Towards Greater Economic Cooperation and Integration among BIMSTEC Countries and Japan in Money, Finance and Investment

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Towards Greater Economic Cooperation and Integration among BIMSTEC Countries and Japan in Money, Finance and Investment

Biswa N. Bhattacharyay[1]

Abstract

The recent years witnessed increased integration in Asia. Regional cooperation activities in Asia had focused mainly on subregional cooperation. This paper shows that an increased economic cooperation and integration among BIMSTEC countries and Japan will produce significant benefits to all participating countries, particularly sustained economic growth and much needed inflow of foreign investment to the subregion. In addition, according to this paper, this cooperation will strengthen the economic and trade link between South and Southeast Asian countries and will contribute toward a pan-Asian integration and cooperation.

1. Introduction

Economic cooperation and integration is based upon complementarities, and helps maximize the mutual benefits of all involved. By working together, countries enjoy social and economic benefits that may not occur through individual efforts alone. Regional integration can produce win-win outcomes in both the quantity and quality of economic growth. More importantly, it is also a potential driver of sustainable economic growth that will contribute to poverty reduction if accompanied by pro-poor national policies.

The past few decades have seen a remarkable growth and dynamism in Asia as well as a period of recent economic turbulence. The Asian financial crisis of 1997 was a wake-up call for policymakers that regional cooperation and integration can maximize the benefits of globalization while minimizing the costs. With the unsuccessful World Trade Organization (WTO) trade talks in Cancun, there is an increasing trend toward regional cooperation, such as bilateral and regional preferential trade/tariff agreements in Asia, and in other regions, particularly the expanded European Union (EU), and North American integration, namely, the North American Free Trade Agreement (NAFTA), Central American Free Trade Agreement (CAFTA), and Gulf Cooperation Council (GCC) Currency Union in 2010.

The recent years witnessed increased integration in Asia; however, it is still one of the least integrated regions. Regional cooperation activities in Asia had focused mainly on subregional cooperation. In Asia, the major subregional economic cooperation include (i) Associations of South East Asian Nations (ASEAN) in Southeast Asia, (ii) South Asian Association for Regional Cooperation (SAARC) in South Asia, (iii) Greater Mekong Subregion Economic Cooperation Program (GMS) in Southeast and East Asia, (iv) South Asia Subregional Economic Cooperation (SASEC) in South Asia, (v) Bay of Bengal Initiative for Multisectoral Technical and Economic Cooperation (BIMSTEC) in South and Southeast Asia, (vi) the Brunei Indonesia Malaysia the Philippines–East ASEAN Growth Area (BIMP-EAGA) in Southeast Asia and (vii) Kunming Economic Cooperation Initiative among Bangladesh, the People Republic of China (PRC), India and Myanmar in South and East Asia.

A new dimension to regional cooperation is evolving as "bridges" and "linkages" are being built across such subregions. There are several free trade agreements (FTA) between various subregions of Asia such as ASEAN - India FTA, Singapore-India FTA, and Thailand-India FTA. In addition, the Asia Cooperation Dialogue (ACD) among countries in South Asia, East Asia, and several Middle

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Eastern countries has addressed the area of money and finance, and the possibility of joint infrastructure projects between SASEC and GMS.

The recent years witnessed increased integration in Asia. Seven-nation BIMSTEC comprising Bangladesh, Bhutan, India, Myanmar, Nepal, Sri Lanka, and Thailand, set up in 1997, is emerging as one of the major subregional groups in Asia. This covers 1.32 billion people around the Bay of Bengal with its immense resources and strategic shipping routes. BIMSTEC's subregional grouping consists of some geographically adjacent South Asian (or SAARC) and Southeast Asian (or ASEAN) member countries in the Bay of Bengal. It was founded in 1997 with Bangladesh, India, Myanmar, Sri Lanka, and Thailand as members to utilize the synergies in their capabilities and resource endowments for their development. In 2004, Bhutan and Nepal also joined the group. BIMSTEC plans to establish a Free Trade Area in the region to promote harmonious development of economic relations among member countries through expansion of trade by providing fair conditions of trade competition among them. The six areas of cooperation are trade and investment, technology, transport and communication, energy, tourism, and fisheries.

BIMSTEC countries and its key trading partner, Japan's cooperation will strengthen the economic and trade link between South Asian and Southeast Asian countries. Hence, it can act as a viable bridge between SAARC and ASEAN and eventually may contribute towards pan-Asian integration and cooperation. Japan is the second largest trading partner for BIMSTEC countries, which requires low-risk and higher returns destinations for its surplus savings that are now invested in developed countries capital markets with low returns. It also needs new markets for addressing its excess industrial capacity problem. Growing ageing population and rising wages in Japan thus call for additional human resources. Outsourcing to BIMSTEC region is also an attractive economic opportunity for Japanese companies.

In view of the above, the opportunity costs of not moving toward greater economic cooperation integration among BIMSTEC countries, and their key trading partner—Japan—could be enormous. Subregional cooperation and integration can be building blocks for region-wide integration. Another important factor for pushing this integration is the emergence of India as a major economic force in the region. India is fast becoming open and has been playing a key role in this subregional integration.

Over the last decade, some BIMSTEC countries have liberalized FDI and trade regime and started liberalizing their financial sector. As a result, the recent years witnessed a significant growth in exports and imports of BIMSTEC countries. The major trade partners of BIMSTEC countries are Japan, Singapore, and United States. During 2003-2004, USA accounted for 21.6% of total BIMSTEC exports and 7.7% of imports, whereas Japan accounted for 9.7% and 9.6%, respectively. Therefore, an increased economic cooperation and integration among BIMSTEC countries and Japan will generate significant benefits to all participating countries, particularly in terms of sustained economic growth and the much needed inflow of foreign investment to BIMSTEC. This cooperation will strengthen the economic and trade link between South and Southeast Asian countries, and eventually can play an important role towards a pan-Asian integration and cooperation.

This paper discusses various opportunities and prospects for strengthening cooperation and integration in money, finance, and investment among BIMSTEC countries and Japan as well as associated challenges and problems.

2. Recent Economic and Financial Sector Trends and Prospects

During 2003-2004, all BIMSTEC countries, except Nepal, witnessed strong economic expansion in the range of 5%-13% as well as 4%-5% per capita Gross Domestic Product (GDP) growth. According to the estimates of the Asian Development Bank (ADB, 2005), GDP growth rates of all countries, except for Nepal, are expected to be firm (in the range of 5.3% - 8%) during 2005-2007. Except for Bhutan and Nepal, inflation rates of all countries increased during 2003-2004, whereas Myanmar witnessed a very high inflation rate of 36% in 2003. India had high fiscal deficits of 9% -10% for the last 20 years, but has been stable in other macroeconomic areas, with GDP growth of around 6% during 2004-2005. In general, output growth, inflation, and fiscal deficit are not similar among member countries in BIMSTEC. The average inflation rate and fiscal deficits of the region are much higher than European Union member countries and have not created an environment conducive to enhanced integration (Table 1).

Table 1: Selected Economic Indicators for BIMSTEC Countries: 2003–2007

	2003	2004	2005	2006*	2007*
Bangladesh					
Growth rate of GDP (% per year)	5.3	5.5	5.3	6.0	6.0
Growth rate of per Capita GDP (% per year)	3.9	4.1	-	-	-
Inflation (% per year)	4.4	5.8	7.0	6.0	5.0
External debt outstanding (US$ million)	16,953	17,175			
Fiscal balance of central government (% of GDP)	-3.4	-3.2	-4.7	-4.6	-4.5
Bhutan					
Growth rate of GDP (% per year)	6.5	7.0	8.0	8.0	8.0
Growth rate of per Capita GDP (% per year)	3.9	4.0	-	-	-
Inflation (% per year)	1.8	1.3	-	-	-
External debt outstanding (US$ million)	406	529			
Fiscal balance of central government (% of GDP)	-10.4	4.5	-	-	-
India					
Growth rate of GDP (% per year)	8.5	6.5	6.9	6.1	7.0
Growth rate of per Capita GDP (% per year)	6.7	4.7	-	-	-
Inflation (% per year)	5.5	6.0	4.2	3.0	3.5
External debt outstanding (US$ million)	111,830	131,923			
Fiscal balance of central government (% of GDP)	-9.4	-9.1	-8.8	-8.5	-8.0
Myanmar					
Growth rate of GDP (% per year)	13.8	12.6	-	-	-
Growth rate of per Capita GDP (% per year)	11.6	-	-	-	-
Inflation (% per year)	36.6	-	-	-	-
External debt outstanding (US$ million)	-	-			
Fiscal balance of central government (% of GDP)	-4.9	-	-	-	-
Nepal					
Growth rate of GDP (% per year)	2.9	3.3	3.0	3.7	4.3
Growth rate of per Capita GDP (% per year)	0.6	0.8	1.0	1.3	-
Inflation (% per year)	4.8	4.0	4.5	4.0	4.0
External debt outstanding (US$ million)	2,968	3,120			
Fiscal balance of central government (% of GDP)	-1.5	-1.5	-1.7	-3.0	-3.5
Sri Lanka					
Growth rate of GDP (% per year)	5.9	5.5	5.2	5.8	5.9
Growth rate of per Capita GDP (% per year)	4.6	4.4	4.7	4.7	4.8
Inflation (% per year)	2.6	7.9	12.0	9.0	7.5
External debt outstanding (US$ million)	10,644	11,742			
Fiscal balance of central government (% of GDP)	-7.5	-7.6	-8.0	-8.0	-7.0
Thailand					
Growth rate of GDP (% per year)	6.9	6.1	5.6	5.8	6.0
Growth rate of per Capita GDP (% per year)	5.9	5.7	4.7	5.0	5.2
Inflation (% per year)	1.8	2.7	3.5	3.0	2.5
External debt outstanding (US$ million)	51,783	50,592			
Fiscal balance of central government (% of GDP)	0.6	0.3	0.0	0.2	0.2

Note: * The figures for 2005-2007 are projected
Source: Asian Development Bank Outlook 2005, Asian Development Bank, Manila.

In recent periods, Japan witnessed signs of recovery. Following an absolute decline of 0.3 % in output growth in 2002, the Japanese economy expanded by 1.4% and 2.6% in 2003 and 2004, respectively. Japan's global trade expanded significantly: merchandise and services trades increased from US$ 754 and 172 billions in 2002 to US$ 855 and 86 billions in 2003, respectively.

Exports and imports of all BIMSTEC countries, except Myanmar, improved remarkably during 2003-2004 and are expected to grow significantly during 2005-2007. BIMSTEC countries have also experienced diverse growth rates in exports, imports and current account balances (Table 2).

Table 2: Selected Trade Indicators for BIMSTEC Countries: 2003 – 2007

	2003	2004	2005	2006*	2007*
Bangladesh					
Current account balance (% of GDP)	0.2	0.2	-1.0	-1.0	-1.5
Trade Balance (US$ million)	-2,215	-2319	-3,159	-4,183	-5,203
Merchandise imports (% per year)	13.1	13.0	20.0	16.0	13.0
Merchandise exports (% per year)	9.5	15.9	15.0	10.0	8.0
Trade in goods(% of GDP)					
Bhutan					
Current account balance (% of GDP)	9.0	7.1	-	-	-
Trade Balance (US$ million)	-77	-88	-	-	-
Merchandise imports (% per year)	1.7	29.6	-	-	-
Merchandise exports (% per year)	8.9	39.7	-	-	-
India					
Current account balance (% of GDP)	1.8	-1.0	-1.0	-1.4	-1.9
Trade Balance (US$ million)	-15,454	-31,707	-42,397	-50,328	-58,818
Merchandise imports (% per year)	24.4	39.0	19.7	15.4	14.4
Merchandise exports (% per year)	20.4	23.2	14.1	13.8	13.2
Myanmar					
Current account balance (% of GDP)	0.0	-	-	-	-
Trade Balance (US$ million)	810	-	-	-	-
Merchandise imports (% per year)	-4.9	-	-	-	-
Merchandise exports (% per year)	3.0	-	-	-	-
Nepal					
Current account balance (% of GDP)	2.5	2.4	1.9	0.3	-1.1
Trade Balance (US$ million)	-902	-1,107	-1,126	-1,432	-1,807
Merchandise imports (% per year)	7.1	18.4	5.0	20.0	20.0
Merchandise exports (% per year)	-13.8	12.4	10.0	10.0	10.0
Sri Lanka					
Current account balance (% of GDP)	-0.6	-3.2	-5.8	-5.2	-3.0
Trade Balance (US$ million)	-1,539	-2,170	-3,018	-3,117	-2,884
Merchandise imports (% per year)	9.3	19.3	17.2	8.5	6.0
Merchandise exports (% per year)	9.2	12.7	9.0	11.0	12.0
Thailand					
Current account balance (% of GDP)	5.6	4.5	2.3	1.3	1.3
Trade Balance (US$ million)	3,759	1,682	-1,453	-2,597	-2,805
Merchandise imports (% per year)	17.4	26.9	13.5	6.0	8.0
Merchandise exports (% per year)	18.2	23.0	10.0	5.0	8.0

Note: * The figures for 2005-2007 are projected
Source: Asian Development Bank Outlook 2005, Asian Development Bank, Manila.

In terms of direction of trades, the export of BIMSTEC countries (except for Nepal) to Japan declined significantly during 1995-2003 (Table 3), which, in other words, indicates that BIMSTEC-Japan cooperation is essential to recover member countries' export to Japan.

Table 3: Direction of Exports (% of total) of BIMSTEC Countries: 1995 and 2003

To / From	DMCs	People's Rep. of China	Japan	United Stated	European Union	Others
Bangladesh						
1995	8.2	0.6	3.3	3.19	44.8	11.2
2003	4.8	0.2	0.8	23.9	47.2	23.1
Bhutan						
1995	-	-	-	-	-	-
2003	-	-	-	-	-	-
India						
1995	20.2	0.9	7.0	17.4	27.5	27.0
2003	21.9	4.5	2.9	18.6	22.5	29.6
Myanmar						
1995	51.1	11.3	7.1	6.6	6.1	17.7
2003	52.6	5.6	4.6	9.8	13.9	13.5
Nepal						
1995	9.8	0.1	0.5	30.5	53.3	5.8
2003	46.0	0.9	1.1	29.6	16.6	5.8
Sri Lanka						
1995	8.9	0.1	5.3	35.6	32.4	17.7
2003	11.2	0.3	3.1	34.6	28.5	22.2
Thailand						
1995	29.2	2.9	16.6	17.6	16.1	17.7
2003	29.8	7.1	14.2	17.0	15.2	16.7

Note: * DMCs are Asian developing member countries of Asian Development Bank.
Source: Asian Development Bank Outlook 2005, Asian Development Bank (ADB), Manila.

Table 4 presents selected financial indicators for BIMSTEC countries. FDI inflows to Bangladesh and India have increased during 2003-2004, but declined for the remaining BIMSTEC countries. Exchange rates have been stable during this period. The gross international reserve shows a healthy increasing trend for all countries, except for Myanmar and Sri Lanka.

In recent years, BIMSTEC countries witnessed noticeable progress in macroeconomic stability and soundness and efficiency of their financial systems as evidenced by the financial soundness indicators in Table 5. Bangladesh, India, Sri Lanka, and Thailand have active stock and bond markets. During 2002-2003, stock markets capitalizations (as % of GDP) of these countries have increased significantly. Loan to deposit ratio and real bank credit growth showed a healthy trend for all countries.

Table 4: Selected Financial Indicators for BIMSTEC Countries: 2003–2007

	2003	2004	2005	2006*	2007*
Bangladesh					
Foreign direct investment (US$ million)	376	385			
Exchange rate to the US dollar (annual average)	57.9	58.9			
Gross international reserves (US$ million)	2,470	2,705			
Gross domestic investment (% of GDP)	23.4	23.6	24.0	26.0	26.0
Bhutan					
Foreign direct investment (US$ million)	2	3			
Exchange rate to the US dollar (annual average)	47.9	45.4			
Gross international reserves (US$ million)	373	383			
Gross domestic investment (% of GDP)	-	-	-	-	-
Stock Market Capitalization ((% of GDP)					
India					
Foreign direct investment (US$ million)	3,420	4,374			
Exchange rate to the US dollar (annual average)	45.9	44.9			
Gross international reserves (US$ million)	107,448	134,584			
Gross domestic investment (% of GDP)	26.3	26.5	26.5	27.0	27.5
Myanmar					
Foreign direct investment (US$ million)	128	-			
Exchange rate to the US dollar (annual average)	6.1	5.7			
Gross international reserves (US$ million)	456	424			
Gross domestic investment (% of GDP)	11.0	-	-	-	-
Nepal					
Foreign direct investment (US$ million)	12	0			
Exchange rate to the US dollar (annual average)	77.9	73.8			
Gross international reserves (US$ million)	1,159	1,447			
Gross domestic investment (% of GDP)	26.0	27.3	26.2	28.0	29.9
Sri Lanka					
Foreign direct investment (US$ million)	171	133			
Exchange rate to the US dollar (annual average)	96.5	101.2			
Gross international reserves (US$ million)	2,329	1,824			
Gross domestic investment (% of GDP)	22.3	25.9	27.0	27.0	27.0
Thailand					
Foreign direct investment (US$ million)	1,466	656			
Exchange rate to the US dollar (annual average)	41.5	40.3			
Gross international reserves (US$ million)	42,148	49,832			
Gross domestic investment (% of GDP)	25.0	27.1	24.0	26.0	27.0

Note: * The figures for 2005-2007 are projected
Source: Asian Development Bank Outlook 2005, Asian Development Bank, Manila.

3. Prospects and Challenges Facing Greater Economic Cooperation and Integration

As a result of market-oriented reforms in the past decade, economic growth has accelerated more evenly across BIMSTEC countries than in the past, which predicts well for further cooperation and integration among these countries and Japan. Economies of BIMSTEC countries, home to 1.32 billion people, account for over US$ 800 billion. It is also a fast growing region compared with other predominant regional cooperation blocks, with an average 5% growth rate of GDP and 4% per capita GDP in 2004. This remarkable growth is primarily due to the structural reform and liberalization polices adopted by most BIMSTEC countries since the mid. 1980s. Increased economic and financial integration is crucial for sustainable growth. Because of the complementarities of diverse BIMSTEC member nations (in terms of production and exports), regional integration achieved properly can produce benefits to all participating countries in terms of quantity and quality of economic growth. Increased economic growth resulting from economic integration will, in turn, reduce poverty if accompanied by pro-poor national policies.

Table 5: Financial Soundness Indicators for BIMSTEC Countries: 2003 – 2004

	Bangladesh		India		Myanmar		Sri Lanka		Thailand	
Indicator	**2003**	**2004**	**2003**	**2004**	**2003**	**2004**	**2003**	**2004**	**2003**	**2004**
Gross Foreign Liabilities of the Banking Sector as % of Total Liabilities, end of period	2.13	1.49			1.95	1.44	11.30	12.43	5.50	6.31
Loan-to-Deposits Ratio	1.03	1.01	1.03	1.06	1.03	0.82	1.11	1.07	1.12	1.10
Real Bank Credit Growth Rate	2.66	10.21	3.66	22.34	- 52.1	20.90			4.95	2.38
Ratio of Gross Foreign Liabilities of the Banking Sector to Gross Foreign Assets, end of period	0.57	0.41			N.A.	N.A.	0.97	0.86	0.53	0.69
Stock Market Capitalization (% of GDP)	3.12		46.47				14.87		83.04	

Source: Asia Regional Information Center Website, ADB, (http://aric.adb.org/index.asp)

In a study published by Wilson and Purushothaman (2003) traced the growth path of the Indian economy until 2050. The forecast is obtained by extrapolating from current growth rate but based on specific assumptions on how the process of growth and development will work. The assumptions include (i) the latest demographic projections; (ii) growth of capital accumulation and productivity, and (iii) modeled GDP growth for the world's leading economies. A major finding of the study is that, India, the largest democratic country in the world, will grow faster (by more than 5% a year) for the next 30 years. India's economy will be larger than that of Japan by 2032 and close to US GDP by 2050. The emergence of India as a large economic power will provide a great impetus and a driving force for BIMSTEC-Japan cooperation. A Japan-India Joint Study Group is now considering ways to strengthen a burgeoning economic partnership.

Japan is the second largest economy in the world and trading partner of BIMSTEC countries. Japan and BIMSTEC countries are becoming increasingly interdependent. Japan has been one of the world's leading sources of FDI since 1980 mainly because of continuous globalization of Japanese organizations. It has established trade and investment links with BIMSTEC countries and contributed toward their trade and industrial development. Asian developing countries have received a major portion (53.6% or US$ 3.2 billion) of Japan's total bilateral Official Development Assistance (ODA) in 2003. Japan has contributed towards economic growth of developing Asian countries by coordinating its ODA with trade and FDI. Therefore, an increased cooperation of BIMSTEC countries with Japan will benefit all participating countries.

Economies and domestic markets of BIMSTEC and Japan are quite diverse. BIMSTEC has 10 times more population compared to that of Japan. On the other hand, Japan's per capita income is about 60 times that of BIMSTECs average. Agriculture accounts for the major portion of BIMSTEC economies. On the contrary, Japan's services sector accounts for 68% of its GDP. In recent years, BIMSTEC witnessed 6% average economic growth rate, whereas Japan experienced 2.4% growth. Therefore, the cooperation between Japan, the second largest economy of the world and BIMSTEC, the emerging growth region of the future will create a win-win situation.

BIMSTEC countries are emerging as an important economic power in Asia as well as in the global economy. However, BIMSTEC countries are still facing significant challenges. These countries and Japan differ significantly in land area, size of economy, and population. The BIMSTEC countries and Japan range from the developed and industrial country of Japan, which alone accounts for 52% of Asian GDP and 60% of Asian financial assets, to some of the poorest and small economies in the world, such as Bhutan, Myanmar, and Nepal. The vast cultural, social, and economic diversity of BIMSTEC countries and Japan and heterogeneous states of development make regional integration a difficult and complex task, requiring careful prioritization of achievable targets.

In addition, intra-regional trade did not increase significantly in recent years. However, BIMSTEC countries have similar levels of human and economic development as evidenced from the Human Development Index.[2] The major challenges include imbalanced or unstable growth, increasing income inequalities and persistent poverty, natural disaster like flooding and Tsunami, earthquake, security problems in some countries (particularly in Nepal and Sri Lanka). Due to lack of strong and deep financial sectors, many countries could be exposed to external shocks resulting from increased financial integration. These problems may pose a serious threat to political and economic stability of the region.

In order to address these challenges and issues, BIMSTEC countries and Japan need to make their economies more integrated regionally and internationally. Build-up of significant foreign reserves, especially by Japan, India and Thailand in recent years has enabled these countries to reduce economic and financial vulnerabilities, and they will be able to assist other member countries in distress. In order to be more resilient against external shocks and financial crises, they need to further develop national and regional economies and financial markets through regional cooperation and integration in the areas of trade and investment, money and finance, and key real sectors, particularly infrastructure, transport, communication, and energy.

Several regional cooperation mechanisms in Asia involve some of BIMSTEC member countries. Myanmar and Thailand belong to ASEAN and GMS[3], and the rest of BIMSTEC countries belong to the SAARC. BIMSTEC stands to gain much by encouraging and accelerating the activities of both of these regional mechanisms. In addition, Bangladesh, Bhutan, India and Nepal belong to SASEC[4], a subregional cooperation in eastern South Asia (supported by ADB). Japan is also involved in ASEAN plus Japan, Korea and China (ASEAN+3) financial cooperation. Therefore, BIMSTEC-Japan cooperation would be very much important to establish link and strengthen the prospects of cooperation between ASEAN+3 and SAARC as well as to drive a pan-Asian economic cooperation. Areas of cooperation and integration and activities should be consistent with those of the above subregional cooperation mechanisms, particularly ASEAN and the SAARC and global initiative of the World Trade Organization (WTO). BIMSTEC-Japan cooperation should be open and complementary to the regional and global initiative. This should be a building block and not a stumbling block to member countries' integration to the rest of the world and other subregional initiatives.

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[2] Refer, UNDP (2002).

[3] GMS covers the countries through which the Lancang River (called Mekong outside of China) flows, namely, China, Cambodia, Laos, Myanmar, Thailand and Viet Nam. The GMS Economic Cooperation Program was launched in 1992 and is coordinated by the Asian Development Bank (ADB).

[4] At the request of Bangladesh, Bhutan, India and Nepal, ADB launched assistance for subregional cooperation under the South Asia Subregional Economic Cooperation (SASEC) Program.

Regional cooperation in trade, investment, infrastructure development,and money and finance can foster outward-oriented development and generate economic and social benefits. Greater economic cooperation and integration among BIMSTEC countries and Japan has important implications that include: (i) economies of scale and improved allocation of resources, (ii) lower costs of production through lower transaction and transportation costs, (iii) higher economic productivity through increased competition, (iv) improved access to markets and resources by eliminating impediments to trade and investment, (v) accelerated joint infrastructure development to increase connectivity, (vi) greater intra-regional trade and investment leading to higher economic growth, (vii) reduced risks of financial contagion, (viii) larger and more stable capital markets, and (ix) increases in foreign investment. Increased economic growth resulting from economic integration will, in turn, reduce poverty if accompanied by pro-poor national policies.

4. Approach and Areas of Cooperation

While economic integration can produce significant economic and social benefits, it may also lead to sectoral and distributional imbalances, increased vulnerability to external shocks, creating political, economic, social, and environmental challenges. Therefore, there is a need to discuss greater economic integration in terms of developing the most effective means of harnessing its potential.

There are different models of cooperation and integration, such as, (i) European model of common market and currency through institution-building and achieving common regulatory standards; (ii) NAFTA free trade model of the reduction of trade impediments, investment, and financial market linkages and the establishment of a dispute settlement mechanism; and (iii) the Latin American Mersosur customs union model that falls between the above two models.

The important question is what model should be adopted for BIMSTEC-Japan cooperation. In view of the diverse geographical, population, and economic sizes of member states, a balanced approach, similar to NAFTA and Mersosur, should be adopted to preserve the national interests, particularly of small members. The cooperation model should encourage collaboration rather than competition between member countries, and should ensure that every member benefits from the integration process. Proper sequencing and planning of trade integration, financial integration, and monetary and exchange rate collaboration is essential to obtain maximum benefits. The cooperation should be able to maximize the benefits of globalization, while minimizing its risk. It should enhance sustainable economic growth and poverty reduction through (i) investing the region's huge pool of savings within the region, (ii) utilizing vast pool of human resources and natural resources endowments, (iii) expanding markets, (iv) creating synergies in complementary resource endowments and production structures, and (v) enhancing the region's resilience against external and internal economic and financial shocks.

A comprehensive economic partnership between BIMSTEC countries and Japan should also include enhanced investment cooperation and a gradual monetary and financial cooperation as well as integration. Cooperation in this area will depend on the level of economic and trade integration. The various opportunities in this area include (i) investment cooperation to strengthen intra-regional investment for achieving industrial and market integration; (ii) regional information exchange and policy dialogue; (iii) regional economic and financial sector surveillance; (iv) exchange rate policy coordination, such as harmonization and adoption of an appropriate exchange rate regime (v) banking (including central banking) and financial cooperation: (vi) financial sector reform; (vii) harmonization and strengthening prudential supervision and regulation of banking and financial Institutions; (viii) liquidity support initiative for financial and natural distress; (ix) regional institution building; and (x) integration of capital markets and development of regional and local capital market as an alternative source of financing for both public and corporate sectors in the region.

(i) Monetary, Financial and Investment Integration and Cooperation

Financial integration or openness is a process by which separated financial markets become connected, open, and unified so that all the market players have full and free access of the integrated markets. It can be achieved through deregulation, liberalization, and privatization of the market. Liberalization of the capital account is a key step toward openness. This allows the market players, consumers, and investors free and full access to all markets to acquire different kinds of financial products, risk management methods, and investment and portfolio diversification facilities. In theory, financial integration or financial globalization assists in supplying and allocating capital, fostering economic growth, and reducing macroeconomic volatility, and hence increasing the standard of living or welfare. It assists economic growth by developing effective financial sector, enlarging supply of savings, enhancing risk management systems, decreasing the cost of capital, and transferring modern technology and skills. Financial integration is usually achieved by reducing restrictions on capital flows and allowing markets to set prices of currencies and securities. It often requires privatizing state-owned banks and firms.

It is to be noted that integration in the financial sectors can produce significant benefits as well as bring new risks and challenges. As real sector integration, financial sector integration brings economies of scale and promotes competition and efficiency of the markets. It will enhance the provision of financial services, decrease funding costs, and facilitate diversification of risks across markets. However, regulators and supervisors of financial sectors face new and increased challenges.

According to Agenor (World Bank, 2002; 2003) and Prasad *et. al.* (2003), a sudden financial integration without sound economic policies, flexible exchange rate, effective institutions, and good governance can increase vulnerability to crises, recession, and increased poverty. But a proper system of regulations and supervisions should be in place. Otherwise, banks and other financial institutions can undertake excessive risk taking activities in the absence of adequate prudential monitoring. On the other hand, if the financial sector is well developed and supervised, a proper exchange rate policy is in place, and institutions are strengthened prior to financial openness, it can minimize the adverse effects of increased vulnerability to crisis and maximize its benefits in terms of growth and welfare. To have a positive impact on poverty through higher economic growth and lower instability, countries should continue with the process of financial integration until substantial progress is achieved and a certain threshold with respect to the soundness of their domestic monetary, and fiscal policies and the quality of their social and economic institutions have been surpassed.

Therefore, BIMSTEC-Japan cooperation should promote an appropriate financial integration process that takes into account heterogeneous states of development of member economies, particularly banking and financial sectors, bond markets, exchange rate systems, and capital account systems. There is an urgent need to strengthen and harmonize prudential norms and financial supervisions between member countries. The country capacity building needs to be undertaken to efficiently perform consolidated supervision in the light of increased cross-border banking and financial activities. Monetary and financial integration is a very complicated and long process and usually lags behind the real sector integration as evidenced in the European integration process. The Asian financial crisis has shown that financial matters should be considered in tandem with real sector integration.

On the other hand, through monetary cooperation, BIMSTEC countries and Japan can be involved in increased coordination of monetary and exchange rate policy, which is similar to increased monetary integration (Talvas, 1994). This coordination can stabilize exchange rates of member countries, thereby minimizing uncertainty in their movements and assist in creating a stable financial environment to facilitate efficient transition for greater economic integration.

Since the Asian financial crisis, there have been moves to enhance monetary and financial cooperation, especially among ASEAN countries—Japan, Korea and China, and ASEAN+3.

ASEAN+3's initiatives fall into three broad categories: (i) information exchange and policy dialogue, (ii) reserve sharing and pooling, and (iii) regional bond market development. In information exchange and policy dialogue, the ASEAN+3 Informal Policy Dialogue Process is now well established. With regards to regional reserve sharing, the group has the currency swap arrangement under the Chiang Mai Initiative. Finally, to promote bond market development, concrete steps are being taken for the first time at the regional level under the Asian Bond Market Initiative.

In recent years, there has been significant widening and deepening of several BIMSTEC countries. As a result of increased liberalization, financial markets will play a greater role in the allocation of resources and consequently will contribute to greater efficiency in economy. However, one can not ignore the adverse consequence of the financial instability. It is very important to build a strong and resilient financial system.

There are significant opportunities and challenges facing BIMSTEC-Japan financial integration as well as avenues to enhance regional surveillance and monetary cooperation. They should recognize and learn from the steps taken since the Asian financial crisis to enhance regional financial cooperation and integration, particularly ASEAN+3 Surveillance Process.

(ii) Investment Cooperation to Strengthen Intra-Regional Investment

Intra-regional investment can be divided into two categories: FDI and portfolio investment. According to a study carried out by the Associated Chambers of Commerce and Industry of India (ASSOCHAM, 2005): "exports of BIMSTEC countries increased from US$ 104.9 billion in 1999-2000 to US$ 143.2 billion in 2003-2004; whereas the imports grew firmly from US$ 103.4 billion in 1999-2000 to US$ 152.4 billion in 2003-2004. In contrast, FDI inflows reached over US$ 15.0 billion during 1999-2000 and subsequently fell to little over US$ 12.0 billion towards the end of 2003-2004". In terms of the distribution of FDI inflow during the period, the highest recipient of FDI was India with 69.6% of total FDIs in the region, followed by Thailand (21.7%), Sri Lanka (4.9%), Myanmar (2.6%), and Bangladesh (less than 0.10%). In view of this trend, investment cooperation is of utmost importance to strengthen intra-regional investment for achieving industrial and market integration. At the same time, member countries have to strengthen their productivity and competitiveness to attract FDIs.

A recent study by Schiff and Winters (2003) shows that the flow from FDI tends to increase both from within and outside the region as a result of increased economic integration. Large inflows of FDI contribute directly to increased income through raising the capital intensity of production, and indirectly through enhancing ethnical progress.

Several BIMSTEC economies are quite small to undertake productive activities that could exploit large economies of scale. Economies of scale are better utilized for larger markets arising out of economic integration and small countries have a larger market access. BIMSTEC economies will gain significantly from combining resources and markets as a result of scale effects and increased intensity of combination.

Increased foreign private investment in the region will depend on the quality of governance and accountability, in public and private sectors, transparency and predictability of investment related policies, and rules and regulation. In order to achieve increased intra-regional FDI and portfolio investment flows, member countries should further strengthen macroeconomic conditions and liberalize and harmonize investment regime. Furthermore, strong domestic financial infrastructures and deregulation of domestic financial and capital markets are essential to attract private investment. Domestic financial institutions should provide support for intra-regional investment.

A formal institutional mechanism should be established for investment facilitation, strengthening and harmonizing investment rules, procedures and standards as well as dispute settlements. Therefore, a center for promoting greater investment cooperation needs to be set up to attract increased intra-regional investment. This center will be one stop clearing house for all investment/FDI-related information. It will undertake analytic work and monitor investment related activities. A study group should be established to identify sector/project areas with comparative advantage and significant potential for growth. This will lead to a strategy for investment cooperation in the areas of joint ventures, intra-regional trade and third country exports. The group should assess the investment climate that will identify production capabilities and export-related investment projects. The group should assess price competitiveness, supply constraints, problems of specification, and design and level of technology in the identified areas. Finally, a long-term strategy for investment cooperation and integration should be formulated and implemented.

(iii) Information Exchange and Policy Dialogue

Macroeconomic stability is essential for achieving fast integration. There is a need to establish a mechanism of Information exchange and policy dialogue among member countries. This will focus on macroeconomic stability, such as monetary and fiscal policies as well as policies to further integrate real economy. There is a need to ensure that member countries have low inflation and exchange rate volatility and fiscal stability. In addition, policy dialogue should include trade and FDI regime and financial and economic infrastructure. Liberalized and outward-oriented trade and FDI-related polices will enhance imports and encourage capital flows. At the same time, quality economic infrastructure facilities particularly transport, communication, and energy should be available for greater integration among participating countries. Financial infrastructure, such as easy access to funds to corporate sector, is also crucial.

(iv) Regional Economic and Financial Sector Surveillance

Financial integration with BIMSTEC countries and Japan and with more open and globalized international markets will make countries more vulnerable to external shocks. Therefore, they need to enhance resilience against external shocks.

Several emerging market economies witnessed a large number of financial crises in the last decade which resulted in severe economic, social and political problems. On many occasions these financial crises did not occur in a single country but had a contagion effect to other regional countries as well. For example, the Asian crisis of 1997 and the Latin American crisis of 1994 affected many countries in the region.

Financial sectors are highly vulnerable to instability and systemic risk, and increased financial liberalizations monitoring these sectors assumes great importance in the light of the severity and frequency of financial crises, especially the combined currency and banking collapses of the past decade, such as the recent Asian financial crisis. To prevent future crises and financial instability or to minimize their impacts in the region, there is a need to strengthen regional economic monitoring activities.

The virulence of the contagion among neighboring countries and trading partners highlighted the need for a regional surveillance mechanism, particularly the peer review process to prevent future crises and financial instability or to minimize their impact in the region.

In 1997 and 1998, sudden outflows of capital from several East Asian countries (such as Indonesia, Republic of Korea, Malaysia, Philippines, and Thailand) led to a devastating financial crisis, which resulted in severe economic, social, and political problems. Their open financial markets sparked a plunge in their currencies, stocks and other assets and severely damaged some of their financial institutions. Economies contracted and the standard of living of millions of people worsened. Economic development was set back for years in some areas. The Asian financial crisis demonstrated how financial integration could expose developing counties to external shock. These shocks reversed the success in poverty reduction in some countries due to the openness of the financial markets and caused a significant increase in poverty in the short- to-medium term. Following years of robust growth, strides in standards of living, and export expansion, these economies suffered from a crippling devaluation, massive capital flight, corporate and banking failures, and spikes in unemployment. In a relatively short span of time, close to US$ 100 billion of capital flew out of the region. The cost of a financial crisis could be severe (Bhattacharyay, 2005).

In order to prevent financial turmoil and its contagion effect, the monitoring of financial sectors as well as spillover effects of weaknesses of the real sector assumes great importance. A regional economic and financial sector surveillance process needs to be initiated. An appropriate system together with an institution for monitoring regional economic and financial sector vulnerabilities should be established. The monitoring system should be able to detect the magnitude and nature of potential economic and financial vulnerability at an early stage and suggest appropriate remedial and pre-emptive policy actions to address them (Bhattacharyay, 2005). This regional surveillance system will not compete but complement those of international institutions.

(v) Monetary and Exchange Rate Policy Coordination

Exchange rate regimes of BIMSTEC countries are quite diversed. Except for Thailand which has a free float exchange rate system, BIMSTEC countries have either a pegged or managed float exchange rate regime. India and Sri Lanka[5] use a managed float for their exchange rate management. On the other hand, Bangladesh, Bhutan, and Nepal have a pegged exchange rate (IFS, 2002). Bhutanese currency “ngultrum” enjoyed one-to-one convertibility with the Indian rupee for the last 20 years, whereas the exchange rate between Nepalese and Indian rupee was adjusted only three times during this period with the last adjustment 10 years ago (Maskay, 2003).

Myanmar has a very restrictive exchange rate regime. Both exportation and importation of kyats are prohibited. “*The Kyat is not negotiable abroad. All external payments are subject to authorization. All export proceeds and invisible receipts must be declared to the Myanmar Foreign Trade Bank at present. The currency of Myanmar is the Myanmar Kyat, which is pegged to the SDR at K 8.50847 = SDR 1. The buying and selling rates of the Kyat for the Deutsche mark, the French franc, the Japanese yen, the pound sterling, the Swiss franc, and the US dollar quoted by the Myanmar Foreign Trade Bank are determined based on the daily calculations of the value of these currencies against the SDR. Buying and selling rates for other currencies are determined by the appropriate cross rates in different money markets of various geographical regions”* (AsianBondsOnline[6]).

One of the key pre-requisites for financial integration is capital account liberalization. Except for Thailand, no BIMSTEC countries have liberalized their capital account. In order to utilize a large and growing pool of regional savings, particularly from Japan, BIMSTEC countries need to gradually liberalize their capital accounts. However, it may bring risks and challenges. Counties need to undertake appropriate reform of their financial sector and properly manage their macroeconomic policies prior to liberalization.

Therefore, monetary and exchange rate coordination among BIMSTEC countries and Japan is a very challenging and complex task. A slow and gradual development of an exchange rate coordination mechanism should be adopted to maintain financial stability and growth. An orderly adjustment of exchange rate is desirable, and that flexibility in choosing appropriate exchange regime should be allowed.

[5] Exchange rate has been characterized as a free float since January 2001.
[6] A website of the Asian Development Bank, Manila (http://asianbondsonline.adb.org/regional/regional.php)

(vi) Banking and Financial Cooperation

As discussed earlier, prior to the financial integration, there is an urgent need to strengthen and harmonize financial regulatory and supervisory standards consistent with international standards. Prudential supervision and enforcement should be harmonized and strengthened in the following areas: (i) rules and accounting standards of the financial sector in line with international standards, (ii) financial regulatory and supervisory standards consistent with international standards, (iii) consolidated supervision of cross-border banking and financial activities, and (iv) a centralized credit information system. Efforts at the regional level for effective consolidated supervision should assist the process of strengthening prudential mentoring capacity of supervisors at the country level. A common framework for supervising financial groups should be established. International institutions (like IMF) and regional institutions (like ADB) could support this effort through harmonizing regulations at country level. This harmonization and strengthening of financial sector together with associated financial initiatives would make the region more attractive for foreign investment and enhance intra-regional capital flows.

At the same time, legal and regulatory framework and institutional arrangements should be strengthened to ensure greater autonomy and independence of supervisory authorities, particularly the central banks or monetary authorities. Capacity of security or financial regulators responsible for market supervision needs to be enhanced through training, seminar, workshops and hands-on experience.

Many BIMSTEC countries' financial sector, such as Bangladesh, India and Nepal, receive a significant amount of workers' remittances within region and outside the region. A small portion of these remittances are intermediated through the banks. A regional coordination in strengthening remittance-related services can contribute to the reduction of transaction costs and the increase in financial deepening.

(vii) Financial Sector Reform

Several member counties have shallow financial markets. The liberalization of the domestic economy and the strengthening of the domestic financial infrastructure are essential prior to the comprehensive economic, monetary, and financial integration. BIMSTEC countries should continue to undertake further economic and financial sector reforms, which are the building blocks for enhanced financial integration.

BIMSTEC countries should allow participation of regional institutions in the domestic financial markets. The opening of the financial sector will increase competition and market size, which will reduce the price of financial services. The competition will enforce better capital allocation resulting in efficiency gain.

There is a need to develop a strong insurance system, including health insurance sector as countries often face large shocks, such as natural disasters (including earthquakes, heavy rainfall, flood, and drought), contagious diseases (including AIDS, SARS and Avian Flu) and crop diseases. Regional insurance companies can be more efficient and effective as they can pool risk covering a larger and diverse market.

(viii) Integration and Development of Capital Markets/Local Bond markets

The bond and stock markets are quite shallow in most BIMSTEC countries. Bhutan, Myanmar, and Nepal do not have active stock and bond markets. Myanmar is now taking measures to develop a capital market, including the issuance of treasury bonds.

India and Thailand have active and comparatively large bond markets. Bonds issued can be divided into two major components: government and corporate debt securities. The market is dominated by Government debt securities. Bond investors comprise individual and institutional investors, including insurance companies, pension funds, mutual funds, and banks. During the 1990s, many BIMSTEC countries have improved access to their capital markets.

Integration and development of local bond markets are essential to have an alternative source of financing for both public and corporate sectors in the region. There is a need to adopt measures to widen, deepen, and diversify BIMSTEC capital/bond markets and integrate BIMSTEC-Japan capital markets through linking up with each other. There is a need to create deeper, efficient, and well-regulated capital markets for effective allocation of BIMSTEC-Japan savings.

It is very important to develop a regional market for government securities to assist in improved liquidity management by financial institutions. BIMSTEC countries should undertake further institutional and regulatory reform that will enhance the development of local bond markets. The main areas of reform include: (i) strengthening bond market infrastructure, (ii) liberalizing the local bond markets to allow supranational and international financial institutions, and (iii) promoting appropriate financial products to attract retail and offshore investors.

Well-functioning clearing, payment settlement, and credit rating systems have to be in place for efficient securities markets. The adoption of a common clearing, payment settlement system and credit rating system for member countries will achieve large economies of scale. Common regulations for processing check and securities and a common framework for electronic payment and settlements and book entry system will assist in increased integration of cross-border banking and financial transactions and, thus promote the development of a regional financial system.

(ix) Liquidity Support Initiative for Financial and Natural Distress

BIMSTEC countries are still facing significant challenges, such as imbalanced or unstable growth, increasing income inequalities and persistent poverty, natural disasters like flooding, earthquake and Tsunami, infectious diseases like SARS and Avian Flu and security problems. At the same time, financial integration could expose counties to external shocks. Japan has considerable expertise in disaster management, particularly, earthquake and Tsunami problems. Therefore, BIMSTEC Countries and Japan could set up a liquidity support initiative (similar to the Chiang Mai Initiative) for member countries in case of distress arising out of financial crisis, security problems, and natural disaster. This will complement existing international and regional financial arrangements, and will enhance resilience of BIMSTEC countries to external shocks arising out of more open and globalized international markets and from natural disasters.

(x) Free Movement or Trade of Banking and Financial Services

Most of intra- and inter- regional trade of BIMSTEC countries is in manufacturing of goods. The contribution of service sectors, particularly financial services, is insignificant. The legal and institutional barriers for trading financial services are main reasons behind very small amounts of trade in financial services within BIMSTEC countries and Japan. There are no regional banks with significant business in all countries. The liberalization of financial services sector should be actively pursued for greater free trade in this area. A study group should be established to examine the merit and the process of establishing an open financial services market. This can facilitate cost-effective transfer of immigrants' remittances to their home countries.

(xi) Regional Institutions Building

Proper regional institutions need to be established for BIMSTEC-Japan cooperation. The objectives of the institute building should include (i) work as the secretariat for setting up regional economic and financial sector surveillance; (ii) monitor economic and financial stability, polices, rules and regulations of member countries; (iii) work toward the establishment a regional economic and financial market; (iv) monitor short-term highly speculative capital flow and suggest preventive measures, including regulations; (v) organize training programs, seminars, conferences in the area of monetary and financial cooperation; and (vi) organize meetings of policy makers for information exchange and policy dialogue. As discussed earlier, a center for promoting FDI into BIMSTEC countries should be established under the institute.

In view of the inadequate and weak statistical information system prevailing in most BIMSTEC countries, it is essential to establish a professional regional statistical program to address the need for monetary and financial integration. The program should envisage institution building and creating statistical infrastructure at the domestic and regional level, and provide high quality and frequency statistical information on monetary, finance, and investment areas.

5. Conclusion

An increased economic cooperation and integration among BIMSTEC countries and Japan will produce significant benefits to all participating countries, particularly sustained economic growth and much needed inflow of foreign investment to BIMSTEC nations. In addition, this cooperation will strengthen the economic and trade link between South Asian and Southeast Asian countries and will contribute toward a pan-Asian integration and cooperation. Appropriate monetary and financial cooperation and integration will make member countries more resilient against external shocks and financial crises.

The vast cultural, social, and economic diversity of BIMSTEC countries and Japan and heterogeneous states of development make regional integration a difficult and complex task, requiring careful prioritization of achievable targets. The diverse structure, development, and openness of the financial sectors, exchange rate regimes, financial and supervisory regulatory frameworks, and country capacity makes the task of regional cooperation and integration in money, finance, and investment highly challenging and time consuming.

There is a potential for mutually beneficial cooperation between BIMSTEC and Japan. However increased cooperation needs some essential pre-requisites. BIMSTEC need to create conducive business environment or climate and macroeconomically stable economy to attract Japanese and other investors. They should ensure efficient utilization of foreign capital and technology. The inefficient state-owned enterprises should be privatized. Infrastructure should be strengthened. There should be scope for mutually beneficial cooperation once BIMSTEC gets its act together. Further economic reform and liberalization and greater conformity to international standards will boost investors' confidence. At the same time, strong corporate governance and anti- corruption policy need to be formulated and implemented, where red tape in business transactions is eliminated.

The major areas of possible monetary, investment and financial cooperation include: (i) investment cooperation to strengthen intra-regional investment for achieving industrial and market integration; (ii) information exchange and policy dialogue in investment and money, banking and finance areas; (iii) economic and financial sector surveillance; (iv) monetary and exchange rate policy coordination, such as harmonization and adoption of an appropriate exchange rate regime; (v) banking (including central banking) and financial cooperation: (vi) financial sector reform; (vii) regional institutions building; (viii) integration and development of local capital/bond markets as an alternative source of financing for both public and corporate sectors in the region; and (ix) free movement or trade of banking and financial services.

Governments and key institutions should understand the challenges and complexities associated with deepening monetary and financial integration. Moving the vision closer to reality requires defining a clear direction for integration, and identifying strategies and actions to get there and harness its full potential. Multilateral institutions such as the IMF, World Bank, and ADB can help the economic cooperation and integration process (within their mandates) by helping test ideas through feasibility studies and research, building country capacity, working toward improved effectiveness, avoiding duplication, and taking on a subsidiary role in supporting and nudging forward the regional policy agenda.

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