

RIS DISCUSSION PAPERS

**Towards an Asian Economic Community—
Vision of Closer Economic Cooperation
in Asia: An Overview**

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RIS-DP # 32/2002



**Research and Information System
for the Non-Aligned and
Other Developing Countries**

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**Towards an Asian Economic Community -
Vision of Closer Economic Cooperation in Asia:
An Overview**

By

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Interim Draft: July 2002

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Enhancing Trade and Investment Cooperation in Asia: Issues, Policies and Institutional Reform

This paper forms a part of a larger research project launched at RIS in October 2001 on 'Enhancing Trade and Investment Cooperation in Asia: Issues, Policies and Institutional Reform' as a part of the Sasakawa Peace Foundation (SPF)'s Research Programme on Future of Asia: Institutional and Structural Changes.

The objective of the project is to present a case for an Asian Economic Community (AEC) that would be broader in coverage than the current programs for economic co-operation in different sub-regions such as East Asia, South Asia and Central Asia. Such a grouping would facilitate fuller exploitation of the region's considerable resources –material as well as human—for expediting the process of its development.

There is growing realization that stimulus for future growth in the region has to come from within given the trend of formation of regional trading blocs in rest of the world and slow down in growth expected in the US and EU over the medium term. The Asian region combines the fastest growing economies in the world. Together they form a huge market that is growing faster than any other region in the world.

The project reviews the rationale, significance and relevance of Asia-wide economic integration. It would cover closer economic cooperation in all areas of mutual interest where the complementarities exist. These areas broadly include monetary and financial cooperation, infrastructure development, trade and investment liberalization in the framework of a regional trading bloc, complementarities in industrial and technological capabilities and other resource endowments, among others.

It will also discuss the policy challenges for the regional economic integration in Asia to succeed. A roadmap for a phased implementation of economic integration in the region will be proposed.

The project is progressing as per schedule. After the Inception Meeting held in Manila in October 2001, the project team reviewed the progress of the work at the Coordinating Workshop held in Kuala Lumpur on 20-21 February 2002. Some interim reports will be discussed at a Workshop to be held in Bali on 30 September-1 October 2002. RIS proposes to organize an International Conference in New Delhi in early 2003 to discuss the outcome of the project along with the projects coordinated by the Malaysian Institute of Economic Research (MIER) and the Centre for Strategic and International Studies, Jakarta under the auspices of the SPF research programme.

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Towards an Asian Economic Community

1. The Context

The 1990s have witnessed a strong trend in different parts of the world especially the developed countries to form regional trading blocs. These attempts include formation of the Single European Market (SEM) in the European Union and North American Free Trade Area (NAFTA). In addition, formation of APEC and Free Trade Area of America (FTAA) has been put in motion. These attempts to form integrated markets by developed countries were followed by similar moves in other regions and sub-regions and include MERCOSUR, ASEAN Free Trade Area, COMESA, COMECON, among others. The formation of these trade blocs had been prompted by the anticipated increased emphasis on competitiveness with the conclusion of Uruguay Round negotiations that were underway and have since led to the formation of the World Trading Organization (WTO). An immediate effect of these regional integration agreements (RIAs) has been the rising proportion of the world trade that is conducted within the trading blocs. Over 60 per cent of all EU exports in 1996 have been destined to other EU member states. The proportion applicable to NAFTA is 47 per cent (World Bank 2001: Figure 1.14). The intra-regional trade within these RIAs has been rising much faster than the extra-regional trade of the member countries. Nearly 60 per cent of European FDI flows are also absorbed within the Single Market or in the candidate countries.

Thus the trading blocs in Europe and North America have led to a substantial diversion of trade and investment and have become an important factor in shaping the patterns of location of production and competitive advantage. Given their weight in the world

economy and the world trade that EU and NAFTA enjoy, this diversion of trade and investment away from the rest of the world economy in favour of intra-regional trade has adversely affected the growth process in other regions that are not part of these blocs. The Asian countries, on the other hand, have pursued multilateralism in their trade and investment policy throughout except for sub-regional attempts at economic cooperation such as ASEAN Free Trade Area (AFTA) that is currently in process of formation. There is now growing recognition in Asia of the importance of regional economic integration¹ for generating growth impulses from within, especially in the wake of the East Asian crisis. Voices emanating from different parts of the region in support of pan-Asian cooperation and integration are ample proof of the growing recognition of the importance of Asian economic integration. At the initiative of Prime Minister Dr Thaksin Shinawatra of Thailand, the Asian Cooperation Dialogue (ACD) was launched on 18-19 June 2002 at Cha-Am, Thailand. Similarly the Chinese President Jiang Zemin had launched the Boao Forum for Asia in 2001 at Boao, in Hainan province of China, as a pan-Asian economic forum².

Against that backdrop, the objective of the project 'Enhancing Trade and Investment Cooperation in Asia: Issues, Policies and Institutional Reform' is to present a case for an Asian Economic Community (AEC) that would be broader in coverage than the current programs for economic co-operation in regions such as East Asia, South Asia and Central Asia. Such a grouping would facilitate fuller exploitation of the region's considerable resources –material as well as human—for expediting the process of its development. The project seeks to review the rationale, significance and relevance of Asia-wide economic integration and to provide a **vision** and a framework for the AEC. This would include the scope and coverage of AEC covering various key segments and sequencing. Finally it will discuss the policy challenges and will outline a roadmap for further work on the subject. The Project was launched in October 2001 with the financial support of the Sasakawa Peace Foundation and will be completed by March 2003. This paper presents an overview of the progress of the work completed so far and outlines the work planned for the 2002-2003 period.

¹ See Panchamukhi (1995), and Sobhan (1995), for an early conception of the Asian economic area. More recently Yamazawa (1998, 2001a, 2001b), Ali Alatas (2001), Shinawatra (2001), among others, have argued persuasively for closer economic cooperation in Asia.

² See Singh 2002, for a report on Boao Forum.

2. Relevance of Asian Economic Community

As observed above, there is a growing recognition of the importance of intensive economic integration at the pan-Asian level in the region and that the opportunity cost of not going in for intensive economic integration are substantial. There is the realization that stimulus for future growth in the region has to come from within given the trend of formation of regional trading blocs in rest of the world and slow down in growth expected in the US and EU over the medium term. Substantial complementarities exist between Asian economies that remain to be exploited for their mutual common benefit. For instance, while the region has economies that are surplus in capital resources, there are also economies which have inadequate domestic savings for rapid development. The region is similarly characterized by complementarities in the demand and supply of other resources such as technology, and skilled manpower. Over the last five years, the region's dependence on outside regions has increased in terms of trade, investment, and banking finance. The excessive dependence on outside the region has brought in vulnerabilities. The East Asian economies that were recovering from the Crisis of 1997 are slowing down again because of the slow-down of the US economy. The region may now be trapped in a prolonged slump. Japan's economy has been in a prolonged slump for over a decade. The Japanese recession has also affected the growth in the rest of Asia. The lost output because of under-utilization of capacity could be of the order of 10-15 per cent of the GDP of the region or about a trillion dollars a year³. A more intensive cooperation for matching the underutilized capacity in some countries of the region with unmet demand in others could go a long way in pulling the region out of the current slump.

The sub-regional attempts at regional co-operation that have been initiated such as those under the framework of ASEAN and SAARC are unlikely to exploit the full potential of the regional economic integration in Asia. This is because the extent of complementarities are limited at the sub-regional levels. It is clear from the fact that trade of South Asian countries with the East Asian countries is much larger than the intra-regional trade. The same is the case with ASEAN. At the pan-Asian level, the diversities in the levels of economic development and capabilities are quite wide thus

providing for more extensive and mutually beneficial linkages. The diversity in economic structure provides its own indigenous capacity and markets for dynamic industrial restructuring within the region on the basis of 'flying geese' patterns⁴. It is for this reason that the success achieved so far from the sub-regional attempts at cooperation or from the 'truncated regionalism' as it has been termed as have so far been meagre⁵.

The Asian region combines some of the fastest growing economies in the world. Together they form a huge market that is growing faster than any other region in the world and could form a vibrant regional grouping that would be roughly of the size of the EU in terms of GDP, will have larger magnitude of trade than NAFTA and international reserves bigger than those of EU and NAFTA put together. The formation of AEC will also help the region to play a more effective role in shape the emerging world trading and financial system responsive to its needs. The Asian countries feel the need of promoting an Asian identity in international affairs and the Prime Minister of Thailand during his visit to India in November 2001 proposed formation of an Asian Cooperation Dialogue (ACD)⁶.

The Asian region has a distinct Asian Identity shaped by history and cultural exchanges over several centuries⁷. There have been vibrant flows of goods and services as well as labour and capital amongst Asian countries sustained over several centuries. In the ancient time, the famed Silk Routes provided the channels for such exchanges. Marco Polo's tales are just one of many such descriptions. During the nineteenth century, the colonial powers provided the framework for extensive and liberal trade within Asia in goods and services as well as massive movements of labour and capital. Assisted by Japan's rise, trade was brisk In the first half of the 20th century too; the intra-regional trade ratio was over 50 per cent. These trade and investment flows were disrupted by political and military factors during the colonial period and in the post-war Asia. Along with the trade there was a vibrant exchange of ideas. Chinese scholars visited India and visa versa. Ideological influences spread across the nations binding them in ties of

³ See Agarwala (2002) for more details.

⁴ See Sobhan (1995).

⁵ Op.cit. for more details.

⁶ Shinawatra (2001).

⁷ See Panchamukhi (1995).

religion. Hinduism and with it the art of governance of Chankya found its way across to much of Indonesia, Malaysia and Thailand. The sweep of Buddhism is well known. Religion has been a strong unifying factor for with the religious beliefs comes a way of life and as religious influence spread so did the cultural ties. Pagan, Borobudur and Angkor Wat are only but a small testimony to the vast trading and cultural network that Asia was in ancient times⁸.

3. Building Blocs of the Regional Economic Cooperation in Asia

The preceding section has provided a rationale for a pan-Asian regional economic integration. It has been highlighted that such a grouping would be able to generate internal impulses for growth and pull the region out of current slump besides other favourable effects for the region. Keeping in mind the experiences of regional economic integration from other regions, a practical approach to regionalization in Asia would be a phased one, as outlined below.

A Phased Approach to Integration

In order to make it manageable, Asia would have to approach the regional economic integration in a phased manner. In the initial phase it could cover the five blocs of the Asian regional economy. These includes: **J**apan, **A**sean, **C**hina, **I**ndia and **K**orea (**JACIK**). Once the process of integration is consolidated and some gains of integration are visible, it could be thrown open to other economies of the region. This provides a more manageable and coherent approach towards cooperation. This is the approach adopted by the EU and NAFTA to first create an effective skeleton with a core group of countries and expand the membership later to others.

JACIK economies combine between them fourteen of the largest and fastest growing economies with vast complementarities. For instance, they combine between them a population of 3 billion and a GNP of over \$ 7.2 trillion comparable to that of EU in 2000 (see Table 1). In terms of purchasing power parity, the JACIK grouping will have the gross national income of \$ 13 trillion, much larger than either NAFTA or EU.

⁸ See Shankar (2002) for more details. More work has been planned on history and political economy of regional cooperation in Asia in the Phase II.

JACIK's exports will add up to \$1.37 trillion compared to \$ 1.2 trillion of NAFTA. The combined official reserves of the JACIK economies at \$ 750 billion will be much larger than those of the US and the EU put together. Therefore, the region would have sufficiently large market and financial resources to support and sustain expedited development of the region's economies.

Table 1: Proposed JACIK Economic Community in relation to European Union and NAFTA in 2000

(billion US \$)

Parameter	EU	NAFTA	JACIK (14)
GDP	7260	11147	7262
Per cent to World total	23.17	35.57	23.17
GNI PPP	8315	11350	13361
Per cent to World total	18.68	25.50	30.02
Exports	2025	1226	1367
Per cent to World total	31.89	19.31	21.53
International Reserves	381	197	751
Population Millions	354	411	3012
Per cent to World total	5.85	6.79	49.76

Source: *World Development Report 2002 & WDI 2001*, CD-ROM

Some process of cooperation among the JACIK economies has already started. An important step was taken under the Chiang Mai Initiative launched in May 2000 with a currency swap plan established between 10 member states of ASEAN and Japan, China and South Korea linking the international reserves of these countries⁹. It covers a series of bilateral swap arrangements that would allow participating countries to draw automatically on 10 per cent of available capital without triggering any linkage to conditions imposed by IMF programmes. The ASEAN Plus Three Swap Arrangement was concluded at the annual meetings of the ADB in Honolulu in May 2001. On a parallel track, the other member of JACIK viz. India has also intensified her economic cooperation with the JACIK economies. During the 1990s India has also adopted a Look East Policy to strengthen her economic cooperation with Southeast and East Asian countries. As a part of this policy, India started taking interest in ASEAN affairs and became a Sectoral Dialogue Partner of ASEAN in 1992 followed by a full dialogue partnership in 1996. In 2002, India and ASEAN have been upgraded to the level of the Summit level, as applicable in the case of ASEAN plus Three. The India-ASEAN

⁹ See Bergsten (2000) for more details of monetary cooperation.

cooperation has progressed substantially in many spheres, in particular in science and technology, IT and electronics, human resource development, transport and infrastructure, space technology, tourism and trade and investment, among others¹⁰. Besides a large (US\$ 500 billion) market, the Indian economy has shown strong fundamentals and has sustained one of the fastest growth rates in the world over the past two decades and macroeconomic stability in the region. India has intensified her global and regional economic integration with a decade of economic reforms and the economic structure is fast converging with the ASEAN levels in terms of trade and investment policy. As is shown later India and other JACIK economies have considerable complementarities between them¹¹.

4. Areas of Regional Economic Integration

The scope of the proposed AEC should extend to all areas of mutual interest where the complementarities exist. The major areas of cooperation include monetary and financial cooperation, formation of a regional trade bloc, foreign direct investment and transfer of technology and skills, among other sectors. In what follows we outline some issues concerning cooperation in these areas.

Monetary Cooperation:

The experience of the past suggests that the region has suffered from severe exchange rate fluctuations. Absence of adequate foreign exchange safety mechanism forced the region to take resort to IMF packages that have cost several countries in the region several percentage points of GDP. Therefore, an important area of regional cooperation would be to create some mechanism for greater stability in real effective exchange rates. Substantial regional funds under a possible Asian Monetary Fund are essential for achieving stability of real effective exchange rates and for an orderly response to external shocks. Some progress has been made in this direction with the creation of the ASEAN+3 Swap Arrangement. However, the funds available under these arrangements without IMF conditionality are only about \$ 3 billion, grossly inadequate for meeting the balance of payments security of Asian countries. The available swap funds need to be expanded and greater independence from IMF programmes is needed. Furthermore, another step to invigorate the Swap Arrangement would be to extend it to all JACIK

¹⁰ See Kumar (2002) for more details.

countries. This will be possible by extending it to cover India. India has had bilateral swap arrangements with some of the ASEAN countries¹².

Financial cooperation:

As observed earlier, some countries of the region have large excess capacity in sectors such as construction and IT and some others have large unmet demands in these areas. In such a scenario, regional pump-priming or regional Keynesianism could be quite effective in reviving demand for utilizing the excess capacity. Regional efforts can be particularly successful if a suitable mechanism can be devised for funding such regional Keynesianism without adding to the Government expenditure in the surplus countries. The proposed Asian Monetary Fund can help here. One possible avenue is creation of an Asian SDR backed by deposits of surplus countries (which are currently going mostly to the US) and will be used to finance infrastructure and IT investments in the region. The borrowers could be regional companies (such as Channel Tunnel Company for the UK and France) jointly owned by governments and private sector in the region. The Asian SDR can be used increasingly as a unit of account and as reserve asset in the region¹³. A mechanism also needs to be created for seeding and developing viable Regional Infrastructural Projects such as Asian Railway, Asian Highway, Asian power grid, Asian gas grid or pipeline, Asian satellites, Asian Information Infrastructure (such as broad band cable). Such projects would not only facilitate trade and other economic exchanges within Asia but would also generate a lot of demand for the idle capacity for engineering and construction industry in Asia. Besides funding regional projects some of the JACIK countries are projecting a tremendous demand for infrastructural investments in the coming years. India, for instance, has projected US\$ 400 billion of investments in infrastructure development over the coming decade¹⁴.

Regional Trading Bloc:

The relevance of a regional trading bloc for JACIK region is to be evaluated on the basis of relative costs and benefits. The presence of substantial diversity in the endowments and levels of development of JACIK countries provides a prima facie

¹¹ Op.cit.

¹² see Agarwala (2002) for more details.

¹³ Op. Cit.

justification for a RTA¹⁵. The experience of APEC shows that countries are less enthusiastic of liberalization without any reciprocity¹⁶. Hence, open regionalism may not be an effective means of trade integration. The experience available from EU and NAFTA suggests that deeper and wider forms of economic integration are necessary for realizing the full benefits of integration such as efficiency seeking industrial restructuring. Furthermore, trade policy liberalization needs to be accompanied by additional measures such as freer capital mobility, harmonization of customs procedures and product standards and mechanisms to ensure an equitable distribution of gains. The relevance, form and content of an appropriate RTA for JACIK countries remains to be examined in greater detail¹⁷.

Intra-regional FDI, Transfers of Technology and Skills:

Complementing the monetary and financial cooperation and formation of an RTA, will be greater intra-regional exchanges of technology, skills and FDI. The resource endowments and skill bases of JACIK countries complementary to each other. Japanese (and increasingly Korean) MNEs are leading sources of FDI in the region. Japan has also established its leadership as a source of technology in a number of industries such as semiconductors, automobiles, industrial automation, electronics and some chemicals. Korea, China, India, Singapore are also emerging sources of technologies in different areas. For instance, Korea in auto, consumer electronics, semiconductors, shipbuilding; China in consumer electronics and light engineering; India in biotechnology, pharmaceuticals and computer software, and so on. Within industries too, there are patterns of complementarity. For instance, in IT industry East Asia has huge hardware capacity and some countries like India, and the Philippines have the software capacity. A similar situation exists in chemicals, pharma, biotech, etc. This emerging pattern of complementary capabilities provides a great potential for intra-regional FDI and technology transfers. Furthermore, Asia has its own model of industrial restructuring viz. flying geese model which provides for industrial specialization and division of

¹⁴ See Kumar (2002) for more details.

¹⁵ See World Bank (2000) for various issues concerning the formation of an RIA or RTA.

¹⁶ Yamazawa (2001).

¹⁷ This has been planned to be studied in the Phase II of the present project.

labour based on changing comparative advantage¹⁸. The potential of intra-regional FDI, technology and skill transfers remains to be examined in detail¹⁹.

5. The Work Plan 2002/03

In the year 2002/03, the studies launched during the Phase I would be finalized and consolidated and would carry forward the work with preparation of more papers. The specific objectives of the Phase II are as follows:

1. Study on the Relevance of an RTA for JACIK countries: This paper will examine the desirability and evaluate the opportunity costs of such cooperation and its potential in unleashing an efficiency seeking restructuring within the region.
2. Paper on the Potential of Intra-regional FDI flows and Transfers of Skills and Technology: Potential of regional self-sufficiency in technology, skills and FDI (or entrepreneurship) will be examined as a part of this paper.
3. Paper on Asian Identity and Political Economy: A paper reviewing the long-term history of co-operation in Asia, currently perceived social and geo-political impediments to fuller regional cooperation and suggestions for faster progress in the area.
4. Preparation of a Vision Document on the Asian Economic Area drawing upon the papers prepared as a part of the project in Phases I and II.
5. Finally, the papers prepared and the Vision Document would be discussed at a workshop organized with participation of some leading experts from the region, planned for January 2003, in conjunction with the SPF Conference. We propose that this Conference is organized in New Delhi, so as to serve to propagate the outcome of the project to the policy makers in the country.

¹⁸ See Kumar 2001 for an analysis of flying geese pattern of production.

¹⁹ This has been planned to be studied in the Phase II of the present project.

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