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Regional integration amid global fragmentation

Key takeaways

- *Regional integration among emerging market economies complements global integration rather than substituting for it, which implies that strong regional ties act as buffers against global fragmentation.*
- *Emerging Asia is more integrated than other emerging market regions due to a higher share of manufacturing with complex supply chains and the presence of regional financial centres in Hong Kong SAR and Singapore.*
- *Trade and banking integration reinforce each other, and regional payment system integration has positive externalities by reducing the transaction costs of trade and enabling cross-border banking services.*
- *Tapping the significant potential for further regional integration requires concerted efforts on cross-border cooperation and the implementation of targeted trade and banking sector liberalisation policies.*

Trade and banking integration have benefited emerging market economies (EMEs) by enhancing growth, providing alternative sources of credit and smoothing expenditures. But the recent lurch towards global fragmentation calls for a concerted rethink on how EMEs can best meet the challenges ahead. To what extent can greater regional integration serve as a counterweight to global fragmentation?

Over the past decade, rising geopolitical tensions have tempered the pace of global integration, while regional trade and banking linkages have gained increasing importance, particularly in emerging Asia and Latin America. [1] These developments show the growing relevance of regional integration as a complementary force to global integration.

This bulletin shows how regional trade and banking integration have evolved in EMEs and discusses the potential benefits of regional integration. It then analyses how trade and banking integration interact and considers which potential structural policies could deepen regional integration.

Trends in global trade and banking integration

Before the 2010s, global trade expanded faster than GDP, with complex global value chains growing to straddle major regions of the world (Graph 1.A). However, in the mid-2010s the expansion slowed. As geopolitical tensions intensified after 2017, the regional trade share rose in emerging Asia (Graph 1.B).

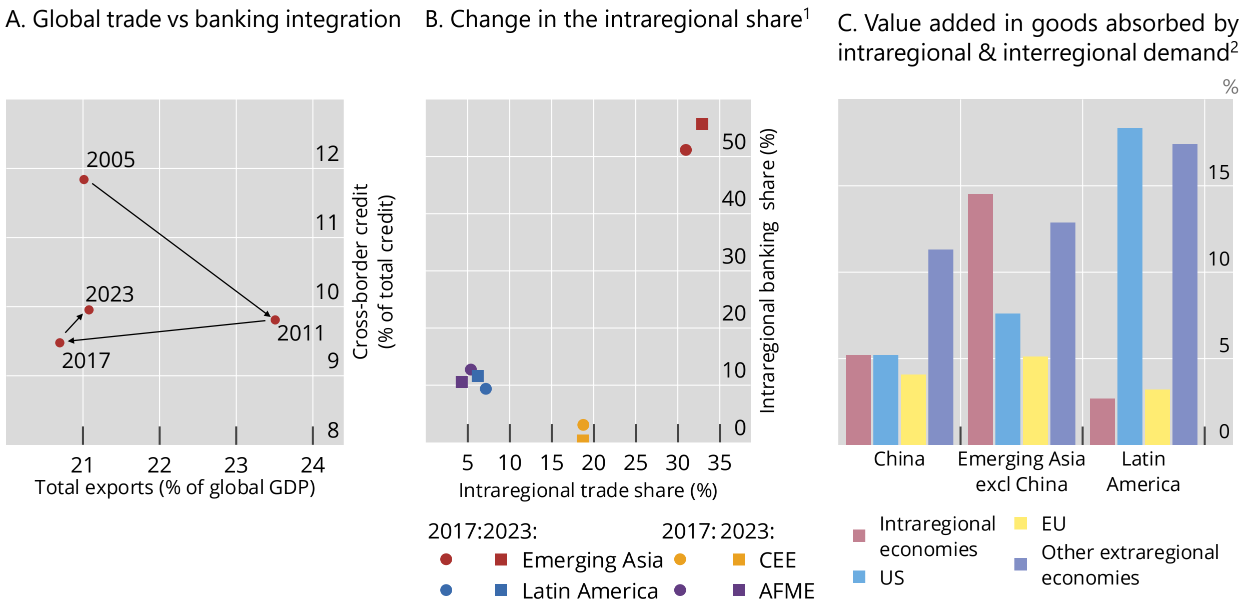
Global banking market integration, on the other hand, decreased significantly after the global financial crisis and did not reverse much afterwards (Graph 1.A). Similar to trade, regional banking integration made some progress in emerging Asia and Latin America from 2017 to 2023 (Graph 1.B).

[1] Broner et al (2023) document that EMEs increased their participation in global finance as a share of total global investments from 2001 to 2018 and that investments within EMEs grew faster than those within advanced economies.

While trade and banking integration have deepened in some EME regions, regional integration generally complements rather than acts as a substitute for global integration. For example, in Latin America, nearly 40% of value added in goods is induced by final demand from economies outside the region, compared with just 2.7% from within the region. In emerging Asia, the share of final demand from economies outside the region is lower but still exceeds 20%. The share of final demand from within the region remains modest, with 5.2% for China and 14.5% for emerging Asia excluding China. This underscores that regional demand is still relatively small when compared with global demand in EME regions (Graph 1.C).

Evolution of global and regional trade and banking integration

Graph 1



[1] The intraregional banking share is calculated as the shares of intraregional bank credit in total cross-border bank credit. AFME = Africa and the Middle East; CEE = central and eastern Europe. [2] Each bar represents the share of value added absorbed in 2023 by final demand from intraregional economies (excluding domestic), the United States, the European Union and other extraregional economies.

Sources: Asian Development Bank, *Multiregional Input-Output Table*; IMF; BIS locational banking statistics; BIS.

Trends in regional trade integration

Intraregional trade integration has been largely driven by goods trade supporting manufacturing supply chains. For instance, trade in physical goods can benefit from lower production costs and proximity to major markets.

The degree of trade integration varies significantly across regions. This can be explained largely by differing economic growth models. In particular, Asia exhibits the highest trade integration due to the significant role of manufacturing, with complex and extensive supply chains (Graph 2.A). Manufacturing makes up over 70% of total exports and 80% of merchandise exports in China, Korea and Vietnam, higher than the global averages of 50% and 70%, respectively (Graph 2.B). In contrast, the degree of supply chain integration in Latin America is lower, as primary goods (eg commodities) account for more than 50% of total exports. Mexico is an exception, as it has a broader manufacturing base and around 80% of its exports go to the United States. Unlike manufacturing, commodity production does not entail complex supply chains and therefore does not necessarily drive regional trade integration.

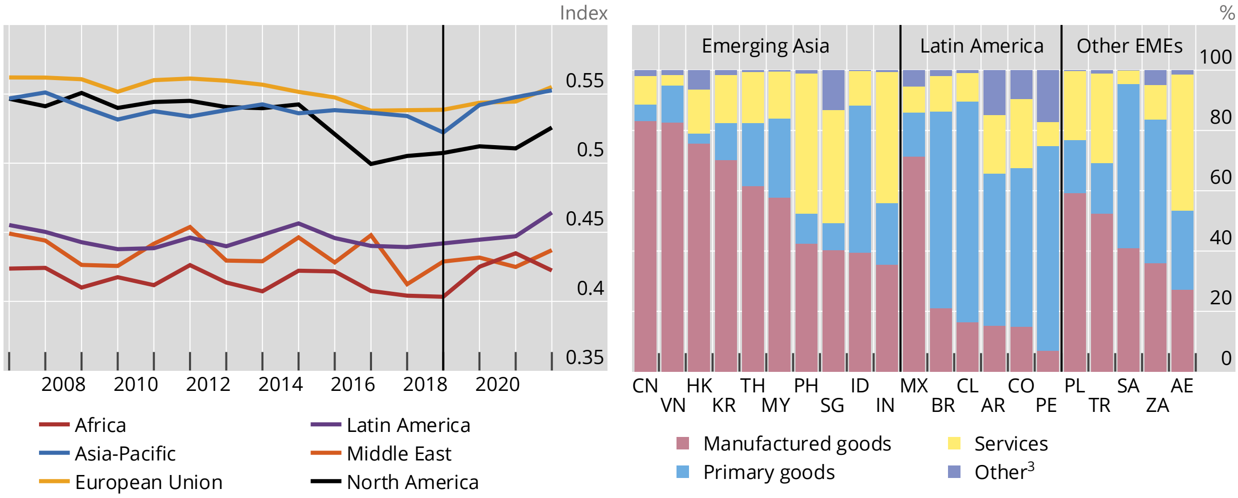
After the start of the US-China trade conflict in 2018, regional supply chain integration deepened somewhat in all regions. This raises the question of whether and to what extent global fragmentation can be compensated for by regional integration. To some degree, the realignment of trade patterns reflects trade diversion. To mitigate the impact of trade tensions, some Chinese companies have established overseas subsidiaries and expanded trade with emerging Asian economies, redirecting exports to the US market through regional partners (Qiu et al (2023)).

Regional supply chain integration and export structure by region

Graph 2

A. Regional supply chain integration[1]

B. Export structure of EMEs by region[2]



[1] The regional supply chain integration index by the Asian Development Bank tracks regional trade and value-added links. "North America" includes Canada and the United States, while "Latin America" includes Mexico. The black line marks the start of the US-China trade war. [2] Figures as of 2023, except for Korea and Vietnam which are as of 2022. [3] The "other" category covers goods exports other than manufactured and primary goods.

Sources: Asian Development Bank; World Bank; BIS.

EMEs have experienced faster growth in services exports than manufacturing exports (Graph 3.A). The expansion has been driven by "modern services" including sectors such as business services and information and communication technology. For example, India posted more than a 60% increase in services trade from 2018 to 2023, driven largely by technology-related services such as software exports.

Despite significant progress in trade integration, regional trade barriers remain a challenge. According to United Nations Trade and Development (UNCTAD) data, tariffs average 6.8% in southern Asia and 2.0% in Latin America, higher than the 1.1% average in advanced economies (AEs). Non-tariff measures such as quotas, import licensing requirements and technical standards also restrict regional trade. For instance, measures designed to prevent the spread of diseases, control pests and ensure food safety are prevalent in Association of Southeast Asian Nations (ASEAN) countries, while quantitative restrictions (eg non-automatic licences and quotas) are common in Latin America. Further, many EMEs impose barriers to services trade, such as restrictions on foreign entry, which hinder integration.

Trends in regional banking integration

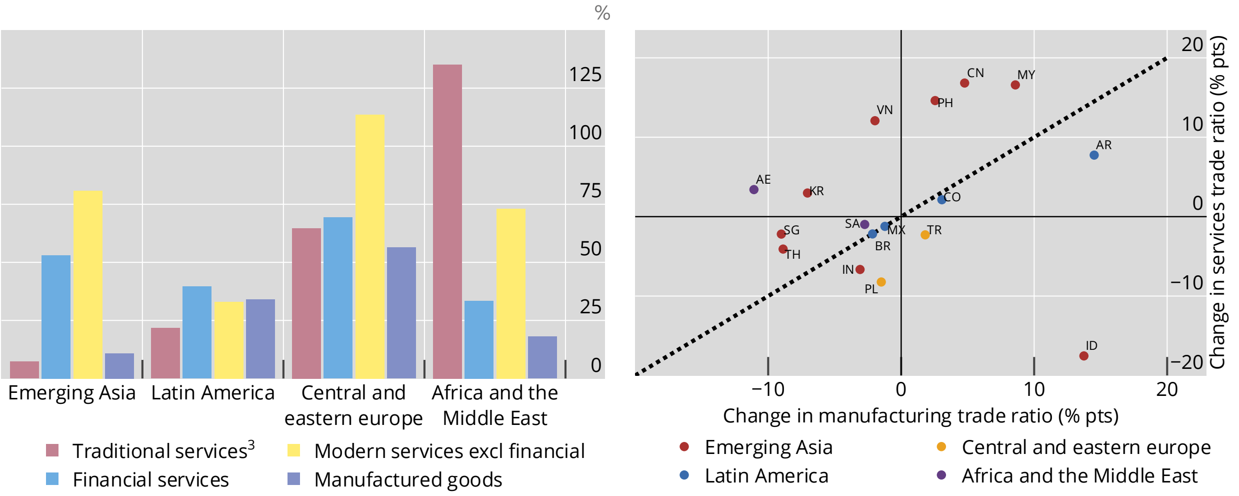
While trends in regional banking integration (within EMEs in the same region) appear similar to those in trade, their economic mechanisms are different. High regional banking integration in emerging Asia mirrors that of trade. However, regional financial centres – Hong Kong SAR and Singapore – provide deep pools of capital from within and outside the region. In other regions, this role is fulfilled by adjacent major AEs. This hints at the large benefits of centralisation in finance as money can relatively easily cross borders. The US dollar, and to a lesser extent the euro, are the key means of exchange in these markets.

Manufacturing vs services exports in EMEs[1]

Graph 3

A. Growth in manufacturing and services exports[2]

B. Intraregional share of manufacturing vs services exports



[1] Changes from 2017 to 2023. [2] Chile and Mexico not available for traditional services and modern services excluding financial. Saudi Arabia not included for manufactured goods. [3] Traditional services include travel, transport and construction services. Modern services include insurance and pension services, financial services, charges for the use of intellectual property, telecommunications, computer and information services, other business services, personal, cultural and recreational services, government goods and services, and goods-related services.

Sources: Asian Development Bank, *Multiregional Input-Output Table*; IMF; UNCTAD; World Bank, *World Development Indicators*; BIS.

The regional share of cross-border banking differs widely across EME regions. Direct cross-border credit (credit to non-banks), which is about half of cross-border credit to EME borrowers, can be related to trade credit or the financing of working capital to support integrated supply chains. The other half is indirect (interbank) cross-border credit, which is an important source of funding for local banks. The regional share of cross-border banking is highest in emerging Asia at about 60%. Hong Kong SAR and Singapore play a key role (Remolona and Shim (2015)). By contrast, in Latin America and central and eastern Europe, the proximate major AEs (Canada and the United States, and large euro area economies, respectively) are key providers of cross-border credit. The high share of cross-border lending in US dollars (about 80% in EMEs) is a hurdle for deeper regional integration among EMEs.

The intraregional share of cross-border bank credit can enhance stability because these flows are more stable than banking flows from outside the region. This is confirmed by an analysis which shows that since 2000, EME intraregional cross-border banking flows have been less sensitive to global financial shocks, as measured by the broad US dollar index and the Chicago Board Options Exchange's Volatility Index (VIX), than those from outside the region.[2]

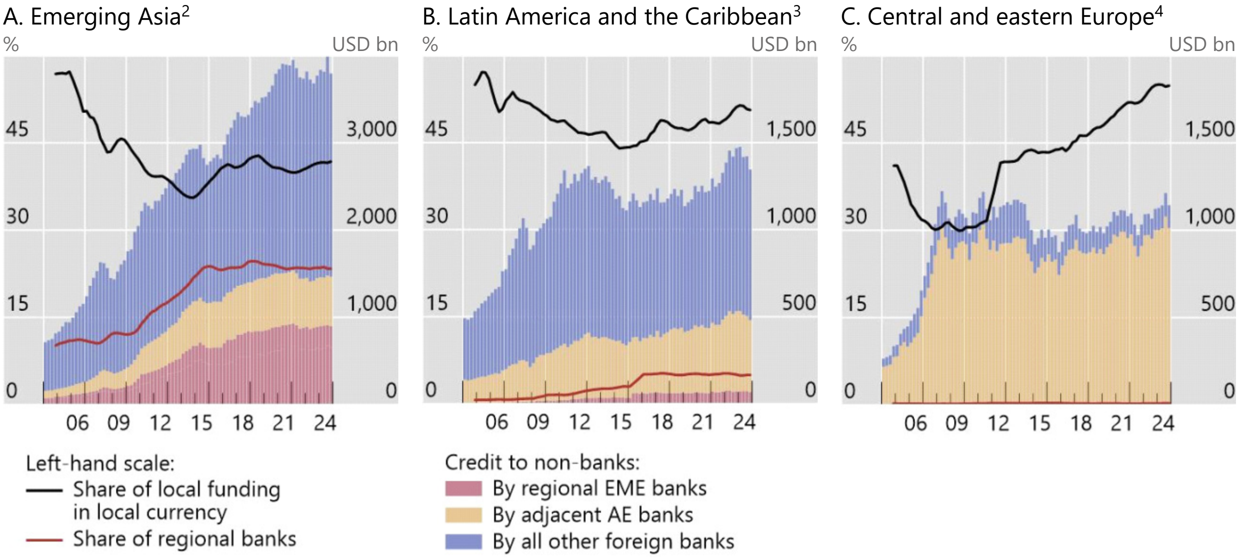
An arguably deeper mode of banking integration is the presence of foreign banks as subsidiaries funded by local deposits. Subsidiaries of foreign banks typically offer the same services as local banks and may serve to deepen the local banking market and induce more competition. Indeed, credit from foreign banks to non-banks is, to a significant extent, funded locally in local currency (Graph 4). The presence of *regional* (foreign) banks, however, appears to be more limited in EMEs, except in emerging Asia. In Latin America, there are signs of regionalisation in some individual countries. For instance, Brazilian banks are active through local subsidiaries in Chile and Colombia, while Colombian banks have a large footprint in central America (eg El Salvador and Panama).

Banks also play an important role as intermediaries of foreign exchange (FX) spot and derivatives transactions for firms and financial institutions hedging their FX risks. The cross-border share of banks'

[2] This may be due to (i) smaller FX volatility between intraregional EME currencies than that between an EME currency and the US dollar when global shocks hit EMEs in the same region; (ii) strong trade-related banking flows in emerging Asia; and (iii) strong local funding of foreign AE banks in Latin America.

nominal FX spot and derivatives trading volumes in regional currencies (including the domestic currency) is high in some jurisdictions, hinting at possible intraregional activities. Apart from Hong Kong SAR and Singapore (83% each), this notably includes Brazil (52%), Mexico (62%) and countries in central and eastern Europe, where the average cross-border share is 67%.

Foreign bank credit to non-bank borrowers in EMEs[1] Graph 4



[1] Foreign bank credit includes cross-border and foreign currency credit as well as credit extended locally in local currency. The shares are four-quarter moving averages. [2] Regional banks include "outside area" (ie non-reporting banks) which are mostly Chinese banks. Adjacent AEs: Australia and Japan. [3] Adjacent AEs: Canada and the United States. [4] Central and eastern European countries do not include countries in the euro area. The share of regional EME banks is low partly due to a lack of reporting countries. Adjacent AEs: euro area countries.

Sources: BIS consolidated banking statistics; BIS.

The trends of trade and banking integration and the economic drivers behind them suggest that regional integration can partly counterbalance global fragmentation but not fully offset it. Regional integration can act as a buffer against geopolitical shocks which lead to global fragmentation. An increase in final demand from within the same EME region could significantly deepen regional trade integration, but this may only materialise in the longer run. For instance, the economies of Latin America share similarities as commodity exporters, which constrain the potential benefits of regional trade integration. However, Mexico stands apart from the rest of the region with its strong manufacturing sector. Brazil, primarily a commodity exporter, also has some notable manufacturing activities such as the automotive and aviation industries.

Deeper regional integration is likely to develop in both trade and banking, due to their reinforcing nature. Since production takes time, firms rely on working capital to bridge the gap between costs and cash flow (Kim and Shin (2023)). This requires a minimum level of international banking activity which can be either regional or global. An analysis on 44 exporting (lending) economies and 209 importing (borrowing) economies during the period 2001–24 finds that bilateral trade flows are positively correlated with cross-border bank lending in Asia, while no strong relationship is observed in the Americas and Europe. This may be because many Asian countries are heavily involved in the manufacturing trade and their firms often establish local subsidiaries, as well as because their working capital tends to be financed by banks from the parent country. As their exports are invoiced largely in US dollars, receiving bank credit in US dollars limits currency mismatches. Manufacturing is also more capital-intensive than primary commodity exports, which dominate in regions like Latin America, the Middle East and Africa.

Which structural policies could promote regional integration?

Various structural policies could promote EME regional integration. In trade, further regionalisation could be achieved by identifying industries where individual countries can provide added value to other regional economies. In EMEs that primarily export commodities, the development of more advanced manufacturing and services sectors could naturally enhance regional integration.[3]

Reducing the barriers to trade can also deepen regional integration. There have been various regional free trade agreements such as the Regional Comprehensive Economic Partnership, Southern Common Market and Andean Community. These agreements tend to formalise pre-existing relationships among members, as they are typically signed between long-standing regional partners. As a result, their impact on the export sector's expansion into new markets has been limited (Dingemans and Ross (2012)). Policymakers would need to consider complementary strategies to enhance the agreements' effectiveness in promoting broader market access and stimulating structural transformation of the export sector. Such policies may encompass the digitalisation of trade, the protection of property rights, the harmonisation of regulations and the promotion of macroeconomic stability.

Increasing regional demand is essential to deepen regional trade integration. Currently, the United States and European Union together account for a large share of global manufacturing goods imports. In 2023, their shares were 14.9% and 28.6%, respectively. However, those shares had declined from their respective shares in 2000 of 19.5% and 30.8%. Meanwhile, EMEs' share of global manufacturing goods imports increased. For example, China's share increased from 3.7% in 2000 to 9.3% in 2023, and that of emerging Asia excluding China increased from 11.7% to 14.1%.

Regional payments integration has potentially large positive externalities for both trade and banking integration. Allowing money to more easily flow across borders facilitates both goods and services trade and enables the delivery of cross-border financial services and asset holdings. This, in turn, reduces costs for trade-related payments and can help to facilitate necessary cross-border credit flows for working capital and foreign direct investment. In addition, effective cross-border supervisory cooperation is key for advancing banking integration, as comparable rules and standards facilitate cross-border payments and the development of regional banking markets.

Overall, it is important for regional authorities to commit to policy goals such as payments integration and supervisory cooperation and make continued policy efforts to implement them. One example is the initiative of the ASEAN Economic Community as pursued by the ASEAN member countries over the past few decades.

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[3] For example, commercial aircraft production is one area that Latin America can develop further.