Submission to the Trade sub-committee of the Joint Standing Committee on Foreign Affairs, Defence and Trade

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Terminology:

CMLV: Cambodia, Laos, Myanmar, Vietnam
ASEAN 10: CLMV + Philippines, Singapore, Malaysia, Thailand, Indonesia, Brunei
ASEAN + 3: ASEAN 10 + Japan + PR China + South Korea
ASEAN + 6, or +3+3, or EAS, "East Asia Summit":

ASEAN + 3 + Australia + New Zealand + India

The ASEAN +6 region has reached a relatively high level of integration in the traded goods sector, with FDI and its adjunct, the fragmentation & assembly trade the most visible manifestations. Between 1985 and 2006, intra-regional trade expanded by a factor of 11, to reach 43% of the total. That compares to 67% in the EU-27 and 44% in the NAFTA. ASEAN +6 has achieved this level of trade despite major disadvantages in logistics, greater bureaucracy, a polyglot of exchange arrangements and legal systems and the severe economic dislocation brought about by the Crisis of 1997/98.

Further reduction in tariff and non-tariff barriers to trade due the proliferation of FTAs emerging across the region will no doubt increase the share of trade that occurs within the region – even if we acknowledge that some of this trade will be diversionary and therefore does not necessarily represent a net gain. Modelling work[1] suggests that the elimination of tariff barriers from current levels will provide modest gains for the parties concerned. The halving of non-tariff barriers would have a more substantial positive impact. In terms of the regional alignments that generate the strongest outcomes, it is

[1] Cited in JETRO's 2007 Trade White Paper, p23.

safe to say that bigger proves to be better, with an ASEAN 10 internal pact as compared to ASEAN + 6 more than a full percentage point apart in one study. These are not controversial results.

My aim is not to focus on integration via the increasing trade in goods, as I am sure that these details are well known to the Committee. I am going to focus on those areas of integration that have less momentum but are arguably more important when it comes to achieving the end game of raising average East Asian living standards to the level achieved in the major advanced regions. The underlying assumption is that if we help Asia make the right decisions at the macro level, Australian exports to the region will grow organically even if the multilateral system remains gridlocked or increasingly by-passed. It is demand that drives trade flows in the long run, rather than the ephemeral rules systems that evolve in its wake. We must nurture demand.

Greater service sector integration, and its bedfellow, a heightened willingness to engage in financial openness, offer intriguing possibilities for East Asia's future. Real success in integration, in the long run, cannot exclude these issues. And it in these areas that an expanded East Asia – boosting the ASEAN 10 with the inclusion of both high income and mass consumer markets – would show its benefits most fully as the decades unfold.

I will begin making this case by examining the arguments for and against financial openness in East Asia. This discussion will conclude with the contention that we may be reaching the critical moment when policy makers begin to see heightened openness to two-way financial flows as more of an opportunity than a threat.[2] The opportunity needs to be seen in the context of the collateral benefits of openness, rather than the direct impacts that are traditionally advocated.

I will then proceed to argue that the entire ASEAN + 6 group as a whole offers profound advantages over any subset of these nations. This argument comes in two parts.

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[2] The sub-prime crisis in the US has not been helpful in this regard, as a lack of openness has become a short term advantage for Asia in this environment.

One, there is a huge amount of expertise housed in the four wealthiest economies in the +6, gained through both success and failure in their own financial maturation experiences. It seems extremely useful to bring these countries “in-house”, and enmesh the performance of the advisor to the advisee, to cover any real or perceived incentive gap in the provision of this counsel. Ambitious middle powers such as Australia and Korea will find much that they agree on regards regional integration, as will Australia and Japan.

Two, to optimise the benefits of greater freedom of capital movement, diversity and scale of opportunities are extremely important. The ASEAN +6 offers a unique demographic arbitrage in coming decades. The same fundamental factors that argue against formal monetary union in East Asia (diversity of development levels) argue that returns to capital will be stronger than in other major regions that are more homogenous. It is the populous low income economies in the +6, China and India, at the forefront of this story.

At this point in time, it is quite clear that many of the nations within the ASEAN 10 have policymakers that are extremely sceptical of the virtues of financial openness, with risk averse policy settings evident in many jurisdictions. This description can be extended to China, and in a different fashion, to India. Exchange arrangements in these locales have been clearly designed to limit the influence of private portfolio capital flows on monetary conditions. One consequence of this policy is that current account surpluses are recycled primarily by the public authorities through reserve accumulation, and foreign exchange turnover – the mirror of cross border financial transactions – is unnaturally suppressed.

Scepticism towards the benefits of financial openness is the default position for a low income country with a dubious balance sheet position. For one, the costs of the destructive episode of the late 1990s crisis are extremely tangible, while projected future benefits from liberalisation are somewhat amorphous and easily discounted. Furthermore, the economics discipline is unable to present a united front on the linkage between financial openness and living standards. While much of this debate has become emotive, and is occasionally confused with one’s politics, it is safe to say that a consistently positive relationship is difficult to deduce from the existing empirical record.

My view is that the traditional views of financial openness are too blunt. The pro-finance group point to an improved global allocation of capital from the closed economy alternative, with the diversification of risks and capital deepening in labour rich regions seen as growth enhancing. The counter argument is that institutional factors such as poor governance and weak market infrastructure expose financially open developing economies to unacceptable crisis risk.

A synthesis of these competing schools, to my mind, dangles an extremely attractive carrot in the face of East Asia's less financially open regimes.

The synthesis argues that the traditional view is essentially correct, but that for the posited relationships to gain traction, the institutional ground must be fertile. But also, and of most relevance to East Asia, are the collateral benefits of financial openness: enhanced policy and corporate discipline, improved governance, institutional and market development.

It is these collateral benefits that should appeal in East Asia – most of the countries in question have surplus savings, eschewing the need for external financing of investment – as the reliance on bank dominated financing, weak corporate governance, lack of market discipline, weak or non-existent neutral ratings agencies (some may smirk at this in the context of the current issues in developed country financial markets), the absence of central credit registries and relationship driven transacting have long been acknowledged as major contributory factors in the balance sheet weakness that ultimately created the Asian Crisis.

Note well that initiatives such as the Asian Bond Fund, a targeted response to these precise issues, will proceed at a glacial pace unless the flow of capital within Asia is liberalised.

The synthesis approach leads to the nomination of various benchmarks above which financial openness might reasonably be expected to reduce crisis risks, rather than increase them. In India, the Reserve Bank recently completed a study on the “concomitants” that would signal a readiness for greater capital account openness. That is an explicit acknowledgement of the synthesis view.

Elsewhere in East Asia, improvements in both balance sheets and institutional structures argue that a number of jurisdictions must be reaching the threshold levels that will convert financial openness from threat to opportunity in the minds of policymakers. In some instances, it can be persuasively argued that a position of relative strength was achieved some time ago in a number of threshold areas.

The enormous build-up of reserves across the region are the mirror of sustained external surpluses and actively managed exchange rate regimes. As far as balance sheets go, we can also observe a marked improvement across Asia in terms of non-performing loans. Last year was the 10 year anniversary of that crisis, and the regional banking system has moved on.

The question of balance sheets is directly related to exchange arrangements. There is a negative relationship between the system NPL ratio and the degree of volatility in exchange rates that the monetary authority allows.

Yet this is an indirect relationship – as it is desire to restrict short term capital flows that are the root cause of the illiquid foreign markets. The volatility of various forms of capital flows are depicted in this next chart. Interesting, advanced countries experience the greatest volatility in equity and FDI flows, whereas emerging markets experience greater volatility in debt and financial system flows (commonly referred to as hot money).

It was hot money that rapidly reversed course during the Asian Crisis. Hot money flows show a strong pro-cyclical link to global economic activity. The result of a rapid bail-out can be catastrophic for a leveraged economy. The Korean experience is represented in chart 11.

The argument can become circular at this point. If financial openness is pursued prior to institutional thresholds being met, crisis risks presumably rise. However, once the house is in order, liberalising exchange arrangements can make an economy more resilient to shocks. The disciplines imposed by openness are a check against the excesses in corporate, public and bank balance sheets and behaviour that make an economy vulnerable to disturbances.

Now, let us bring the debate back to the role of the +6 nations in future integration in partnership with the ASEAN 10. As indicated above, the combined historical experiences of Japan, Australia, New Zealand and Korea are an amazing storehouse of information on the process of opening to two-way capital flows. These experiences are informed by mistakes as much as success. Just as the ASEAN and China have benefited from observing the industrialisation path of Japan and Korea, they might also take advantage of wise counsel from this pair on the path of liberalising exchange arrangements and in the case of Japan, internationalising the currency.

While Australia and New Zealand may not immediately seem to be relevant in this context, that is not the case. Australia's experience with unwinding capital controls, floating the exchange rate, internationalising the Australian dollar, opening the domestic market to foreign banks and transitioning to independent central banking is a particularly useful model.

Obviously an ASEAN + 6 free trade area is not required before advice can be given and received. However, an ASEAN + 6 commitment to greater real economy integration can help surmount the wall of scepticism within East Asia's middle and lower income nations regards external advice on financial matters. With closer real economy integration, the + 6 would link their economies more tightly with each other and with the ASEAN 10. Therefore, the incentive to seek rents from their neighbours is much reduced. ASEAN + 6 would create an encompassing interest in the welfare of East Asian growth for the individual members.

This is the best kind of trust – a Pareto position, if you will. Asking for the free flow of capital when the advisor benefits from success but is not impacted by failure is one thing. When the advisor will be penalised in a significant fashion is the advisee goes astray, that is another thing altogether.

Australia would benefit directly and indirectly from these developments. Higher Asian living standards will deepen the market for Australian exporters across the gamut. A back of the envelope menu of beneficiaries includes agriculture, resources, metals manufacturing, tourism, education, financial services, engineering, health care, logistics, business services and transport.

And now to my final point: that demographic arbitrage opportunities would abound in an ASEAN + 6 grouping characterised by free capital flow. It is here that China and India become very valuable additions to the core ASEAN 10. The concept of demographic arbitrage is based on the view that funds should flow from labour scarce & capital rich regions to labour abundant & capital poor regions. Taking this framework to the United Nations' population projections for East Asia, and the opportunity is clear.

Chart 12 shows the estimated proportion of the population in each area accounted for by persons of working age in 2010 and 2020. North Asia is ageing while the ASEAN and India will be enjoying the fruits of an expanding worker cohort. When the proportion of the population above 65+ is presented, the relativities are constant. North Asia will wish to export capital to the ASEAN 10 and to India, and the latter regions should be happy to receive it.

IMF research into the matter[3] estimates that Asia offers by far the greatest opportunity for this sort of demographic arbitrage. They argue that intra-regional capital flows could be equivalent to 1.8% of Asian GDP over the next 50 years, with more than three quarters of Asia's total flows within the region. The fundamentals seem to support a deeply embedded investment complex across the countries of the ASEAN + 6. It is important to note that without the + 6, the opportunity to arbitrage is dramatically diminished.

As I conclude, it is appropriate that I return to my basic point that real success in East Asian integration, in the long run, cannot exclude the issues of greater financial openness within the region.

[3] The citation for this paper is on chart 15.

The end game for East Asia is not to achieve the most efficient and competitive vertical production chains and the best industrial innovation clusters. This is merely the vanguard of regional integration. Raising average East Asian living standards to the level achieved in the major advanced regions will require that industrial productivity gaps are closed in both manufacturing and services. This will not be achieved if services, and more specifically finance, are not opened up at the due time.

The ASEAN + 6 formation of nation states has a great chance to become the epicentre of global economic activity. This will not be achieved in the absence of a greatest appetite for financial integration in the ASEAN 10, the transfer of expertise from the wealthy countries in +6, and constructive engagement from India and China over the long haul. Australia can play a constructive, role in these developments based on the virtuous coincidence of unilateral and reciprocal interests.

Addendum (charts beyond number 15)

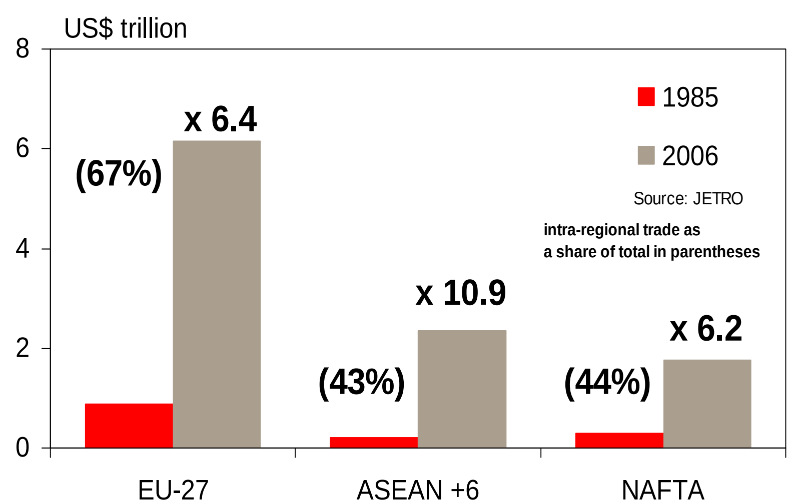
The global credit crisis has made the difficult job of financing Australia's current account deficit harder still. More open capital accounts in Asia (with private outflows still heavily suppressed) would create a new source of deficit funding for Australia.

The committee may wish to consider this in light of the remarkable rise in interest in foreign direct investment (FDI) in Australian resources of late. The dynamics of long run external solvency is a major subject in itself, but there are a number of specific issues that might be raised:

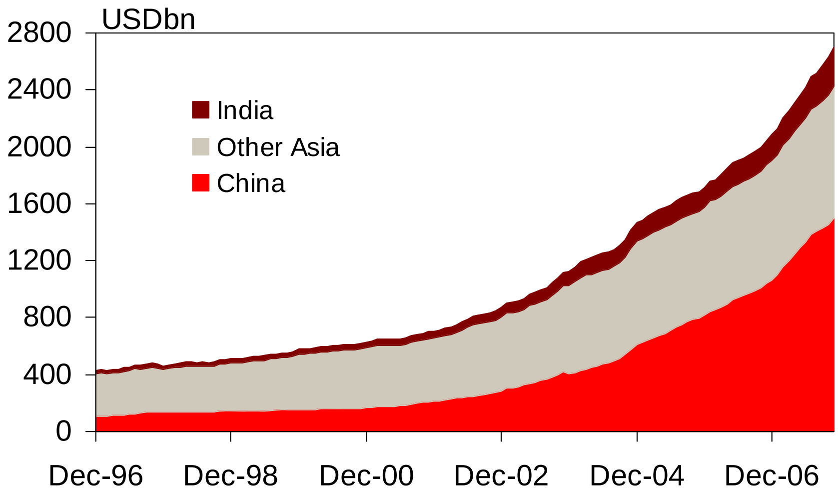
- Exactly what categories of resources are "strategic" and which are not?
- What constitutes a "profit motive" on behalf of a potential buyer?
- Can Australia expect to say "no" in the FDI arena and expect to hear a "yes" in return on issues of importance like Doha, the UN Security Council or bilateral FTA negotiations?
- Would a move to reduce our reliance on external financing in the long run enhance or hinder living standards?

This broad subject was a remarkable omission from the agenda for the 2020 summit stream on **Security and Prosperity in a Rapidly Changing World**. It is intimately associated with Australia's long run living standards.

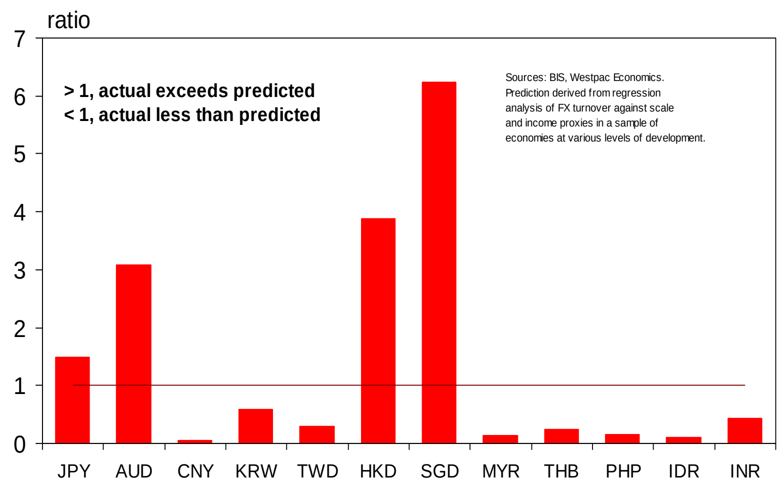
1. Intra-regional trade expansion: 1985 to 2006



2. Asia excluding Japan: foreign reserves



3. Ratio of actual to predicted FX turnover



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4. Financial openness: why pursue it ?

This traditional view is hotly disputed on empirical and emotional grounds

Financial openness

↓

Traditional capital allocation view
Capital deepening benefit
Risk diversification

↓

GDP rises
Volatility falls

Asian policymakers are clearly sceptical

Based on Kose, Prasad, Rogoff & Wei (2006) – IMF WP/06/189.

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5. Financial openness: why pursue it ?

A more sophisticated view acknowledges the orthodox channel, but emphasizes collateral benefits

Financial openness → Traditional view

↓

Financial market depth and development
Institutional development
Improved governance
Macroeconomic discipline

↓

GDP rises via TFP
Volatility falls

Asian policymakers have much to gain via the indirect channel

Based on Kose, Prasad, Rogoff & Wei (2006) – IMF WP/06/189.

6. Financial openness: why pursue it ?

**Timing is important.
Circularity is an issue.**

Financial openness

↓

thresholds

Local financial market development
Institutional development
Local balance sheets
Trade integration

Thresholds exceeded ↓

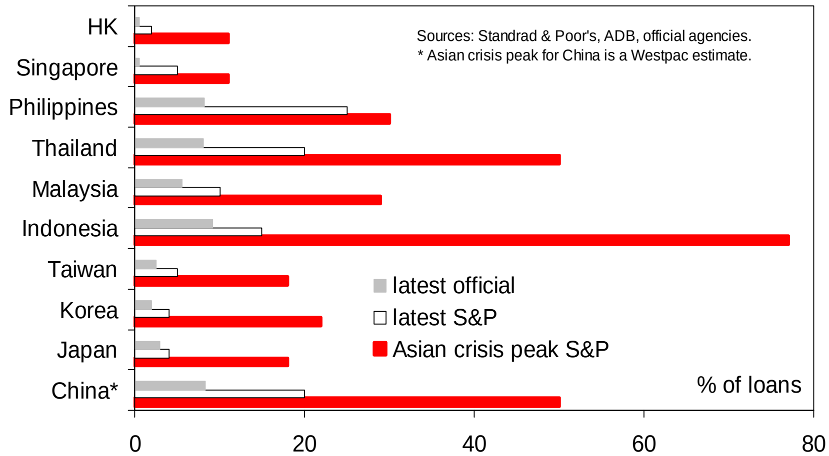
GDP rises via TFP
Crisis risk falls

Thresholds not met ↓

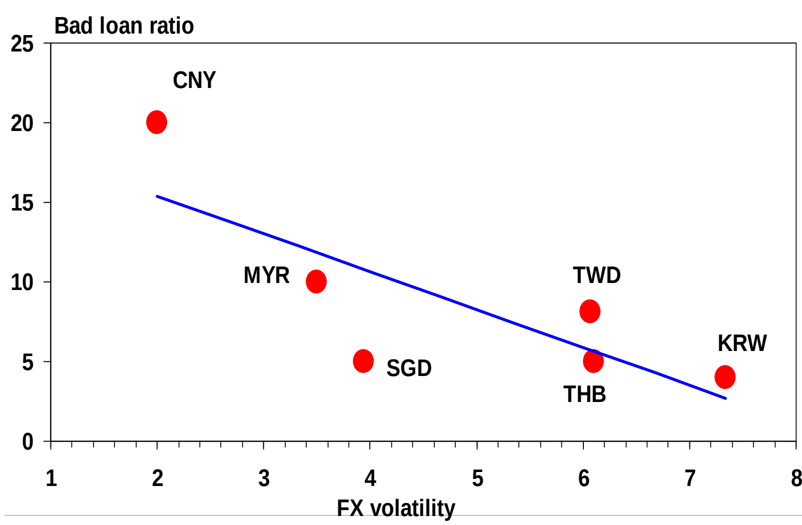
GDP ? TFP ?
Crisis risk rises

Based on Kose, Prasad, Rogoff & Wei (2006) – IMF WP/06/189.

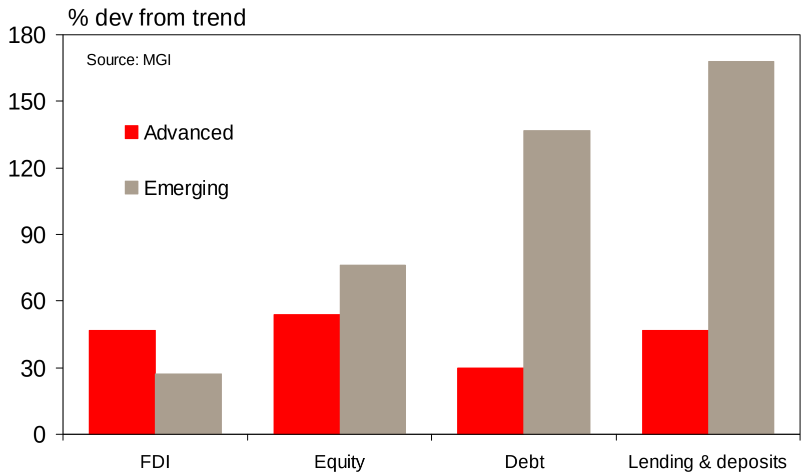
7. Asia has made progress on NPLs



8. FX volatility versus financial sector strength



9. Capital flow by type: volatility measures



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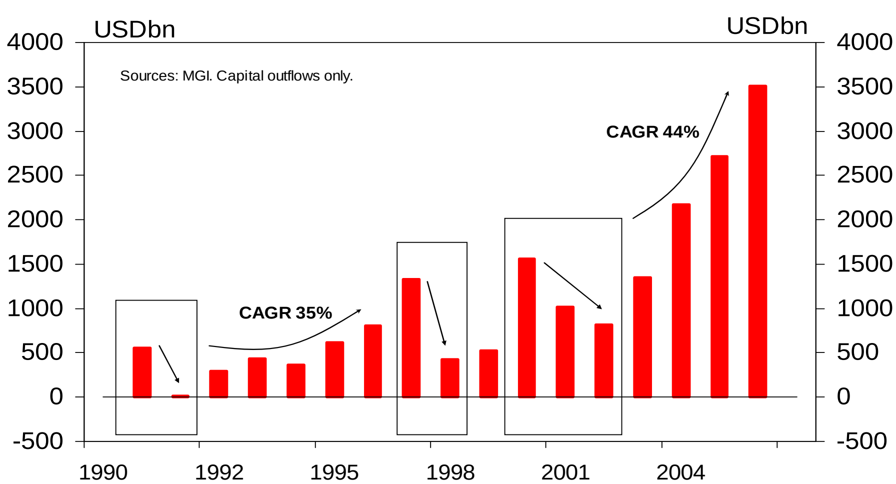
10. Cross border lending & deposit flows



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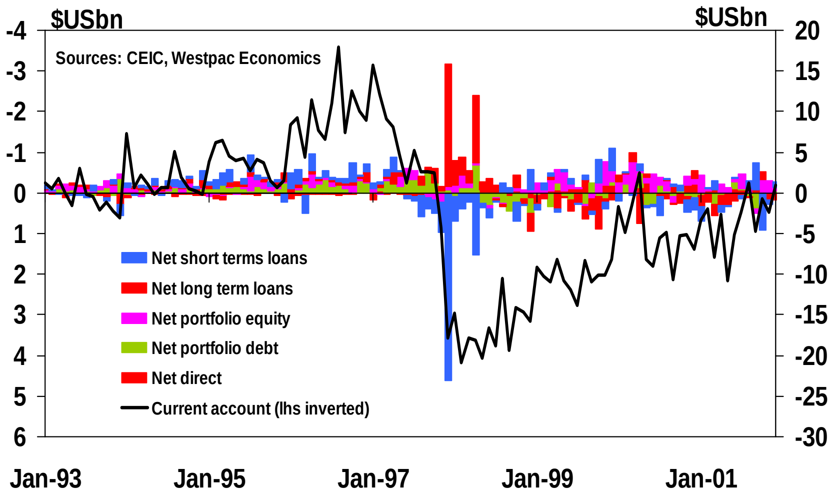
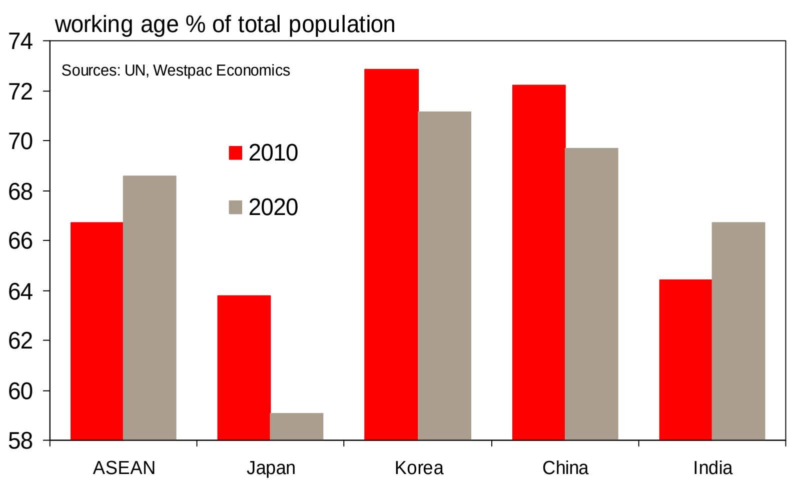
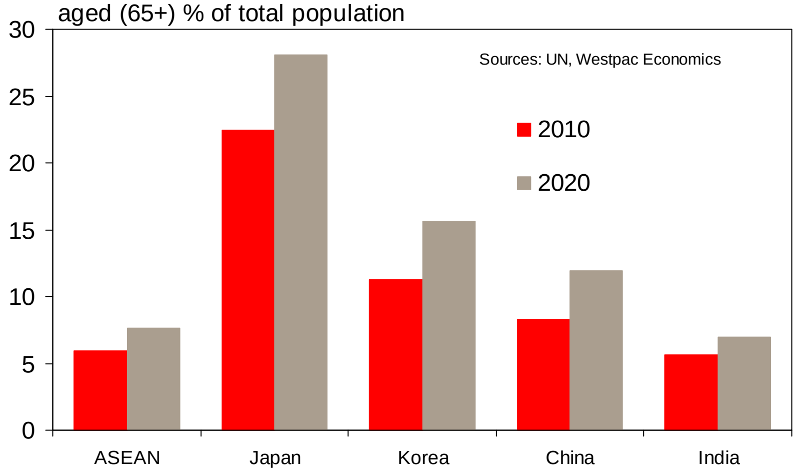
11. Korean external financing



12. Demographic futures will drive capital flows



13. Demographic futures will drive capital flows



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14. Potential intra-regional capital flows 2004-2050*

	as a share of	
	Regional GDP	Regional capital flows
Europe	0.1	8.3
Asia	1.8	75.8
Latin America	0.3	30.3
Africa	0.1	3.1

Source: Lueth (2008) – IMF WP/8/08. Based upon UN population projections and free capital mobility.

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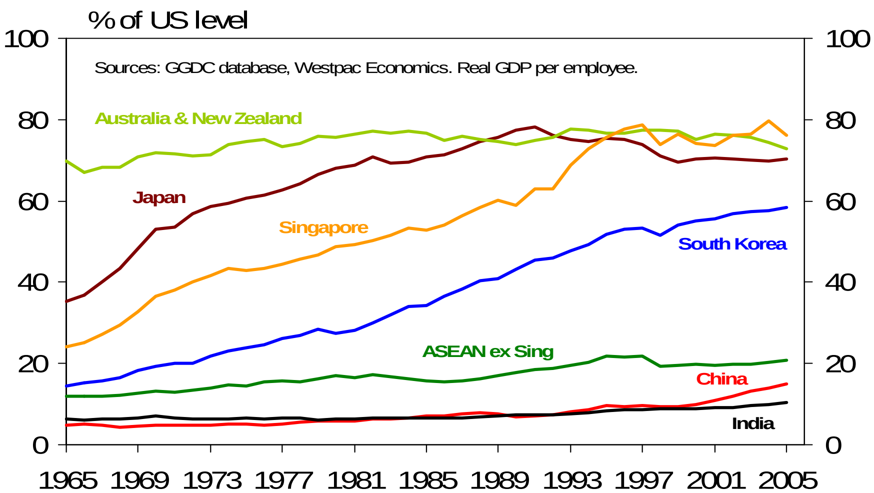
15. Relative productivity levels in ASEAN + 6



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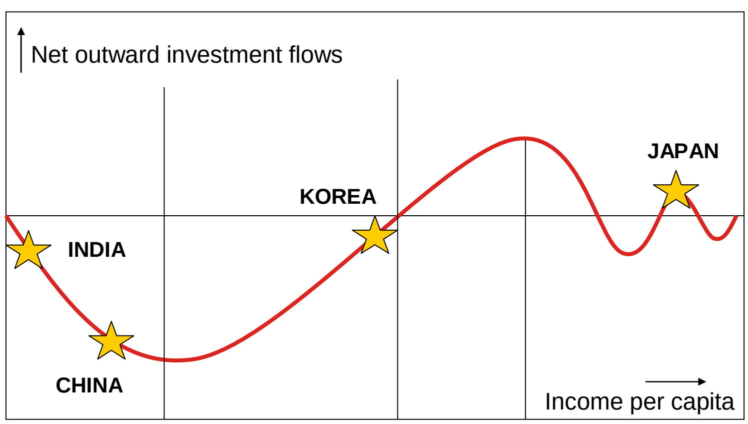
Foreign direct investment: Asia in context



Sources: DFAT EAU, Dunning and Narula (1996), Westpac Economics.

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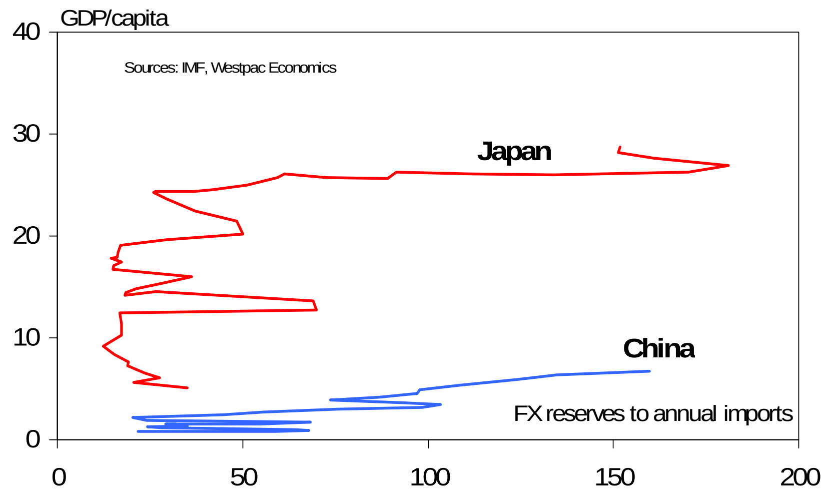
Foreign reserves & income level



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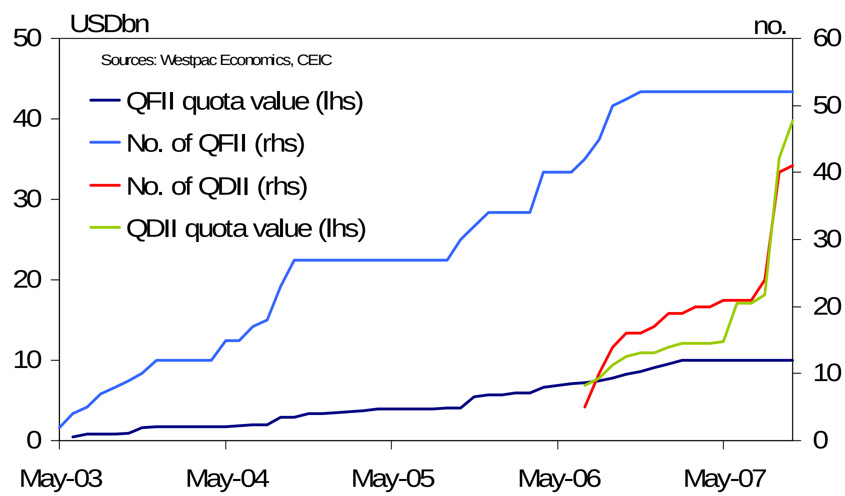
China's professional investor quotas



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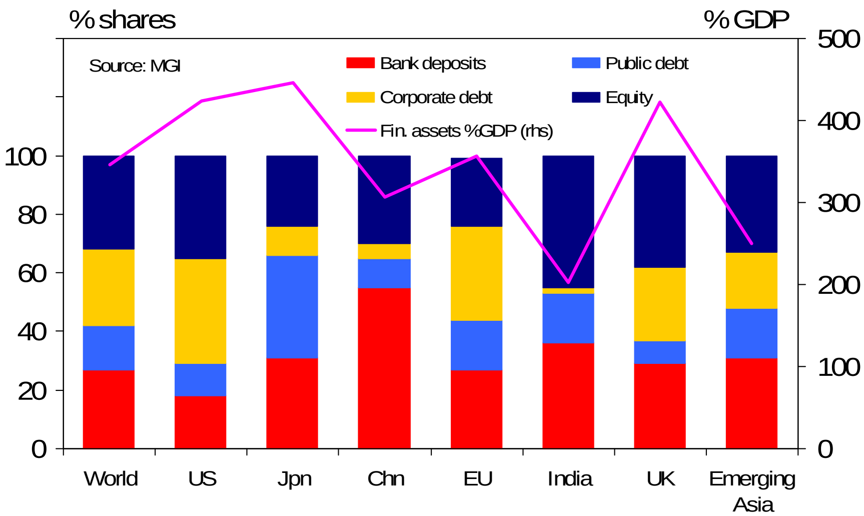
Financial depth in selected countries: 2006



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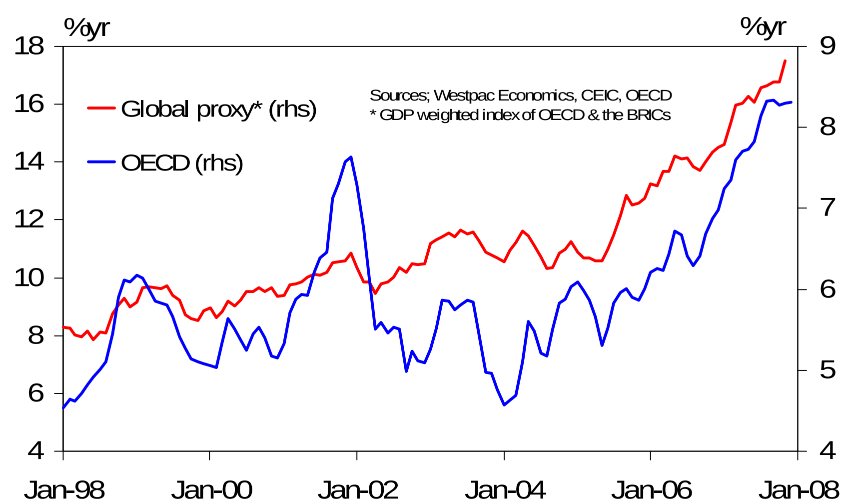
Global liquidity is ample …



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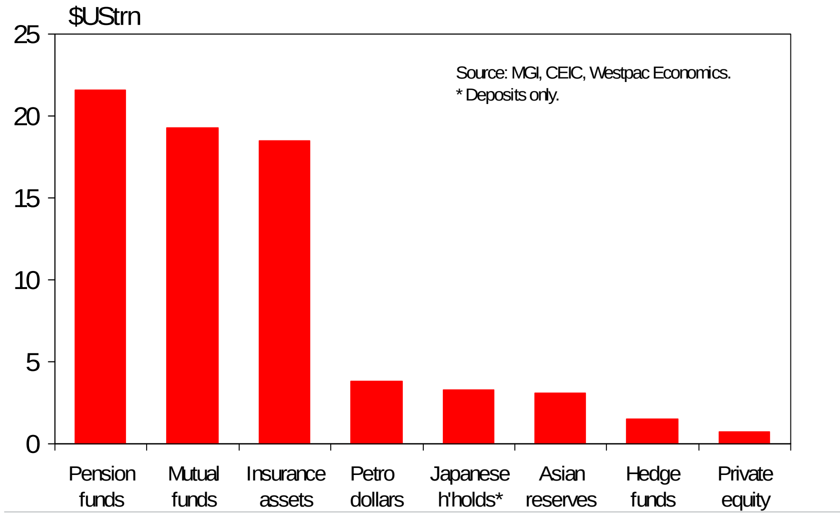
… but only if it circulates



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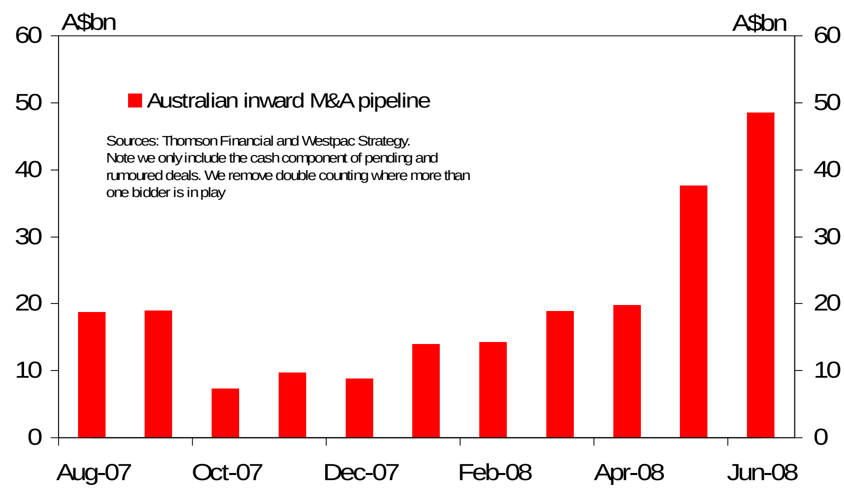
Inward FDI pipeline remains very strong



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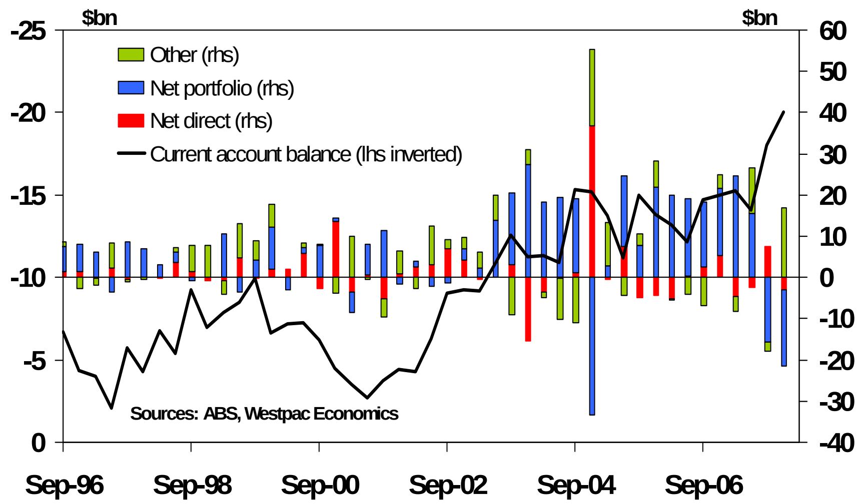
Aust external financing: portfolio dominates



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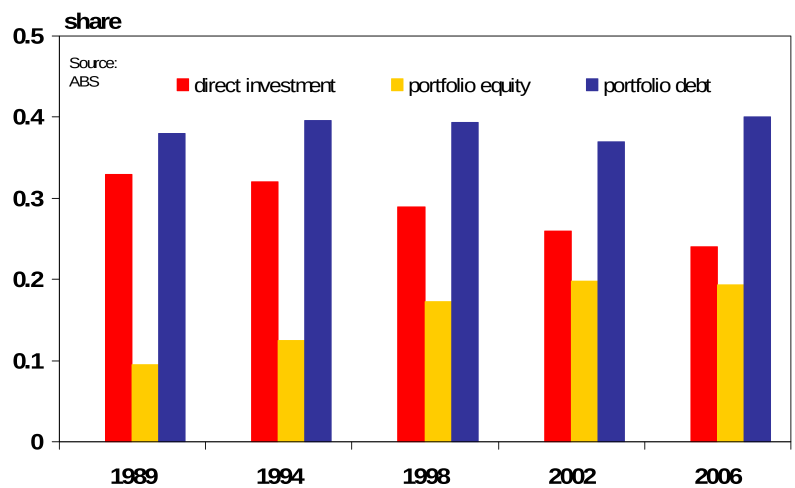
Inward foreign investment to Australia



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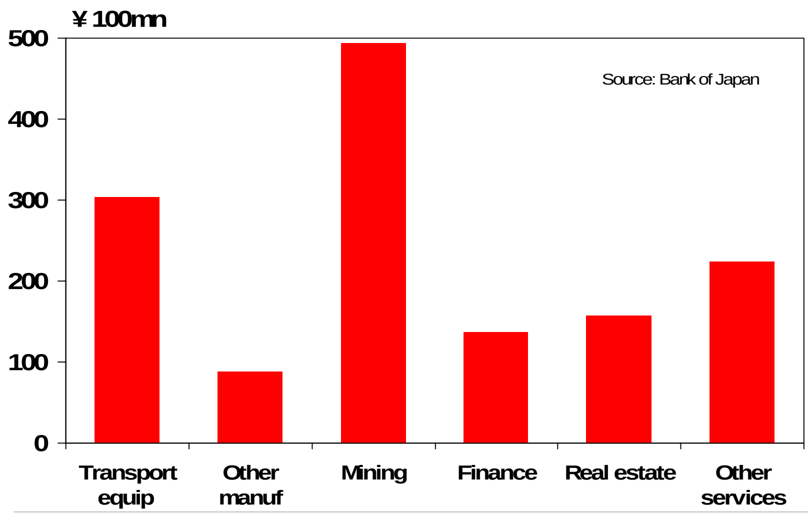
Japanese direct investment in Australia



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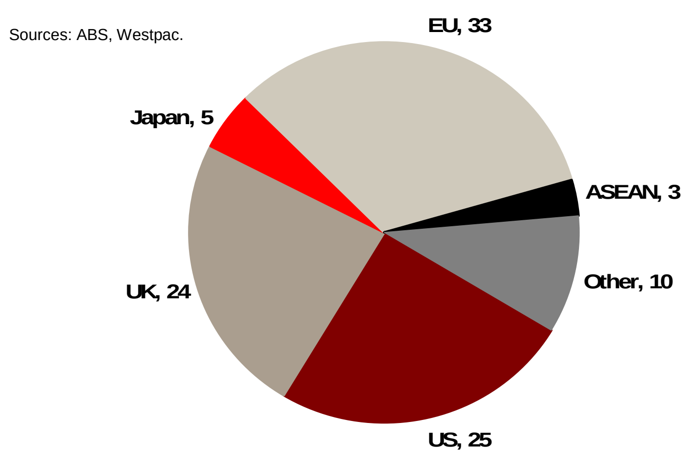
Foreign investment stock in Australia



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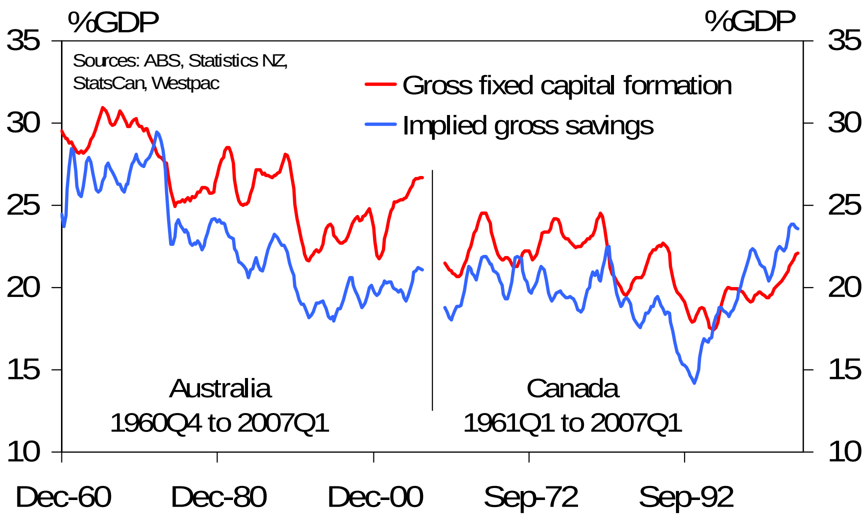
Investment & domestic savings



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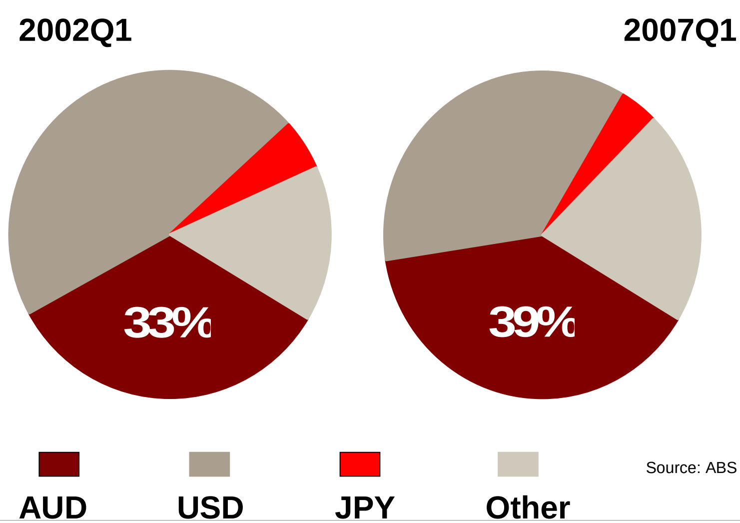
FX denomination of Australian foreign debt



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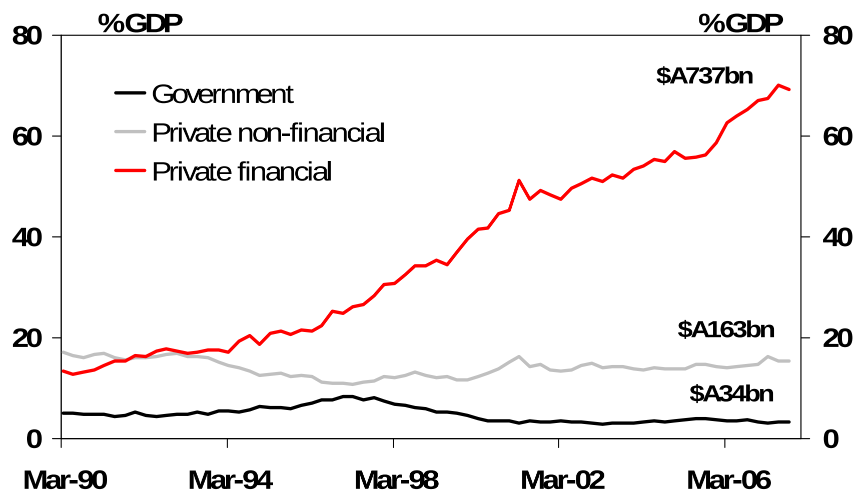
Foreign debt liabilities are concentrated in banks



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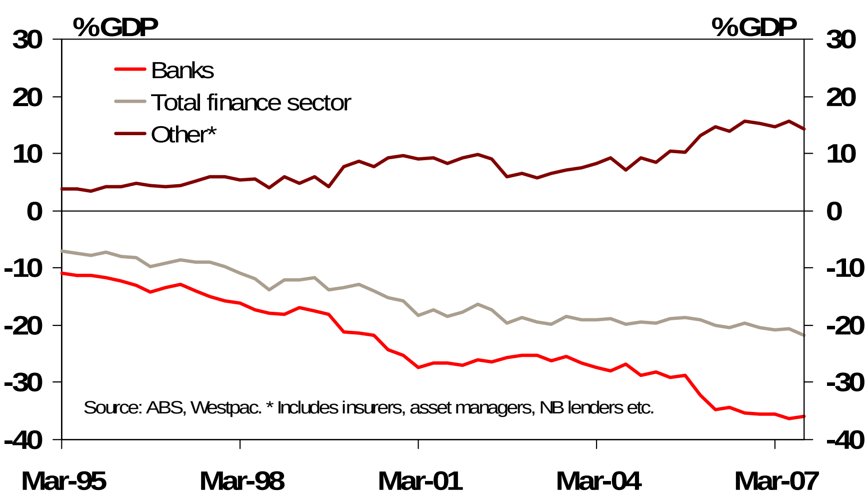
Net offshore assets: banks and other financials



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