



Regional Integration in Southeast Asia: Better Macroeconomic Co-operation Can Mitigate Risks

by Kensuke Tanaka

- ◆ Improving regional risk management frameworks is vital to implement the ASEAN Economic Community according to its schedule.
- ◆ More timely and effective sharing of economic information among Southeast Asian countries is essential to well manage the *de jure* integration process in the region.
- ◆ Promoting peer learning among the countries of the region can contribute to deepening macroeconomic policy co-operation in Southeast Asia.

The ten member states of the Association of Southeast Asian Nations (ASEAN) have created one of the most dynamic developing regions. They have unveiled the Blueprint for the ASEAN Economic Community (AEC) to achieve a “single market” by 2015. More recently, the full ratification of the ASEAN Charter in December 2008 has provided an institutional framework for what had been *de facto* regional integration underway since the 1980s. Realising the end goal of economic integration enshrined in the association’s blueprint and in the charter poses a major challenge to the region facing the global economic downturn. This Policy Insight suggests possible ways forward.

Managing Risks to Ensure Continued Integration

Strengthening regional ties in Southeast Asia – the potential benefits of larger markets of 570 million people that bring about economies of scale and reduced transaction costs – will enhance the competitiveness of the region. The benefits of integration may, however, be jeopardised unless proper frameworks to cope with risks are put in place. Such risk management frameworks are crucial to implement the AEC according to schedule.

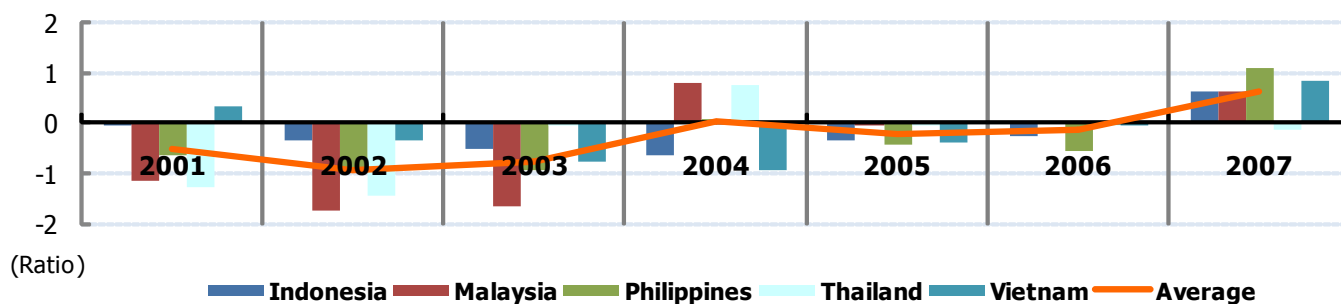
The current global financial crisis points to the importance of managing risks related to volatile financial markets and their disruptive effects on domestic markets. The experience of the last few months also shows the danger inherent in equity-market declines and tight credit markets for many economies of the region.

Better macroeconomic policy co-operation among Southeast Asian countries is one of the options to mitigate these risks. For instance, joint regional efforts to provide liquidity would help to avoid further contagions. Appropriate macroeconomic policy co-operation would increase the credibility of monetary authorities and help control expectations. Collective actions to cope with cyclical factors could also enhance business confidence across the region. As yet, macroeconomic co-operation in the region is still limited.

Stronger Regional Interdependence Makes Macroeconomic Co-operation More Feasible

Regional integration among the ASEAN countries has been accelerating since the early 1990s. The 2008 OECD study shows that the share of intra-ASEAN trade in world trade has almost doubled in the past 20 years to constitute a quarter of the region’s total trade. Trade and foreign direct investment within the region and from neighboring countries are also mutually reinforcing. Business cycles in Southeast Asia have also become increasingly synchronised in the last several years. This increased synchronisation is partly stemming from strengthened economic links through trade and investment flows, similar institutional arrangements and to a certain extent also from common shocks, such as the burst of the IT bubble and the more recent oil and food price movements (Figure 1). At the same time, real interest rates in the region have been moving together partly as a result of easing monetary policies to stimulate domestic demand following the Asian Crisis in the early 2000s, policies to contain inflation after

Figure 1. **Output Gaps in Selected ASEAN Countries, 2001-07**



Note: The output gap is a deviation of actual output from its potential level.

Source: Asian Development Bank, 2008.

the recent surge in commodity prices and the very recent relaxation of monetary policies to boost liquidity since the breakout of the global financial crisis. Switching to similar institutional arrangements, such as inflation targeting in Indonesia, Philippines and Thailand, has reinforced this trend.

Finally, fiscal stances have also converged, mainly driven by the common challenge of fiscal consolidation in the region after the Asian Crisis. In particular, public debt has declined in Indonesia and Thailand that are among the most affected countries by the 1997 crisis. This increased regional interdependence and more similar economic conditions will make macroeconomic co-operation more feasible.

Key Elements for Successful Macroeconomic Policy Co-operation

Successful macroeconomic policy co-operation in Southeast Asia requires several elements.

- *Information sharing.* When information is shared, the identification of potential risks becomes easier. In particular, sharing information on economic conditions and available policy options in a timely and systematic manner could be an important step towards establishing a reliable early warning system in the region. In doing so, peer learning can contribute to deepening the co-operation¹.

- *Incentive compatibility.* It is crucial to share the benefits of collective policy actions among participating countries. For instance, the reputation effect stemming from continuous macroeconomic co-operation and peer learning/peer pressure from other countries will enhance incentives to participate in collective actions. Strong commitment to co-operation is also critical for effective collective actions.

- *Consistency with other policy frameworks.* Macroeconomic policy co-operation should be clearly consistent with other national and international policies aimed at risk management. In particular, given that Southeast Asia has bank-based financial systems, macroeconomic co-operation needs to be consistent with prudential financial regulatory frameworks. Swap arrangements for short-term liquidity, regulations to strengthen solvency of financial intermediaries and capital market development to ensure the provision of long-term capital must be consistent with each other.

Further reading:

Tanaka, K. (2008), "Economic Integration Amid Diversity and Peer Reviews in Southeast Asia – Where Do We Stand?" the overview chapter in *Shaping Policy Reforms and Peer Review in Southeast Asia*, pp. 21-62, OECD, Paris.

OECD (2006), *Miracle, Crisis and Beyond: A Synthesis of Policy Coherence Towards East Asia, the Development Dimension*, Paris.

Fukasaku, K., M. Kawai, M.G. Plummer and A. Trzeciak-Duval (eds.) (2005), *Policy Coherence towards East Asia: Development Challenges for OECD Countries*, Development Centre Studies, OECD, Paris.

1. OECD will organise, in co-operation with ASEAN Secretariat and the Asian Development Bank, the 2nd OECD-Southeast Asia Regional Forum in Bangkok in April 2009. This Forum will provide an opportunity for promoting peer learning in the region.