

Harnessing Regionalism for Economic Growth and Development in Asia and the Pacific

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1. In the brief time that I have, I would like to outline my interpretation of the regionalism trend in Asia from a variety of perspectives. I will couch my remarks with general reference to the ADB's excellent survey of regionalism in the recent *Asian Development Outlook 2002*, as well as the highly comprehensive treatise on new regional trading arrangements by Professors Robert Scollay and John Gilbert ("New Regional Trading Arrangements in the Asia Pacific"). While I agree with much of their analysis, I would like to add my views and recommendations regarding this new, exciting and potentially highly productive trend in the Asia-Pacific. In particular I find that, apart from their impact on trade, regional and subregional trading arrangements (RTA's and SRTA's) can have wider and deeper effects on economic growth.

Regionalism and Subregional Trading Agreements

2. Regionalism has become a critical part of the new international trade order. The GATT/WTO has been notified of over 200 regional trading agreements; 150 are currently in force. This is a ponderous figure, given that the backbone of the GATT/WTO is supposed to be non-discrimination! Its founders allowed for exceptions (with conditions) under Article XXIV, but the "exceptions" are proving to be the rule. Moreover, the trend is fairly recent with over 100 regional trading agreements being established since 1995.

3. While Asia was characterized by a very few concrete regional integration agreements prior to the 1990s, it has seen a wave of new accords and proposed agreements in the 2000s. Many Asian countries are breaking with a strong history of multilateral activity, discussing and implementing regional preferential arrangements. The new regionalism has initially proceeded more rapidly in financial area (e.g., the Chang Mai initiative). But with decreasing reoccurrence

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of financial crises, the ASEAN plus three have been shifting more to the direction of a free trade area.

Economic growth in South Asia has been very rapid for some time and several attempts have been made at regional cooperation such as SAARC, but these are not included in this paper.

4. The proliferation of SRTA's in the Asia-Pacific region represents a significant new departure in the approach to trade integration in the region and raises questions on APEC's future role in the evolution of trade liberalization. Asia-Pacific trade relations appear to be at a point from which they could move in several different directions. Further proliferation of SRTA's, the gradual emergence of an East Asian trade bloc, and a renewed commitment to APEC (either in its present form or new variation) are all possibilities. The ultimate direction will of course be heavily influenced by the region's major economic powers.

5. The important question is why have East Asian countries changed their direction toward preferential arrangements.

(a) It should be remembered that regionalism in Asia—as well as in the rest of the world—has a strong political content. All major regional trading agreements essentially have political goals at their foundations. Indeed, certain accords exist in which the economics were not strong but the politics were over-riding; the opposite has never been true. Hence, when considering where Asian regionalism should be heading, one must keep in mind that the trend is not merely about economics.

(b) At several points throughout the past 30 or so years since the inception of ASEAN, observers have questioned the relevance of a grouping of Southeast Asian countries. Efforts over the years to increase economic interdependence and reduce trade barriers between the countries have been tentative and progress slow. Yet in my opinion, this does not make ASEAN irrelevant. ASEAN continues to improve collaboration among first five and now ten culturally and economically divergent countries. This grouping has fostered peace and stability in the region. And unlike other free trade areas among developing countries, ASEAN has continued to move

forward. Its slow pace has allowed ASEAN to reach its goals over time. Its Post Ministerial Conference where ASEAN interacts with its dialogue partners such as Japan, the United States, China, Korea, and others have played a major role in fostering APEC and other regional cooperation efforts. International cooperation is, of course, critical. But sometimes we need regional solutions to regional problems.

- (c) This is why I continue to argue for the “ASEAN Way” of negotiations. These agreements should be seen as a means not only of integrating economies, but also of strengthening bilateral and plurilateral partnerships more generally. Thus, an overly-ambitious program might be counterproductive. In my view, developing Asia is not yet ready for NAFTA/EU type formal accord and such rigid agreements.

- (d) Previously Japan hesitated, even insisting, for example, that the original (all-East-Asian) Australian proposal to create what was to become APEC must include North America. Recently, however, Japan has demonstrated that it is, indeed, ready to play a leadership role in Asia itself, e.g., in negotiations that concluded with agreements with Singapore, South Korea, and ASEAN in the area of trade, and in the Chiang Mai and related initiatives in the area of finance.

- (e) Asia was quite disappointed by the way the West handled the Asian Crisis. There is a strong feeling in Asia that it needs to look after itself, while still maintaining its traditional partnerships outside the region. That is, regional integration can take place within a framework of open regionalism. In fact, many policy-makers in the region, as well as economists, have become convinced that open regionalism, that is, regionalism that seeks to integrate economies with the world (rather than create a discriminatory bloc), can be beneficial to short-and long-term economic development. Open regionalism can be the basis for associated economic and political economy reforms, or a less-dramatic, but required stepping-stone process of structural adjustment.

(f) While the aggressive regionalism programs in the region's major markets (the United States and Europe) could lead to considerable trade and investment diversion in certain sectors, the trend has given the impression -- true or false -- that regionalism is beneficial to economic development. Recent European integration—first in the form of the Single Market Program and then monetary union, and the North American experience under NAFTA all seem to be big successes. The “bandwagon” rationale always needs to be given some credit.

(g) This change in perspective allows now for closer cooperation between certain countries in the region in a way that was not possible prior to the Crisis. In particular, it lowered resistance in some countries to larger Japanese leadership.

6. It is, of course, natural to ask if this process is just building the East Asian Economic Group (EAEG), proposed by Prime Minister Mahathir in December 1990, from the bottom up. It certainly seems that way, except that it is not “Asia only” (Australia and New Zealand have also been taking part). Moreover, Mahathir conceived of the EAEG as a “bloc” without any real commitment to open regionalism. The new regional accords are likely to be quite outward-oriented, certainly more outward-oriented than emerging agreements in the Americas and in Europe.

APEC and Asian Regionalism

7. Thus, Asian regionalism has been picking up. But where is this trend heading? An obvious question is whether these agreements can be successfully “nested” within APEC, or if they will compete with it. To answer this question, we first must take stock of what has been happening in APEC. While there has been some progress in trade facilitation under APEC, as well as increased consultation on finance-related matters since the Crisis, the ambitious “Bogor Vision” of open trade and investment by 2010 (2020 for developing countries) appears to be on hold. Although every year, countries table what appear to be impressive Individual Action Plans (IAPs) towards the Bogor target, in reality these tend to be merely commitments already made under other agreements, especially the Uruguay Round. APEC “value added” in trade

liberalization is very low, at least at this point.

8. Still, APEC remains an important regional institution—one that embraces both sides of the Pacific. The rationale for its existence derives fundamentally from the highly integrated nature of the Asia-Pacific trade and investment; the importance of these flows and the interdependence of Asia-Pacific economies will remain, whatever the future of regional trade governance.

9. To summarize my remarks to date and focus more specifically on the role of APEC, let me turn to the excellent volume by Professors Scollay and Gilbert and their path-breaking Computational General Equilibrium (CGE) modeling project, in which they calculate the effects of these RTA's and SRTA's on partner and non-partner countries. In this exercise, they include several theoretical initiatives, as well as two possible APEC scenarios: non-discriminatory, concerted liberalization ("APEC MFN") and a traditional APEC FTA. They note that the former is more consistent with the stated goal of "open regionalism." Although there is no universally accepted definition of this term, the APEC MFN scenario is then used as a benchmark for the other agreements.

10. Several interesting and important results obtain. First, the APEC MFN tends to generate the best results for the Asia-Pacific region. APEC MFN causes regional GDP to rise by 0.56 percent. Moreover, many non-member countries gain (including the EU) and global GDP rises by 0.36 percent. Hence, this is a strong argument for APEC "open regionalism" as a building-block toward global trade liberalization.

Interestingly, if the United States is excluded from the APEC MFN simulation, the results do not change much, presumably because the United States is already an open market. However, the non-discriminatory APEC MFN results are not much better than an APEC free-trade area, i.e., with discrimination. In the aggregate, they are almost identical for the region. Not surprisingly, global liberalization is always best, with results exceeding any other scenario by at least 50 percent.

11. The other formidable finding of the exercise is that in comparison with results for a

Western Pacific trading bloc (basically APEC minus North America), APEC MFN liberalization shows significantly higher welfare. In this comparison, an equally cogent case can be made for either APEC preferential liberalization or APEC MFN liberalization. Thus an APEC preferential trade arrangement might well be viewed as a possible option if APEC MFN liberalization is not seen as a viable alternative to the prospect of a Western Pacific or East Asian trade bloc.

12. Thus the simulations show that APEC must be the major player in a highly dynamic quest for trade liberalization. As we all know, East Asian regional cooperation is at its early stages. There are many difficulties and much uncertainty that lie ahead. What route APEC can take will either be the result of political reconsideration by the major powers (the United States or Japan) or economic contingencies that presently statistical calculations cannot predict or confirm.

13. Hence, I fully agree with Professor Scollay and Gilbert and many other close observers of Asian development that successful pursuit of strategies designed to blend regionalism benefits into a multilateralism framework will require political leadership at the highest level; Without this, the risks are high that choices made will lead to increasing trade conflict and lower regional economic welfare. Alternatively the region may become submerged with a proliferation of preferential agreements, which point to a suboptimal or at best, second-best, regional outcome.

14. I believe the United States now has the opportunity to place a higher weight on its activities in APEC. First, President Bush now has (“fast track”) Trade Promotion Authority, which gives him more leverage to act; second, his support for the Free Trade Area of the Americas (FTAA), which he said in his election campaign was a priority, is in deep trouble, with economic crisis in Argentina and a newly elected left-wing government taking control of Brazil; and third, the United States is becoming nervous (rightfully so) about losing ground in Asia. A re-invigorated focus on an institution that espouses open regionalism can enable U.S. to reassert its global leadership in the multilateralism that has been the basis for its international economic policy.

Building Bloc or Stumbling Bloc?

15. Despite some critics who believe that regionalism can be a “stumbling bloc” to global integration, neither simulation nor economic accords in Asia and the Pacific have negatively affected member-states’ commitments to the letter or the spirit of the WTO and other global organizations. I would make an even stronger case than does the ADB in arguing that it has been a salutary trend. Certainly it is consistent with multilateralism: the large increase in trade liberalization and growth in trade in the Asia Pacific region has coincided with rising regionalism. Majority of regional economies are members of the WTO or are at various stages in the application process. In fact, WTO applicant countries see regionalism as a stepping stone to WTO membership; none harbor the illusion that regionalism can be a substitute for multilateralism.

16. Hence, in the “building bloc” versus “stumbling bloc” debate, I am more persuaded by arguments espoused by the former. But, of course, the other camp has its legitimate reservations. In particular, my support comes with a *caveat*: the nature of the agreement and the policy orientation of its member-states are of the essence. Outward-oriented agreements tend to be not only consistent with multilateralism, but indeed, they advance it. This is the ASEAN experience and, looking at the ASEAN-China agreement, Japan-Singapore, etc., I am convinced that, with a few sector-specific exceptions, this is the case in the other arrangements in the region as well. However, inward-looking regionalism especially in developing countries—and this has often been the case in Latin American and African groupings-- tend to be counterproductive.

17. One danger of the regionalism trend is that we could be heading for a three-bloc world. Paul Krugman has noted theoretically that this would be the worst outcome for global welfare, and many others believe that such an eventuality could lead to the downfall of the WTO. I believe that this view is overly pessimistic. First, while subregional and regional arrangements do tend to be geographically based, many of those accords are inter-regional. Second, even if three general blocs did emerge (Europe-African, the Americas, Asia), why would the world suddenly withdraw behind their fortresses? The economics behind such a move are weak and political-economy aspects even weaker. Third, the new regionalism trend seems to be outward-oriented overall, suggesting that the risks to the international system are not large.

Besides, to the extent that these agreements rely on trade liberalization, the potential for trade (and, hence, investment) diversion is not high, as tariffs have come down greatly over the years and, therefore, “margins of discrimination” have fallen greatly. For example, at the end of the Uruguay Round, the average tariffs for the United States and EU will be about 3 percent and for Japan, less than 2 percent. AFTA defines free trade to be 0-5 percent! If one throws in the positive gains that can be realized in terms of non-tariff-related trade liberalization and facilitation, services, investment cooperation, etc., the threat seems even less worrying.

18. I am uneasy about the spaghetti-bowl type arrangements that have been emerging in the region. For example, it does not make sense to me that the ASEAN-China framework agreement that is being finalized as we speak (with AFTA negotiations set for next year) should exclude South Korea and Japan, who each would like to reach accords with ASEAN and China themselves. Moreover, ASEAN has an agreement with the CER. My own view for clearing up the spaghetti bowl is to merge such agreements into one. This would lead to greater consistency, reducing the “human resource” cost, and, effectively, lowering the chances that these agreements could be captured by special interests that might put the agreement on the wrong track. The agreement that I envision—call it, for example, the East Asian Free Trade Area—would be based on open regionalism, and would be consistent with the WTO, APEC, and ASEM. It would not meet opposition from the EU and NAFTA. On the contrary, it would likely support the case for a successful Doha Round—which has been promised to be the “development round”—and should push countries within APEC to better define the Bogor Vision and to meet its deadlines

19. Trade agreements should not neglect the services sector. As a percentage of trade, services exports of developing countries have risen from 9 percent in 1980 (approximately half the share of developed countries) to about 18 percent in 2000, on par with that of the developed countries. It is estimated that about half the benefits that would be generated from global free trade would derive from service-related liberalization. Given the spill-over effects of greater efficiency in the services sector (from infrastructure-related services such as transport, to financial services), the health of any economy is intricately linked to the development of its services sector.

20. The need to emphasize the effects of regionalism on DFI flow is clear. Evidence that DFI is a key catalyst in the development process is extremely strong; it leads to increases in productivity, technology transfer, ready-made external trade markets, and long-term capital flows. Regionalism in the Asia and Pacific region, from ASEAN to ECO, is devoted in large part to the attraction of DFI. While empirical modeling of these effects is difficult, there is a literature that looks at the effects of regionalism on DFI flows, as well as trade-investment links. Most of these studies support the notion that DFI is extremely important for growth and development. I feel that the ADB could have strengthened the argument for regionalism by focusing more on these trade-DFI links.

Trade and Financial Links in Regional Accords

21. A further important issue facing the region in my view, concerns the need to integrate trade and financial links systematically in regional accords and to move more quickly in the area of financial cooperation. I feel that this subject is inadequately addressed in the economics discipline, though I was pleased to see that the IMF's most recent World Economic Outlook (October 2002) includes a chapter on Trade and Financial Integration. Trade is important, but it is not the only thing of importance. The WTO exists on the trade front and plays a leadership role on the real side. However, no such organization exists on the financial side even though there are tremendous opportunities in this regard.

22. Trade and financial links are pervasive in the economy. To cite a few examples: the Asian Crisis itself was in part caused by a strong slowdown in export growth and financing of current account deficits. A major reason cited for closer financial/monetary cooperation--from Europe to Asia--is its positive effects on international trade. Regional trading agreements that have excluded financial cooperation have often faced crises. This is currently a problem in MERCOSUR but **it** also hurt NAFTA during the Mexican Peso Crisis and even periodically affected the EC/EU prior to monetary union. Interestingly, the measures that are used to gauge whether or not a group of countries constitutes an "optimal currency area" (e.g., economic symmetry and a large share of intra-regional trade in total trade) tend to be the same as those used to consider *a priori* if a regional trade grouping can be expected to be efficient.

23. The Asian Crisis is thought to have run its course over two years ago and many seem to consider it already as an (ugly) part of the region's history. Economic growth in the region was strong in 1999-2000, and while last year the growth slowed, this year things are once again picking up. However, we still have many lingering problems that must be dealt with particularly in the area of finance. Fundamental weaknesses in financial structures and controls within countries still need to be addressed; institutional improvements need to be made; and financial authorities need to be continually vigilant. Even developed countries have periodic financial crises. The ADB has done some excellent work in helping regional economies recover from the Asian Crisis and in fortifying domestic financial systems. Yet, much more can be done at the regional cooperation level.

Now, Asian leaders have been working in this area. ASEAN, for example, has launched a series of proposals to move forward on the financial-cooperation front, e.g, the financial part of the ASEAN Vision 2020, the Joint Ministerial Statement of the Fourth ASEAN Finance Ministers Meeting, and the Hanoi, Plan of Action. The bilateral swap arrangements negotiated between Japan and the ASEAN countries may be small, but are significant in their potential and as examples of intra-regional financial cooperation. Proposals for an Asian Monetary Fund, monetary union, etc., are far more comprehensive and are being actively considered.

As we move in this direction, I feel that we need to stress monitoring, cooperation, and consultation. The ADB is on the vanguard of this process with the "ASEAN Surveillance Mechanism." In my view this can be expanded and a regular process of discussion between finance ministers and central banks -- sort of a "G-7" for Asia -- should be advocated with some urgency. The Asian Crisis revealed to us how fragile our financial systems can be, how inter-dependent they are, and how important it is to develop common goals and, in my view, common (best) practices.

The case for financial cooperation is stronger once one considers the importance of institutional development. We rely too much on bank lending in the region and inter-mediation from outside the region is exaggerated. To diversify our financial systems and to keep inter-mediation at home, we need to deepen domestic financial institutions, and to create more regional interaction. This can be in the form of closer cooperation between equity exchanges (with the possibility of subregional exchanges), cross-issuances of bonds, and the like. We should keep in mind that liquidity is key in developing such financial cooperation. This is why I

would argue for a common currency denomination as a reference basket, much as was done in Europe

Regional Cooperation and Infrastructure Development

24. Finally, I turn to what I have earlier termed the “wider beneficial effects” of regionalism, apart from its impact on trade. I note that regionalism as a political economy force can result primarily from a decentralized operation of markets. Or it can result from the determined actions or regional cooperation of states, with guidance from an international entity such as the Asian Development Bank.

I view regional cooperation in this stance as a positive force, and take as a prime example, the Greater Mekong Subregional (GMS), in which ADB has already established a sponsoring and funding unit. The GMS program can be considered a pragmatic, results-oriented program, where six countries, or subregions thereof along the Mekong River agree to plan and implement projects to their mutual benefit.

Decisions are made at Ministerial-level conferences (nine held since origination in 1992), which set the direction and agenda for subregional economic cooperation. Priority projects are endorsed and donor assistance sought and mobilized. Working groups now exist in the areas of: transportation infrastructure, energy telecommunications, human resource development, tourism, environmental management, promotion.

ADB’s principal role has been to support major infrastructural projects that are designed to boost trade and industrial activity through regional cooperation in these areas, which can be viewed as “regional public goods”. As is always the case with public goods, there is a tendency to undersupply infrastructure if left to the individual country or market, particularly since the gains are shared across national borders. However, through regional cooperative action, the externalities can be internalized. Minor infrastructure projects-including linking roads between countries, building bridges across border rivers, may be just as effective in promoting development. Transportation costs to regional markets and ports could be greatly reduced and employment gained for poor, interior populations in the region. Through such initiatives, the Greater Mekong Subregion (GMS), for example, could be transformed into an Asian “rice basket.” And the trade and investment ties that would likely develop would promote regional peace and stability.

Regionalism in a Framework of Multilateralism; What Can Be Done.

25. Hence, let me offer some recommendations by which positive gains from regional cooperation can be sustained in a multilateral framework.

- a. Regional trade groupings should be encouraged, provided that they are outward-looking. I believe that Asia should take a leadership role in the “open regionalism” movement, emphasizing WTO conventions and going beyond GATT Article XXIV to ensure, for example, that not even *individual* tariffs should be raised within a regional grouping (rather than the GATT requirement that they be no higher on average.)

But, I would like to stress once again that these agreements should not be discriminatory and should continue to base their approaches on “open regionalism”. “Discrimination” would be the negative side of the EU/NAFTA model but would be more expensive in the case of developing Asia, as Asia is far less intra-regionally dependent. Moreover, for transitional economies who are not yet members of the WTO, I would emphasize that regional accords in Asia should be used as an intermediate step in reaching the goal of WTO accession. Distortions created by traditional free-trade agreements could lead to problems in the accession process, and potentially create greater costs in terms of economic structural adjustment. That is, if economies must first transform themselves according to *regional* comparative advantage, and then according to *global* comparative advantage, the costs will be higher.

- b. The region needs to consider greater means of monetary cooperation and information sharing between central banks and financial authorities in the short-run, and greater coordination in the long-run. I am not advocating a Maastricht-type agreement in Asia (especially since the Growth and Stability Pact itself seems to be in crisis!), but the Asian Crisis clearly revealed the negative externalities associated with macroeconomic disruption. We might consider some rules of thumb and informal “peer pressure” to deal with these issues at the regional level.
- c. We need greater consultation and coordination on capital market development, with

the possibility of integrating markets through greater cross-listings in the capital markets and cross-issuances of bonds. Doing this requires a great deal of cooperation and standardization of laws, adoption of best practices, etc. The region is moving in the direction of liberalization anyway; but moving forward together, in my view, makes a lot more sense.

- d. I also continue to advocate the creation of an Asian Monetary Fund, with special windows for economies in transition and key sectoral issues of regional importance (e.g., the environment). I also believe that the Chiang Mai Initiative and related agreements, which have the goals of crisis management and crisis-prevention are important first steps on the road to deeper financial cooperation.
 - e. Further, I think that the process created by the consideration of monetary union in Asia should be a carefully planned, step-by-step process in which monetary union eventually makes sense, rather than rushing it with a top-down decision and hoping for the best (Europe was a bit too inclined to favor this latter approach and this created a lot of obstacles, even in a region that is far less diverse than Asia and the Pacific).
26. APEC, with its highest political leadership at the presidential and prime ministerial level, does have a most significant role to play. This role must go beyond the actual summit meetings and the issuance of sound-biting declarations. I would envisage APEC's primary role as keeping faith with its basic mandate--"keeping regionalism open."