



## Regional Cooperation in Asia

**T**he discussion in Part I of this *Outlook* noted the key linkage between openness of economies and their ability to sustain high rates of economic growth over a lengthy time span. The heightened interest in, and development of, regional economic cooperation arrangements in Asia over recent years is closely related to that context. Policies of openness are an instrument for securing efficiency in the use of resources, thereby enhancing growth; and a major purpose of cooperation arrangements is to facilitate the achievement of that efficiency objective by promoting the free flow of goods, services, capital, and labor across national boundaries. That facilitatory or catalytic role is a characteristic feature of many of the regional cooperation initiatives that have been taken in Asia in recent years. It is especially true of the subregional economic zones (SREZs) which have been formed in Southeast Asia and Northeast Asia, covering provinces or states within countries. A principal objective of the SREZs is, in many cases, to promote development; they are not exclusive and discriminatory to the rest of the world. They seek to promote the intraregional flow of resources, not just to promote intraregional trade. Frequently, private initiatives are a central element, with governments providing facilitation.

The Asia Pacific Economic Cooperation (APEC) is of special significance. It is not founded on a formal agreement in accordance with Article XXIV of the General Agreement on Tariffs and Trade (GATT); however, the 18 Asian and Pacific countries, including the US, have agreed by consensus on a program of action to achieve a state of “free and open

trade and investment” by the year 2010 for industrial country members and 2020 for developing country members. APEC members have also agreed to move forward on a wide range of other measures to promote trade and investment in the coming years. What is not yet clear is whether trade and other liberalization measures are to be confined to APEC members or whether they are to extend on a most-favored-nation basis to other countries. However, the fact that many of the members have already made significant unilateral tariff reductions suggests that the latter is likely to be the case.

Nevertheless, regional trading arrangements of the traditional kind, such as those conforming to the requirements of Article XXIV of the GATT, do exist in Asia. ASEAN, covering most of the economies of Southeast Asia, has now evolved into a comprehensive regional trading arrangement, the ASEAN Free Trade Area (AFTA), with an explicit timetable for eliminating tariffs within the group by the year 2003 and for introducing its common effective preferential tariff (CEPT). Viet Nam has now joined ASEAN and there are plans to include the remaining Southeast Asian economies, i.e., Cambodia, Lao PDR, and Myanmar. Similarly, the South Asian Association for Regional Cooperation (SAARC) covering the countries of South Asia is now moving toward the establishment of a South Asian Preferential Trading Area (SAPTA). However, these are the only two regional trading agreements in Asia. The other economies of the region, including those such as the People’s Republic of China; Korea; Japan; and Taipei, China, which account for a very

large share of total Asian trade, are not part of any formal trading arrangements.

The focus of nondiscriminatory forms of regional cooperation in Asia is on the exploitation of actual or potential complementarities to promote growth as well as efficiency and competitiveness on a global scale. Many of the countries in Asia have been externally oriented for some time and attach high priority to export promotion. Those that have not been so oriented in the past are now moving in that direction through policy reforms. However, exports are aimed at the global market, not just intraregional trade. Of course, the exploitation of endowment complementarities would itself involve a high volume of trade within the region, reinforced by the advantages of proximity. For instance, the flow of capital from advanced to developing countries within the region is export oriented; and it usually brings with it a corresponding flow of capital equipment and intermediate inputs. However, the outputs produced in the developing countries may be destined as much for the rest of the world as for countries within the region. The full circuit of such three-way trade would naturally not be captured in measures of intraregional trade. Indicators of regional trade confirm this. Intraregional trade intensity is quite high and the share of intraregional trade in the total trade of the region has been rising over time, although not more than might be expected given the rising share of the region in total world trade. Further, regional trade arrangements often lead to trade diversion, as opposed to trade creation, i.e., an increase in intraregional trade at the cost of trade with the rest of the world. However, there is no evidence to suggest that the new forms of regional cooperation in Asia have resulted in any such trade diversion.

The facilitation of capital flows within the region is an important goal of regional cooperation in Asia. Such intraregional capital flows, particularly foreign direct investment (FDI), have grown very rapidly over the past decade. They have also entailed an increasing flow of technology associated with individual projects and embodied in the flow of capital equipment and intermediate inputs arising from projects. Japan and the NIEs are the source of much of this intraregional FDI. The share of intraregional FDI rose from about 36 percent of total FDI in 1992 to almost 52 percent in 1993. About two thirds of this

now comes from the NIEs. The destination of most of this capital flow is China and Southeast Asia. South Asia began opening up to external capital flows from the early 1990s and is only now beginning to attract FDI. However, much of it is from sources outside the region.

Regional cooperation arrangements in Asia may also be aimed at coordinating the cross-border flows of labor. Intraregional labor migration has accelerated in recent years. Although the growth of labor is still tightly controlled in all immigrant countries, there have been significant shifts in the sources and destinations of migrant flows over the past decade or so, with a major part of labor migration now occurring within the region. As shown later in this chapter, there are marked differences in labor migration patterns between South Asia and East and Southeast Asia. The countries of South Asia are still large sources of emigration and most of the migration has flowed westward. The countries of East and Southeast Asia, on the other hand, are both sources and recipients of migrant labor, the Philippines being the only large net emigration country.

One aspect of regional cooperation that is of growing importance is the sharing of information. Cooperation can reduce the transaction costs of gathering information and, through economies of scale, can reduce the research and development costs of generating information. The sharing of information may be embodied in the form of technology transfers within a region. It may also encourage capital flows into or within a region by lowering perceived risks.

Regional cooperation efforts can also yield useful non-trade benefits such as policy cohesion or harmonization at an informal level. Cooperation may provide important international political support for unilateral liberalization efforts or diplomatic peer pressure for undertaking or enforcing other politically difficult decisions concerning trade and economic relations.

Within countries, regional and particularly subregional, cooperation may serve the equity objective of promoting balanced regional development. Between countries, greater control and protection of migrant labor may be achieved, effects of transboundary environmental spillovers mediated, and security concerns, both within and between regions, allayed. Similarly, bargaining power in

multinational (or multiregional) forums such as the World Trade Organization (WTO) may be enhanced. Indeed, through regional cooperation, the whole can become greater than the sum of its parts.

Reference was made earlier to the key role of openness in sustaining high growth in Asia. This openness is a necessary condition to allow the intraregional flow of resources, goods and services through which regional resource endowment complementarities can be fully exploited. However, many of the projects and networks of projects being conceived under such cooperation arrangements are either cross-border in nature or entail externalities which spill over national boundaries. There is, therefore, an important coordination function which the market cannot perform. This includes coordination across countries, as well as between project investments and policies or other related measures necessary to bring such investments to fruition. Without such coordination, many of these projects might not be viable or even feasible. Hence, governments have to compensate for this coordination failure of a purely private market mechanism. The new forms of regional and subregional cooperation in Asia have to be seen, therefore, as one of the instruments being employed to facilitate the exploitation of regional complementarities, that is, to improve the efficiency of resource allocation on a regional scale, thereby enhancing the global competitiveness of the region and also sustaining high rates of growth.

The remainder of this chapter is organized into six sections. The next section provides an overview of the nature and extent of formal and nonformal cooperative arrangements as they have developed in Asia over recent years. This is followed by three sections which deal in turn with the growth among Asian countries of trade in goods and services, capital flows, foreign investment, and changing patterns of labor flows. The next section then considers the concept of economic integration and its relevance to Asian growth. The final section offers some general conclusions.

## **REGIONAL AND SUBREGIONAL COOPERATION**

Economic cooperation can assume many forms. The most extensive and advanced forms of

cooperation among trading countries have occurred in customs unions and free trade areas such as the European Union (EU) and the North America Free Trade Agreement (NAFTA) notified to the GATT in terms of Article XXIV of that Agreement (Box 3.1). Asia is the least regionalized of the world's regions in terms of the coverage of trading arrangements. The only regional trading arrangement in East Asia is AFTA, and the only one in South Asia is SAPTA.

The other countries in Asia are not members of any formal regional trading arrangement, and this includes China and Japan which are two of the major trading countries of the world. While there has been discussion of the proposal for an East Asian Economic Caucus and other proposals for bilateral or trilateral trade links in South Asia and Melanesia, no trade preference arrangements have yet resulted from these discussions. By contrast, all of the countries in Latin America, North America, and Western Europe, and most of those in Africa and the Caribbean are members of at least one regional trading arrangement.

Like the second generation agreements in Europe (the EU), North America (NAFTA) and Australia/New Zealand (Closer Economic Relations [CER]), ASEAN has evolved into a more comprehensive regional trading arrangement. AFTA is a free trade area with a timetable to eliminate tariffs under the CEPT by the year 2003. The CEPT was formerly restricted to manufactured and processed agricultural products; however, at the ASEAN Economic Ministers Meeting in September 1994 and the ASEAN Economic Ministers Retreat in April 1995, a number of measures were taken to reduce exclusions and extend the commodity coverage to services, and to accelerate the timetable. These new measures were arrived at by consensus, an approach which has largely characterized ASEAN meetings.

Under the Framework Agreement on Enhancing ASEAN Economic Cooperation, members have agreed to eliminate quantitative restrictions and nontariff barriers on trade in products in the CEPT and to cooperate in some areas of service trade. Members have also agreed to explore cooperation regarding some nonborder measures, including harmonization of standards, reciprocal recognition of tests and certification of products, and removal of barriers to foreign investments.

Another unusual feature of this Agreement is the intent to free the movement of capital and to increase investment, industrial linkages, and complementarity among members.

South Asia's counterpart to ASEAN, SAARC, is more recent, having been formed only in 1985. Although early attempts were made to liberalize trade in goods among its member countries, the first comprehensive proposal for freeing up trade among the countries was the SAARC Preferential Trading Arrangement (SAPTA), which was proposed in 1993. In December 1995, the seven member countries agreed to ratify the Arrangement. Under this Arrangement, each member country is expected to exchange a request list of commodities for which it seeks tariff concessions from another SAARC country. SAARC, too, has a broader mandate than the GATT-notified regional trading arrangements. It aims to promote active cooperation and mutual

assistance in socioeconomic fields among its seven South Asian members. An action plan has been prepared which includes a strategy for social mobilization, empowerment of the poor, promotion of agriculture and small-scale industry, and the development of human and financial resources. The breadth of the SAPTA mandate is indicated by the institutions it has created. Besides the Secretariat, there is a SAARC Agricultural Information Center and a Meteorological Center.

### **Informal Cooperative Arrangements**

While there are only two formal regional trading arrangements in Asia, there has been substantial cooperation of a more informal nature among countries in the region. This cooperation has taken several forms, including bilateral or multilateral trade and investment agreements, and SREZs. In general, these

#### **Box 3.1 Regional Trade Arrangements: Costs and Benefits**

Regional trade arrangements typically involve tariff reductions that are preferential, discriminating in favor of members and against third countries; they may be contrasted with unilateral tariff reductions, which are normally nondiscriminatory and do not require reciprocity on the part of other countries. Regional trading arrangements may take any of the following forms: preferential trading area (PTA), free trade area (FTA), customs union (CU), common market (CM), or complete integration. In a preferential trading area, member countries impose lower tariffs on each other than they do on outside countries. Under a free trade area, which is a special case of a preferential trading area, union members free up trade entirely among themselves but retain their own tariffs on outside countries. A customs union is a free trade area with a common external tariff across countries but not necessarily across commodities. A common market is a customs union with free mobility of factors within the union. Finally, a complete integration scheme allows for harmonization of domestic policies. A good example of a customs union was the European Community and that of a free trade area is NAFTA. However, because agriculture and services are not fully covered, even these arrangements are imperfect

examples of the two types of schemes. On the other hand, the European Union, formerly the European Community, goes beyond a customs union in that it is also characterized by free mobility of capital, partial mobility of labor, and policy harmonization among members.

Unilateral reduction in tariffs is a positive development because it raises economic efficiency. Preferential reductions may be beneficial if they are trade creating, but not if they are trade diverting. To illustrate this distinction, suppose that as part of a free trade area, country A removes its tariff on video cassette recorder (VCR) imports from country B but not for such imports from the rest of the world. Suppose further that this change leads to an expansion of VCR imports into country A from country B. The change would be beneficial if the extra imports from country B displace previously protected, inefficiently produced VCRs from country A and harmful if they displace previously competitive and more efficiently produced VCR imports from the rest of the world. The former case is one of trade creation and the latter one of trade diversion. A preferential trading area or a free trade area is likely to be beneficial if, on balance, it gives rise to more trade creation than it does to trade diversion.

cooperative schemes are intended to give rise to more trade creation than trade diversion.

These forms of agreements among economies are unlike free trade areas and customs unions and other arrangements notified under Article XXIV of the GATT. GATT arrangements cover the whole of the territories of the countries concerned. By contrast, these other subregional Asian cooperative arrangements relate to areas which are, for at least one of the countries involved, only a part of the national territory.

Some of these areas have been called "sub-regional" economic zones to distinguish them from the "regional" GATT-notified trading arrangements. They are also popularly referred to as "growth triangles," "growth polygons," or simply "growth areas." In most cases, subnational areas constituting SREZs are provinces or states of the nations involved. However, in the case of Singapore, as a member of the Indonesia-Malaysia-Singapore (IMS) growth triangle, the zone applies to the whole of the national territory. This growth triangle, which comprises Singapore, the southern part of the Malaysian state of Johor, and the islands of the Riau Province of Indonesia, was recognized in 1989 as a trilateral agreement by the Governments of Singapore, Malaysia, and Indonesia. Labor-intensive industries are being shifted from Singapore to Johor and the Riau Islands as Singapore's unit costs increase because of rising real wages. Since 1989, a number of other SREZs have been formed in Southeast Asia and Northeast Asia.

The main focus of the SREZs is on the transnational movement of capital, labor, technology, and information and on the intercountry provision of infrastructure rather than on trade in goods and services. These zones are oriented toward the expansion of resources in the area and the growth of future output rather than the realization of static efficiency gains using existing resources. They emphasize the complementarities of the actual or potential resource bases of the constituent areas which arise from major differences in the supplies and prices of factors. However, jointly agreed specialization or localization of economic activity, leading to intra-industry or intra-firm trade, is regarded as an important approach to the efficient utilization of resources and the promotion of growth.

The SREZs are centered mainly on private sector initiatives, with governments providing the basic infrastructure and conducive policy

environments, thereby facilitating the establishment and operation of businesses in the zones. Some of the zones, such as the Brunei Darussalam-Indonesia-Malaysia-Philippines East ASEAN Growth Area (BIMP-EAGA) and the Tumen River Area Development project in China, are intended to hasten economic growth in areas where average incomes are lower or that are less developed than are other parts of the participating countries. The Indonesia-Malaysia-Thailand Growth Triangle (IMT-GT) and the Greater Mekong Subregional (GMS) Economic Cooperation project are also intended, *inter alia*, to pay increased attention to lagging subnational areas. The relatively low level of economic development of most of the members of the GMS requires emphasis on projects, particularly for infrastructure and energy development, for implementation through the public sector, financed from the international aid community and external private financiers.

The concept of an SREZ is becoming a distinctly Asian form of regional cooperation which has evolved from the area's experience with export processing zones, industrial and technology parks, and other subnational zones. All the SREZs incorporate industrial and technology parks and export processing zones within their boundaries. For the ASEAN countries, this was a way of encouraging regional cooperation among ASEAN countries without requiring the participation and formal agreement of all six ASEAN countries. ASEAN is unique among formal regional trading arrangements in that Article 4 of its Charter acknowledges that subregional arrangements among member states or nonmember countries may complement ASEAN cooperation.

Other forms of subregional cooperation that mix private sector ventures and multi-government cooperation are emerging. For example, after an initiative by the Government of the People's Republic of China in 1992, the Governments of Singapore and China have cooperated in the establishment of the China-Singapore Suzhou Industrial Park Development in the town of Suzhou in Jiangsu Province. The Singapore-led consortium of investors includes the Economic Development Board of Singapore and other state agencies as well as private companies from Singapore and some participation from Japanese and Korean companies. This cooperative effort is developing a Singapore-style township. This

is a flagship project to penetrate the large Chinese market and to transfer Singapore technology to China in areas of public administration and private sector activities. The Singapore Government is training Chinese officials on a range of public administration areas. The Singapore Government, in partnership with India, is also setting up a technology park in Bangalore, and is planning investments in infrastructure-related projects in Myanmar and Viet Nam which combine government and private sector inputs.

Another example of a subregional arrangement is cooperation on environmental issues (Box 3.2). Multicountry cooperation in the area of the environment is recent in Asia and the problems are complex. However, these subregional bodies provide a forum for defining

the problems and increasing awareness of the real issues, thereby hastening the design of solutions. In the setting up of SREZs, the protection of the environment is invariably highlighted as a concern to be given attention in sectoral studies and strategies.

The most comprehensive form of multi-government cooperation in terms of both countries and the scope of issues addressed is the APEC forum. This organization was established in 1989 and currently has 18 member countries in Asia and the Pacific. APEC is a part of the distinctive Asian style of policy formation. At the Blake Island, Seattle, US meeting in 1993, the leaders of the APEC countries put forward a vision of a "community of Asia-Pacific economies." At Bogor, Indonesia in November 1994, these leaders set a number

### **Box 3.2 Cooperation on Environment Issues in Asia**

Rapid economic growth throughout much of Asia has come at a high cost to the environments of these countries. In the large and rapidly growing urban areas, pollution and congestion are common. In rural areas, deforestation or desertification, depletion or contamination of ground water supplies, soil salinity in irrigated areas, and erosion are just some of the major problems. Asia is the region with the lowest per capita freshwater availability in the world and it has experienced the greatest amount of soil degradation. Yet, the Asian environment sustains most of the world's population, the majority of its poor population who depend on the rural environment for their survival, and a large share of the world's biodiversity.

These environmental problems lower the health and well being of large numbers of Asians resident in urban areas and lower the productivity of farmers, foresters, and other producers. In some countries such as Brunei Darussalam, Myanmar, Papua New Guinea, and Solomon Islands, oil and other minerals are major exports and the rapid depletion of natural resources threatens the future of these economies.

Many environmental problems, especially those affecting rural areas and fisheries, spill over national borders; examples include acid rain, groundwater contamination, and the depletion of fish stocks. In such cases, much of

the costs are not borne by those in the country whose producers or residents give rise to the problem and no legal framework exists which allows the residents of one nation who are adversely affected to take any action against the residents of another. In these circumstances, governments have acted as agents of their resident populations and initiated bilateral or multilateral inter-governmental discussions.

Much of this discussion has occurred in multi-government organizations or forums which were established to examine other regional issues. In this respect, the Asian propensity for considering international trade and investment and other matters of mutual concern in regional and subregional forums, has aided the development of cooperation on environmental questions. These forums include ASEAN, the South Pacific Forum, the South Pacific Commission, and APEC.

ASEAN has developed a plan of action on the environment and a working group on transboundary pollution that is developing procedures to control cross-border movement of hazardous wastes between its member countries. Among other aspects, the plan of action aims to strengthen legal and institutional capacities and to harmonize ambient air and river water quality standards.

South Pacific countries have been particularly active in international discussions of the

*Source:* Food and Agriculture Organization (1993).

of specific goals and objectives under the general headings of free and open trade and investment in the Asia-Pacific region, expansion and acceleration of trade and investment facilitation programs, and intensified economic cooperation. The goal of free and open trade and investment is to be achieved no later than the year 2010 in the case of the industrial country members and 2020 in the case of the developing country members.

At Osaka, Japan in November 1995 agreement was reached on a set of fundamental principles to guide the achievement of liberalization and facilitation of trade and investment. At present, it is not clear whether the countries will implement the proposed trade liberalization measures and, if they do, whether APEC will become a regional trading

arrangement in the discriminatory sense of Article XXIV of the GATT, or whether each member of the organization will extend the reductions in border tariffs and other measures which it offers to all countries, including those outside the organization, on a most-favored-nation basis. The latter possibility differs radically from either the discriminatory reductions under GATT-notified arrangements or the nondiscriminatory reductions which have resulted from the exchange of offers in the multilateral negotiations under the GATT.

At the Osaka meeting, the participants also agreed to take a set of individual actions in each economy to liberalize and facilitate trade and investment. This is the first trade liberalization measure that can be attributed

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environment through the South Pacific Forum and the South Pacific Commission. The South Pacific Forum established the Forum Fisheries Agency in 1979 to provide technical assistance to Forum member countries in developing and managing fisheries. It adopted the South Pacific Nuclear Free Zone Treaty, also known as the Treaty of Rarotonga, in 1985. In 1989, the Forum issued the Tarawa Declaration calling for a cessation of driftnet fishing in the South Pacific, which was followed by later UN resolutions to the same effect. The Forum has also drafted a treaty to ban the importation of toxic waste into the region. The South Pacific Commission – which comprises the South Pacific Forum and other Pacific island countries and France, the UK and the US – has a variety of consultative, advisory, and training activities which deal with environmental problems, including cross-border problems, mainly relating to fisheries. The Commission also serves as the implementing agency for the South Pacific Environment Programme which undertakes research, monitoring, and provision of information for sustainable management of natural resources.

The largest multicountry environmental program in the region is in the Mekong River area. Six countries share the Mekong River. The interdependence of the river economies of these countries was recognized as early as

1957 when the Committee for the Coordination of Investigations in the Lower Mekong Basin was formed. Cooperation among the Mekong River countries has recently increased with the formation of the Greater Mekong Subregion (GMS) as an SREZ. The ADB has played a catalytic role by identifying and implementing projects and enhancing cooperation among the countries of the region. The newly formed Greater Mekong Subregional Working Group on Environment is to facilitate cooperation regarding environmental and natural resource management among the six countries of the subregion and to address the environmental implications of the various infrastructure and other projects undertaken in the area. Other cooperative activities in the subregion include a subregional environmental monitoring and information system technical assistance project, a training and institutional strengthening project, and a project on sustainable management of forest resources.

APEC has listed concern over common environmental problems as one of the matters for discussion within the group. As a part of its economic and technical cooperation program, APEC has developed principles and begun a dialogue on some environmental and natural resource problems. It has concentrated upon marine resource conservation and fisheries to date and has initiated an action program in these areas.

directly to APEC and the first example of concerted liberalization at a regional level outside the multilateral negotiations and agreements under Article XXIV of the GATT. While some of the individual actions had already been committed in the Uruguay Round or under unilateral actions, others were novel. In particular, China and Japan announced substantial additional reductions in trade barriers.

At the same meeting, there was agreement on a set of APEC Nonbinding Investment Principles for investment flows in the region. These are intended to reduce restrictions on the international flow of portfolio investments.

APEC discussions have gone well beyond traditional border trade measures to the consideration of other measures of trade and investment facilitation, such as visa-free travel for business people, standards and harmonization, and the possibility of implementing an open skies policy.

Along with APEC developments, there have been discussions of these issues in the Pacific Economic Cooperation Council (PECC) and the Pacific Business Forum. The PECC is a tripartite body with representatives from the government, business, and academic communities of each country. The Pacific Business Forum is a meeting of representative business leaders from each country. This multilevel process of discussion is similar to the process used in the ASEAN and other regional forums to build a consensus before binding decisions are taken.

There are other nongovernmental forms of linkage in the region as well. The sharp increase in intra-Asian FDI has led to the development of Japanese and "overseas Chinese" production networks throughout all the countries of East Asia. These are an important vehicle for spreading market information, new products, and new technologies of production.

The world has seen a proliferation of regional trading agreements in recent years. According to the WTO, between 1947 and 1994, 98 regional integration agreements were notified to GATT under its Article XXIV. Nearly half of these were notified during the decade of 1985-1994. It is understandable that interest in regional integration agreements increased when the prospects for successful completion of the Uruguay Round of multilateral trade negotiations seemed dim. Surprisingly, even

with the conclusion of the Uruguay Round and the establishment of the WTO, the interest in regionalism has not declined.

### **Are Regional Arrangements Worthwhile?**

A pertinent question is whether regional arrangements are conducive to the achievement of multilateral free trade or are more likely to be obstacles to such trade. From Asia's viewpoint, this is a crucial issue because much of Asia's prosperity is based on its success in trade.

In support of the favorable view, it is argued, first, that if small countries organize themselves into a few groups, multilateral negotiations will be among these groups instead of among 120 or more individual countries. This will make the negotiations more efficient. However, the validity of the efficiency argument is likely to be strongest if groups are organized into customs unions. Under a free trade area (FTA), members have their own external tariffs and will have to resort to individual multilateral negotiations. By contrast, the EU, which operates as a customs union having a common external tariff, participated as a single unit in past negotiations.

Second, under certain circumstances, political leadership in a country may not be able to get support for either unilateral or multilateral liberalization but may be able to do so within a regional context. Once regional liberalization has taken place, however, the economic environment may become more conducive for wider liberalization.

Third, progressive expansion of regional groupings may eventually lead to multilateral free trade. Admitting new members to a regional group increases the group's market power and improves its terms of trade. Those that are excluded lose out progressively. The group increases in size until it encompasses the whole world - a happy outcome. However, this assumes that the group places prohibitive tariffs on outsiders at each stage. Similarly, it is also argued that, when the group reaches a certain size, it may choose not to accept new members because its own welfare begins to decline after that. The group then has an incentive to reject multilateral liberalization. If there is more than one group initially, strategic considerations come into play and once again, without cooperation, multilateral free trade is unlikely to be obtained.

There are three main arguments supporting the view that regionalism is likely to be a barrier to the achievement of multilateral free trade. First, an FTA may end up being an instrument of protection rather than liberalization. It can be argued, for instance, that NAFTA extended protection to the US automobile industry over the entire North American market. Under an FTA, the rules of origin can also be manipulated to increase protection. It is also likely that negotiators would seek to exclude precisely those sectors which will be threatened most by welfare-enhancing trade creation.

Second, at least in a customs union setting, groups have an incentive to raise rather than lower tariffs on imports from third countries. A larger group has more monopoly power than have individual countries in the group. Therefore, there need be no presumption that a small number of groups will facilitate global liberalization.

Finally, the forces of liberalization may have a better chance of prevailing over protectionists if the choice is just between the status quo and multilateral free trade. However, if the additional choice of regionalism is offered, the political process may take the regional route rather than that of multilateral free trade. Businessmen and bureaucrats, after having achieved a regional agreement, might not find the extra effort for multilateral negotiations worthwhile.

These various arguments demonstrate that the choice between multilateralism and discriminatory trade arrangements on a regional basis may not be clearcut in practice. In principle, however, as some economists have suggested, there may be only two compelling arguments for the adoption of a regional approach: first, a group of countries wants to develop a common market with a common external tariff and free mobility of capital and labor among the group just as in a federal state; or second, the multilateral trading-negotiation route closes because some countries refuse to negotiate multilaterally and the only feasible path to trade liberalization is open-ended, easy-to-join preferential trading areas among as many nations as are willing to join. The Asian style of regional arrangements, as exemplified by APEC, along with the Asian countries' disposition to engage in unilateral liberalization, is in keeping with this latter view.

## Summary

In summary, there has been rapid development of economic cooperation among Asian countries in recent years, especially in the 1990s. Various forms of cooperation have developed, including formal and informal arrangements at the subregional level, and some of these have involved joint action by both the government and private sectors. Cooperation has extended beyond trade relations to cover environmental issues, common infrastructure interests, and joint development of resources and economic capacity in less economically advanced parts of some countries. The approach of Asian countries has not been inward-looking but rather has been one of using regional cooperation in support of increased multilateral trade and economic liberalization.

## INTRA-ASIAN TRADE IN GOODS AND SERVICES

One of the most important aspects of the pattern of economic growth is the linkage between growth in international trade and growth of real output and income. These interlinkages have been instrumental in explaining the dynamism of the ADB's developing member countries (DMCs).

### Pattern of Trade in Goods and Services

*Goods Flows.* In volume terms, merchandise exports from the DMCs have grown at two to three times the rate of growth of world exports over the last three decades (Figure 3.1). As a consequence, the share of these countries in total world merchandise exports has increased from 7.3 percent on average over the decade 1971–1980 to 11.9 percent over the decade 1981–1990 and to 16.2 percent over the period 1991–1994. Exports from the DMCs have also grown much more rapidly than have those from other developing countries.

The rapid growth of exports has been associated with rapid growth of real output (Figure 3.2). For example, over the period 1991–1994, growth of real output for the DMCs averaged 7.9 percent per annum which is much higher than the 2.5 percent for other developing countries.

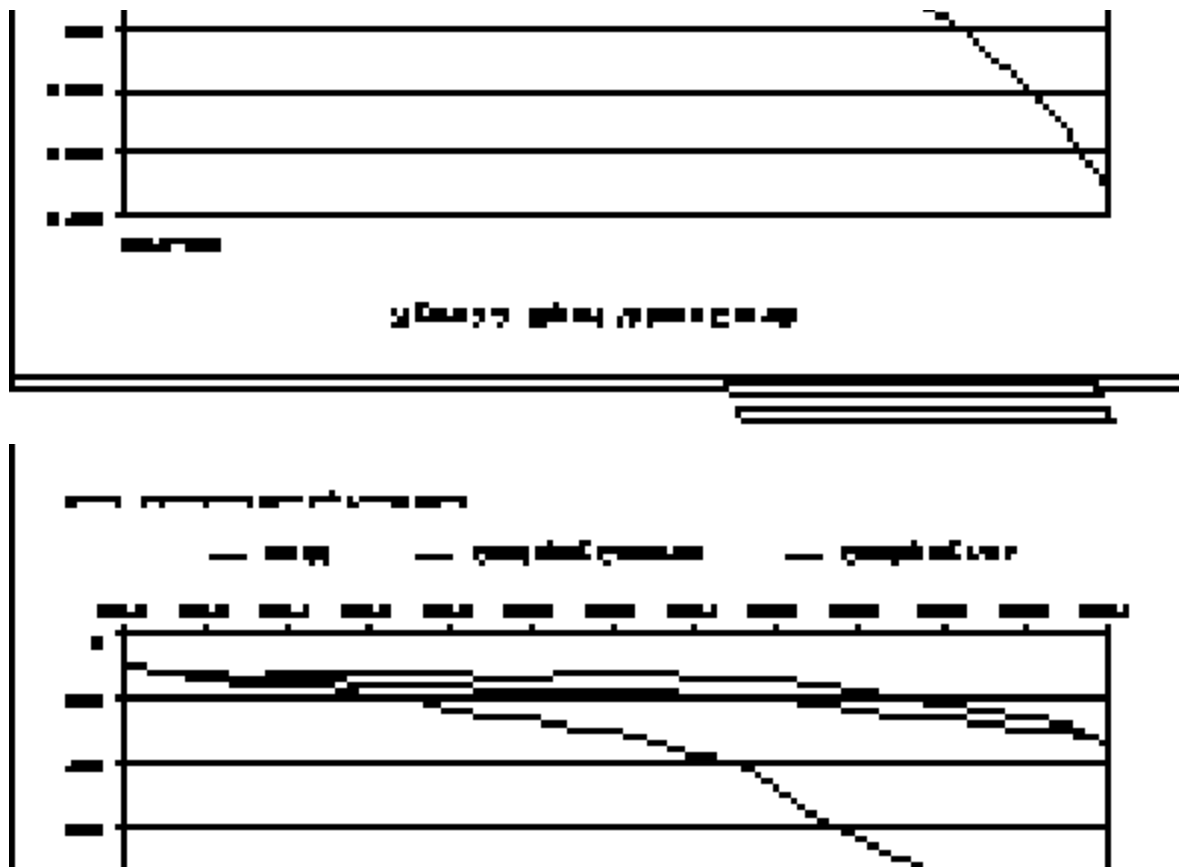
An increasing share of Asia's rapidly growing trade has been directed to other DMCs. Consequently, the value of intra-Asian trade has grown even more rapidly than has the total trade of these countries.

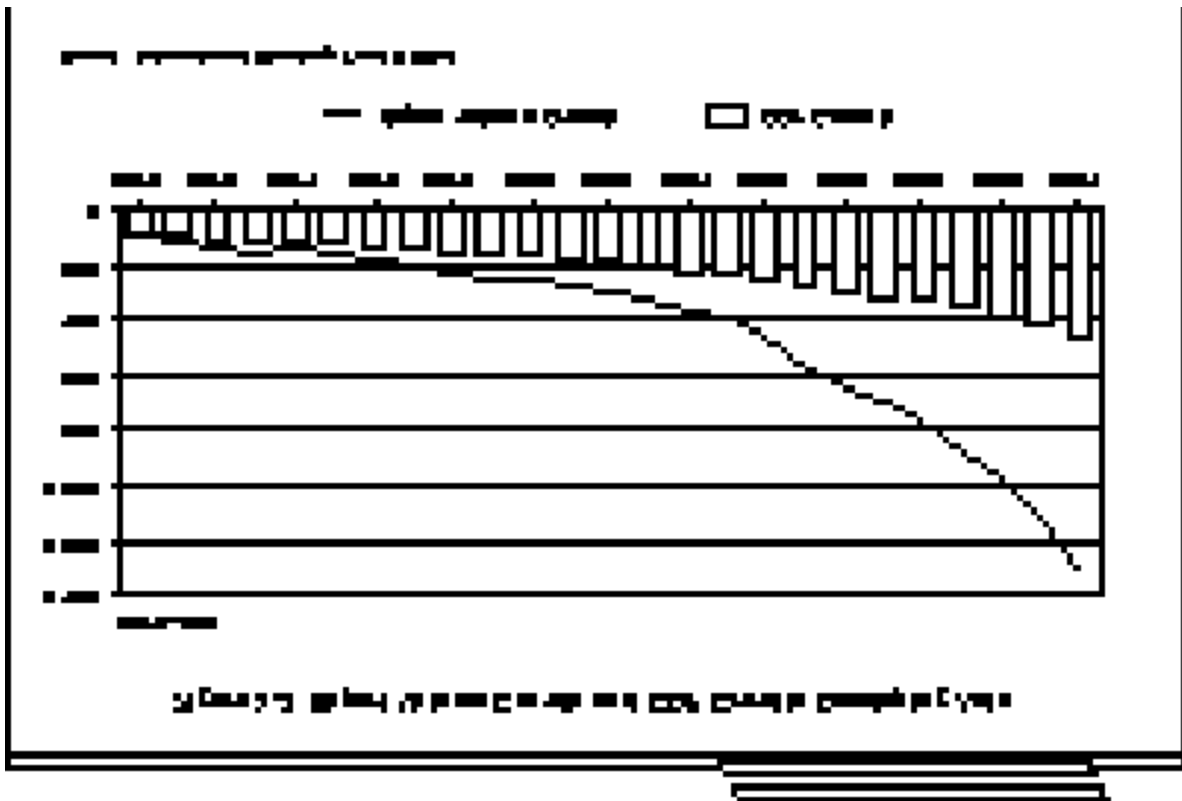
As a proportion of total trade, intra-Asian trade has risen sharply, especially since 1985 following the Plaza Accord (Tables 3.1 and 3.2). Japan is included in these tables because of the role that it has played in promoting the development of new products through its FDI in these economies and through the complementary export of Japanese technology. Interestingly enough, trade among the DMCs has grown more rapidly than has trade between the DMCs and Japan. In 1994, 48.7 percent of total exports from the DMCs and Japan was directed to the region, and an even higher percentage of total imports (52.6 percent) came from the region.

*Service Flows.* The trend in movements of services in international trade is similar to that of goods. Asian exports of commercial services, such as transport, tourism, and financial services, but excluding remittances

and other capital and labor services, roughly trebled between 1984 and 1993 (Figure 3.3). As with international trade in goods, Asian exports of commercial services, particularly the NIEs, have increased more rapidly than have those of the rest of the world. The NIEs provide over 90 percent of the total exports of commercial services from the region. This trend in the growth of services is a reflection of the more important role which the services sector plays in the more prosperous economies as well as the measures taken by the Governments of Hong Kong and Singapore to develop tourism, financial, and transport services.

*Patterns of Trade.* It is also useful to compare the level of intraregional trade within Asia with that of the two other large trading blocs, North America (NAFTA) and Europe as reflected in the EU, as well as other developing regions (Figure 3.4). Considering trade in goods (data on services exports by destination are not available) the intra-regional share of trade in the DMCs is much greater than that in other developing regions. In fact the intraregional share of trade by





Asian countries, excluding Japan, is now approaching that of North America, which is dominated by very strong and integrated linkages between Canada and the US. The share of intraregional trade in total trade within Asia is still substantially less than in that of intraregional trade within the EU. This is understandable, given the very high level of intraregional cooperation and trade facilitation which has developed in Europe over the past three decades. Nevertheless, the size of Asia's intraregional trade as a share of total trade is remarkable, particularly in view of the lack of formal arrangements to facilitate trade.

Much of this growth in intraregional trade is a result of the important role which Japan has played in facilitating trade and the transfer of technology. However, that role has changed dramatically over the years. In the beginning, trade between Japan and the DMCs was dominated by what might be termed typical north-south trade. Primary products were shipped by the DMCs to Japan and manufactured goods and capital were shipped from Japan to the DMCs. More recently, that trade pattern has become much more complex and the exports of the DMCs are now primarily manufactured goods.

The overall pattern of trade within the Asian region has also changed. In 1994, Japan was the source of 21.8 percent of total imports by the DMCs. However, only 12.3 percent of total exports of these DMCs was destined for Japan. From the point of view of Japan, the balance is reversed; the DMCs accounted for 29.9 percent of Japan's total imports and 31.4 percent of its total exports. The Japanese pattern is more symmetric because its imports from the DMCs represent a larger proportion of its total imports than is the case with its exports. This is because Japan has a large export surplus.

Within the DMCs as well, there are marked differences in trade patterns among the four groups of economies: the NIEs, Southeast Asia, China, and South Asia. Southeast Asia has the highest level of intraregional trade, chiefly with the NIEs and China. The share of intraregional trade within the NIEs has risen most sharply due to a phenomenal increase in trade with China (especially for Hong Kong) and an increase in trade within the NIEs themselves. China also has a high level of intraregional trade, chiefly with the NIEs and Japan, although this intraregional component of trade is somewhat inflated by reexports from Hong Kong to other countries.

**Table 3.1 Shares of Various Regions in Exports from the DMCs and Japan**  
(percent)

<b>From/To</b>	<b>NIEs</b>	<b>Southeast Asia</b>	<b>China</b>	<b>East Asia<sup>a</sup></b>	<b>South Asia</b>	<b>DMCs</b>	<b>Japan</b>	<b>DMCs and Japan</b>
<b>NIEs</b>								
1980	8.3	9.5	2.0	19.8	2.2	22.0	10.1	32.0
1985	7.8	6.8	7.2	21.8	2.1	23.9	10.0	34.0
1990	12.3	7.9	7.9	28.1	1.6	29.7	11.3	41.1
1994	15.2	11.9	16.5	43.5	1.5	45.1	8.9	54.0
<b>Southeast Asia</b>								
1980	15.5	3.4	0.8	19.7	1.4	21.1	34.5	55.6
1985	17.9	4.5	1.3	23.7	2.1	25.9	30.6	56.5
1990	20.0	4.6	2.1	26.7	1.7	28.4	24.7	53.1
1994	25.6	5.8	2.9	34.2	1.8	36.0	18.3	54.3
<b>China</b>								
1980	26.3	4.3	...	30.6	1.1	31.7	22.2	53.9
1985	33.7	2.7	...	36.4	1.7	38.1	22.3	60.4
1990	47.1	2.9	...	50.0	2.0	52.0	14.6	66.6
1994	34.4	3.5	...	37.9	1.7	39.6	17.8	57.4
<b>East Asia<sup>a</sup></b>								
1980	13.0	6.8	1.4	21.1	1.8	22.9	19.8	42.7
1985	14.1	5.6	4.7	24.4	2.1	26.5	16.9	43.4
1990	19.1	6.5	5.5	31.1	1.7	32.8	14.6	47.4
1994	20.7	9.1	10.7	40.5	1.6	42.1	12.5	54.6
<b>South Asia</b>								
1980	5.9	2.6	2.5	11.0	5.1	16.1	8.2	24.2
1985	4.8	1.8	0.8	7.4	4.7	12.1	10.2	22.3
1990	6.5	2.7	0.5	9.8	3.4	13.1	8.4	21.5
1994	11.6	3.5	1.1	16.3	4.2	20.4	7.3	27.7
<b>DMCs</b>								
1980	12.4	6.4	1.5	20.3	2.1	22.3	18.8	41.1
1985	13.4	5.4	4.4	23.2	2.3	25.5	16.5	42.0
1990	18.4	6.3	5.2	29.8	1.8	31.6	14.2	45.8
1994	20.3	8.8	10.2	39.3	1.7	41.0	12.3	53.3
<b>Japan</b>								
1980	10.8	7.1	3.9	21.9	1.8	23.7	...	23.7
1985	9.9	4.3	7.1	21.3	1.8	23.1	...	23.1
1990	14.4	7.8	2.1	24.3	1.2	25.6	...	25.6
1994	23.7	10.5	4.7	38.9	1.0	39.8	...	39.8
<b>DMCs and Japan</b>								
1980	11.7	6.8	2.6	21.0	2.0	23.0	10.2	33.1
1985	11.8	4.9	5.7	22.3	2.1	24.4	8.8	33.1
1990	16.8	6.9	4.0	27.7	1.6	29.2	8.6	37.9
1994	21.4	9.4	8.3	39.1	1.5	40.6	8.0	48.7

<sup>a</sup> East Asia includes the NIEs, Southeast Asia, and China.

Note: Numbers may not add due to rounding.

Source: International Monetary Fund (1995c).

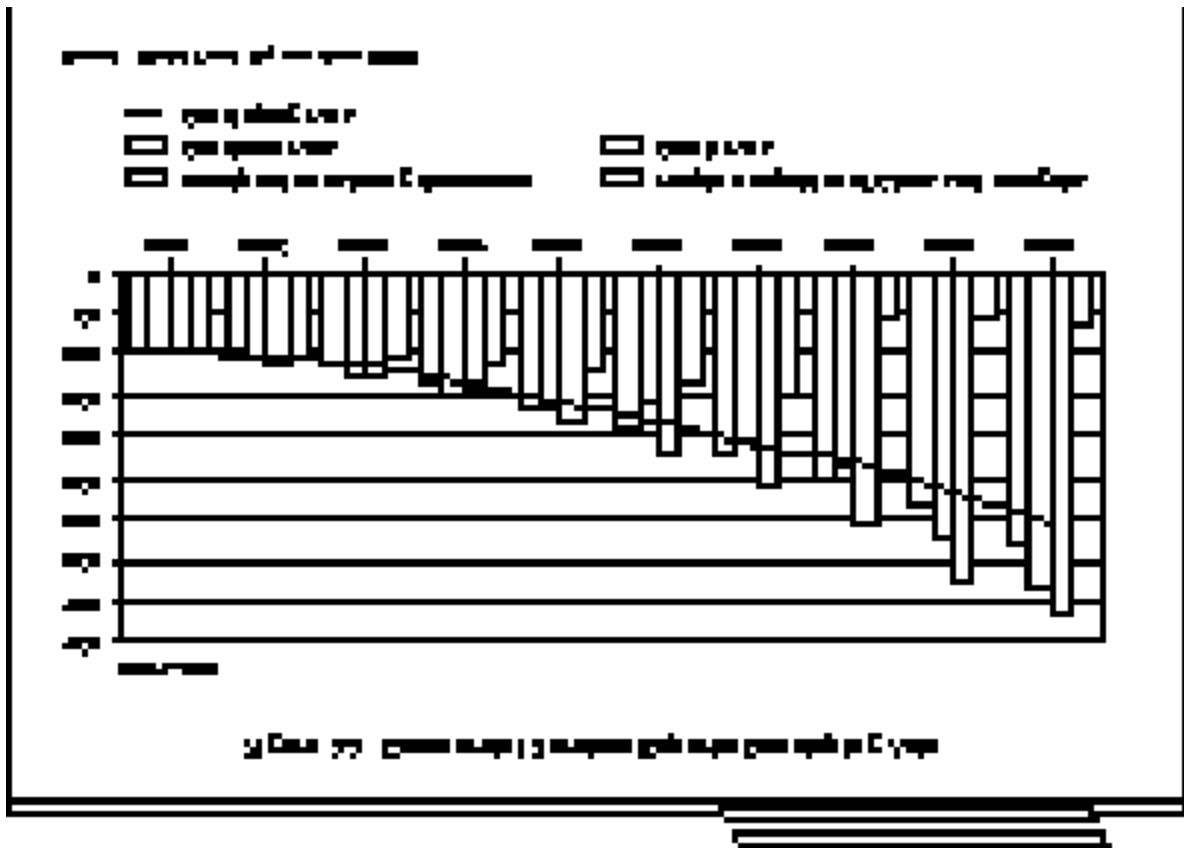
**Table 3.2 Shares of Various Regions in Imports into the DMCs and Japan**  
(percent)

To/From	NIEs	Southeast Asia	China	East Asia <sup>a</sup>	South Asia	DMCs	Japan	DMCs and Japan
NIEs								
1980	4.8	8.9	7.3	21.0	1.1	22.1	22.4	44.5
1985	4.6	8.2	9.2	22.0	1.1	23.1	22.8	45.9
1990	11.3	7.4	12.1	30.8	0.9	31.7	22.4	54.1
1994	12.0	8.9	15.5	36.4	1.9	38.3	21.1	59.4
Southeast Asia								
1980	11.0	4.0	2.8	17.8	1.0	18.7	24.2	43.0
1985	13.2	5.8	2.6	21.6	0.9	22.5	22.6	45.1
1990	14.4	4.3	2.5	21.1	1.5	22.7	25.1	47.8
1994	21.0	5.8	2.7	29.5	1.0	30.5	26.7	57.2
China								
1980	3.9	2.4	...	6.3	1.3	7.5	26.5	34.1
1985	11.8	2.1	...	13.9	0.4	14.3	35.7	50.0
1990	29.0	4.1	...	33.1	0.6	33.7	14.2	47.9
1994	28.9	3.9	...	32.8	0.6	33.4	22.8	56.1
East Asia <sup>a</sup>								
1980	6.6	6.4	4.8	17.8	1.1	18.8	23.6	42.4
1985	8.0	6.4	5.8	20.1	0.9	21.0	25.7	46.7
1990	14.3	6.3	8.3	28.8	1.0	29.8	22.0	51.8
1994	16.7	7.4	10.1	34.2	1.5	35.7	22.7	58.4
South Asia								
1980	4.8	2.9	1.7	9.4	2.2	11.6	8.8	20.5
1985	5.1	4.0	1.6	10.7	2.0	12.7	10.6	23.3
1990	7.9	4.3	2.0	14.3	2.1	16.4	9.4	25.8
1994	11.1	5.9	4.5	21.6	3.6	25.2	8.2	33.4
DMCs								
1980	6.3	5.8	4.3	16.2	1.3	17.6	21.1	38.7
1985	7.6	6.1	5.2	18.9	1.0	19.9	23.8	43.7
1990	13.7	6.1	7.7	27.6	1.1	28.7	21.0	49.6
1994	16.4	7.3	9.8	33.5	1.6	35.1	21.8	56.9
Japan								
1980	3.6	14.1	3.1	20.8	1.0	21.8	...	21.8
1985	5.0	12.9	5.0	23.0	1.4	24.3	...	24.3
1990	7.4	10.7	5.1	23.2	1.2	24.4	...	24.4
1994	12.6	13.5	11.2	37.2	1.4	38.6	...	38.6
DMCs and Japan								
1980	5.0	9.8	3.7	18.5	1.1	19.6	11.0	30.6
1985	6.6	8.7	5.1	20.4	1.2	21.6	14.8	36.4
1990	11.6	7.6	6.9	26.1	1.1	27.2	13.9	41.1
1994	15.5	8.8	10.1	34.4	1.6	35.9	16.7	52.6

<sup>a</sup> East Asia includes the NIEs, Southeast Asia, and China.

Note: Numbers may not add due to rounding.

Source: International Monetary Fund (1995c).



South Asia is a relatively minor trader and has a much lower proportion of intraregional trade than do the other three subregions. Japan and the NIEs are the most significant Asian export markets for South Asia, although they account for less than 10 percent of total exports. Exports from South Asia to China are insignificant. Also, intra-South Asian trade is negligible and is lower than that of any other Asian subregion. Rather, South Asia is generally inclined to export more to the US and the EU, which are also its main suppliers of imports. Recently, however, South Asian imports from the DMCs have increased sharply from 12 percent of their total imports in 1980 to 21 percent in 1993.

For all four subregions, the US is the most important market for exports, outpacing both Japan and the EU. However, as a source of imports, Japan is the most favored supplier for the NIEs, Southeast Asia, and China, outranking both the US and the EU.

As is evident from this discussion, a triangular pattern of trade has developed for the NIEs, Southeast Asia, and China with imports coming primarily from Japan and other DMCs and exports going to a much greater extent to countries outside the region, principally the

US and the EU, in that order. South Asia does not conform to this pattern; the EU is its largest single source of imports as well as being the major export market for this region.

The triangular trade pattern is likely the result of the changing pattern of commodity trade which has evolved over the past two decades. For Asia, exports of manufactures (excluding resource-based manufactures of iron and steel) now account for a large proportion of total export trade, higher than they do for any other region in the world. For exports within Asia, the proportion of manufactures was 76.5 percent in 1993, whereas for exports to countries outside Asia, the share of manufactures was 81.4 percent (and 90.6 percent if Japan is included).

With respect to imports, the pattern of capital imports still reflects previous flows when the DMCs exported primary products and imported machinery and finished goods. As a result, there is a much higher proportion of imports of capital equipment and materials and components in total imports from the rest of East and Southeast Asia (chiefly Japan and other Asian NIEs) than in imports from outside the Asian region. Correspondingly, and reflecting the triangular trade pattern,

there is a much higher proportion of exports of more highly processed materials and finished goods to the US, the EU, and other markets outside Asia than is the case with exports to other Asian destinations.

As expected, the composition of trade differs somewhat for individual countries. For example, Korea, with its emphasis on heavy and chemical industries, has a relatively high share of resource-based manufactures in total trade. It is also the only major producer and exporter of automobiles and automobile parts outside Japan. Until recently, its automobile exports have been directed primarily to Asian countries, partly at least because of greater trade barriers in the major markets of Europe and North America. As a second example, Malaysia has become specialized in producing components for the electronics industry with strong vertical intra-industry links outside Asia and, to a lesser extent, within Asia.

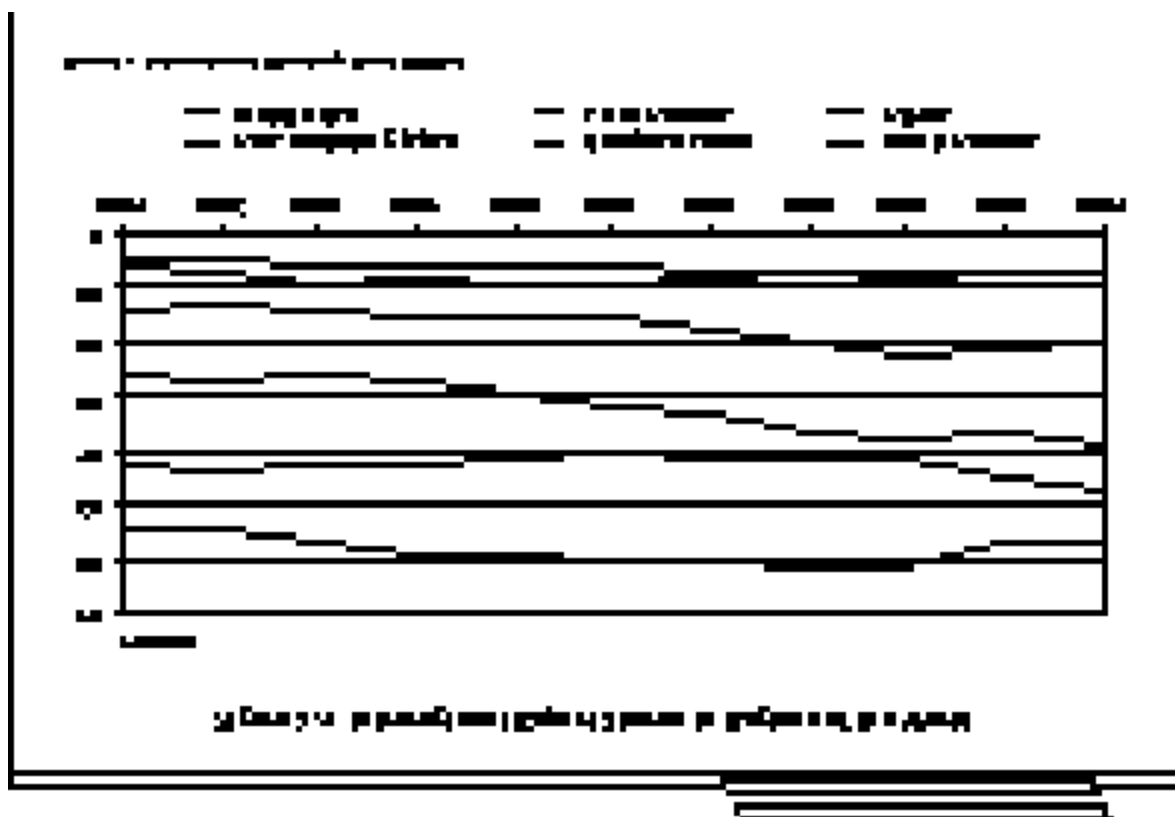
### Causes of Trade Expansion within Asia

What are the important features of the general pattern of international trade in Asian economies? What are the causes of these

movements? Why has intra-Asian trade expanded so rapidly? It is difficult to provide clearcut answers to these questions since it is hard to estimate empirically the effects of different factors. International trade is a complex phenomenon. The trade flows in any period reflect simultaneous adjustments in all commodity and factor markets and in all of the trading countries of the world economy. Therefore, it is virtually impossible to separate individual variables and factors which can be identified as key or critical determinants of trade flows and patterns. The following discussion is, therefore, qualitative in nature.

Two key factors are important in explaining the growth in trade generally and in the expansion in Asian intraregional trade in particular: real output growth and reductions in trade barriers.

*Real Output Growth.* Both the real output and trade of the region has grown more rapidly than has that of the rest of the world. This means that the demand for imported inputs and final goods has expanded more rapidly in the region than it has elsewhere. How is



this overall growth in trade shared between intraregional movements and trade with the rest of the world outside Asia? Box 3.3 suggests that a number of variables must be taken into account, including distance and other factors, in order to answer that question. It also suggests that, while the share of intraregional trade within Asia has increased more quickly than would be predicted by size alone, the “intensity” of intraregional trade in total trade has been falling in recent years. However, caution should be exercised in using such changes in trade shares to draw inferences regarding the causes of shifting trade patterns. While the growth in the propensity of Asian countries to trade more with each other is more modest than is the overall growth in their income levels, this observation is nevertheless not inconsistent with the view that the steps that many East Asian countries have taken to liberalize their trade have led to trade expansion rather than diversion. Had only diversion occurred, both trade shares and trade intensity would have risen within East Asia. Second, these observations are not inconsistent with the view that East Asian economies have become more adept at exploiting their comparative advantage in the international arena. Increasing penetration of markets outside the Asian region is likely to have been abetted by the market-friendly reforms that have been spearheaded by the East Asian countries. Third, it is possible that decreasing intraregional trade intensity has been the result of shifts in the international pattern of comparative advantage, technology, and tastes. For example, the ubiquitous character of the information technology revolution, together with East Asia’s comparative advantage in electronic assembly operations, may have encouraged diversification of East Asia’s export markets. Equally, the explosion of incomes in East Asia has stimulated the demand for a much greater variety of consumer goods, many of which are likely to be imported from outside of the region.

Whatever the underlying cause of rising intraregional trade shares, but falling intraregional trade intensity, these trends, of themselves, do not reveal much about the impact of regional cooperation on the pattern of trade or their impact on economic growth and development. Regional cooperation arrangements in East Asia transcend trade, and the benefits of cooperation are likely to be

transmitted through a wide variety of channels. Falling regional trade intensity is perfectly consistent with a more efficient allocation of resources, a greater integration of regional markets, and trade creation. These are precisely the objectives that regional cooperation should seek to promote.

*Reductions in Trade Barriers.* The second factor that helps to explain the growth of intra-Asian trade is the reduction in barriers to international trade in the region. The DMCs began to liberalize their import trade sooner and have continued in the 1980s and 1990s to do so more rapidly on average than have developing countries in other regions. The progressive liberalization of international trade in goods and services through the lowering of tariff barriers and removal of nontariff barriers has made a vital contribution to the growth and dynamism of the region as well as being an explanatory factor in the continued high trade intensity of the DMCs.

Most of the industrial countries had opened their borders to freer international trade by 1960. Among the DMCs, Hong Kong had a very open policy and Malaysia and Singapore had relatively open policies from the time of independence. The other two NIEs – Taipei, China and then Korea – opened their economies to substantially freer international trade in the mid-1960s. With the exception of Chile, almost all other developing countries, including the remaining DMCs did not open their economies until the mid-1980s or later.

Trade liberalization in the Asian economies has taken two main forms. The first is through unilateral liberalization where barriers to imports of a commodity from all sources are reduced. The second is the establishment of export processing and other local “free trade” zones. Both have been important historically in Asia.

All of the NIEs and ASEAN economies have engaged in unilateral liberalization of trade. Hong Kong, Korea, Malaysia, Singapore, and Taipei, China began this process in the 1960s. Subsequently, other economies in Asia have opened up their economies by means of unilateral liberalization. Unilateral reductions have continued during the last decade outside the multilateral Uruguay Round. Unilateral trade liberalization in ASEAN countries is important in its own right since ASEAN is the only regional trading arrangement in East Asia and the only regional arrangement in

### Box 3.3 Trade Patterns in East Asia

East Asian intraregional trade shares have been rising since the 1980s. More of East Asian imports as a share of their total imports are being sourced from other East Asian countries; and more exports, as a share of their total exports, are being sold to their East Asian neighbors. This increase in trade shares is sometimes interpreted as evidence of strengthening trade integration within the region. What might explain this trend?

The pattern and volume of trade between the two countries are influenced by a variety of factors, including complementarity in their endowments, differences in their tastes, the distance between them, the costs of overcoming that distance, and their comparative size in terms of GDP. Each of these factors is likely to have played a role in explaining rising shares of intraregional trade in East Asia.

Imagine that trade flows were random, with the exports of one country being randomly assigned to importing countries. "Expected" bilateral trade flows would then be proportional to the size of origin and destination countries, as measured by their share of total world trade. Other things being equal, the share of large (small) countries in small countries imports would then tend to be large (small). By comparing actual flows to these "expected" flows, the contribution that a country's size makes to its trade shares can be isolated. By extension, the degree to which changes in size influence changes in trade shares can be determined. The deviation expected from observed changes in shares might then be attributed to changes in those factors, other than size, that influence the composition and volume of trade flows.

This information can be summarized in terms of an index of "trade intensity," measured as the ratio of the observed bilateral flow to its expected value. This index can be calculated as

$$I_{ij} = \frac{F_{ij}}{M_j} \cdot \frac{E_i}{E - E_i}$$

where  $I_{ij}$  is the index of intensity between country  $i$  and country  $j$ ,  $F_{ij}$  is the exports from country  $i$  to country  $j$ ,  $M_j$  is the total imports of country  $j$ ,  $E_i$  is the total exports of country  $i$ , and  $E$  is the

total volume of trade. An analogous index can be defined for imports to country  $i$  from country  $j$ . A value of  $I_{ij}$  greater than one would indicate a trade intensity stronger than would be "predicted" by size alone, and a value less than one, an intensity less than what would be predicted by size. Equally, an increase in the index would indicate a strengthening of intensity over and above that which would be suggested by the change in the share of those countries in total world trade, and vice versa.

For the countries of East Asia, the trade intensity index calculated in this way is typically 2.5 or higher. Accordingly, East Asian countries trade with each other to an extent greater than would be predicted by their size alone. One obvious reason for this is that the countries of East Asia are geographically proximate to one another. It is not uncommon to observe indexes of value greater than one for countries separated by comparatively small distances.

When changes in trade intensities of East Asia are examined, it is observed that they have fallen rather than increased, at least since the 1980s. This means that East Asian countries' share of total world trade has increased more quickly than has their bilateral trade. This suggests that the growth of intraregional East Asian trade has not occurred as a result of trade being diverted from other regions of the world. Falling trade intensity within the East Asian region might be explained by the falling costs of moving goods over longer distances, by changes in the pattern of factor complementarities, or by changes in the pattern of tastes across countries, by income growth outside East Asia, or by more aggressive marketing by East Asian countries in outside markets.

This perspective on emerging trading relationships has been confirmed by other empirical studies that have used gravity models of intercountry trade flows. Several authors have examined whether the share of intraregional goods trade is higher, or is increasing more quickly than would be predicted on the basis of distance, common borders, and the size of GDP of trading partners. The influence of distance and related factors can explain strong intensity, but that intensity in East Asia has been falling in the 1980s.

Sources: Anderson and Norheim (1993); Petri (1993); Frankel (1993); Frankel and Wei (1993); and Yamazawa and Associates (1994).

Asia which has substantially liberalized trade on a regional basis. This experience is discussed in detail in Box 3.4.

More recently, countries in South Asia and some of the transition economies, such as the Central Asian Republics, Mongolia, and Viet Nam, have begun to liberalize their trade regimes unilaterally.

A second form of unilateral freeing of trade does not apply to all imports of a particular commodity. This method of liberalization has been accomplished through the formation of subnational local zones and through other forms of concessional entry.

The most common form of subnational zones are export processing zones. A feature of these zones is the establishment of some subnational customs area that gives customs treatment to goods entering the area which is different from and preferred to that of goods entering non-zone parts of the same country. These preferences are normally restricted to export activities. Export processing zones may also give preferences or privileges relating to the establishment of foreign-owned enterprises and to nontrade-related instruments of government policies such as reduced income tax rates or preferences in government loans.

In the post World War II period, the first zone created was the Shannon Free Zone, which was established in Ireland in 1959. Subsequently, the growth of these zones was concentrated in the developing countries, chiefly in East Asia and to a lesser extent in Central and South America. In recent years, this form of organization has become even more concentrated in Asia than in other developing regions. There are now more than 30 such zones in China alone.

Total employment in export processing zones and other special zones in developing countries had grown to about 4 million employees around 1990. Fifty percent were in China alone and 64 percent in East Asia as a whole. Much of the growth of manufactured exports from Asia has originated in these zones.

Subnational zones are a device for the freeing of trade in a controlled and limited way. Zones by nature discriminate among producers located within the national borders and they, therefore, raise issues concerning the merits of piecemeal reform. In Asia, such zones undoubtedly resulted in substantial freeing of trade and have, at the same time and in the same locations, allowed the liberalization of

restrictions on capital flows for multinational producers and joint ventures. This has made subnational zones attractive to foreign investors.

A closely related form of subnational zone is the financial service zone, such as a financial offshore center. These zones essentially provide preferences for the finance service industries, analogous to those provided for manufactured goods in export processing zones. There are other subnational zones which are not international trade-related, such as science and technology parks. The number of these parks has increased rapidly in many Asian countries since 1980.

It is difficult to assess the extent to which subnational and subregional zones have contributed to the overall pattern and growth of trade in the Asian region. However, their growth may explain part of the paradox that increasing intraregional trade is combined with a low level of intraregional trade preferences within regional trading arrangements. While these zones do not discriminate among nations in terms of the entry of goods across national borders, in Asia, at least, there is a regional element in the establishment and operation of some zones. In Asia, export processing zones began in the 1970s – largely following Japan's relaxation of investment abroad after the Plaza Accord in September 1985 – as a way of attracting foreign investment and technology transfers to take advantage of the low labor costs in these countries and to boost exports of manufactures. Similarly, financial offshore centers in Asia are a part of the general strategy of nations to encourage the growth of financial services as well as trade and investment in the region. Most science and technology parks in Asia have concentrated primarily on attracting foreign investors. Subnational zones are, therefore, an integral part of the wider pattern of intra-Asian trade development. Subregional zones play a similar role in areas which cross national borders. Consequently, subnational and subregional zones have increased the intraregional share of total trade in goods and services as well as intraregional flows of FDI.

Reductions in border barriers, which apply to all imports or to concessional imports only, raise the issue of data interpretation as well as important policy considerations. Both zones and other concessions reduce border barriers. In relation to tariffs and other barriers which apply to all imports entering the country, the

existence of these reductions means that the measured applied tariff rates overstate the true rates for the country as a whole. Over time, the reductions in barriers to trade through the introduction of zones and concessions means that measures of reductions in border barriers that have looked only at the applied rates and nontariff barriers and ignored the zonal and other concessions have understated the degree of liberalization that has occurred in the Asian economies.

A more important issue for policymakers is the discriminatory nature of these concessions. They discriminate among domestic producers of the same goods covered by these concessions. This form of discrimination is additional to the discrimination among

producers of different goods which comes about because of the different levels of protection for different industries or groups of commodities. It is true that the frequent use of zones, in particular, has permitted a piecemeal controlled reduction in trade barriers in circumstances when general reductions in tariffs and other border barriers may not have been feasible. Nevertheless, at a time when reductions in trade barriers are widespread in terms of the countries conducting them and the goods covered, it may be preferable for a liberalizing country to cut applied rates and lower quantitative restrictions without introducing concessions for zones or particular producers. Free entry for inputs is necessary for fully efficient

#### **Box 3.4 Unilateral Trade Liberalization in ASEAN**

Despite their membership in ASEAN since its formation in 1967 and the establishment of the much more comprehensive ASEAN Free Trade Area (AFTA) in 1992 and their participation in the Uruguay Round, all of the ASEAN countries continued to reduce their barriers to imports unilaterally during the period from the beginning of the Uruguay Round of negotiations in 1986 and since its conclusion in December 1993. ASEAN is in fact a rare example of a GATT-notified regional trading arrangement in which the individual member countries have lowered tariffs substantially during the formation of the regional trading arrangement itself.

Throughout almost all of their history as independent nations, both Singapore and Brunei Darussalam have had very low tariffs. Before the independence of Malaysia, of which it was originally a part in 1963, Singapore had been a duty-free port for over 100 years. Soon after the establishment of Singapore as a separate independent state in 1965, it eliminated the quotas and most of the tariffs which protected a range of manufactured products. This made it a virtual free trade state with the remaining tariffs being revenue duties on imports of automobiles, alcoholic beverages, and petroleum, all of which were not produced locally. In addition, there are no quantitative restrictions on goods and very few nontariff barriers. Similarly, Brunei Darussalam, whose endowments of crude oil have provided a

high level of per capita incomes, has since its independence in 1984, exempted most imports of goods from duty and has had few nontariff barriers to trade.

Indonesia, Malaysia, Philippines, and Thailand have carried out unilateral liberalization during the period since the formation of AFTA. This includes Indonesia and the Philippines which were previously quite protective of some local industries. Indonesia, unilaterally and in addition to its regional commitments, lowered its tariffs in a series of reductions starting in 1985 and continuing in 1990, 1993, and 1995. During the 1980s, Malaysia lowered some tariffs and eliminated some quotas unilaterally. During the later period 1988–1993, there has been a rapid decline in Malaysian tariffs so that there are now minimal controls on imports and very few items remain subject to quantitative restrictions. The Philippines began to liberalize its trade regime in the 1980s by reducing tariffs and phasing out quantitative import restrictions. Thailand announced a major reduction in tariffs in December 1994, following earlier reductions.

In January 1994, Singapore extended the tariff cuts which it had agreed under the AFTA timetable to all countries as a part of its Uruguay Round commitments. In May 1995, Indonesia similarly multilateralized some of its AFTA tariff cuts, an action which is unique in the modern history of free trade areas.

*Source:* Pangestu (1995).

production in the whole economy. Within the setting of the overall economy, this can be achieved by concessions and drawbacks on customs duties for goods incorporated into exports. This reduces the burden that the protection of imports imposes on exporters. Furthermore, such measures avoid the costs of discriminatory zones which favor some local producers over others.

*Other Factors.* Several other factors may be important in explaining the changing pattern and growth of intraregional trade within Asia. For example, the pattern of exchange rate adjustments after the Plaza Accord brought about a shift in comparative advantage. This has been reflected not only in a changing pattern of trade but also in a shift in the pattern of production with the transfer of some manufacturing activities from Japan to lower-wage countries in the region.

Reductions in transport costs are another factor which could explain the increase in intra-Asian trade. Maritime transport costs have fallen within Asia, owing to the emergence of new shipping lines, especially in East and Southeast Asia; an oversupply of tonnage caused by widespread subsidization of shipbuilding in many Asian countries and concomitant declines in freight rates in both bulk and liner trade; and containerization and massive modernization of port services. There has also been a dramatic expansion in telecommunications capacity and services in Asia resulting from the development of Asian satellite networks and rapidly growing intra-Asian FDI in information services as well as the importation of new technologies from the technological leaders in Japan and the rest of the world. All these developments would help to promote intraregional trade in goods and other nonfactor services. The growth of intra-firm trade associated with FDI has also reduced information costs for intra-Asian trade.

Additional factors commonly cited for the growth in trade include financial integration in the region, geographical proximity and cultural similarities such as common languages and business networks, and investment in human capital and technologies. These are obviously important supporting and contributory developments; however, it is difficult to assess their overall contribution to the growth of intraregional trade. Finally, it has been suggested that the DMCs of East and Southeast

Asia have liberalized their regulations of FDI substantially and probably to a greater extent than has the rest of the world. FDI will be taken up more fully in the next section.

In assessing the relative importance of the growth of real income, regional trade liberalization, transport costs, and other factors, it is useful to note the interactive nature of their contribution to explaining changes in intra-Asian trade. Their effects are not simply additive. The real income effect first mentioned is, in part at least, a product of trade liberalization and other reforms, such as deregulation and privatization of markets. Trade liberalization has direct effects through opening markets to international traders and indirect effects through the higher real incomes associated with improved resource allocation and greater efficiency. Only to the extent that the growth differential can be attributed to technological catch-up or factors other than trade liberalization can this factor be treated as independent. Similarly, studies of trade liberalization in Europe and other areas suggest that trade liberalization increases the proportion of trade with countries of similar per capita income and spending patterns. Hence, cultural similarities may not be a separate factor because they have been fairly constant over time. However, they increase the proportion of the rise in trade which is conducted with neighboring and "similar" countries after trade is liberalized.

## **Summary**

In summary, the observed increase in the share of intra-Asian trade in total Asian trade is explained by several factors. The most important appears to be the effect of higher growth among the trading countries themselves. Another contributing cause is the unilateral reduction in trade barriers. This liberalization has worked in combination with trade and investment facilitation in subnational and SREZs and reductions in transport costs to increase the proportion of total trade carried out within the region.

## **INTRA-ASIAN INVESTMENT**

The interlinkages between the movement of goods and services across international borders and the flow of capital between

countries was alluded to earlier in this chapter. Both flows contribute to increasing economic efficiency either by permitting goods which are produced at lower cost and according to comparative advantage to move across national boundaries or by facilitating the augmentation of production facilities in different countries through the transfer of real and portfolio investment.

The simultaneous liberalization of trade in commodities and capital, coupled with the simultaneous growth in intra-Asian trade, FDI, and portfolio investment along with the triangular pattern of commodity trade and a decline in trade intensities within the region all indicate that the flows of commodity trade and foreign direct and portfolio investment are closely linked.

### **Pattern of Investment Flows**

Since the mid-1980s, the DMCs as a whole have experienced a balance-of-trade surplus with the rest of the world; total exports of goods have exceeded total imports. However, the total trade in goods and services – the current account balance of the DMCs – has been in deficit. The NIEs as a group have a persistent annual surplus on the current account whereas South and Southeast Asia have persistent annual deficits. This means that the NIEs are net lenders or investors to the rest of the world while South and Southeast Asia are net borrowers or recipients of capital funds from the rest of the world. On balance, the deficit on the current account for the DMCs as a whole is small in relation to the aggregate GDP of the region, only 0.3 percent in 1994.

There are many different forms of borrowing and lending, either by the government or the private sector in an economy. Compared to portfolio and other investments, such as official development assistance, bank loans, and export credits, FDI flows are of particular interest. This is especially true when the relationship with international trade in goods and services is considered. FDI is an acquisition which gives the investing company control of the acquired assets and, therefore, the production activities of the enterprises. Thus, FDI represents the internationalization of the production activities of multinational corporations. FDI is, therefore, part of the decision strategy of these corporations relating to the

location of production as well as the sales of the outputs of the goods produced and the sources of the inputs used in their production processes. Since the late 1980s, FDI, along with private portfolio investment, has become the major form of capital inflows for a growing number of East and Southeast Asian countries.

*FDI Flows.* FDI is a two-way flow as almost all countries are both host and source countries for FDI. As FDI results in the acquisition of durable capital assets, the data may be reported on either a flow or a stock basis. Flow data measure the current level of flows or the current additions to stock whereas stocks measure the cumulative values of historical investments. Stock data, therefore, show the aggregate importance of the foreign ownership of productive assets and generally exhibit much lower year-on-year variability. Frequently only flow data are available.

There has been a tremendous upsurge of outward FDI from Japan since the mid-1980s. This outflow was precipitated by the large appreciation of the yen following the Plaza Accord in 1985 and aided by deregulation of financial outflows by the Japanese Government. In the late 1980s and during the 1990s, the Asian NIEs have also become major sources of foreign direct capital flows, complementing the flows from Japan. For the period 1990–1993, outflows of direct capital from the NIEs exceeded the inflows into these countries.

Flows of FDI across national borders have also increased, at about four times the rate of growth of world commodity trade, and those in the DMCs have grown even faster. Inflows of FDI in East Asia rose sharply from an annual average of less than \$4 billion in 1982–1985 to an estimated \$26 billion in 1993. By 1993, the share of East Asia in world FDI inflows had risen to over 26 percent compared with an average of only 9 percent for the period 1982–1986. In terms of world flows, East Asia is relatively less important in the FDI market than in the goods markets. This is because the world flow of FDI is still very much dominated by inflows into the three major groups of industrial countries: the EU, the NAFTA countries, and Japan.

Table 1.3 of Part I (page 20) shows the levels of FDI inflows for the DMCs since 1989. East and Southeast Asia dominate FDI flows in the region. The major host countries have been the Asian NIEs followed by ASEAN.

China is a major recipient of FDI, showing a phenomenal increase in annual inflows from \$3.8 billion in 1982–1985 to \$27.9 billion in the period 1990–1993. From 1992, China has been the largest recipient of FDI in Asia or in the developing countries, accounting for nearly one half of the total inflows into Asia in 1992 and 1993, and the second largest recipient in the world after the US. According to the latest available statistics for 1993, Singapore, Malaysia, Indonesia, and Thailand, in that order, were the other main recipients within Asia.

In 1993, the inflows into South Asia were not much more than one eighth of those into the NIEs or any of the major ASEAN FDI recipients. The outflows from South Asia were then, and continue to be, negligible. Aside from India, none of the countries in this region has reached a stage of development to become a major source of either capital or technology.

The fundamental reason for the difference between flows of FDI into South Asia and those into the countries of East and Southeast Asia, which received large capital inflows in the late 1980s and the 1990s, has to do with the strategies adopted by the two groups of countries. The countries of South Asia, all of whom began liberalizing their economies in the early 1990s, retain some exchange controls, including controls on capital transactions, as well as comprehensive restrictions on the establishment of FDI. They also have much higher border barriers to trade in goods than do countries in East and Southeast Asia.

*Direction of FDI Flows.* Analysis of the distribution of FDI flows by country of source and/or destination is severely handicapped by data limitations. Nevertheless, as of 1993, over 50 percent of the total value of the stock of foreign direct capital in East and Southeast Asia originated from within the Asian region (Figure 3.5). The major source is, surprisingly, the Asian NIEs, followed by Japan. However, the total for the Asian NIEs is dominated by investment from Hong Kong into the People's Republic of China. Some of this is a return of capital outflow from China itself, a phenomenon known as "round-tripping." Japan has been the dominant investor in East and Southeast Asia in recent years, with the NIEs becoming increasingly important. The main destinations of NIE and Japanese

FDI into Asia have been the ASEAN countries, chiefly Thailand and Indonesia.

The South Asian countries, on the other hand, have drawn their limited inflows of FDI from North America and Europe to a much greater extent than have the East Asian countries. Japan has not been a substantial source of FDI for South Asia. The distribution and the level of FDI inflows into South Asia reflect the historical preference for import substitution rather than export promotion strategies, although these barriers to FDI have also been aggravated by political and economic instability.

Keeping in mind the caveat that FDI intensities combine the influence of total size and proximity, the growth in intra-Asian FDI flows parallels the growth of intra-Asian commodity trade analyzed earlier. The intensity of FDI can be measured using the same measure as that used in the analysis of commodity trade flows, except that the countries (or regions) are the host and source countries rather than the importing and exporting countries, and stock rather than flow data must be used because of the unavailability of data on the distribution of flows. For a country investing in another country, the index of FDI intensity measures the share of the investing or source country's investments in the host country relative to the host country's share in total world FDI (less that of the source country). If this index is greater than unity, the source country has a bias toward the host country in locating its investments, as its share of FDI in that country is greater than can be explained by the importance of the host country in world FDI.

The intensities of FDI inflows among Southeast Asian and East Asian economies and Japan are very high (Table 3.3). The average intensity for East Asian countries investing in other East Asian countries is four. Thus, the FDI flows between these countries are four times as high as the importance of these countries in the world flows of FDI would suggest. For Japan and the NIEs, the two major sources of FDI in the region, there are two major trends. First, Japan, with an index just over 3, has a strong bias toward investing in the East Asian region. Secondly, the bias is strongest in the cases of Hong Kong with an index of 10.4, Singapore with an index of 8.8, and Taipei, China with an index of 4.5. Also, the small but rapidly

increasing FDI flows from Indonesia and Malaysia have an even stronger bias toward the Asian region. None of the Asian countries shown in the table has an intensity index below 3, a much higher value than the comparable indexes calculated for intra-Asian goods trade. None of the trade intensities indexes was as high as 3.

Unfortunately, it is not possible to measure the change in these country intensities over time because there are no comparable statistics of the distribution of the stocks of FDI for earlier years. It is likely, however, that unlike intranational trade intensities, these FDI intensities have increased substantially in recent years. The growth of intra-Asian FDI has accelerated and the strategy of relocation of production activities among the countries of the region has intensified.

There are no comprehensive data for Asian countries of the distribution of FDI inflows or stocks of FDI by industry in which the investments are made. It is, however, likely that FDI has flowed increasingly to manufacturing, financial, and other services. It can be inferred that much of the FDI in the DMCs is in intermediate goods production. For example, in Singapore, the export propensity of US affiliates located in East and Southeast Asia – calculated as the share of international sales of foreign affiliates in their total sales in 1992 – was 62.4 percent (UNCTAD 1995, Table IV.4). Many of these exports are intra-firm transactions in intermediate inputs.

### **Causes of Expansion of FDI within Asia**

The explanation of the growth of intra-Asian FDI is complex. The growth of the real output of the Asian economies has undoubtedly made them a more attractive location for investors, including investors from other Asian countries. The rapid relaxation of controls on inward FDI has also played a role. This relaxation involved several elements: greater rights of establishment for foreign investors through relaxation of approval procedures; more complete application of national treatment through the removal of performance requirements on foreign corporations; privatization and other reductions in administrative controls on capital; and factor income movements.

There has been a movement toward liberalization of capital flows in virtually every economy in the world. This stems from the

view that capital movements are desirable because they are beneficial for the host country as well as for the source countries. Basically, the international movement of capital occurs because investors seek the highest returns. Capital moves from locations with lower returns to locations with higher returns. Investments which have positive returns also benefit the host countries as they receive some of the additional income flows as well as the transfer of technology which accompanies the FDI flow. The international movement of capital increases aggregate world output as it tends to equalize the marginal returns on investment. Capital movement in the form of FDI is also an important device for the international transfer of knowledge, know-how, and technology generally, much of which is specific to the multinational corporation. FDI may have other positive spillover effects as well, such as through the demonstration of new technologies and management methods. Today, the main concerns of the host countries are about environmental, cultural, and other adverse side effects which may accompany some investments. For these reasons, some sectors are still subject to prohibitions or restrictions on foreign investments.

The DMCs have generally been ahead of developing countries in other regions in recognizing the possibilities of new production and exports associated with FDI. As noted earlier, many Asian governments promote foreign investments through financial incentives or export processing zones and other modalities.

These proximate factors tell only a part of the story of integration in capital markets, however. The situation of the DMC economies in the world economy needs to be considered to gain a better appreciation of the factors influencing the flow of FDI. In particular, trends in FDI must be related to developments in the markets for commodities. Unlike trade of goods, which takes place primarily as a result of cost advantages and comparative advantage, FDI is a production-related decision which involves operations in a number of different economies and depends, to a large extent, on export prospects in several countries.

From the point of view of the East and Southeast Asian countries, foreign corporations have been a major force in the development of exports, especially of manufactures. For example, in the late 1980s and early 1990s,

Figure 3.5 is a two page spread, goes on 194 and 195



the share of foreign affiliates in national exports was as high as 57 percent in Malaysia (all industries), 91 percent in Singapore (non-oil manufacturing), and somewhat less at 24 percent in Hong Kong (manufacturing), and 17 percent in Taipei, China (manufacturing) (UNCTAD 1995, p. 214).

There has been increasing acceptance of a product cycle model based on comparative advantage to describe this process. The modern interpretation of this hypothesis, originally called "flying geese" by Japanese economists, is one of a changing pattern of comparative advantage in Asia, linked to FDI as a deliberate strategy to relocate activities from the source countries that no longer have a comparative advantage in the production of certain goods, to host countries that do. As it is a dynamic hypothesis and involves links between the patterns of commodity trade and FDI, the flying geese hypothesis is difficult to test. However, individual observations listed earlier are consistent with the hypothesis. Shifts in the pattern of comparative advantage have been verified from empirical studies of revealed comparative advantage. As the first lead goose in the Asian formation, Japan has gone through a sequence of structural upgrading in its manufacturing industries, progressing from the labor-intensive industries such as textiles to a second tier of heavy capital-intensive

industries such as steel and shipbuilding to a third tier of assembly-oriented industries such as motor vehicles, electronics, and machine tools and finally to a fourth tier of high technology industries such as biotechnology and super-conductors. In the later stages of structural change, some of these activities have been relocated by the Japanese firms to the Asian NIEs and, more recently, to the ASEAN countries. In turn, the Asian NIEs have begun to transfer some of the more labor-intensive and less technology-intensive manufacturing activities, which have become noncompetitive, to new locations in the ASEAN countries and China which can now carry out these activities at lower cost.

In this process of shifting comparative advantage, growth in FDI has partly followed, and partly led, the growth in trade in goods and services. This points to complementarity, rather than substitutability, between international trade in goods and services and international flows of capital. This is particularly true, especially if trade results primarily from differences in technology rather than from static comparative advantage.

In the case of Asia, much of the FDI has been directed toward activities which are export oriented and whose outputs are destined mainly to third country markets outside both

**Table 3.3 Foreign Direct Investment Intensities for Asian Countries, 1992**

From/To	Canada	US	Japan	China	Korea	Hong Kong	Taipei,China	Singapore	Indonesia
Japan	0.55	0.54	-	-	78.00	3.61	50.50	16.00	1,212.00
China	0.13	1.08	0.26	-	-	29.52	-	0.63	-
Korea	0.02	0.37	0.17	-	-	1.05	-	5.13	1,790.00
Hong Kong	0.23	0.08	0.24	1,055.50	16.25	-	416.50	99.13	2,595.00
Taipei,China	-	0.97	0.13	-	9.75	4.64	-	43.81	888.00
Singapore	-	0.04	-	-	-	13.06	38.50	-	230.00
Indonesia	0.18	-0.05	-	11.50	-	-	777.00	478.63	-
Malaysia	0.03	0.07	-	-	-	0.27	710.50	417.13	521.00
Thailand	-	1.02	-	-	-	54.88	-	37.69	-
Philippines	-	0.57	-	49.00	-	3.89	3,123.00	11.88	1,491.00
NIEs	4.05	0.10	0.20	835.00	13.00	2.11	335.50	79.44	2,172.00
ASEAN	4.01	0.25	-	17.50	-	2.35	1,357.50	275.69	792.00
East Asia	0.49	0.49	0.02	101.50	68.25	3.47	110.50	28.75	1,318.00

- Data are either zero, negligible, or unavailable.

Source: Bora (1996, Table 2.5).

the host and source Asian countries. As inputs, these activities have used capital goods and upstream intermediate inputs supplied by Japan and other foreign investors. Thus, FDI is associated with both import and export trade in goods. Much of the FDI into East Asia has come from Japan and the NIEs, and has been associated with inputs of capital and intermediate goods. Consequently, the joint operation of these changes in the commodity and the capital goods markets provides a link between the growth in intra-Asian imports of goods and services and that of FDI.

This process of international flows of capital and restructuring will continue. One group of economies which urgently need restructuring and more investment are the Central Asian Republics. These countries have special problems resulting from the recent creation of their independent economies following the breakup of the Soviet Union (Box 3.5).

### Summary

In summary, there has been a very rapid increase in FDI flows in Asia and the pattern of FDI has been changing. The Asian NIEs have emerged as new investors in other Asian countries. The share of intra-Asian FDI in total Asian FDI has increased. This increase is partly a result of the liberalization of FDI in the region and partly the result of the

opportunities for investment created by high rates of growth. It is also partly the result of the liberalization of trade in goods and services which has encouraged the transfer of some productive activities to new, more competitive locations.

In the context of integration of markets across national borders, the liberalization of the commodity and the capital markets in the Asian economies has been superadditive – i.e., the combined effect has been greater than the sum of the effects singly. In the presence of capital market liberalization, the effects of trade liberalization in stimulating trade flows have been greater than they would have been in isolation. For example, much export trade would not have occurred if there had been no export-oriented FDI. Consequently, part of the explanation of the growth of trade in goods and services in Asia is the very rapid liberalization of FDI which has taken place in all countries in Asia and the associated trade in producer and intermediate goods as well as the exports of the final goods from the new foreign-owned enterprises. Conversely, there would have been less FDI in the region if commodity trade had not been liberalized. Part of the explanation of the growth of acquisition of capital assets by foreign corporations is the liberalization of trade in goods and services and the new profit opportunities that this has created.

Malaysia	Thailand	Philippines	Australia	New Zealand	North America	NIEs	ASEAN	East Asia
17.80	–	28.17	12.35	7.00	0.59	9.23	98.06	3.05
4.00	–	–	–	–	0.99	23.43	2.35	3.11
0.50	–	17.83	2.88	16.40	0.34	1.61	137.41	2.69
121.50	–	22.50	9.31	–	0.09	23.66	250.59	10.43
30.60	–	162.83	1.85	–	0.88	10.71	155.65	4.47
60.80	–	19.17	7.71	–	0.04	11.06	318.59	8.75
49.50	–	–	5.63	–	-0.05	87.73	35.76	11.36
–	–	1.33	15.56	–	0.07	77.31	46.59	10.29
–	–	–	–	–	0.93	48.17	–	7.00
1.80	–	–	–	–	0.52	54.84	97.18	8.56
187.80	–	24.67	8.69	0.60	0.11	20.66	263.00	9.77
3.20	–	0.83	9.46	–	0.23	69.72	60.59	9.68
38.10	–	27.00	13.92	6.00	0.52	11.84	117.12	4.00

## INTRA-ASIAN LABOR MIGRATION

If labor were completely mobile across international borders, there would be migration from countries with limited capital per worker and loose labor markets to countries

with abundant capital and tight labor markets. Within Asia, there is ample evidence that such a pattern has evolved and intensified, despite tight control of labor migration by governments. International labor movement is, therefore, much

### Box 3.5 Restructuring in the Central Asian Republics

The Central Asian Republics of Kazakhstan, the Kyrgyz Republic, and Uzbekistan were republics of the former Soviet Union until 1991. Independence brought major problems to these states which required a drastic transformation of their economies.

The transition has not been smooth. Each has to build a national economy based on private markets. Besides these problems, each has to build national institutions and create national economic policies in all areas.

Independence resulted in the loss of much of the trade with the other republics of the former Soviet Union. The pattern of goods and services produced reflected their integration with the central plan of the Soviet Union. There was little trade with countries outside the Soviet bloc. With the breakup of the Soviet Union, many of the markets for their products and many of the sources of raw materials, energy, and other inputs were disrupted. There were supply shortages of all commodities. Trading problems were exacerbated by the dismantling of the ruble zone.

The production infrastructure of these economies had been created for a role within this bloc, much of it for the specialized military-industrial complex of the Soviet Union, and there is little prospect that this infrastructure can be adapted easily for the production of goods and services which can be sold on world markets. Transport, electricity distribution, and other networks were not designed as national systems. Railways and highways which are owned by one country traverse other countries and are important transport and communications links for neighboring countries.

One of the essential tasks for each of the Central Asian Republics is to establish trading links with the rest of the world based on the goods and services which these countries can produce competitively in the context of a world economy. This will require the lowering of border barriers which inhibit international trade. Kazakhstan, the Kyrgyz Republic, and Uzbekistan have liberalized their international trade partially through the removal of

exchange controls and administrative restrictions on exports. Increased trade with outside countries will also, in the case of these economies, require adjustment to new relative prices of goods as subsidies of major inputs are removed and there is a continuation of the programs of macroeconomic stabilization that have recently brought down the very high and destabilizing inflation previously present in all Central Asian Republics.

Besides the need to encourage interaction with the world economy, the three Central Asian Republics have recognized their mutual interests in building up trade among themselves, because of their complementarities, common problems, and common borders. Border barriers can be lowered on a regional basis. To this end, they created an Economic Union in early 1994. Although the name suggests extensive economic integration, to date it has provided only a mechanism for discussion and review of issues of mutual interest. In addition, Kazakhstan has joined the recently created customs union between the Russian Federation and Belarus; two other republics have also been invited to join.

Foreign investment can play a major role in the restructuring of their economies and in increasing their capacity to produce goods and services that can be sold on the world market. The Republics have rich endowments of oil, gas, other minerals, and land. Foreign investment is an ideal vehicle for supplying the technical expertise and other inputs required, including marketing skills.

The development of these economies will require large-scale assistance from international agencies and national aid programs. Given the common origin and similar nature of the problems of these economies and their geographic contiguity, there may be scope for the development of subregional cooperation. The Asian experience with SREZs and other forms of subregional cooperation provides models for the development of subregional assistance, policy coordination, and infrastructure development in these countries.

smaller in relation to stocks of labor than are the corresponding international flows of capital in relation to capital stock. Furthermore, there has been a marked acceleration in the scale of labor movements within Asia and an increase in intra-Asian movements as a proportion of total Asian flows of migrants worldwide.

### **Patterns of Labor Migration**

The pattern of Asian migration has shifted over the years, especially as income levels in the region have risen. As a result, migration is now chiefly an intra-Asian phenomenon. In the past, labor movement from Asia – particularly from China and Japan – was to the US and other industrial countries, a process which began in the late nineteenth century. Until recently and for nearly 100 years, Asia had been a region of net emigration, with little immigration.

As with international trade and capital movements, labor flows are two-way. Asian countries with surplus labor and limited capital tend to be labor exporters; hence, there is net emigration. In countries with large capital stocks and low levels of unemployment and underemployment, there is net immigration or labor importation. The Philippines – a country where income stagnated for many years, and which has a high level of unemployment and underemployment – is the largest net exporter of labor in Asia and the second largest in the world after Mexico. Migration from the Philippines is varied, with North America and the Middle East being the favored destinations. Its pattern of emigration reflects its close historical ties to the US and the relatively high level of numeracy and English language literacy attained given its standard of living.

Many low-income countries in South Asia, where labor markets are loose, are also important suppliers of labor to the world market. Bangladesh, India, Pakistan, and Sri Lanka are all large suppliers of mainly unskilled contract workers. A decade ago, the flow of these workers was quite high, with their primary destination being the Middle East. However, the numbers have fallen in the 1990s owing to the Gulf War, the fall in the price of crude oil, and the completion of major infrastructure projects in the Middle East.

The ratio of emigrants to immigrants varies widely across countries in East and Southeast Asia. Within these diverse groups of countries, international labor balance and current labor migration experiences can be divided into three categories: countries that are primarily labor importing, those that are primarily labor exporting, and those that import certain types of labor and export others. In the aggregate, East and Southeast Asia still constitute a net emigration region. Nevertheless many countries in this region have made dramatic improvements in their living standards over the past two decades and are quickly becoming net labor importers as the rate of immigration grows relative to emigration.

The higher income countries such as Brunei Darussalam, Japan, Singapore, and Taipei, China are primarily labor importing. These countries have emerged as the new destinations for migrant labor because of their higher real wages and tight labor markets.

Besides the Philippines, the primarily labor-exporting countries which are located at the lower end of the income scale include Indonesia, China, and Viet Nam, ranked in that order in terms of the number of emigrants. Due to their particular historical circumstances and different sectoral features, some countries, including Hong Kong and Korea, import some kinds of labor and export others. For example, despite its high level of income and tight labor market, Korea still has a modest number of contract workers in the Middle East, while Hong Kong's close relationship with China involves sizeable flows of labor in both directions.

Malaysia and Thailand also export some types of labor and import others. However, these two countries are shifting rapidly from being primarily labor-exporting to primarily labor-importing countries.

Statistics of the current migration situation of countries in East and Southeast Asian are reported in Table 3.4. The data on legal immigrants and emigrants are flows; those of legal aliens and workers and illegal workers are stocks. The two sets are not, therefore, directly comparable. Interestingly, annual emigration from Hong Kong is higher than the status of Hong Kong as a labor-exporting country with a small population and high per capita income would otherwise suggest. This is because labor emigration is a family income-diversification strategy.

Following the dramatic increase in the price of oil in 1973, the flow of workers to the Middle East oil-producing countries grew rapidly. Subsequently intra-Asian labor migration began to grow. It began on a significant scale as real wages within the East Asian region rose and labor markets tightened. The flows have diversified both in terms of destination countries and the occupations of migrants. While the Middle East remains the principal destination of contract workers, there are significant and growing flows to other destinations, notably workers from Bangladesh to Malaysia, Singapore, and Korea; workers from Thailand to Taipei, China; and a growing diversity of movements of semi-skilled and skilled workers within the region (Box 3.6).

### Causes of Labor Migration

Why does international labor migration take place? Although opportunities in the host country also play a role, to a large extent

migration reflects internal labor market conditions in the sending country. Put simply, there will be more emigration (immigration) where labor markets are loose (tight). There is, in turn, a close relationship between inter-country differences in these external labor flows and the fact that countries are at different stages of what has been called the migration transition (Box 3.7). Furthermore, the net movements into Asian countries are changing rapidly because of the speed of the economic and demographic changes in the region. For example, Korea was a major supplier of labor to the Middle East between the mid-1970s and the mid-1980s; however, the number of Korean workers in the Middle East is now insignificant and Korea has become a destination of migrants from some other Asian countries.

As the migration transition proceeds, shortages emerge in particular sectors. After domestic reservoirs of flexible labor are exhausted, employers press their governments for access to foreign workers, and countries

**Table 3.4 Migration Status in Seven Labor-Importing Asian Nations**

Country	Migration Turning Point	Legal Emigration to US, Australia, Canada, New Zealand 1992	Contract Labor Departures	Total Legal Aliens, Foreign Work Force, Legal Immigrants Annually	Illegal Labor Force (estimates of predominant mode)
Japan	mid-1960s	14,997	--	1,218,891 <sup>a</sup>	296,751 (overstayers)
Taipei, China	late 1960s	27,881	--	177,000 <sup>b</sup> or 20,000 <sup>c</sup>	40,000 (overstayers)
Hong Kong	early 1970s	67,093	--	95,425 <sup>c</sup>	27,000 (clandestine entries annually)
Singapore	early 1970s	2,894	--	150,000 – 170,000 <sup>b</sup>	12,000 (clandestines apprehended in recent year)
Korea	late 1980s	23,628	83,000 (1988)	33,600 – 80,000 <sup>b</sup>	100,000 (overstayers)
Malaysia	late 1980s	7,003	--	134,000 <sup>b</sup>	400,000 (clandestine)
Thailand	mid-1990s	56,130	137,950 (1993)	--	300,000 – 520,000 (clandestine)

<sup>a</sup> Legal aliens

<sup>b</sup> Foreign work force

<sup>c</sup> Legal immigrants

Source: Freeman and Mo (1996).

permit or tolerate the entry of foreign workers. All the post-transition Asian countries are having to design new policies to meet these evolving conditions in their labor markets, which are quite similar to those faced in the past by the industrial economies of Western Europe and North America.

### **Two Special Features of Asian Migration**

Much of the emigration from the DMCs, particularly low-skilled workers from South Asia and the Philippines, is temporary in nature and is undertaken for the purpose of augmenting family incomes. In South Asia and the Philippines, remittances are a major source of foreign exchange earnings. Table 3.5 shows remittances in these countries as a percentage of GDP and merchandise exports. In both Bangladesh and Pakistan, remittances make an important contribution to export earnings and to national income. In the Philippines, the contribution of remittances is more than 1 percent of GDP. The country has considerably more contract workers abroad than have the other two countries from a population base which is little more than one half that of either of the other countries. However, remittances as a proportion of overall national income are lower in the Philippines than in either Bangladesh or Pakistan because the Philippines has a much higher level of per capita income.

Surveys of return migrants in the labor-exporting countries of Asia indicate that these workers move from the home country to the host country for a short period only, covering two to five years. This short-term feature of the labor movement distinguishes it from the movement of labor to North America, Europe, and Australia/New Zealand where a large part of the immigration is for permanent settlement. In these latter countries, there has been an ongoing debate about the costs and benefits of receiving permanent settlers. Permanent settlers who move to take employment in the receiving country may be unemployed, at least for a time, or they may increase unemployment among existing residents of the receiving country. They may bring dependents with them. These factors may impose costs on existing residents. On the other hand, skilled immigrants represent an addition to the stock of human capital which for the recipient country is virtually costless to acquire.

### **Labor Migration and Public Policy**

Immigration in all the high-income, labor-importing Asian countries has been strictly controlled and very selective. There is evidence of a strong convergence of basic immigration policies for all these countries toward a set of policies which has been dubbed the 3-S strategy (Freeman and Mo 1996). These countries are seeking skilled workers to take up short-term employment in specific sectors.

Because of tight restrictions on immigration in all Asian countries, there is a large and growing number of illegal migrants throughout the region. The number of immigrants legally permitted into East and Southeast Asian countries with tight labor markets is much lower than the number of potential migrants seeking entry and substantially lower than the flow of workers needed in the productive and services sectors. As a result, there is a large amount of illegal immigration, primarily of unskilled workers, who flow into occupations that local residents are reluctant to fill. Because of proximity as well as cultural and language ties, most of these illegal immigrants are from other East Asian countries.

The strong upward trend in migration within Asia and the concomitant rise in illegal migration raises an important question of the desirability of labor movements. To explore

#### **Box 3.6 Labor Migration in Malaysia**

As a large country in the middle of the migration transition, Malaysia provides a good illustration of the growing diversity of labor movements. Owing to rapid growth since the mid-1980s, Malaysia has become a new destination country while also remaining a major source of labor. The country hosts about one half of all developing Asia's foreign workers and a majority of these are from neighboring Southeast Asian states. There were over 500,000 legal foreign workers in Malaysia in 1994 and perhaps another 500,000 illegal workers, making a total of over 1 million foreign workers. Malaysians also emigrate to work. About 200,000 Malaysians work in Singapore (some of them commute daily between the countries) and others work in Taipei, China.

this issue—recognizing that the effects of international movements differ between the countries of emigration and immigration—the effects of such movements on both sets of countries need to be considered.

Basically, labor, like capital, moves from one country to another to receive a higher income. The differences in real wages across countries arise fundamentally because of differences in the marginal productivity of labor. Hence, the movement of a worker from his or her home country to a foreign country with higher wages and labor productivity will generally decrease the aggregate real output of goods and services of the source country and increase the aggregate real output in the host country. Since the increase in output in the host country is greater than the decrease in the source country, the aggregate output of the world as a whole will be increased and

the per capita incomes in both places may be raised. Additions to the labor force from immigration also result in substantial income redistribution in the host country. This follows as the increase in the stock of labor available to the host economy raises the marginal productivity of capital directly and lowers that of labor, or rather that of the types of labor which are imported. Empirical studies in the US suggest that the income distribution effect of labor inflows is quite large.

While this argument in favor of international labor movements is powerful and correct as far as it goes, international movement of labor has other effects on the countries of immigration and emigration. In the country of immigration, the structure of the population in terms of age and other demographic characteristics, and the structure of the labor force in terms of skills and other labor force characteristics

### Box 3.7 Migration Transition in Asia

In the early 1990s, scholars of international migration observed that the levels of net emigration from each of the rapidly growing Asian NIEs had declined over a relatively short period and some had begun to import a substantial number of workers. This phenomenon was called the migration transition. Attempts were made to date the turning points for the NIEs and to develop an explanation for the transition. Other Asian countries are also believed to be now experiencing the same process.

The migration transition is usually defined as a switch from positive net emigration to net immigration. This is sometimes also referred to as the switch from being a labor-exporting to a labor-importing country, although in the strictest sense, the term refers to all migrants – workers and nonworkers alike. One difficulty with this definition is that the actual flows into all countries and in some countries, such as the Philippines, the flows out of countries, are controlled. There is likely, therefore, to be a large difference between the actual or realized net flow and the potential net demand for migrants in some countries.

Evidently, the change in net migration into a country is the sum of the changes in emigration and immigration. Most of the theories which have been developed to explain the

migration transition have concentrated on changes in emigration from the Asian economies. This is reasonable since emigration is not restricted for the great majority of potential emigrants and, consequently, much of the change in the net flow is determined by the change in the number of emigrants. The most common factor cited as a cause of the decline in the number of emigrants from these countries is the decline in the pool of unemployed labor as the growth of real output increases the aggregate demand for labor.

Several authors have associated the growth in the demand for labor with the success of export-led growth strategies and the opening up of these economies. Others have linked the migration transition to the decline in the rate of growth of the labor force due to the aging of the population and the decline in fertility rates as per capita incomes rise. This explanation was dubbed the demographic transition by earlier demographers.

These views seem to fit the facts. Those countries that have passed the migration turning point all have relatively open economies with higher per capita incomes, low unemployment, and low fertility rates; while those that have not reached this point have less open economies, much lower real incomes, higher unemployment, and higher fertility rates.

Source: Abella (1994).

will be affected. Immigration, especially large-scale or permanent immigration, also has cultural effects. In the countries of emigration, the effects on the structure of the population and labor force are the opposite of those for immigration and there may be additional issues, such as the security of workers, especially that of women. Partly for long-run demographic and economic effects and partly, in some cases, because of a desire to preserve cultural homogeneity, Asian labor-importing countries favor temporary migration and also restrict these flows.

To consider this pattern of labor movement as an integrating factor in the region, labor migration needs to be viewed in the context of changes in real factor prices and comparative advantage over a longer time frame than has been identified for trade in commodities. Notwithstanding the small share of intra-Asian labor movements in the labor markets compared to those of commodity trade and capital (and also compared to intraregional labor movements in Europe and North America) as well as the temporary nature of this immigration, labor migration is an important component of the dynamic changes which are taking place in Asian economies.

Some types of labor movements are plainly complementary with trade in goods and services rather than substitutes for it. Thus, imports of expatriate foreign labor into managerial and skilled labor positions of foreign investors accompany and facilitate the establishment of new foreign enterprises and new technologies. Countries such as Hong Kong and Singapore have allowed the entry of skilled foreign workers into sectors that they are seeking to develop and for which the supply of domestic labor is inadequate. These include industries such as financial services, high technology industries, and universities. Generally, however, Asian countries have not granted permanent residence to immigrants and much more emphasis has been placed on training domestic labor to replace these foreign workers than has been the case in the industrial countries with large-scale immigration.

On the other hand, intra-Asian movement of unskilled or low-skill labor may be a substitute for trade if the immigrant labor is employed in import-substituting industries. The flows of this type of labor have been the most tightly controlled although the level of

unskilled labor migration, including illegal migration, remains high. Both the countries of immigration and the countries of emigration in Asia now have policies giving preferences to the movement of skilled labor. When real wages increase with economic growth, countries face a choice of permitting immigration to maintain the competitiveness of more labor-intensive industries or of restructuring.

As net emigration countries, China, Indonesia, and the Philippines have planned the export of labor as a part of their economic development strategies and are seeking to upgrade their labor exports by supplying more skilled and higher-wage labor rather than unskilled workers. These movements are most important to the Philippine economy. According to Philippine Government estimates, over 4.2 million Filipinos work in 120 foreign countries. This estimate implies that emigrant workers are equivalent to more than 15 percent of the country's 26 million labor force.

**Table 3.5 Share of Remittances to GDP and Merchandise Exports in Selected DMCs (percent)**

DMC	Year	GDP	Merchandise Exports
Philippines	1980	1.9	10.6
	1985	2.6	17.4
	1990	3.3	17.8
	1993	4.7	22.3
Bangladesh	1980	2.2	36.1
	1985	4.0	50.2
	1990	3.7	46.6
	1993	4.2	44.1
India	1980	1.6	32.7
	1985	1.1	25.6
	1990	0.7	12.4
	1993	...	...
Pakistan	1980	8.9	82.1
	1985	8.7	97.2
	1990	5.5	40.4
	1993	3.3	23.7
Sri Lanka	1980	3.5	13.1
	1985	3.9	17.7
	1990	4.6	19.9
	1993	5.4	19.8

Source: Quibria (1995); and International Monetary Fund (1995a).

Producers in Asian countries generally have accepted the changes arising from industrial restructuring induced by their own country's unilateral liberalization of trade in goods and services and the changes in relative factor prices which have occurred with trade liberalization and higher real wages. In Japan and more recently in the NIEs, when the international competitiveness of industries has fallen, firms have sought to restructure their industries or to relocate them in other countries. Outward FDI has been used as a vehicle for maintaining the global position of firms while retaining those segments of the production chain which remain competitive in the source countries. Employees have accepted this process of planned transformation and restructuring because of the emphasis on labor training and retraining and rapid increases in their real wages.

In this long-run context, restrictions on immigration of lower wage workers and the admittance of workers with skills in short supply have accelerated the movement of these industries up the technology ladder in the new labor-importing countries of East and Southeast Asia. Similarly, the admittance of workers with lower levels of skills in services industries which are not tradeable, because the service provider must be located in the country in which the consumer or user of these services resides, may also be complementary to the international trade in goods, and benefits the labor-importing countries. Construction workers in Japan, Taipei, China, and other NIEs are an important example of this type of complementarity.

Finally, the temporary nature of immigration has increased labor market flexibility in the host countries. Labor markets in East and Southeast Asia are generally much more flexible than are labor markets in most industrial countries. This labor market flexibility has been an important factor in permitting rapid restructuring of production in the countries of East and Southeast Asia, especially as the restructuring of outputs required the re-allocation of labor among activities and locations in these countries.

### **Summary**

In summary, the pattern of migration in Asia has changed markedly. International movements of labor have responded to the changes

in incomes in the region, which have followed from the opening of these economies. Several countries in East and Southeast Asia which have had high rates of growth for a long period have become new countries of destination for emigrants. Some have switched from net emigration to net immigration. Asian migration is now chiefly intra-Asian migration, although Asia as a whole is still a net emigration area. These changes reflect changes in relative per capita incomes, unemployment rates, and other features of labor markets in the region. They have posed new policy problems for those Asian countries which are now countries of destination for potential emigrants from other Asian countries.

### **INTEGRATION IN THE ASIAN REGION**

Previous sections of this chapter have noted increased intra-Asian shares in the markets for goods and services, capital, and labor. The growth of intra-area trade can be evidence of integration of a region. Greater intra-area trade in goods and services and factors is also evidence of greater interdependence in the sense that a larger part of the sales of producing enterprises are sold to other countries in the geographic region, a larger share of the purchases of inputs are sourced in the region, and a larger part of FDI and labor inflows come from other countries in the region. These developments link the economies more closely and have important implications for economic policy-making at the national and regional level. For example, macroeconomic shocks are transmitted more strongly through economies that are more interdependent.

However, in its purest sense, economic integration is understood by international trade economists to refer to the integration of individual markets across countries. It may apply at the national level or for a group of countries (an economic region) or for the world economy. One market is completely integrated when competition is unrestricted by intercountry differences in access to national markets and by taxes and other government interventions, and it results in the "law of one price" prevailing in all of the countries. A group of countries is completely integrated if all markets are completely integrated in these countries. Given this definition, the

appropriate test of integration is the conformity of national prices with the law of one price.

Convergence of prices across countries results directly from the removal of barriers to the international trade in the commodities or assets concerned. Obviously, the freeing of trade in some market is a policy which contributes toward convergence and applies both to goods and services as well as to factors of production.

To the extent that economic integration occurs, it brings greater interdependence. Nevertheless, it is useful to distinguish between economic interdependence and economic integration. Two or more national economies may have reached a high degree of integration but have a low degree of interdependence in terms of the proportion of trade carried out between them. For example, Australia and New Zealand have reached a high degree of integration due to a vigorous program of bilateral liberalization; however, the share of the total trade in goods which is conducted with each other was less than 10 percent in 1993. This is because the comparative advantage of the two countries lies chiefly in trade with other countries. Conversely, a group of countries may have a high level of intra-area trade without being well integrated, as was the case of the European Community countries before the development of the EU.

Conversely, it is possible to have a high level of trade as well as convergence toward the law of one price, particularly if the economies involved are small. The states of the US are a case in point. Evidence points toward convergence of incomes, and there are few if any impediments to the free flow of capital and goods and services among the states. Nevertheless, because of their size and differences in comparative advantage, each state depends on other states for much of its goods and services as well as capital.

As noted earlier, the growth of intra-area commodity trade reflects, in large part, greater trading opportunities between growing economies and is not in itself evidence of a greater intensity of intraregional trade. On the other hand, there appears to have been an increase in the intensity of both capital and labor movements within Asia.

There needs to be, therefore, an independent test of greater integration in Asia based on price convergence. An empirical convergence

test based on the hypothesis of greater integration should be applied to the prices of all commodities and factors. A partial test of convergence could be applied to either goods and services or to factor prices separately.

So far, no convergence test of greater economic integration has been carried out for commodity prices or factor prices in the Asian region. Hence, it is not known if there has been price convergence. Evidently, very large differences in factor prices persist in the region. National income per capita is a weighted average of factor prices and is largely determined by the average real wage. Excluding Japan, the richest Asian nations have per capita incomes that are more than 50 times that of the lowest incomes in Asia.

ASEAN illustrates the continued diversity of prices and the incompleteness of the integration process. In 1993, intra-ASEAN exports were 21 percent of total ASEAN exports and intra-ASEAN imports were 18 percent of total ASEAN imports. This intra-area proportion is low when compared with the flows among the East Asian countries. This is surprising, given the proximity of the ASEAN countries with each other, their outward orientations, and the fact that ASEAN is the only free trade area in the East and Southeast Asian region. Moreover, the largest bilateral intra-ASEAN flows all involve Singapore. Most of this is reexport trade in the broad sense, with the goods traded regionally being incorporated into final goods or more processed goods which are then exported outside the region, principally to the US and Europe. Most of the inflows of capital to the ASEAN economies originate in Japan and the other non-Asian industrial countries.

There is one set of markets in which there have been empirical studies of price convergence (Box 3.8). This is the market for financial assets. As in commodity markets, the ultimate reason for considering the question of greater integration in markets is that an integrated set of markets is efficient in supplying goods and services to these markets. In the case of financial markets, differentials in the rates of return across markets mean that some lenders are not receiving the highest returns and some borrowers are paying a higher price for capital borrowing than they would if the markets were integrated. Integration of capital markets across countries also spreads and reduces risks in the

global markets. Integration, especially of portfolio capital markets, can actually increase the risks in national markets if international investors lose faith in the assets and thereby destabilize some asset and foreign exchange markets. On the other hand, integration imposes more discipline on government macroeconomic policymakers and may, in the long run, lead them to avoid policies such as the maintenance of unrealistic exchange rates which exacerbate this national instability.

Comparable data on rates of return are available for interest-bearing assets only. For these markets, the studies reach the qualitative conclusion that there has been greater integration. There is, unfortunately, no evidence relating to stock market returns which are arguably more important as FDI is a major vehicle for the international transmission of technologies and management methods.

Perhaps the most important aspect of price convergence or divergence is whether average real per capita incomes have been converging or diverging among the Asian nations. This

is an aspect of factor price convergence since per capita national incomes are an average of factor prices. This question is critical for policymakers and especially for countries seeking to emulate the success of the fast-growing countries.

The studies reviewed in Box 1.1 in Part I of this *Outlook* (pages 14–15) showed that there has not been convergence of incomes among the countries of Asia when viewed collectively. This conclusion is broadly consistent with the observations about the pattern of trade in goods and services and factors reviewed previously. The dominant trade in manufactures is still based on large differences among countries in real incomes and real factor prices which have led to intra-regional specialization. The flying geese model and the associated pattern of FDI flows, the pattern of intra-Asian labor movements, and the formation of SREZs in East and Southeast Asia are based on these differences. Indeed, the geographic region of East and Southeast Asia is probably much less integrated than is

### Box 3.8 Financial Market Integration in Asia

Several studies have examined integration of capital markets in Asia. The main question examined in these studies is whether there has been integration in these financial markets. The starting points have been the definition of a completely integrated market for an asset as one in which the law of one price prevails. That is, for a particular asset with a given risk profile, the expected rates of return, which are the appropriate prices in these markets, are equal across countries if the market is completely integrated. Thus, the degree of convergence of the rates of return on assets is the test of the degree of integration in financial markets.

A first and indirect approach to this question of greater integration is to examine the magnitude of flows of gross and net capital into Asian countries as a proxy for direct observation of price convergence. This approach suggests greater integration of financial markets in East Asia over the 1980s and 1990s. Bond placements in international markets by Asian countries have grown rapidly in the

1990s and have become a major source of finance. Foreign direct investments and portfolio stock investments have increased dramatically in most Asian countries. This rapid increase in capital transactions across national borders in Asia and the increase in the proportion of these transactions which are intra-Asian are consistent with greater integration. This approach, however, is rather crude and several objections can be made. The increase in these flows may be due in large part to the increase in the size of the markets themselves, not merely to an opening up of the markets to international transactions. Also the use of balance-of-payments measures of long-term capital flows aggregates many different assets; the returns and risks from holding stocks or a majority interest in a company are very different from those associated with the holding of interest-bearing assets.

Direct evidence of the convergence of asset returns is scant. It is confined to interest-bearing assets only and looks at the markets of one country compared to the markets abroad.

Sources: Chinn and Frankel (1994); Frankel (1989); Frankel and Chinn (1993); Glick and Moreno (1994); Montiel (1994); and Riedel (1995).

the EU or North America in terms of the degree of price uniformity.

However, the results summarized in Box 1.1 do show convergence among the subset of countries which have had relatively open economies. This is not surprising, given the substantial degree of liberalization which has taken place in these economies. Convergence in these economies is due to both the liberalization of trade in goods and services and the liberalization of trade in capital. Labor market integration through greater intra-Asian labor movements has probably played a much weaker role.

This finding of convergence among open economies is a most important result. It shows that openness has not only raised the incomes of these countries through increased efficiency, but it has tended to be an equalizing factor through income convergence.

What distinguishes East Asia in particular from other regions is that it is becoming more interdependent without discriminatory regional preferences in border trade and

investment flows or actions to harmonize tax rates or business laws or exchange rates within the region. Indeed, the nonpreferential liberalization of both commodity and factor trade has enabled these countries to increase the intensity of their trade with countries outside the region, once allowance is made for the changing size of the markets.

It is important to recognize the synergy of the liberalization of trade in goods and services and of trade in capital. Convergence of prices in one market or one set of markets may lead to convergence in the prices of other, but related markets. Here, two sets of markets can be considered: those for the goods and services which are traded internationally and those for the primary factors which are assumed not to be traded internationally. These two sets of markets are connected by input-output relations. If there were completely free trade for all goods and services in the world economy, this would lead to the equalization of the goods and services prices across all countries – the law of one price

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Complete integration would result in interest rate parity across the countries. Incomplete integration would result in differences in nominal interest rates between the home market and those abroad, after allowing for the expected rate of appreciation or depreciation of the currency and the currency risk, and expected rates of inflation. In practice, the best that can be done is to calculate the uncovered interest rate differential, that is, the nominal interest rate differential adjusted for the expected rate of currency appreciation or depreciation since most Asian countries do not have forward exchange markets. A variant of this approach, used by Glick and Moreno (1994), is to examine the pattern of co-movements of domestic and international interest rates over time.

This evidence tends to confirm the qualitative conclusion of greater integration in the main financial markets in East Asia. It can be regarded as providing weak evidence of the integration of the financial markets in general since stocks and bonds are

generally close substitutes for many investors as they are alternative forms of earning a financial return.

The studies indicate greater integration among the financial markets of Hong Kong, Singapore, and Thailand. This is not surprising, given the greater development and depth of the markets, deregulation of these markets, and the establishment of offshore financial centers in Hong Kong and Singapore in particular. It is perhaps surprising that the markets of Indonesia and Malaysia are not better integrated with the world financial markets as both countries have removed most restrictions on capital mobility. There have been no tests of convergence conducted for the South Asian countries, but the much lower levels and rates of increase of capital flows between these countries and the rest of the world, and the much lower levels of intra-Asian trade in capital assets for these countries, have been taken by some as *prima facie* evidence of a lesser degree of integration of these capital markets with those elsewhere.

would hold for all goods and services markets throughout the world. The equalization of the prices of the produced commodities would, in turn, lead, under certain well-known conditions, to the equalization of the prices of nonproduced or primary factors used in their production. This holds even if the factors are not traded internationally.

The question is whether the partial freeing of commodity trade will lead to factor price convergence. Convergence of the prices of produced goods and services will imply convergence of the prices of immobile factors if the technological differences among countries are not great and other conditions apply (Falvey 1995). Conversely, the convergence of factor prices implies the convergence of the prices of produced commodities under certain conditions. In these circumstances, the integration of goods and services markets will spill over into factor markets and vice versa.

The growing sense of cohesion among these Asian economies may be due in part to the commonality of policies which affect significantly the rate of growth of real output and income over time, going beyond the traditional focus of economists on border policies which integrate national markets. These policies include those which affect national savings rates, capital formation and infrastructure development, education and other forms of human capital formation, and technology updating. There is a coherence in their policies with respect to international trade in goods and services and in foreign capital and labor movements. Inflows of foreign capital and the restrictions on the inflows of unskilled labor have accelerated structural change toward higher-technology activities and the increase in domestic household incomes. Regional and subregional efforts are leading to greater cooperation in these areas.

### **Summary**

In summary, there is no direct evidence of price convergence among Asian markets, apart from some studies of specialized financial markets. The increase in the intra-Asian shares of the markets for commodities and factors is not proof that these markets have become more integrated. Intensity indexes which remove the effect of the size of the market are

a better indicator of integration. Intensity indexes have probably increased for FDI flows and for labor movements; however, they have not increased for goods trade. Nor do real per capita incomes seem to be converging in Asia generally. There is evidence, however, that real incomes have converged for the relatively open economies. This is an important and powerful finding as it shows that growth in open economies has an equalizing effect on incomes across countries.

### **CONCLUSION**

Economic cooperation among Asian countries has gained considerable momentum in recent years, especially in the 1990s. It has taken a variety of forms, ranging from formal regional trading agreements among groups of Asian countries, to less formal but innovative arrangements of the subregional level, with highly focused, pragmatic objectives, to schemes of sweeping vision (such as APEC) encompassing countries both within and outside Asia. An important feature of most is that they are not designed to make gains for their participants by discriminating against third parties but are intended to be trade-creating rather than trade-diverting. Indeed, in recent years, many countries in Asia, even those belonging to formal or nonformal cooperation arrangements, have continued to make unilateral reductions in tariffs and other barriers to trade. Thus, the expansion of economic cooperation is seen as centered firmly in the context of the broader policy of openness to the rest of the world – a policy that has paid rich dividends in terms of growth and affluence to those Asian countries that have embraced it in the past.

A central point is the search for efficiency in the use of the physical and human resources available to a country as the foundation for long-term growth of incomes. That means, in turn, the adoption of policies that are conducive to this end, especially openness to trade and exchange with the rest of the world. This allows structural change of an economy to occur readily as comparative advantages change in response to evolving differences among countries in incomes, human resources, and receptivity to technological changes whose long-term impact on comparative advantage may not be easy to discern.

Policies of openness to trade and exchange with the rest of the world are more likely to achieve this state of affairs than those that are inward-looking. International exchange of goods and services makes available goods and services both as intermediates and for final consumption which either cannot be produced in an economy or can be produced only at higher cost than elsewhere. Such exchange has further profound effects on the structure and functioning of markets and in changing comparative advantages over time. Increased access to domestic markets for producers in other countries increases competition in local markets, increases specialization, makes producers more receptive to the acquisition of new technology and, in general, makes markets increasingly responsive to changes in products and production methods in the global economy. Complementing the expansion of trade in goods and services among Asian countries and between them and the rest of the world that has occurred in recent years, capital flows into and within the region have also increased sharply. Many imports and exports of goods and services are associated directly with FDI. FDI has aided the export drives of Asian countries, especially those in East and Southeast Asia, by improving their access to markets, lowering their costs of production, increasing their access to new technology and facilitating their specialization in profitable and growing segments of markets for manufactures and services.

There are important relationships between the intercountry movement of goods and services, on the one hand, and capital and labor, on the other. Changes in these markets are interactive and complement each other. There have been significant changes in recent years in the flows of skilled and unskilled labor among countries in Asia, although for the most part, they remain tightly controlled and often are directly related to the needs of export industries.

The simultaneous liberalization of trade in commodity and factor markets has resulted in a greater increase in trade than if the liberalization had proceeded separately. Joint action in commodity and factor markets has increased the benefits of liberalization both in terms of greater economic efficiency and in stimulating growth.

The opening up to freer trade in goods, services, and factors has had profound effects on many Asian economies. A continuation of this process is desirable in all Asian countries, particularly those which have only recently begun to liberalize trade in commodities and in capital movements. The expansion of existing regional trade arrangements or the creation of new ones should be accompanied by the lowering of barriers to international trade and investment vis-à-vis all countries. Openness needs, of course, to be supplemented by other policies important for human capital formation and for increasing factor supplies, productivity, and economic growth.

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