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CHALLENGES FACING A GLOBALLY CONNECTED ASEAN

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1. INTRODUCTION

The countries of the Association of Southeast Asian Nations (ASEAN) are more regionally integrated and globally connected today than ever before. These features continue to grow, and have delivered significant benefits, but they also carry risks. Increased vulnerability to external shocks, as well as contagion that spreads rapidly across the region, are the main concerns. Five years after the global financial crisis (GFC), the economies of the United States and the eurozone continue to struggle, with the eurozone recovery lagging behind that of the United States. Monetary authorities have responded by sharply easing monetary policy. This has brought policy interest rates down to close to zero. Having quickly reached the interest rate floor, both the US Federal Reserve and the European Central Bank (ECB) have resorted to unconventional monetary policy through episodes of quantitative easing. The Bank of Japan, under new leadership, has recently followed suit. This has further increased liquidity in the banking system.

However, these policy moves have yet to produce the desired effect in the home countries, as private lending has failed to increase as expected. Banks are facing pressure to beef up their capital, making them hesitant to lend. Consumers and businesses are also reluctant to borrow as uncertainty remains high and confidence in the recovery remains low. All of this suggests that the problems in the eurozone are unlikely to end anytime soon. It also points to the very real possibility that the situation could indeed worsen. This remains true despite official figures showing that, technically, the recession in the eurozone came to an end in the second quarter of 2013. Nevertheless, the eurozone economy is still expected to shrink in 2013.

It is against this global backdrop that this chapter pays attention to the situation in Southeast Asia. How has the global financial turmoil affected ASEAN economies? Is there a real risk that this crisis could spread to the region? Given the fragility of the financial system, what are the possible effects of a shock to the eurozone financial system on the economies of Southeast Asia? This is a real possibility, given that vulnerability in the region has increased following massive inflows of capital and the build-up of debt related to successive bouts of quantitative easing, initially in the United States and now in Japan. Given that East Asia is now more integrated than it has ever been, how will this affect the depth and spread of the crisis? If East Asia succumbs, is it ready to deal with the fallout, or will it again have to seek support from the International Monetary Fund (IMF), as it did during the 1997/98 Asian financial crisis (AFC), but at a time when global resources are even more stretched? These are the key questions examined in this chapter.

The chapter is organized in six further parts. To provide the backdrop, Section 2 traces the process of regional integration in ASEAN, from its beginnings to its current situation and near-term aspirations. Section 3 considers how increased regional integration will affect the ASEAN economies should a crisis hit the region. Section 4 focuses on the impact of monetary policy easing in advanced economies on capital flows in Southeast Asia. Section 5 explores the possible spillovers of a financial shock in Europe on the region's financial sector, examining both direct and indirect effects. Section 6 looks at the readiness of the region to deal with any possible fallout by examining the adequacy of regional financial safety nets. A final section concludes.

2. ASEAN INTEGRATION: TOWARDS THE AEC AND BEYOND

The push towards regional economic integration was not a major part of the agenda of ASEAN during the first decade its existence. In the period between its inception in 1967 up until the mid-1970s, ASEAN's primary focus was on creating harmony and cohesion within the region. ASEAN's tentative steps towards economic cooperation only began in earnest in 1976, with the launch of the ASEAN Preferential Trading Agreement (APTA). The APTA was the first major attempt to promote intra-ASEAN trade through institutional integration and regional trade preferences. Over the succeeding decades, pursuing regional economic integration has gained prominence in ASEAN affairs. From the initial focus on trade liberalization, through APTA and eventually the ASEAN Free Trade Agreement (AFTA), ASEAN's regional economic integration agenda has broadened to include services trade, investment, labour migration, and even macroeconomic policy (Hill and Menon 2012*a*).

ASEAN's regional economic integration efforts are meant to culminate in the creation of an ASEAN Economic Community, one of the three pillars of the ASEAN Community espoused in ASEAN's Vision 2020 (the other two pillars are the Security Community and Socio-Cultural Community). The ASEAN Leaders had originally intended to create the ASEAN Economic Community (AEC) by 2020, but in early 2007 they advanced the deadline to 2015. Three factors prompted ASEAN countries to advance the time frame to achieve the AEC. First was the need to maintain the centrality of ASEAN's role despite the proliferation of free trade agreements (FTAs) between ASEAN and its dialogue partner countries. Many of ASEAN's free trade agreements aim at full liberalization of the markets before or by 2015; if the ASEAN market is not fully integrated before the realization of ASEAN free trade agreements, ASEAN's central role faces the risk of being eroded. Second was the political desire of ASEAN leaders to expedite ASEAN economic integration and thereby take it to the next level. Third was the growing concern over the erosion of ASEAN's competitiveness vis-à-vis its key competitors, such as the People's Republic of China and India.

At the 13th ASEAN Summit held in Singapore on 20 November 2007, the ASEAN Leaders adopted the ASEAN Economic Blueprint for the AEC. The Blueprint defines the four pillars of the AEC and contains seventeen

"core elements" and 176 priority actions to serve as a guide for achieving the four pillars. It also contains agreed goals and specific commitments to be carried out within definite timelines, with a "Strategic Schedule" in the form of a matrix specifying "Priority Actions" to be undertaken over four two-year periods from 2008 to 2015.

Progress towards the achievement of the AEC is measured through the AEC Scorecard mechanism established in 2008. The AEC Scorecard is a self-assessment tool that monitors the achievement of milestones indicated in the Economic Blueprint's Strategic Schedule. It also tracks the specific actions that must be undertaken by ASEAN Member Countries, both individually and collectively, to establish the AEC (Das et al. 2013).

The fulfilment of these commitments would promote predictability in ASEAN, as well as strengthen its credibility. But with only two years remaining before the 31 December 2015 deadline, many are still wondering whether the AEC will become a reality in 2015, or whether it will remain essentially a vision statement? The latest AEC Scorecard released in March 2012 records progress towards the AEC at about 68 per cent of the targets during 2008–11. The biggest strides have been made in integrating into the world economy (Pillar 4, 86 per cent). Progress in other areas of the AEC has been more muted, with ASEAN as a whole achieving just a little over two-thirds of its targets in the other three pillars.

One thing is clear; ASEAN would have moved further down the track towards increased integration. Even if specific targets are not met, the journey towards closer and greater integration would have progressed. As evidenced by the integration indicators in Table 1.1, ASEAN has emerged to become one of the most integrated sub-regions in Asia, both in terms of intra-regional trade and investments. Macroeconomic linkages also seem to be stronger in ASEAN, as evinced by the higher output correlation between economies in the sub-region.

3. RISKS FROM INCREASED REGIONAL INTEGRATION

The discussion on regional economic integration has tended to focus more on the benefits than costs. These include, for example, the creation of larger markets to stimulate demand, positive spillover effects of infrastructure connectivity projects, initiatives to share risk, better resource allocation by liberalizing cross-border flows of factors of production, and so on. Much less is heard about the risks of integration. The cascading effect of the ongoing eurozone crisis is a vivid reminder of the contagion risk of highly integrated systems.

TABLE 1.1
Progress in Regional Integration, 2008–11

	Production Network and Trade		Capital Markets		Macroeconomic Links: Intraregional Output Correlations
	Intra-regional FDI	Intra-regional Trade	Intra-regional Equity Holdings	Intra-regional Bond Holdings	
Asia	**50.08**	**55.02**	**24.98**	**6.36**	**0.36**
Central Asia	0.02	5.33			0.35
East Asia	41.81	36.17	17.6	2.84	0.59
Southeast Asia	6.32	24.61	9.54	9.49	0.7
South Asia	0.03	4.61			0.04
The Pacific and Oceania	1.91	8.05			0.46

Notes:
Data calculated for Asia unless otherwise noted.
Foreign direct investment (FDI): Average share of intraregional foreign direct investment inflows in 2008–9. Data unavailable for Afghanistan; Bhutan; the Cook Islands; Kiribati; Republic of the Maldives; the Marshall Islands; the Federated States of Micronesia; Mongolia; Nauru; Nepal; Palau; Samoa; Solomon Islands; Sri Lanka; Taipei, China; Tajikistan; Timor-Leste; Tonga; Turkmenistan; Tuvalu; Uzbekistan; and Vietnam. Trade: Average share of intraregional trade. Reporter data unavailable for Bhutan, Kiribati, Nauru, Palau, Timor-Leste, and Tuvalu. Reporter and partner data unavailable for the Cook Islands, the Marshall Islands, and the Federated States of Micronesia.
Equity holdings: Average share of intraregional equity investment in 2008–10 based on investments from Hong Kong, China; India; Indonesia; Japan; Kazakhstan; the Republic of Korea; Malaysia; Pakistan; the Philippines; Singapore; Thailand; and Vanuatu. Excludes Oceania. Recipient data unavailable for Azerbaijan, Bhutan, the Federated States of Micronesia, Palau, Samoa, Tonga, Turkmenistan, and Tuvalu as investment destinations.
Bond holdings: Average share of intraregional investment in bonds in 2008–10 based on investments from Hong Kong, China; India; Indonesia; Japan; Kazakhstan; the Republic of Korea; Malaysia; Pakistan; the Philippines; Singapore; Thailand; and Vanuatu. Excludes Oceania. Recipient data unavailable for Azerbaijan, Bhutan, the Federated States of Micronesia, Palau, Samoa, Tonga, Turkmenistan, and Tuvalu as investment destinations.
Output correlations: Based on simple averages of three-year rolling bilateral correlations of annual growth rates (difference of natural logarithms) of detrended GDP series (2005 base year). Data unavailable for Afghanistan, the Cook Islands, the Marshall Islands, the Federated States of Micronesia, Myanmar, Nauru, Palau, Timor-Leste, and Tuvalu.
Source: ADB *Asian Economic Integration Monitor*, July 2012.

The main concern relating to increased integration or interdependence is that it exacerbates contagion in times of crisis. Examples abound of financial crises rapidly spreading from one country to another, especially

when integration is deeper due to either geographical proximity or a regional arrangement.

While a shock may originate in the financial sector of one country, it can rapidly infect others across a region, affecting entire economies and damaging people's welfare. For Asia, the damage caused by the 1997/98 Asian financial crisis is a powerful reminder of the danger of contagion. An idiosyncratic shock occurring in Thailand leaped across boundaries, devastating other economies. And yet, despite some policy convergence, the scale of integration in Asia at the time was more limited than now. One can only imagine how much worse the crisis would have been, had intra-Asian cross-border financial holdings been larger than they were.

As noted earlier, regional integration and global connectedness are progressing hand in hand in ASEAN, as it is in many parts of the world. Goods and services are traded and increasingly produced globally and regionally; labour and capital are becoming more mobile. It is clear that regional integration is progressing in Asia, and this has strengthened further after the recent global financial crisis (ADB 2013).

However, unlike Europe, Asian regional integration, especially in ASEAN, has been more market-driven, institution-light and bottom-up. To the extent that greater integration can also elevate the probability of contagion, there is a need to better manage the market process of integration to reap the benefits while minimizing potential costs.

In many cases, Asia needs to cooperate more and better — not just in trade and finance, but also in macroeconomic policy, infrastructure, energy, and on the environment. In some of these areas, greater cooperation will not necessarily lead to greater integration. Cooperation in providing financial safety nets is an example in point; it can mitigate the risks of contagion-driven crises with no direct impact on integration (Azis 2012). On the other hand, cooperation in infrastructure connectivity will almost automatically increase the cross-border flows of goods, services and people.

With the current uncertainties over the global economy, any country is vulnerable to a contagion-driven crisis through real sector, trade and financial channels. The contagion through the financial channel is perhaps the most difficult to detect, yet its impact can be devastating. While domestic macroeconomic policy can help mitigate the impact, sufficient foreign exchange reserves are usually the first line of defence against financial contagion. But a domestic safety net alone may be inadequate, even for a resilient Asia. If contagion effects are severe, markets may react

indiscriminately. To the extent that an interconnected financial system raises the probability of spillover effects — and that the global nature of most crises calls for a coordinated policy response — a regional safety net can complement the domestic and global financial reforms needed to respond to systemic shocks. An effective financial safety net is thus necessary (see Section 6).

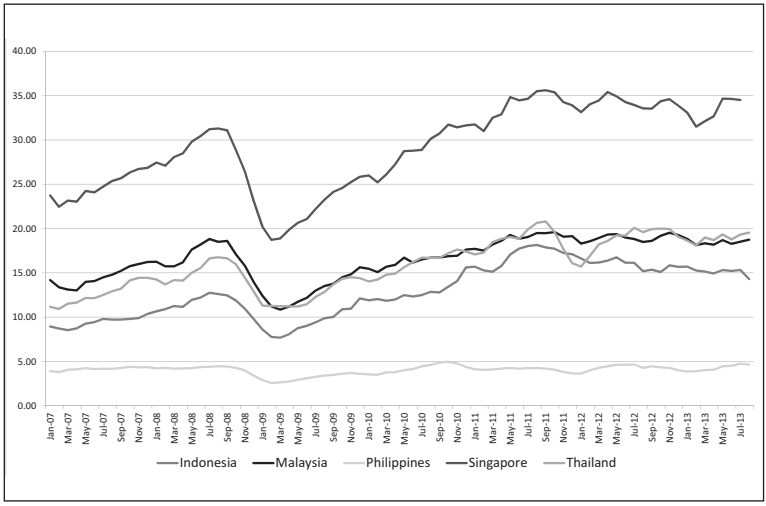
4. SOUTHEAST ASIA AFTER THE GLOBAL FINANCIAL CRISIS

The initial impact of the 2007/8 Global Financial Crisis was the most evident in the real economy. A huge decline in exports led to a sharp slowdown in the region's economic growth. However, this impact was short-lived; the rebound was swift and sharp (see Figures 1.1 and 1.2). This was aided by a partial shift of the region's exports away from the United States and eurozone towards other countries in the region and other developing regions.

On the financial side, there was also an initial outflow of foreign capital from the region's economies. However, inflows of funds resumed quickly. The region's financial system has become more resilient following the reforms carried out after the 1997/98 AFC. Furthermore, prudent management minimized the financial system's exposure to the toxic financial assets that caused heavy losses for American and European banks. The initial outflows from the region likely reflect a flight to safety amid huge uncertainties following Lehman Brothers' collapse. As global financial markets became calmer, fund inflows to the region soon resumed (see Figure 1.3).

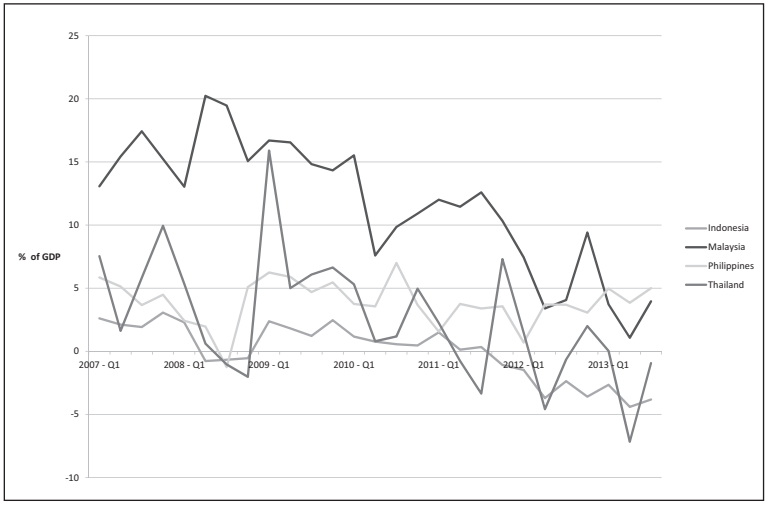
Nevertheless, capital inflows to the region have remained volatile. While the Federal Reserve's announcement in September 2012 to increase quantitative easing spurred capital flows to the region, the more recent decision to begin winding back quantitative easing, combined with further uncertainty in the eurozone, is likely to mean that investors' confidence remains fragile. The sentiment could easily change and capital inflows could suddenly reverse and become outflows. Since sudden reversals in capital flows could disrupt financial systems and lead to macroeconomic instability, there is a need to carefully weigh the benefits and costs of greater capital inflows to the region. Caution is necessary, as the region has experienced volatile capital flows in the past, particularly during the 1997/98 AFC and more recently during the 2008/9 GFC. Large inflows

FIGURE 1.1
Merchandise Export Growth (%, year-on-year, 3-month moving average)



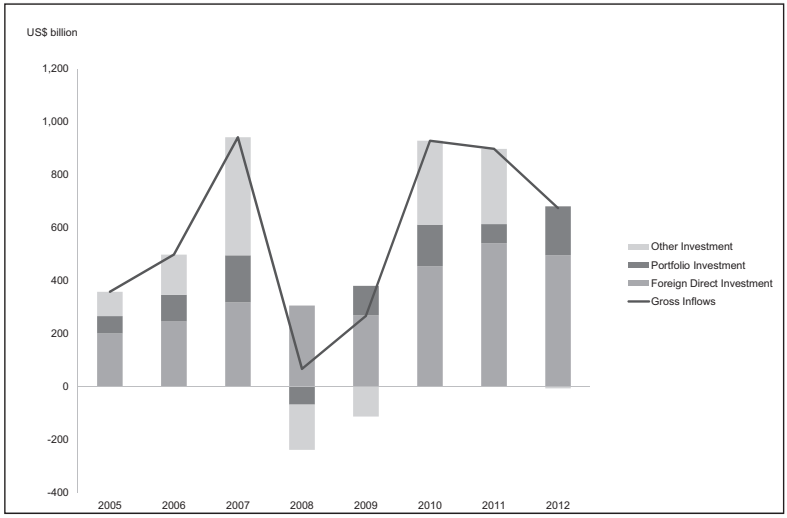
Source: ADB's Asia Regional Integration Centre.

FIGURE 1.2
Current Account of ASEAN-4, 2011–13 (quarterly, as share of GDP)



Source: ADB's Asia Regional Integration Centre.

FIGURE 1.3
Composition of Capital Inflows in Emerging Asia



Notes:
Gross Inflows = Foreign Direct Investment + Portfolio Investment + Other Investment.
Emerging East Asia comprises the People's Republic of China (PRC); Hong Kong, China; Indonesia; the Republic of Korea; Malaysia; the Philippines; Singapore; and Thailand.
Data for 2011 is incomplete. Data for the PRC, Singapore, and Thailand is not available from data source. Data for Malaysia only included Foreign Direct Investment and Gross Inflows.
Source: ADB staff calculations based on balance of payments data (BPM5) from International Financial Statistics, IMF.

to the region before the AFC suddenly reversed, becoming outflows that precipitated currency and banking crises in several countries in Southeast Asia and plunged the most affected countries into deep recession.

The swift resumption of capital inflows in 2009 is seen as a sign of confidence in the region's economies, underscoring economic resilience in the face of the GFC. However, as the size of capital inflows continued to grow, especially in 2010, concerns about a repeat of the 1997/98 AFC also grew. A rapid surge in short-term capital inflows makes it increasingly difficult to manage risks. An attempt to sterilize inflows will only create excess liquidity in domestic financial markets, resulting in exchange rate misalignments, and ultimately derailing economic stability and growth. Fears that the surge in capital flows could lead to asset bubbles and exert upward pressure on the exchange rate have been realized, to varying

degrees, across ASEAN countries. For instance, easy credit combined with strong demand driven by speculative motives have raised property prices in many Southeast ASEAN cities — including Bangkok, Ho Chi Minh, Phnom Penh, Kuala Lumpur and Singapore — in some cases surpassing peaks reached in 2007. This increases the risk of price bubbles that could lead to drastic losses in terms of both real output and price levels (Menon and Chongvilaivan 2011).

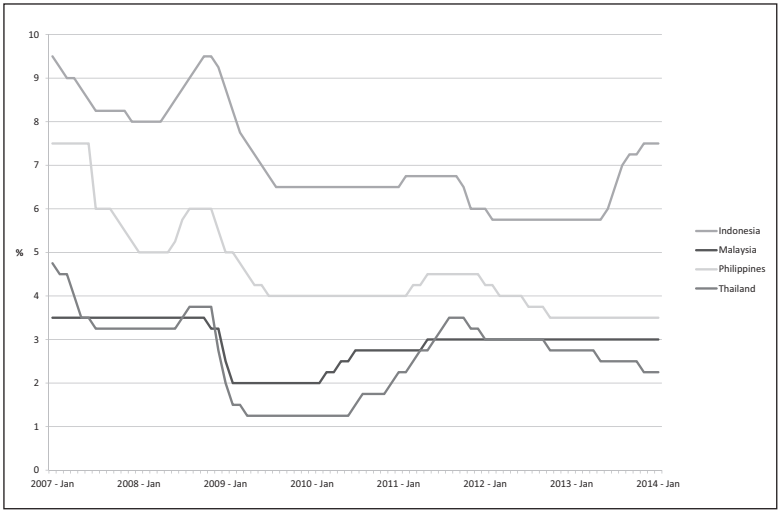
There are also concerns about sudden reversals of capital inflows destabilizing asset and financial markets. Ng (2011) has shown that capital inflows to the region are strongly affected by global risk perception. Concerns relating to future growth prospects of Asia's giant economies of the People's Republic of China (PRC) and India, coupled with the looming deadline of the Fed's unwinding of its quantitative easing, have already seen significant volatility in the region in August 2013, with significant amounts of portfolio capital exiting the region. As can be seen from the severe recession following the AFC, the cost of the volatility of capital flows can be very high indeed.

Given the threat to the region's economies, governments reacted quickly to the 2008/9 GFC by implementing fiscal and monetary stimulus measures. Higher initial policy rates, compared with those in the United States and Europe, provided ample room for the region's monetary authorities to reduce interest rates. As a result, the region's policy rates have fallen considerably (see Figure 1.4). Despite recent improvements in economic performance, policy rates in many countries have remained well below pre-crisis levels. Given the uncertain state of the global recovery, many of the region's governments have been hesitant to raise interest rates quickly.

Monetary policy easing has had the desired impact of increasing bank lending in the ASEAN economies (see Figure 1.5). This likely reflects the region's stronger macroeconomic fundamentals, and possibly a more optimistic outlook among the region's consumers and businesses. The resilience of the region's financial system in the aftermath of the GFC has also likely helped shore up confidence. As Figure 1.4 shows, while bank lending slowed considerably after the GFC, the easing of monetary policy has since led to an increase in bank lending.

Consequently, although Asia had relatively low levels of debt at the beginning of the GFC, it is now more highly leveraged. Domestic bank lending has soared, particularly in Thailand, Malaysia and Singapore (see Figure 1.6). At the same time, given the weakness in global financial institutions, we have seen a considerable decline in loans by European

FIGURE 1.4
Policy Rates in the ASEAN-4

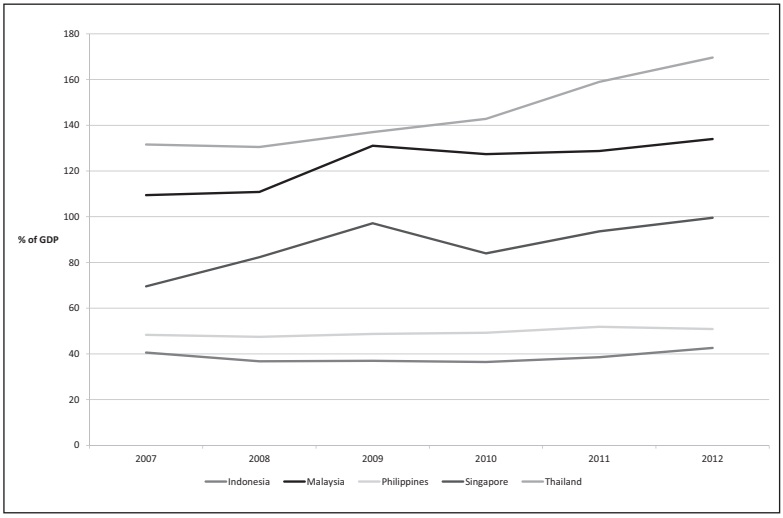


Source: ADB's Asian Regional Integration Centre.

FIGURE 1.5
Growth in Bank Lending (%, year-on-year)

Source: International Financial Statistics.

FIGURE 1.6
Domestic Credit Provided by Banking Sector (% of GDP)



Source: International Financial Statistics.

banks to the region. This has particularly affected the use of trade finance in the region. Basel III regulations aim to increase the capital cushion that banks will have to carry. This means that European banks will have to raise more capital in a difficult environment. Alternatively, the banks may opt to reduce their asset base by reducing lending, which is a major concern for the region.

Another cause for concern is non-core liabilities (usually consisting of interbank borrowings), which have been increasing significantly even prior to the 2007/8 GFC. There are concerns that with European banks deleveraging, the banking system in Southeast Asia will find it more difficult to continue borrowing funds from abroad. The share of other investment flows has declined in the region. Given the importance of the banking system in the region, the trend in non-core liabilities, which is on the rise, is a cause for concern (Menon and Ng 2013).

5. ESTIMATING THE IMPACT OF SPILLOVERS FROM A EUROZONE FINANCIAL CRISIS

While aggressive actions from the European Central Bank have helped to improve market confidence and stabilize bond yields, the risks in

the eurozone's financial system have not faded completely. Financial institutions in the eurozone, particularly banks, are still struggling to regain profitability amidst a weak macroeconomic environment. While there are recent signs of improvement in the eurozone economies, it is still expected to end 2013 mired in recession. As a result of the weak growth, banks are still finding it difficult to lend, with borrowers preferring to remain on the sidelines for now. With eurozone banks pulling back from overseas markets, they have also become more dependent on the slow-growing eurozone market. So while the financial conditions in the eurozone are calmer now, the continued fragility of the financial system means that they remain susceptible to sudden shifts in investor confidence.

The reaction of the region's financial markets to the news of the Federal Reserve potentially tapering its quantitative easing operations demonstrates that the region remains vulnerable to external shocks. A financial crisis in the eurozone will almost certainly have an impact on the region's financial markets — the only question relates to the magnitude of the spillover. To estimate the potential impact of spillovers from a financial crisis in the eurozone, we employ the global vector autoregression (GVAR) model originally introduced by Pesaran et al. (2004) and further developed by Dees et al. (2007). The advantage of the GVAR model is that it not only incorporates the economic structures and global interdependencies of the world economy into a VAR model, it also avoids the identification problem found in VAR models. Furthermore, there are major differences in the cross-country correlations of various real variables. For instance, equity returns are much more closely correlated across countries than real gross domestic product (GDP) growth and inflation. This suggests that different channels of transmission should be considered. The GVAR approach allows us to model these different types of links directly, using trade-weighted observable macroeconomic aggregates and financial variables. The advantage of performing a quantitative assessment of this type is that it allows us to identify which economies are likely to be the most vulnerable in the event of a crisis, as well as providing an estimate of the magnitude of the impact on individual economies. These estimates can provide policymakers with a quantitative assessment of the extent of their vulnerability, and can serve as an important incentive to implement timely remedial policy actions.

The GVAR approach has been used by several researchers to examine spillover effects of this type. Galessi and Sgherri (2009), for instance, analysed the transmission of shocks across financial sectors in Europe. They used bilateral bank lending as the weights in their model. Chen et al.

(2010), on the other hand, used the GVAR model to examine how banks' and nonfinancial private companies' default risk could spread among countries. In their case, a combination of trade and financial variables were used as the weights in conducting the estimation.

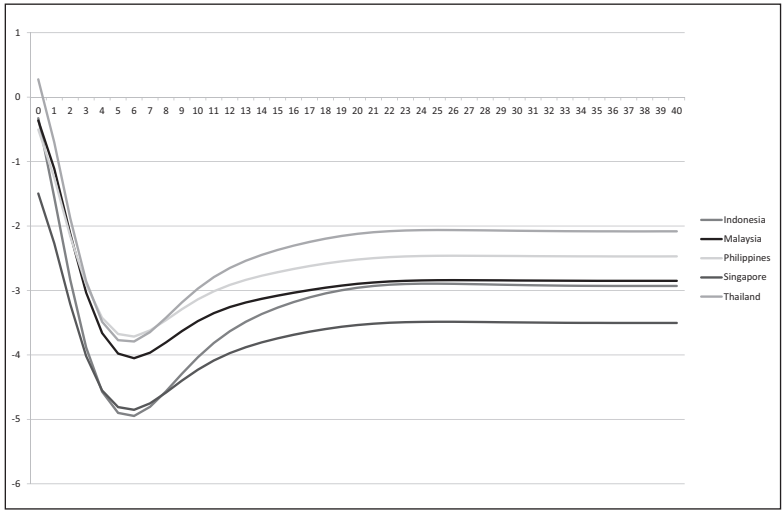
To estimate the spillovers from an external financial shock, we construct a GVAR model for thirteen economies: the United States, United Kingdom and eurozone, plus ten Asian economies — the East Asian economies of the PRC, Hong Kong, Japan and the Republic of Korea; the five original members of ASEAN, which are Indonesia, Malaysia, the Philippines, Thailand and Singapore; and India. The variables included in the model are real GDP growth, equity prices, lending to the private sector, and interbank rates. It is estimated using monthly data over the period 1999–2011. As GDP growth data are only available quarterly, we used interpolation methods to convert quarterly GDP growth into monthly figures, following Smith and Galessi (2011). Since we are interested in examining the impact of financial linkages across countries, we use the share of portfolio investment in the economy — obtained from the Coordinated Portfolio Investment Survey — as the weights for the GVAR model.

In order to examine the impact of a shock from the European financial markets, we estimate generalized impulse response functions (GIRFs). Within the GVAR framework, GIRFs are widely used as they are not affected by the ordering of the variables and countries. In a large model with many countries and variables, there is no obvious way to identify the ordering of countries. Furthermore, the focus of our analysis is to examine the spillover effects from the eurozone on Asian economies, rather than to identify the effects of a specific shock.

Figure 1.7 presents the GIRFs of a negative-one standard deviation shock on eurozone equity markets on ASEAN stock markets. Our dynamic analysis shows that the equity market shocks from the eurozone are transmitted quickly to the region through stock prices. There are substantial co-movements in ASEAN stock markets following a negative shock in eurozone equities. The transmission is rapid, with the peak effect occurring about five to seven months after the onset of a shock.

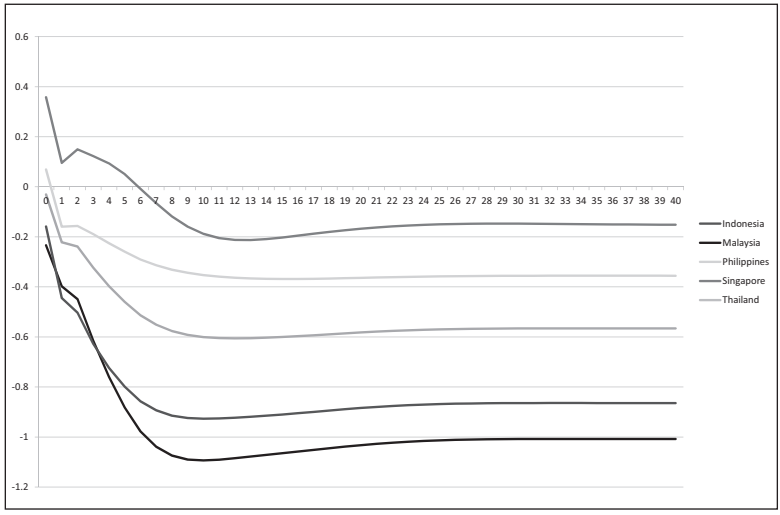
Next, we examine the impact of a eurozone financial shock on ASEAN's economic growth. We find that the responses of the region's economies are mostly similar (see Figure 1.8). However, the impact of the shock on economic growth, as opposed to equity markets, is transmitted over a longer period, taking seven to nine months to reach its trough. Economic growth rates in Malaysia and Singapore are the most affected by a eurozone equity shock. In contrast, the economies of Indonesia and

FIGURE 1.7
Response of ASEAN Equity Returns to a Negative Eurozone Equity Shock



Source: Authors' calculations.

FIGURE 1.8
Response of Output Growth to a Eurozone Equity Shock



Source: Authors' calculations.

the Philippines — with their relatively large domestic sectors — appear to be better insulated against a financial shock from Europe.

Our empirical results show that a eurozone financial crisis would have a small but non-negligible impact on the region's stock markets and economic growth. Such a crisis would affect countries in the region to varying degrees, with Singapore and Malaysia the most affected in terms of real economic impact given their greater exposure to global markets. These are the effects that we can directly attribute to a further shock in the eurozone. What we cannot quantify are the indirect effects that may flow from adjustments that take place via changes in value assessments as a result of heightened risk perception. Since the region's asset prices — both real and financial — have increased significantly due to large capital inflows driven by quantitative easing in the advanced economies, there could be an underlying perception among global investors of overheating that has resulted in an artificial asset bubble. Although difficult to quantify, the possibility of such indirect effects is real, and could accumulate to produce a much greater negative impact on the region.

Given the potential for shocks in eurozone financial markets to affect Asia both directly and indirectly, policymakers need to ensure that they respond quickly to bolster financial stability and avoid deterioration in market confidence. This need is even more pressing now, given the extent of integration in the region and the increased risk of contagion. Policymakers should also continue to carefully monitor banks' portfolios, especially in countries where lending has risen sharply, to ensure that there has not been excessive risk-taking. A further real-side contraction driven by a trade slowdown could compound the debt situation in many ASEAN countries.

6. IS EAST ASIA READY FOR ANY FALLOUT?

How prepared is the region to deal with a shock in the eurozone that translates into a liquidity crisis in East Asia? Although our analysis points to a small but non-negligible direct impact from a further shock to the eurozone economy, this can easily be amplified into a significant one through indirect channels. In this section, we look at whether the region is ready to deal with such fallout. The importance of the region's ability to fend for itself is heightened if such a contagious crisis sees a significant share of the world competing for scarce global resources. The current situation in Europe has already seen the troika — the IMF, European Commission

and European Central Bank — expend €303 billion in bailout funds for Greece (€130 billion total with an IMF share of €28 billion); Portugal (€78 billion total with an IMF share of 27.5 billion); Ireland (€85 billion with an IMF share of €22.5 billion); and Cyprus (€10 billion with an IMF share of €1 billion). Given the sheer size of the amounts involved, it is easy to see how a worsening situation in Europe could constrain the IMF's ability to serve as lender of last resort, should Asia also require emergency support.

When the Asian financial crisis hit, the ASEAN Swap Arrangement (ASA) proved sorely inadequate, given its small size, in providing the liquidity needed by its members. As a result, there was little choice but to resort to the IMF. Amid widespread disenchantment with the way in which the IMF dealt with the AFC, the region has since been working on bolstering its own financial safety nets. The first step towards establishing such a scheme was taken in May 2000 with the launch of the Chiang Mai Initiative (CMI) as part of the ASEAN+3 process. The CMI grew from just US$1 billion at inception to US$84 billion at the onset of the GFC.

If the Asian financial crisis crystallized the need to transform the ASA into the CMI, then the GFC of 2008/9 highlighted the continued shortcomings of that transformation. Despite the CMI having grown rapidly in size, it was still too small to be effective during the GFC, and the absence of rapid-response mechanisms forced affected countries to turn to bilateral swaps with the United States, PRC and Japan, and to regional agencies (Hill and Menon 2012*b*). What followed was a radical transformation of the CMI. First, it was multilateralized so that the revamped CMIM would be a self-managed reserve-pooling arrangement governed by a single contract, reducing costly and wasteful duplication. Second, the size of the pool was increased to US$120 billion in May 2009. A decision was taken to establish an ancillary institution in the form of an independent regional surveillance unit, the ASEAN+3 Macroeconomic Research Office (AMRO), which came into being in May 2011.

The continuing problems in the eurozone and risks of further deterioration have highlighted the need to strengthen the CMIM's capacity to act as a regional financial safety net (Azis 2012). To address this need, the 15th Meeting of ASEAN+3 Finance Ministers in May 2012 agreed to (1) double the total size of the CMIM to US$240 billion; (2) increase the IMF de-linked portion to 30 per cent in 2012, with a view to increasing it to 40 per cent in 2014, subject to review should conditions warrant; and (3) introduce a crisis prevention facility.

These are impressive developments over a relatively short period of time. However, the critical question that needs to be answered is whether these reforms are sufficient to provide the region with a working alternative in the event of a crisis. Is it likely that the CMIM will be called upon when the next crisis strikes? Unfortunately, the CMIM still appears unusable, whether as a co-financing facility in tandem with the IMF or as a stand-alone alternative. There are a number of reasons for this, and therefore an equal number of issues that need to be addressed to make it viable.

First, as a reserve-pooling arrangement, there is no actual fund, but rather a series of promises (Hill and Menon 2012*b*). This is not a problem per se, except when there are no rapid-response procedures to handle a fast-developing financial emergency. Unless these procedures are streamlined, the CMIM is unlikely ever to be called upon, even as a co-financing facility. Yet, if the IMF's resources are already committed elsewhere, especially if conditions in Europe were to deteriorate thus requiring further bailouts, then the role of the CMIM becomes critical. If the CMIM is to be a real substitute for the IMF and serve as a true regional alternative, then the size of the fund, or the portion de-linked from an IMF programme, needs to be increased substantially.

During the AFC, Thailand received over US$17 billion in emergency liquidity. Yet Thailand (and the four other original ASEAN members) can access only a fraction of this amount, about US$7 billion in 2012 US dollars, from the CMIM without an IMF programme. Indonesia received almost six times (US$40 billion) the amount of its de-linked portion of the CMIM, or an even greater multiple if converted into today's dollars. The Republic of Korea was the other crisis-hit country that availed of an IMF-led programme and bilateral support that totalled US$57 billion, while today its full quota with the CMIM is only about US$38 billion (Hill and Menon, 2012*b*).

Unlike with the IMF, the CMIM does not have an exceptional access clause that allows a country to borrow amounts above their quota in exceptional circumstances provided that the country satisfies a predetermined set of conditions. If there were to be a full-blown systemic crisis in East Asia that spread across several members, then this clause would not be of much value either. This is another reason why membership also needs to expand beyond ASEAN+3, not just to bolster the size of the fund, but also to diversify it.

Without these changes, ASEAN+3 is unlikely to turn to the CMIM as a co-financier or a substitute for the IMF, which explains why countries

continue to take the high-cost mercantilist route of self-insurance through excessive holdings of foreign exchange reserves, or why they continue to pursue bilateral swaps separately, often with other CMIM members. Furthermore, Japan is also looking to strengthen bilateral relations with ASEAN directly, bypassing the ASEAN+3 process, and is expected to revive bilateral currency swap agreements with Malaysia, Singapore and Thailand, and to strengthen existing bilateral arrangements with Indonesia and the Philippines. Some see this as an early warning sign of an unravelling of the CMIM, as a result of rising tensions involving territorial disputes and competition among the "+3" countries to gain influence in Southeast Asia. If this process continues or spreads, we could see a return of the so-called "noodle bowl" of bilateral swap agreements that the CMIM's single agreement was designed to replace.

In fact, bilateral swaps are quickly becoming the main instrument in Asia's financial safety net, although on a somewhat ad hoc basis. However, shifting national reserves to a regional fund that is unlikely to be used could actually be counterproductive, as it weakens a country's first line of defence. Although ASEAN+3 may appear to have a co-financing facility with the IMF in the CMIM, it is not a useable one. If it wants its own regional safety net, then it has a long way to go. How far is still unclear, but hopefully it can be made workable before, rather than because of, the next crisis.

7. CONCLUSION

ASEAN countries, even its newer members, have made impressive progress in regional economic integration and cooperation. The region's diversity, development pattern and global links have generated a unique Asian model of regionalism — dynamic, open and market driven — which enhances prosperity not only in the region but also in the rest of the world. Asia's open regionalism underscores the importance of strengthening trade, investment and capital flows within the region while maintaining strong ties with and remaining open to the rest of the world. It aims to build a regionally integrated and globally connected Asia. But while increasing regional integration with rising global engagement brings obvious benefits, it also carries substantial risks.

While ASEAN entered the GFC with relatively low levels of debt, it is now more highly leveraged following large inflows of capital resulting from successive rounds of quantitative easing in the advanced economies of

Europe and the United States. The decision by the Bank of Japan in 2013 to also aggressively pursue monetary easing is likely to lead to further flows into the region. At the same time, given the weakness of global financial institutions, we have seen considerable cutbacks in loans by European banks to the region. The recent decision by the Federal Reserve to begin winding back quantitative easing is already being felt in the region. Trade finance is also being affected. If there is a worsening of the eurozone debt crisis, and there are signs of this with yields beginning to increase again starting June 2013, it could result in a rise in global investor risk aversion that would have an impact on ASEAN economies. And with ASEAN more integrated today than it has ever been, the risk of contagion spreading rapidly across the region and beyond is also higher than ever before.

Estimates from a GVAR model suggest that while the overall impact of a worsening in the eurozone crisis is likely to be quite limited, the larger impact would be on equity markets in the region. There is also the possibility that such spillovers, while relatively small in the aggregate, could lead to a second round of adjustments involving re-evaluation of other asset prices. In other words, even a muted direct impact could result in a magnified overall impact through indirect means, involving adjustments to asset prices viewed to be at inflated levels.

In light of this, there is a pressing need to ensure that crisis management frameworks are strengthened and ready for use. Despite significant progress over a relatively short period of time, East Asia's regional financial safety net still appears unusable. Further reforms are necessary in order to make the CMIM workable should a crisis hit the region, especially if resources are scarce in the event of a global meltdown. With the IMF's resources already stretched in bailing out Europe, a further shock there would leave a lot less available for countries in Asia should contagion hit.

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