-residents is the most important condition for financial integration of the region under the conditions of growing impact of globalization. Having an opportunity to participate in the processes on the national financial markets foreign financial institutions are becoming the channels for the country's integration not only into global economy but with other countries in the region.

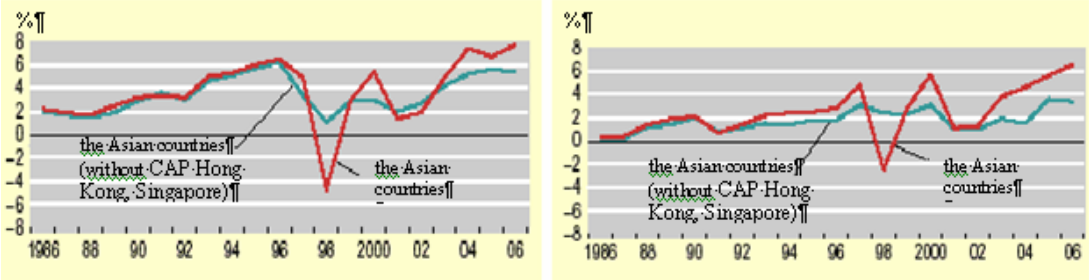

Fig. 2 Inflow (right) and outflow (left) to (www.imf.org)

China the largest and the most influential economy in the Asian region has chosen its won way of integration into global financial system. China's financial system opened for foreign investors when economic reforms started in 1978. However at that moment foreign investors could only cooperate through International Trust and Investment Corporation.

Foreign financial institutions first started their activity in China in 1980. By 1993 foreign financial institutions had opened 302 foreign representative offices and 98 foreign companies on the territory of the country. In 1993 local Chinese non-bank financial institutions were allowed to operate with foreign currency, in 1996 – to issue their won bonds on the international markets. With bankruptcy of the Chinese intermediary International Trust and Investment Corporation in 1998 foreign banks obtained more possibilities to work in the country. As a result 30 foreign banks had been represented in China by the end of 2000. 35 foreign banks including 15 Asian banks, 18 European ones and 2 American (Citibank и Bank of America) were functioning in China in July 2001. By the beginning of 2006 25 cities had been opened for foreign banks and foreign insurance companies. In 2008 China had the biggest in the world currency reserves more than 1500 bln. US dollars due to continuous growth of foreign investments and sustainable growth of the international trade

Imperfect market model in the region under consideration is the main obstacle for full integration in the Asian countries. Differentiation in the ways of getting profit on capital depending on the country where the capital is located will be preserved till corporate management in some countries put insiders into preferable position for obtaining the shares while foreign investors on the contrary have difficulties in obtaining them (Kho, Stulz, Warnock, 2006). Consequently analyzing the level of the financial integration it is necessary to take into account the scales of capital flow together with the measures mentioned above.

Meanwhile mobility of capital has never before been so high in the Asian countries. At present both capital inflow and capital outflow are their record height (Fig. 2).

Such scale of capital flow to the Asian countries resulted from the fact that in the global economy a substantial surplus of global liquidity has accumulated lately and international investors placed it in this rapidly developing region. Direct foreign investment flow to the developing markets is increasing. However this process is characterized by the high degree of concentration – since 2002 China's investment share among all counties with developing market is about 50 per cent. Another dangerous tendency of concentration is massive investment in several sectors of the economy, in particular in real estate and their profiteering character. In the whole such

environment gave advantages of integration into the world economy to the most developed among the developing countries of the region, while most of the economies had limited access to the foreign capital.

Capital outflow from the region is easily explained: currently central banks of the region possess such stock of foreign reserves that to manage these funds effectively monetary authorities had to include long-term American securities, in particular the US treasury stocks, into their management strategies. The region also has substantial sovereign funds for wealth accumulation which contribute much. Besides less investment restrictions on foreign markets for residents as well as ongoing market and industrial integration in the region are the important facts for increasing of capital outflow.

The processes of big capital outflow in the Asian countries graphically demonstrate how liberalization of the restrictions for capital export is able to relax the situation on the currency market and at the same time to promote further transboarding diversification of local investors' portfolios and integration with international markets. For example, regulation reform made easier for private investors to gain and keep foreign assets (China, Southern Korea, Malaysia, Thailand); and Thailand's national pension funds were allowed to invest a good part of their assets aboard.

Last years gross capital flows in the Asian region have been marked by rather high volatility (Fig. 3). Growing significance of portfolio and other kinds of investments (especially bank crediting and operations with derived bank instruments) explains this tendency and speaks about the possibility of dramatic changes of financial flows in any direction. Splashes of capital flows (sometimes brought about by interest arbitrage business in Yens – Yen loans to invest in more profitable assets expressed in

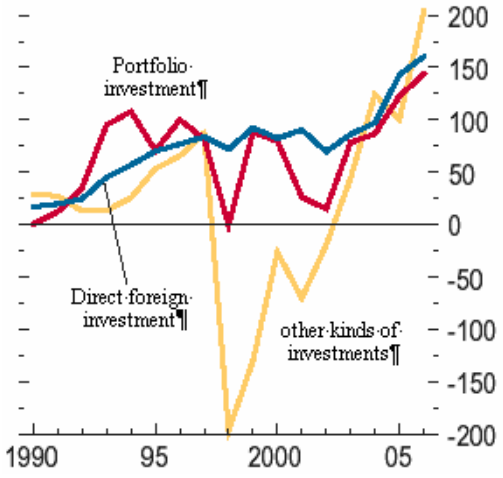

Fig. 3 Gross capital flows to the Asian countries with developing markets (www.imf.org)

foreign currencies became the main concern for the monetary authorities.

In the context of regional financial integration present realia of functioning of financial markets of the region does not look convincing. IMF emphasizes the fact that regional financial markets, except markets CAP Hong Kong, Singapore and Tokyo, especially bond markets are not big; and share markets are less liquid than in the developed economies. It makes clear why there are worries about financial instability and improper control over the capital transactions. Consequently further expansions of financial markets of the Asian countries as well as acceleration of processes of regional financial integration are becoming more and more acute.

In her research A.A. Abalkina (Abalkina, 2007) gives the following arguments for financial integration of the countries the region:

1. developing of the regional financial market will make easier the access to capital, in particular for the countries which have limited access to the international financial markets;
2. developing of the institution of the financial intermediaries inside the region will make the region less dependant on

the world financial market and will reduce loan costs.

3. regional financial system is more resistible to external shocks than separate economies however it does not defend from financial instabilities within the region;
4. integrated financial market makes the region more attractive for investments which encourages extra capital flow from the third countries третьих стран;
5. regional cooperation will stimulate the development and recovery of national financial systems;
6. financial interaction can be an impulse for further integration in adjoining areas.

Heavy criticism of the international financial institutions such as IMF and the World Bank brought about discussions of new projects to support regional economic and currency mechanisms and united countries' forces to implement these projects. Just after the 1997-1998 financial crisis the ideas of deepening of the financial integration in the Asian region to make it less dependant on global markets and diversification of national financial systems got second wind. Moreover the countries strengthened their macroeconomic policy: exchange rates became more flexible to relax outside shocks; official gold reserves were accumulated; and inflation goals were set up. long-term fiscal policy was adopted; the mechanisms enabling financial restructure in the countries which had experienced the 1997-1998 financial crisis were introduced; normative and prudential bases were renovated and corporative management became stronger.

In such environment a group of countries – ASEAN, created in 1967 – became more active. China, Japan and Southern Korea joined this group and succeeded in implementation of the ideas of financial integration.

In 2005 at the meeting of the Ministers of Finance of these countries in Laos the negotiations on liberalization of the financial service market were continued as well as it was agreed to create ASEAN's interconnected equity market by 2010 was achieved (to form large integrated market which is able to ensure bigger liquidity and a wide range of financial instruments through harmonizing markets standards and codes and through assisting to the transboarding access to the market). In the context of convergence of national financial systems a number of initiatives have been realized: for example, The Forum of ASEAN's capital markets, comprising the representatives of the regulating agencies on equity market is functioning; in 2005 the new share index – ASEAN share index – was introduced.

There are three main approaches to strengthen financial integration among Asian countries:

1. information exchange and conducting negotiations concerning the strategy of the financial market development of the region;
2. joint usage of gold and exchange currency reserves by means swap-agreements among central banks;
3. development and strengthening of the regional bond market.

It should be mentioned that two last approaches have concentrated more efforts than the third one. It was realized in the frames of Chiang Mai network two-sided swap lines among central banks of Asia and in the project of the Asian bond fund.

Chiang Mai initiative includes measures directed to joint usage of exchange reserves of the member-countries of the treaty. The system of exchange swaps was developed in accordance with which central banks of the countries provided $ 200 mln. to finance balance of trade

Table 1. Participation of ASEAN countries in swap-agreement

Group 1	Group 2
Brunei, Indonesia, Malaysia, The Philippines – $ 150 mln.	Vietnam – $ 60 mln.
Singapore, Thailand – $ 41,5 mln.	Myanmar – $ 20 mln.
	Cambodia – $ 15 mln.
	Laos – $ 5 mln.

Source: Rana P. Monetary and Financial cooperation in East Asia: the Chiang Mai Initiative and Beyond. ADB Working Paper. 2006. №6. February. P. 9.

deficit. Subsequently the sum was increased to $ 1bln. (Table 1).

Each of these countries according to this agreement is entitled to get loans twofold for six months with the possibility to have it prolongated for more six months.

Subsequently ASEAN countries +3 developed the system of double swaps, provided for preventing profiteering attacks on national currencies. This system together with more extended swap-agreement became the basis for Chiang Mai initiative. In general only IMF's participation can ensure the implementation of these swap-agreements. But the share of funds raised according to these swap-agreements independently from IMF program has been increased from 10 to 20%. By the beginning of 2007 8 ASEAN member-countries +3 completed 16 swap-agreements for $ 47,5 bln.

The development of stock market especially bond market is getting its importance for the development of the Asian financial market. Despite the well-developed banking sector of the region the necessity to diversified development of the financial system is caused by the number of factors especially after the 1997 crisis.

it is necessary to diversify the sources of economy financing then impact of the crisis in one of the segments of the financial market is less negative for the economy in general as the capital can be transferred to a different segment of the stock market;

it is necessary to use more savings placed with short-term deposits to finance long-term economic projects. Asian countries are characterized by higher saving rates (in 2007 – 45,3% GDP, in the developed economies – 19,9% GDP, in the world – 23,6 % GDP), in case of shortage of the potential investment instruments within the region the Asian savings are used to finance other economies;

demand for funds for financing significant infrastructural projects has increased;

shortage of the short-term securities has reduced the number of active open market operations by central banks.

Several groups have taken an interest in this project. Among the most active initiatives Asian dialogue on cooperation, Initiative on development of APEC (Asian-Pacific Economic Cooperation) bond regional markets, Initiative on Asian bond markets in the format ASEAN+3 (ASEAH countries and Japan, China, Southern Korea), as well as the meeting of the leaders of the central banks of Eastern-Asian countries and the Pacific region are to be mentioned.

The size of this segment of the financial market, of course, cannot be compared with the development rate of stock market of developed economies, however in 2002 aggregated volume of bond market was $ 800 bln and market volume, for example, in Indonesia – $ 2 bln and $ 300 bln in Southern Korea (Fabella, Madhur, 2003).

In 2003 central banks of the region declared about the setting up a bond fund with the capital

of $ 1 bln to invest in debt securities issued by the states of this region and denominated in the US dollars. This fund was initiated by 11 Asian-Pacific countries including the most developed ASEAN countries, China, Japan, Korea, Australia and New Zealand.

Later on in 2004 the Asian bond fund-2 was established, it is to invest $2 bln state and quasi-public bonds of 8 states: China, Hong Kong, Indonesia, Korea, the Philippines, Malaysia, Singapore and Thailand. Half of the funds is distributed among 8 national funds, the second half is transferred to Pan-Asian Index Fund set up as a share fund listed on the Hong Kong Stock Exchange and to be listed on the stock exchanges of the other member countries of the meeting of the leaders of the central banks of the East-Asian countries and the Pacific region (Australia, Hong Kong, China, Hong Kong, Indonesia, China, Korea, Malaysia, the Philippines, Singapore, Japan, New Zealand and Thailand) (Abalkina, 2007).

To make the Asian bond fund more efficient a new stock exchange index was introduced – iBox ABF Indices, comprising 490 bond эмитированных by national governments, international institutions and state agencies on 8 national markets.

From the investor's point of view funds of the Asian bond fund-2 are низкозатратное and effective means of investing in the Asian bonds nominated in national currencies. On the other hand the Asian bond fund-2 as a new type of assets together with infrastructure improvements, tax and regulation reforms will promote bond market expansion in the region.

The idea of the Asian bond fund is important for gradual liberalization of the national bond markets. For example, Pan-Asian Index Fund was the first foreign institutional investor to get accesses to the interbank bond market of China. Malaysia liberalized norms of currency regulation and opened its domestic market for issuing bonds of many-sided banks of development and financial institutions. At the same time investors-non-residents started to be exempt from the tax on yield interest earned from investments in debt securities nominated in ringgits. Thailand did the same while investing in Thailand national bonds and national agencies' bonds.

Resume

Under conditions of the development of the Asian domestic financial markets, we think disbalances in the development of its different segments (bonds in comparison with banking market, bond market, financial derivatives, etc.) should be avoided. And the development of the effective control system over the financial sector is becoming more and more significant.

Considering all issues of the integration of the Asian countries it is necessary to touch upon the question of the potential exchange integration. During the 1997-1998 crisis in Asia the idea of setting up The Asian Exchange Fund was discussed which however had never been implemented.

Currently several projects on introducing exchange union in the Asian countries are under consideration. One of them proposes to develop currency zone around and on the basis of the Chinese Yuan. It is caused by a number of factors: one of the main arguments is economic potential of this country, attractiveness and stability as well as good potential of the national currency. At present the project of introducing of full convertibility of Yuan is being discussed.

The more famous project of the introducing of the unified currency – ACU– is an alternative to the «Chinese» project. It started to be realized in 2006, though the idea of the unified currency appeared as long ago as in the 1970-s. The Malaysian Prime Minister Mahathir Mohamad was one of the first to put forward the idea of the unified currency to

simplify trade. He was supported by the leaders of the Philippines and Thailand. But gradually this process slowed down.

Asian countries followed the European way: trying to protect their economy from the American currency fluctuations they set up their unified currency – ACU (similar to European ECU). It has not become the full-bodied currency yet and is called to be a kind of regional indicator against dollar, euro and other hard currencies. However in the future ACU may be transformed into the full-bodied currency which in its turn will be the basis of the Asian currency union.

The European Currency Union was based on the R. Mundell's theory of the optimal currency zones and it has proved that unified currency is very beneficial for a conglomerate of the territories. First of all the prices are more transparent and more optimal (due to removing of the barriers for realization of the competitive advantages), transaction costs are reducing, trade links and labor market are developing. Besides «integrated» currency is gainful for investors they rely on macroeconomic stability and the products of the invested companies will see more customers.

On the other hand according to R. Mundell economies of the countries within the currency zone are at the similar stages of the cycle and have identical structures whereas common currency policy influence equally upon all parts. The first difficulty has not overcome yet but if the consensus among the countries seeking to join the union is achieved the prospects are very good.

The Asian Bank of Development is an initiator of this project. Thirteen countries plan to participate in this project: Japan, China, Southern Korea, and ten member states of the Association of South-East Asia. In prospect Hong Kong, Taiwan and even Kazakhstan may join this zone.

The first stage is to set up a unified currency unit – ACU – similar to European currency ECU, introduced in 1970-s. It is supposed to be a currency basket proportionally reflecting GNP shares and the volume of the international trade of the member countries. The Asian Bank of Development must release all national Asian currency rates against ACU daily.

Although it should be mentioned that Asian economies differ among each other more than the European states used to, consequently it will take longer to create a real currency union. However we are convinced that a currency union consisting of asymmetrical economies is able to function effectively and to be gainful for the participants. Thus, according to the estimated prospects of the currency union in Asia positive results and a wide range of positive effects for the member states are to be expected. Eventually all these will result in leveling differences in the future.

Application of the idea of the currency union should rest upon experiences available. Ratio of national currencies to ACU should be worked out similar to the European one. Meanwhile the member states are to be obliged to conduct common economic policy to reduce misbalances in the exchange rates.

A number of measures have been already taken to implement the project. In 2003 an agreement on free trade zone was signed, it involved seven states of the Association of the regional cooperation in Southern Asia. The zone started to operate in 2006 and comprised the territory with the one fifth of the population of the planet. At the same time eleven counties of the region declared about the creation of the local currency reserves fund consisting of $ 1bln.

Nowadays unified currency is not going to replace Asian national currencies. ACU is to show mutual quotation of currency units of the region and to be used as a fluctuation indicator against dollar and euro. It is to be the aggregated indicator of the average currency value of the thirteen countries (China, Southern Korea, Japan

and ten member states of the Association of South-East Asia); i.e. it is an indicator showing the economy situation in the region. Specific weight of every national currency unit in ACU depends on a number of factors, e.g. DDP, international trade, currency participation in international payments. ACU is planed to be used as a currency fluctuation indicator in the region against dollar and euro, and other hard currencies.

Business application of this currency unit is likely to be nominal rather than real. It may be applied to estimate official reserves, to calculate tariffs or any other indicators every time when it is difficult economically or politically to choose any other means of payments. ACU shares are possible to be issued.

Notsurprisinglythattheprojectimplementation is heavily criticized, but it should not be forgotten that it is too early to speak about any real results. Great heterogeneity in the economic development in the region together with weak economic and financial integration are still remaining the main obstacles. For real currency integration there should be full-scale institutional area in the region; first of all establishing Asian Central Bank and other important financial institutions.

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