

DRAFT, FOR COMMENTS ONLY
NOT FOR CITATION

Regional Economic Cooperation in Asia: Current situation
and future prospects

ESCAP

Background paper
World Economic and Social Survey 2010

Regional Economic Cooperation in Asia: Current situation and future prospects

Inputs for WESS2010¹

1. The search for region-wide cooperation in trade and investment

The current global crisis has exposed the risk of overdependence of the region on trade and investments with developed markets. Developed markets still absorb around half of the region's exports, notwithstanding the gains achieved in fostering intra-regional trade² over the years. Thus, in a post-crisis scenario, the region is continuing with its strategy of diversifying markets, while recognizing that a full "decoupling" from developed countries is neither feasible over the short term, nor would it be desirable.

Increasing regional complementarities

Besides the need to diversify away from the developed markets, there are other considerations for engaging in intra-regional trade. First, given the diversity of the region in terms of economic development, resource and skill endowment, and comparative advantages, the scope for further expanding trade and investment flows and relations among Asian and Pacific developing countries is high. Second, developing countries can trade with each other on a more equal footing than with developed countries, in particular as technical barriers to trade tend to be higher in developed countries. Third, patterns of trade among developing countries, complemented by liberalization of investments, are shifting and have become much more focused on production networks and product differentiation - the basis of intra-industry trade. The burgeoning ASEAN-China trade in electronic parts and components as will be discussed below, highlights the synergistic relationship between investments and trade. Fourth, trade in services, of which the region has plenty to offer, is expanding among developing countries. Fifth, as tariffs remain relatively higher among developing countries in general, and among Asian and Pacific economies in particular, than those maintained by developed countries on imports from developing countries, the potential for further liberalization at the regional level is large.

¹ This input is based on contributions of Nagesh Kumar, Tiziana Bonapace, Aynul Hasan, Shuvojit Banerjee, George Manzano and Nobuko Kajiura of Macroeconomic Policy and Development Division, ESCAP.

² The extensive production network, particularly in the electronics sector, among the countries in the Asia Pacific region, with China as the hub, are still geared primarily to supply the markets in the developed markets. Thus, despite the increases in intra-regional trade in electronic parts and components, the final goods are still destined outside the region.

Experience from the region suggests that intraregional trade and investment in Asia and the Pacific has advanced on the basis of two developments. The first is market-led and based on the spread of international supply chains or international production networks. Progress in telecommunications and logistics has made it possible to fragment the vertically integrated production process across many countries in line with their comparative advantage. The second is policy-led through trade agreements negotiated by governments either bilaterally or plurilaterally. The most fundamental building bloc for economic integration remains the regional trade agreement (RTA) or its more evolved form, economic partnership agreements (EPAs).

Policy flexibilities

The RTAs generally follow a approach of phased liberalization to overcome the resistance of certain industry groups and build political support. The ASEAN Free Trade Area (AFTA) is a case in point. AFTA's blueprint finds little semblance with the advanced formats of North-North or North-South trading agreements. Yet the flexibilities (sensitive list, phased tariff reduction approach) incorporated in the agreement allowed negotiators to gradually take in deeper commitments, building up trust among countries and consensus at the domestic level that is so often lacking. It also enabled ASEAN members to widen engagement with their six dialogue partners ASEAN + 6 through time. Thus, over the years, the engagement was sustained and by gradually associating the major trading countries of the region, an axis of integration is emerging that may eventually see the formation of an Asian economic community. At the same time, within the ASEAN-10 grouping, fresh initiatives such as the ASEAN Comprehensive Investment Agreement (ACIA), and the implementation of the free trade area by 2015, will see an ASEAN Economic Community emerge that implies members are obtaining sufficient benefits from the cooperation, over and above the costs of engagement and loss of policy space.

A particularly controversial aspect of many trade agreements is the inclusion of labour and environmental clauses. The reluctance of developing countries in linking labour and environmental clauses is based on fears that these provisions could potentially be used as non-tariff barriers (murky protectionism). Central to that position is the potential cost of compliance to the standards. Note that this controversy arises usually in North-South RTAs where such provisions are routinely demanded by developed countries. In the context of South-South trading agreements, more flexibilities and policy space are allowed, since these provisions are areas for cooperation rather than linked to market access. Developing countries can therefore improve capacities to comply with global labor and environment standards through deeper cooperation.

Recent developments and future prospects

Importantly, on 1 January 2010 the ASEAN-China Free Trade Area came into force. While the Association of Southeast Asian Nations (ASEAN) has engaged many partners in FTA negotiations over the past years, the ASEAN-China FTA has become more prominent because of its scope. After the EU, and NAFTA, the ASEAN-China FTA which will cater to close to 1.8 billion consumers, will be the third largest in the world in

terms of trade volume. Tariffs are slashed on about 90% of traded products between China and the six original ASEAN members. The rest of the ASEAN members will have until 2015 to cut their tariffs. From the signing of the ASEAN-China framework agreement in 2001 until 2008, ASEAN's exports to China grew more than fivefold. Meanwhile, China's exports to ASEAN over the same period expanded more than sixfold. Such impressive trade performance is indicative of ASEAN's and China's evolution as natural trading partners, despite earlier fears that similarities in endowments and products produced would not have sustained a mutually beneficial trading relationship.

Significant progress was also made in the ASEAN-India Trade in Goods Agreement which came into effect on January 1, 2010, after six years of negotiation. Unlike the ASEAN-China FTA, this agreement only covers trade in goods, as negotiations in services and investments are still ongoing. Similar to other South-South agreements, this agreement incorporates many flexibilities. For instance, there are provisions for 'special products' and highly sensitive lists for which the rate of tariff reduction would be less steep or even minimal. Nevertheless, it is envisioned that by 2016, close to 80% of products or around 4,000 tariff lines, traded by the partners would be liberalized. The ASEAN-India FTA is regarded as the outcome or the confluence of the 'Look East' strategy of India and the need for ASEAN to engage in rapidly growing markets and balance its relationship with the rest of Asia's major economic powers.

The question now being asked is to what extent the ASEAN-China FTA or the ASEAN-India Trade in Goods Agreement could be considered a model for other trade agreements in the Asia-Pacific region? Critics are quick to point out the deficiencies of the FTA agreement in terms of weak dispute settlement processes and the presence of 'sensitive lists' where tariffs are still imposed. Unlike other FTAs, the negotiations were not carried out as a single undertaking. But precisely, these are the features that characterize many South-South trade paradigms and that are proving to have a modicum chance of advancing. The flexibility accorded by 'sensitive lists' and the phased in approach in cutting tariffs, have made it easier for negotiators to garner the political support needed for the FTA. The flexibility provisions alleviated the fear of 'undesirable outcomes' in light of the absence of adequate social safety nets in many developing economies of the region. Furthermore, keeping negotiations in trade in goods separate from services or investments, did not unduly strain the meager negotiating resources of governments. Lastly, although ASEAN countries do not negotiate as one (as the EC does), the ASEAN caucus helped boost the confidence of ASEAN negotiators in dealing with China as a much larger and more powerful partner than the individual ASEAN countries.

Conclusion by ASEAN of FTAs with all the dialogue partners viz. China, Japan, Republic of Korea, India, and Australia-New Zealand CER, is also providing a stimulus for their consolidation into a broader regional arrangement. Upon completion of feasibility studies of two alternative broader schemes viz. the East Asia FTA (EAFTA) bringing together ASEAN+3 countries and Comprehensive Economic Partnership of East Asia (CEPEA) bringing together members of East Asia Summit or ASEAN+6, the respective Summits held in October 2009 in Hua Hin in Thailand launched further work

at the official levels that might lead to emergence of a broader regional trading arrangement in Asia in future.

2. Financial and monetary coordination in Asia-Pacific: momentum accelerating but an unfinished agenda

Crisis management

The return of economic crisis to the region, brought to the fore the extent to which financial and monetary cooperation lagged advances made in trade and investment cooperation. While some countries had built up sufficient reserves to protect their balance of payments, other impacted countries did not have recourse to regional sources of assistance. The funds available through the Chiang Mai Initiative (CMI) of ASEAN+3 (APT), the clearest example of a regional financial cooperation scheme, remained insufficiently developed as a first source of assistance and some regional economies found ready alternative sources of support through bilateral arrangements as discussed below.

To be effective in preventing systemic crises, a regional crisis fund should attempt to include as many countries in the region as possible. The quantum of funds placed in the fund should be sufficient for the fund to act as the lender of first recourse in the event of macroeconomic difficulty. The fund should ideally include support to domestic financial sectors in its remit, in addition to balance of payments support to governments, to enable assistance to banks as was undertaken by governments in the United States and Europe in recent months. The fund would require a physical infrastructure with well-qualified staff to engage in monitoring of economies prior to and during crises, as well as design and monitoring of the terms associated with lending to regional governments.

The multilateralisation of the APT CMI reserves pool, as agreed to in 2009, in its planned form could also evolve into a truly effective first line of defence for the region, if its geographical coverage, size, functions are expanded. In the meeting of APT Finance Ministers in Phuket, Thailand in April 2009 the APT countries reached an agreement to transform the existing bilateral arrangements into a regional foreign reserve pool of US\$ 120 billion to “address short-term liquidity difficulties in the region and to supplement the existing international financial arrangements.”³ Critical details remain unclear, though it appears that the same conditions as the CMI (i.e. 20 percent unrestricted borrowing and 80 percent balance only with IMF conditionality) remain in place. Importantly, the regional economies have agreed to create a stronger regional surveillance system in conjunction with the ADB and the ASEAN Secretariat to provide oversight of the fund and help with its operation.

Presumably if and when this surveillance system is effectively established, the 20 percent of reserve that can be tapped without IMF conditionality will be increased, though one

³ See <http://www.aseansec.org/22536.htm>. Final agreement was reached at the side-lines of the ADB annual meetings in Bali, Indonesia in May 2009.

will have to wait and see. Given that the region holds well over \$4 trillion of reserves, the proposed reserve fund is modest as of now, but has the potential for significant expansion over time especially if other systemically important countries such as India are included. While the membership issues need to be effectively resolved, the CMIM has provided much-needed impetus to monetary regionalism in Asia and is an important step in creating pools of liquidity⁴.

However, effective deepening of regional monetary integration will not happen until there is considerable strengthening of the regional surveillance mechanism with well worked out surveillance and policy conditionality. Thus, the announcement of strengthening of surveillance alongside the creating of the CMIM is an important step. However, surveillance itself is insufficient if it does not include remedial actions by regional members that are found to be running unsustainable policies. There is an equally hard issue of what such a regional liquidity arrangement implies for exchange rate coordination. Countries with relatively more fixed exchange rates will require more reserves to manage their currencies and/or pursue much more disciplined domestic economic policies, while countries running more flexible regimes could potentially cause or be faced with competitiveness pressures in the near-term vis-à-vis the other countries if their currencies appreciate or depreciate sharply.

Exchange rate

Major exporting economies in the region prior to the crisis already engaged in de facto exchange rate coordination by means of tracking relative exchange rates and moving in unison so as to maintain vital trade competitiveness. During the economic recovery phase the pressure on countries to maintain exchange rate competitiveness so as not to impair the revival of exports will increase. The risk without cooperation in such a situation is for a destructive round of competitive devaluations which produce no net benefit in the quantity of exports and instead result in lower domestic export receipts due to exchange rate losses for each country.

The region is characterized by a number of exchange rate arrangements, whose inherent incompatibility is made evident especially in times of instability. At one end are independently floating currencies such as those of Japan, the Republic of Korea, and the Philippines. At the other extreme is Hong Kong China which has a currency board which effectively pegs its currency to the United States dollar. In between are intermediate regimes such as the tightly managed pegs of China and Malaysia and the relatively more flexible regimes of India, Thailand and Singapore. At times of large swings of the dollar, it results in a high degree of instability in Asian exchange rates and/or trigger competitive devaluations among key Asian exporting countries.

⁴ See Rajan, R.S. and R. Siregar (2004). "Centralized Reserve Pooling for the ASEAN Plus Three (APT) Countries," in *Monetary and Financial Cooperation in East Asia*, Palgrave-McMillan Press for the Asian Development Bank.

Asia requires a currency management system which facilitates trade and macroeconomic stability vis-à-vis both extra-regional and intra-regional countries. A possible approach for the region may be a basket parity relative to a number of reserve currencies, a band and a crawl of the exchange rate (BBC regime). This is an approach successfully implemented by Singapore and adopted in different versions by some other countries, including, since 2005, China and Malaysia.

The potential for exchange rate cooperation extends to the critical issue of managing exchange rate vulnerability to short-term capital inflows. The frequency and magnitude of financial crises have given renewed and unprecedented vigor to proponents of restraining cross-border capital movements. Renewed attention is being paid to arrangements such as the Chilean unremunerated reserve requirements (URR) or *Encaje*, which appears to have been helpful in managing capital surges when it was in place in the 1990s⁵.

Numerous mechanisms for managing capital inflows could be considered, ranging from administrative measures e.g. introducing deposit requirements on capital inflows, to market-based instruments such as levying financial transaction taxes on inflows, including taxes that vary with the maturity period of the capital inflow or which are countercyclical. Consideration has to be given to the appropriate level at which to enact such controls, either global or regional, as no one country can engage in such a policy without a likely exit of capital to comparable countries who do not institute such controls.

Funding of development gaps

The crisis has also exposed the need for regional cooperation in funding development gaps – a process in which governments coordinate their fiscal spending around a commonly shared paradigm of inclusive and sustainable development. The region's stock of foreign exchange reserves assumes importance particularly if funding from foreign sources, both through government assistance and the private sector, is likely to be curtailed by the constrained resources available from the developed world in the aftermath of the crisis. The region's reserves are currently being invested in low interest-earning deposits in the developed world while not only more attractive investment opportunities exist, but also opportunities that would bring higher societal welfare gains within the region. The crisis has also highlighted the risks of excessive concentration of investment in the financial assets of the developed world.

Investment of regional funds in developed countries has been encouraged by the relative lack of development of regional capital markets. While there have been some moves in recent years, far greater emphasis may be given to integrating regional equity markets and fostering the development of local-currency bond markets at the regional level. Intraregional investment in local currency bonds has remained small due to too many legal and institutional impediments, as well as a lack of investment information⁶. The Asian Bond Market Initiative (ABMI), intended to foster the growth of local currency

⁵ See Bird and Rajan, 2000 and references cited within

⁶ Arner, Lejot, & Rhee (2006)

bond markets, has moved slowly as countries have remained preoccupied with addressing issues of harmonization of rules and regulations. The ABMI has also not spurred private investment as much as hoped due a lack of transparency in its investment targets and fund performance. Nevertheless an excessive emphasis to growing capital markets in the region may lead to increased risk of financial instability for economies through opening themselves more to speculation. As discussed earlier, this crisis makes a persuasive case for a return to fundamentals to ensure stability through greater use of the banking system, combined with effective regulations, to recycle regional savings into regional investments.

One of the clearest alternative uses for some portion of these assets, both for domestic development and for increasing regional integration, lies in the massive infrastructure funding needs across Asia-Pacific. ESCAP has been at the forefront of analysis regarding this issue over a number of years⁷, estimating that the region needs an annual investment of more than \$600 billion in transport, energy, water and telecommunications, with an annual shortfall of more than \$200 billion. There is need for developing a regional financial architecture in Asia-Pacific that can intermediate between region's growing savings and foreign exchange reserves and uncovered investment requirements. In the context of the need for the region to generate additional aggregate demand, such an architecture becomes highly critical.

3. New forms of development cooperation emerging in Asia-Pacific: South-South and triangular cooperation⁸

With dynamic economic growth and consequent diversity of the stages of development among countries in Asia-Pacific, potential complementarities within the region have increased tremendously. The South-South Cooperation (SSC) has attained a new salience and viability while triangular development cooperation (TDC) emerged as a relatively new trend reinforcing SSC where developed countries and multilateral agencies support the programmes of cooperation between developing countries.

Drivers of south-south cooperation (SSC) and triangular development cooperation (TDC) in Asia-Pacific Region

The rapid growth observed in the SSC and TDC in the Asia-Pacific region in recent years has been driven by a number of factors as follows:

The rise of Emerging Countries: Over the past few decades a number of economies in Asia have emerged as some of the most dynamic in the world. The initial bunch of newly industrialized economies in the region included the Republic of Korea, Taiwan province

⁷ See, for example, UNESCAP, 2006, *Enhancing Regional Cooperation in Infrastructure Development including that related to Disaster Management*. UNESCAP: Bangkok.

⁸ This input is based on the keynote address on "South-South and Triangular Cooperation in Asia-Pacific: Towards a new paradigm in development cooperation" by Dr Nagesh Kumar at the Asia-Pacific development Cooperation Forum held in October 2008 in Bangkok

of China, Hong Kong - China, and Singapore, Malaysia, Thailand have been joined by large populous countries such as China and India in more recent years. These countries have accumulated considerable expertise and capabilities in their process of development. SSC is becoming more significant with emerging countries making new and more ambitious commitments. The emergence of new growth poles in different regions in the South is reshaping the economic geography and creating new dynamics in trade, investment and development cooperation from and within the South.⁹

Rising Diversity and Complementarities in Asia: The range of complementarities among the developing countries has widened with their rise and accumulation of capabilities over time. In particular the diversity in levels of development and hence range of complementarities has widened in Asia, with the doubling of the standard deviation from mean of per capita incomes in Asia over the 1980-2006 period. It increased much more modestly in other regions.

Another indication of rising complementarities among Asian developing countries is clear from a growing proportion of intra-regional trade and investment flows. The proportion of intra-regional trade in Asia has crossed 55 per cent and the largest trade partners of most of the Asian countries are now within the region. Similarly intra-regional investments in Asia have other established sources such as Singapore, Malaysia, Thailand, the Republic of Korea and Hong Kong- China.¹⁰ These are emerging as important sources of foreign direct investment (FDI) in Asian countries especially the least developed countries (LDCs). The UN report¹¹ cites a World Bank source suggesting that even banks based in developing countries are becoming important sources of lending to poorer countries with 27 per cent of foreign bank assets in low income countries being held by developing countries banks. However, as with any private flows, it is possible that these flows may not be reaching the poorest countries.

Recognition of Regional Interdependence and rise of Regional Cooperation: The bulk of SSC is undertaken intra-regionally. It is a result of the growing recognition of regional interdependence. The East Asian crisis of 1997 highlighted the regional interdependence of Southeast and East Asian countries and has led to a number of initiatives for regional cooperation such as the Chiang Mai Initiative among others launched within the framework of ASEAN+3. Over time a number of initiatives of cooperation have been undertaken by the Asia-Pacific countries at bilateral, sub-regional and broader regional levels.

Growing Interest of Northern Donors in Supporting SSC: Another reason of the growing popularity of SSC in recent years is the growing recognition of the potential of TDC by traditional donors and their support to the SSC. In particular Japan has emerged as an

⁹ United Nations (2007a). *The State of South-South Cooperation* – Report of the Secretary General, New York: United Nations.

¹⁰ see UNCTAD (2008) *Information Economy Report 2007-2008*, New York: United Nations; Kumar (2008) “Internationalization of Indian Enterprises: Patterns, Strategies, Ownership Advantages and Implications”, *RIS Discussion Paper # 140*, for a discussion on outward FDI originating from emerging countries.

¹¹ United Nations (2007a). *The State of South-South Cooperation* – Report of the Secretary General, New York: United Nations.

important pioneer in this direction supporting SSC activities especially in capacity building in the Asia Pacific region. Even though developing countries may have development experiences to share with other developing countries, their funding capacities may be limited. Hence, TDC is a win-win approach to meet the ends of both Northern as well as Southern partners.

Emerging trends and patterns of SSC in Asia-Pacific

A recent study on trends in SSC and TDC estimated that Southern countries' economic assistance amounted to be between US\$ 9.5 billion to \$12.1 billion in 2006 representing 7.8 to 9.8 per cent of total development cooperation related flows in the year¹². These figures are likely to be underestimated since, due to differences in definitions, contributions to multilateral institutions and contributions of smaller contributors were not covered. It should also be noted that even though smaller countries and LDCs may lack financial capacities, they do undertake some SSC programmes. The study projected Southern development cooperation to be reaching US 15 billion by end of 2010 in view of large commitments being announced by emerging Asian countries such as China and India.

Among the largest contributors to development cooperation were China, India, each contributing about US\$ 1 billion per annum followed by Republic of Korea and Turkey (both non-DAC members of OECD) contributing around US\$ 500 million p.a.¹³ Considering the fact that Asian countries are among the largest contributors of development cooperation, the relative significance of SSC is likely to be much greater in the Asia-Pacific region than in other continents. This is consistent with our earlier observation that complementarities and diversity have increased in Asia. Furthermore, SSC in Asia-Pacific is likely to expand for another reason. Following its 2003 ODA Charter, Japan has emerged as a major DAC donor supporting triangular development cooperation as an effective aid modality.

Emerging patterns in Triangular Development Cooperation (TDC) in Asia-Pacific

SSC is being increasingly promoted and catalyzed by DAC donors and international agencies in view of its relevance for international partnership for development. TDC recognizes that developing countries are better placed in view of their more relevant expertise for responding to the needs of co-developing countries. It can be more cost effective compared to traditional North-South links. However, developing countries being short of resources have their limitations in fully exploiting the potential of SSC. Through TDC, it is possible to combine the expertise of developing countries and financial resources of developed countries for improved results. Triangular cooperation could thus assist in fuller exploitation of potential of SSC. International agencies such as UNDP, World Bank and regional development banks and DAC member governments support SSC. Japan has been a pioneer of TDC and has paid increasing attention to

¹² UN ECOSOC (2008) *Trends in South-South and Triangular Development Cooperation*, Background Study for the Development Cooperation Forum, April 2008.

¹³ UN ECOSOC (2008)

supporting SSC following the approval of its 2003 ODA Charter which identifies triangulation as an effective modality of promoting development cooperation.

Even though it would be generally accepted that the scale of TDC has expanded in the past decade, it is very difficult to capture the magnitude of development cooperation that takes the form of TDC as DAC countries do not report it separately from bilateral cooperation. Therefore, one has to rely on anecdotal qualitative information to get an idea of emerging trends and patterns in TDC.

It is clear that SSC and TDC in Asia-Pacific have grown in importance over the past decades with the rising complementarities and emergence of growth poles in the region and due to attention paid by the governments to regional economic cooperation. Asian emerging countries have been cooperating with their partner countries within and outside the region primarily through sharing of development experiences, cooperation projects, capacity building, technical assistance, but increasingly also including subsidized lines of credit and grants, preferential market access on unilateral and reciprocal basis. These aspects of cooperation are also complemented by technology transfers and investments by enterprises based in emerging countries that have become important sources of inflows of FDI in low income countries and LDCs in the region. However, the exact scale of SSC and TDC in Asia-Pacific and effectiveness is difficult to be ascertained due to lack of coordination between agencies of the cooperating countries and absence of information compiled at one place of multifaceted programmes of cooperation. Generally different agencies in cooperating country's governments cooperate with their counterparts in the recipient countries sharing development experiences but such information is not compiled at one place. Furthermore, even with the coordination, the scale of SSC is likely to be underestimated considerably because of not accounting all the costs associated with the projects and also lower costs of expertise and living in developing countries. It is extremely important that action is taken at the national and international levels to evolve appropriate guidelines and procedures for fully accounting the true scale of the SSC and TDC and enhance their effectiveness.

Notwithstanding the lack of precise information of internationally comparable nature, it is quite evident from the foregoing review that SSC and TDC have come of age in Asia-Pacific region. The general focus of the SSC programmes of Asia-Pacific developing countries is on capacity-building and sharing their development experience in the form of experts and assisting the partners through deputation of experts and in building infrastructure and productive capacities and providing market access. Triangular development cooperation has also become a sizeable activity in Asia-Pacific region in view of pioneering role played by Japan and some international agencies. Even though a substantial effort is being made by developing countries in development cooperation, its full potential is far from realized.
