

## Towards an Asian Economic Community by 2020

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*Regionalism has become a key component of the new international economic order, fundamentally altering the world trade landscape. It offers to both developed and developing countries a new and attractive complementary strategy to multilateralism. Today, more than one-third of global trade takes place between countries that have some form of reciprocal regional trade agreement (RTA). The European Union (EU) and the United States (US) are playing a prominent role in the proliferation of the RTAs, but Asia is no exception to this trend.*

*This briefing paper examines the evolving regional trading panorama on the Asian continent, spanning from the Far East and Southeast to the South, West and Central Asian region, with its recent surge in bilateralism, including its implications for evolving a regional trade architecture. It argues that by facilitating the development of a seamless region-wide zone of trade and investment, the region will enhance its prospects for becoming the world's centre for economic growth and prosperity by 2020.*

### Background

The post World War II era has witnessed the advent of multilateralism along with waves of regionalism. The General Agreement on Tariffs and Trade (GATT), signed in 1947 and effective from January 01, 1948, was the genesis of rule-based multilateralism under the aegis of which eight rounds of negotiations were held, and which culminated in the formation of the World Trade Organisation (WTO) in 1995.

The history of regionalism in trade and economic cooperation is almost as old as the multilateral trading system (MTS). Since the late 1940s, many European countries have been realising the importance of close cooperation among geographically contiguous countries. Hence, the European Economic Community (ECC) was formed in 1958 and today 25 countries are under the umbrella of the EU. However, the first sign of regionalism, in the sense of regional trade agreement/arrangement that we are witnessing today, was accomplished in the 1980s when the US signed a free trade agreement (FTA) with Canada.

Asia has been the latest region to catch up with the trend, and its countries (from the Far East to South and to West and Central Asia) are exerting renewed efforts to both deepen and expand regional and sub-regional economic integration, as reflected by remarkable scale of negotiating activity underway. The 10 member countries of the Association of South East Asian Nations (ASEAN) have joined hands with big three Asian nations, viz.,

China, Japan and South Korea, to formulate an RTA. Moves are underway to include India in the group, so as to make an RTA of countries with nearly half of the world's population and claiming about 40 percent of the world's total exports.

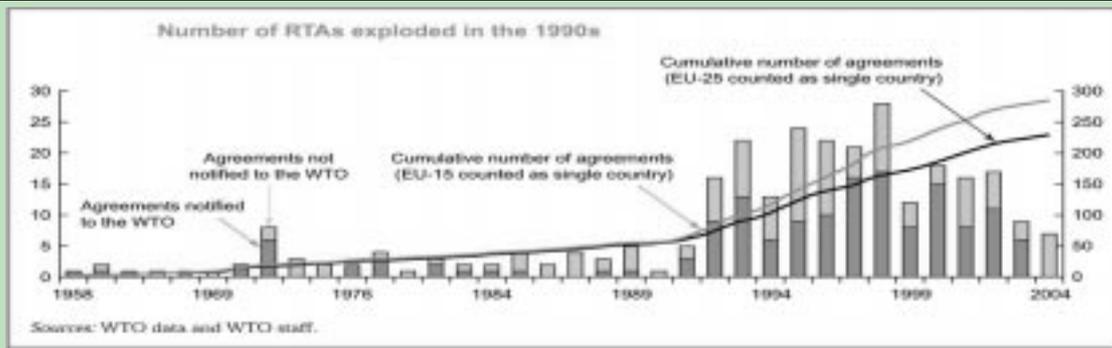
### Proliferation of RTAs

The world has been witnessing a continuous surge in regionalism in trade, despite the advent of WTO in 1995. This proliferation is partly explained by the various roadblocks that the WTO has faced in its effort to liberalise trade and investment through multilateral negotiations. For instance, over 200 RTAs are currently in force and several others are expected to come into existence (Figure 1).

Many of RTAs are a very recent phenomenon. It has been estimated that more than 60 percent of global trade is taking place through regional/preferential trading arrangements (RTAs/PTAs). Some of these RTAs/PTAs are on the 'hub-and-spoke' pattern as the North American Free Trade Area (NAFTA), while many others are manifesting a 'spaghetti bowl' phenomenon, i.e. a country is part of a number of over-lapping RTAs/PTAs. As agreements proliferate, a single country often becomes the member of several different agreements. For example, an average African country belongs to four different agreements, and the average Latin American country belongs to seven (Table 1).

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**Figure 1: Number of RTAs Exploded in the 1990s**



Source: Adopted from World Bank, *Global Economic Prospects*, 2005, P.29.

### Nature of Integration

Economists have traditionally analysed RTAs/PTAs within the framework of neoclassical trade theory. An RTA that considers only border protection measures is described as involving only ‘shallow integration’.<sup>1</sup> In principle, it implies lower barriers - or their elimination - to the movements of goods and services across national borders within the region or addresses preferential reduction in tariffs and non-tariff barriers (NTBs) amongst member countries. The results of creating an RTA, as international trade theory suggests, are a mix of trade creation, trade diversion and changes in terms of trade (international prices). Welfare results of the RTA depend on the net impact of these effects. Potential negative impact if trade diversion is large, helps in ‘diverting’ supply to high-cost producers within the RTA and away from low-cost producers outside the RTA.

In an RTA, which is an FTA, members are free to set their own tariffs: analysis, however, is more difficult because of the complexity and confusing nature of issues related to the rules of origin (RoO) and ‘spaghetti bowl’ effect of membership in multiple RTAs; hence the results

depend heavily on the size of initial tariff barriers.

Furthermore, the member country is free to set tariffs to non-RTA members: it can offset trade diversion effects by unilaterally lowering its tariffs to non-RTA members, perhaps on a most-favoured nation (MFN) basis. Thus an RTA offers ‘policy space’ for countries to mitigate or eliminate trade diversion effects.

An RTA generates ‘trade diversion’ as countries within the bloc trade more with one another and less with potentially lower-cost countries outside the bloc, which can potentially lower economic welfare within the bloc. At the same time, lower barriers can generate new trading opportunities within a bloc. This is known as ‘trade creation’ and is welfare enhancing. Whether an RTA results in net welfare gain for a country depends on the relative strengths of these two effects, and an empirical analysis is required to identify the outcome of an RTA. If only shallow integration is involved, then MFN liberalisation is better, and the countries would probably gain more from multilateral reform under the auspices of the WTO rather than through a bilateral RTA. The decades of the 1980s and 1990s have witnessed many such RTAs/PTAs.

**Table 1: Countries Belonging to More Than One RTA**

	East Asia & Pacific	Europe & Central Asia	Latin America & the Caribbean	Middle East & North Africa	South Asia	sub-Saharan African	North	Total
Number of Countries	32	36	39	21	8	48	25	209
<b>North South Bilateral</b>								
Countries belonging to at least one RTA	4	12	6	10	0	2	10	44
Average number of RTAs per country	2	1	2	1		1	4	2
Maximum number of RTAs per country	4	4	4	3	0	1	24	24
<b>All others</b>								
Countries belonging to at least one RTA	24	22	33	20	8	47	10	164
Average number of RTAs per country	2	6	8	5	4	4	8	5
Maximum number of RTAs per country	3	12	17	12	9	9	15	17
<b>Total</b>								
Countries belonging to at least one RTA	26	26	35	20	8	48	11	174
Average number of RTAs per country	2	6	8	5	4	4	11	5
Maximum number of RTAs per country	7	12	19	13	9	9	29	29

Note: Bilateral agreements are defined as an RTA with two members. North is Organisation for Economic Cooperation and Development (OECD) 24 plus Lichtenstein, and South is all other countries.

Source: Adopted from WB, *GEP, 2005*, P-30.

While new RTAs/PTAs are emerging at a faster pace in recent times, a different kind of regional economic cooperation is also being witnessed. The economic literature describes this as ‘deep integration’. International trade theory (‘new regionalism’) suggests that there could be significant gains from deep integration. The potential chain of relations linking integration to economic performance is:

**Shallow integration → Deep integration → Expanded trade (both exports and imports) → Externalities and scale economies → Productivity increases → Improved economic performance.**

Shallow integration is probably a necessary precursor to successful deep integration, in which some of the links are ‘broad’, involving externalities that affect many economic activities and some of the links are commodities/sector specific. Examples are agriculture, manufacturing, and services etc.

While analysing regional integration (RTAs) *vis-à-vis* global integration/liberalisation, many elements of deep integration are easier to achieve through a regional agreement. Some important elements are not a part of the agenda of global trade negotiations, which tend to focus on shallow (negative) integration i.e. removal of existing policy barriers rather than on positive integration. There are, therefore, strong arguments for linking shallow integration with an RTA to achieve elements of deep integration. Most recent RTA negotiations do involve elements of deep integration. Achieving shallow integration is a part of the process of achieving deep integration. There is a potential trade off between initial negative impact of trade diversion from a shallow-integration RTA and potential gains from deep integration that follows the RTA.

## The Asian Perspective

The Asian region has a distinct identity shaped by history and cultural exchanges over several centuries, which has involved vibrant flows of goods and services as well as labour and capital amongst the Asian countries. In ancient times, the famous Silk Route provided one channel for such exchanges and Marco Polo’s tales

are just one of many descriptions of the exchanges taking place in Asia. During the 19<sup>th</sup> 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. Even during the first half of the 20<sup>th</sup> century the intra-regional trade ratio was over 50 percent.<sup>2</sup>

Along with the trade flows there was a vibrant exchange of ideas. Chinese scholars visited India and *vice versa*. The ideological influences spread across the nations binding them in ties of religion. Hinduism and with it the art of governance of Chanakya found its way across much of Indonesia, Malaysia and Thailand. The sweep of Buddhism is well known. Religion has been a strong unifying factor. Religious beliefs came with the spread of religion and became a way of life, and as religious influence spread so did the cultural ties flourish. Pagan, Borobudur and Angkor Wat are only but a small testimony to the vast trading and cultural network that Asia had in ancient times.

For more than 50 years, Asia has been witnessing regionalism for greater economic and political cooperation, albeit extremely slowly. A number of initiatives have been taken at the sub-regional level (Box 1). Before the late 1990s, the political factors that provided the impetus for regional integration in other parts of the world were largely absent in Asia. However, Asian countries have now become very active in deepening existing sub-regional agreements, and the sub-regional groupings are integrating with each other through a variety of mechanisms, including ‘framework’ FTAs, bilateral FTAs and a new sub-regional agreement, Bangladesh-India-Myanmar-Sri Lanka-Thailand Economic Cooperation (BIMSTEC), which provides an interface for some South and Southeast Asian integration. The energetic role in trade negotiations by China after its accession to the WTO in 2001 has introduced a new dynamism into regional integration in Asia. Japan, South Korea, and India, which had traditionally remained aloof from regional agreements, have also joined the great movement.

### Box 1: Evolution of Trade Agreements in the Asian Economy

Asian countries have been faithful adherents of multilateralism till nearly the turn of the millennium, and thus were slow to respond to the global trend of regionalism. However, in the past there were some sporadic efforts towards some sort of regional economic cooperation in Asia. In the 1970s, the Asian Clearing Union (1974) and the Bangkok Agreement (1975) were formed mainly through the United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP) initiatives. The Bangkok Agreement covered the exchange of tariff concessions among five member countries, viz. Bangladesh, India, Lao PDR, South Korea and Sri Lanka. In 2000, China also joined the Bangkok Agreement. Seven countries - Bangladesh, India, Iran, Myanmar, Nepal, Pakistan and Sri Lanka - formed the Asian Clearing Union. It is generally agreed, however, that these experiences have not been very successful. Over the past few years, Asian countries have also recognised the potential of regional economic integration and have started taking steps to benefit from it. Besides sub regional attempts in the framework of ASEAN (1967), SAARC (1985), and BIMSTEC (1994) groupings, a number of initiatives of broader economic integration are underway to push the agenda of regional economic integration. For deepening the sub regional cooperation among its 10 member states, ASEAN has served to bring major Asian countries, viz. Japan, China, South Korea and India, together as summit-level dialogue partners who meet annually at the ASEAN Summits. Similarly, the Central and West Asian countries formed Economic Cooperation Organisation (ECO) in 1985 and Gulf countries initiated Gulf Cooperation Council (GCC) in 1981. A complex web of the FTAs linking all these countries and ASEAN countries is in progress and a virtual Asian or East Asian economic community is emerging out of this.

## Box 2: What the Politicians-cum Policy-makers Say

"This web of engagements may herald an eventual free trade area in Asia covering all major Asian economies and possibly extending to Australia and New Zealand. The Pan-Asian FTA could be the future of Asia and will, I am certain, open up new growth avenues for our own economy".

**The Indian Prime Minister Dr Man Mohan Singh at the Inaugural session of the Board of Governors of Asian Development Bank (ADB) May 4, 2006 at Hyderabad.**

"The overall peace, stability and development in Asia have led to fast progress in the regional cooperation process. A new type of regional cooperation based on equality, diversity, openness and mutual benefits is taking shape. Various regional and sub-regional economic cooperation mechanisms have grown in strength, which include the Association of Southeast Asian Nations, the SAARC, Asia Cooperation Dialogue, those in East Asia and Central Asia, and multilateral and bilateral free trade arrangements. This is another opportunity that Asia should seize".

**Vice President of China, Zeng Qinghong at the opening ceremony of the Boao Forum for Asia (BFA) Annual Meeting 2006 22, April, 2006.**

"Japan, the 10-member ASEAN, China, South Korea, India, Australia and New Zealand should consider launching regional FTA talks in 2008. There should be a new economic

framework to strengthen current bilateral free trade agreements and should involve not only tariff reductions, but also investment, services and rules on intellectual property".

**The Japanese Economy, Trade and Industry Minister, Toshihiro Nikai at Boao Forum for Asia Annual Meeting 2006.**

"Although it is not an achievable goal (Asia wide FTA by 2008) in the short term, an East Asian Summit (EAS) FTA by the year 2020 can be envisaged .....and the region is likely to become a major driver of the global economy sometime in the first half of this century"

**Singaporean Minister for Foreign Affairs, George Yeo at Boao Forum for Asia (BFA) Annual Meeting 2006.**

"...the possible emergence of a formidable triangle consisting of India, China and the Association of South-East Asian nations (ASEAN) by 2015.....the triangle would indeed be a pulsating economic hub. The centre of commercial activity on the global stage would have shifted from the Atlantic Ocean to the Indian Ocean by 2015. Mumbai, along with Singapore, Hong Kong and Dubai, will eventually become the financial nerve centres of the world- to the rival likes of London, New York, and Tokyo".

**Indian Commerce & Industry Minister, Kamal Nath at Asia Pacific Business Summit in Singapore on April 12, 2006**

## The Asian Initiatives

According to a study by New Delhi-based Research and Information System for Non-Aligned and Other Developing Countries (RIS), there is evidence of complementarities in the production and trade structure between major Asian countries/regions, such as Japan, ASEAN, China, India and Korea. Trade liberalisation alone and between these countries can achieve efficiency gains worth US\$147bn. When this figure is combined with gains from investment liberalisation and mobility of skilled manpower, the overall gains from integration add up to US\$210bn, which is approximately three percent of the combined gross domestic product (GDP) of these countries. However, trade and investment policy liberalisation must be accompanied with additional measures such as freer capital mobility, harmonisation of customs procedures, market standards, and mechanisms to ensure a fair distribution of gains.

In Asia, there is now a growing recognition of the importance of the regional economic integration for generating growth impulses from within, especially in the wake of the East Asian crisis. The notion of a Grand Asian Family comprising all Asian nations was formally introduced at the Annual Meeting of the Boao Forum for Asia in 2003 by the former president of the Philippines, Fidel Ramos. A year earlier, in April 2002, Nobel Laureate Robert A Mundell predicted in his speech at the Sun Yat-Sen University, China, that Asia would have a single currency in the near future. Now leaders of the Asian countries are exploring the possibility of having an Asian Economic Community (Box 2) as a distinctive bloc and a counterweight to the proliferation of RTAs/PTAs in other parts of the world.

Successful experiences with regional economic integration in the industrialised countries of Europe and North America since the mid-1980s have also prompted Southeast and South Asian countries to adopt economic integration strategies. As per the decision taken at the ASEAN+3 Summit held in conjunction with the ASEAN Summit in Laos in November 2004, the EAS bloc was formed at Kuala Lumpur in December 2005 with the objective to launch the process of forming an East Asian Community (EAC) by combining the ASEAN 10, Japan, China, India and South Korea and possibly Australia and New Zealand. Thus, the formation of the new forum could be of far reaching consequences for promoting broader regional cooperation in Asia. It can provide the leaders of the largest and most dynamic economies of Asia a much-needed annual forum for dialogue, which would in course of time take steps towards concreting an Asian Economic Community.

The Boao Forum of Asia (BFA) was launched at Boao in Hainan province of China in 2001 as a pan-Asian forum. The ASEAN+3 (China, Japan and South Korea) announced at the Asian Development Bank (ADB) Annual Meeting at Hyderabad in May 2006 that they would consider a single Asian currency similar to the Euro. In fact, ADB has been keen on the creation of an Asian Currency Unit (ACU) to realise monetary stability, spur regional economic growth and even out disparities. Hence, a key priority consideration for a future EAS and BFA would be to create an Asia-wide FTA as a framework agreement coalescing and consolidating all mutual FTAs, including those in West and Central Asia such as the Economic Cooperation Organisation (ECO) that

consists of 10 Central and West Asian countries and six-country strong Gulf Cooperation Council (GCC).

In addition to these regional economic cooperation initiatives, Asian countries are actively engaged in making FTA agreements amongst themselves such as Japan-China-Korea FTA; India-China FTA; India-Korea FTA; and India-Japan FTA. The South Asian Free Trade Area (SAFTA) of the South Asian Association for Regional Cooperation (SAARC) countries (Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka) was launched in 2006. Apart from these, there are moves in different Asian countries to form RTAs. India is in the process of launching the Comprehensive Economic Cooperation Agreement (CECA) with GCC. The countries of Central Asia and the Middle East (MECA) as well as the Middle East and North Africa (MENA) are also making similar efforts. Figure 2 presents a possible Asian Economic Community by 2020.

### The Concerns

Apart from international institutions such as the International Monetary Fund (IMF), WTO and ADB raising concerns over the proliferation of RTAs all over the world, domestic ‘protectionist’ elements in political parties and business groups in RTA participating countries have also raised their voices against the indiscriminate rise of bilateral/plurilateral FTAs. The IMF contends that RTAs could divert resources from multilateral trade liberalisation, including WTO negotiations, and foster incentives for regional partners to lobby against any MFN-based reforms that would reduce the value of their tariff preferences, endangering prospects for India reforms.

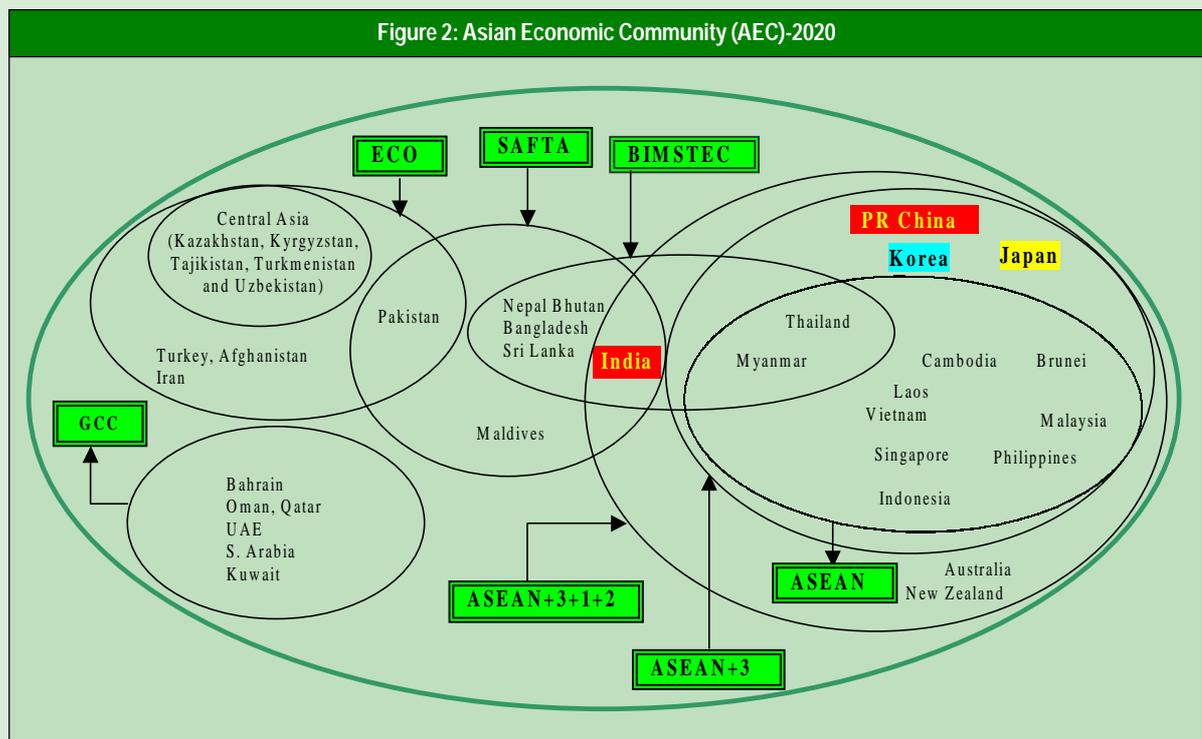
The IMF (May 2006) says it is useful to ask whether the recent proliferation of preferential agreements in Asia is a healthy development or if it will result in an unmanageable ‘noodle bowl’ regionalism in the future, more likely to divert trade than to create it.

The ADB, in a similar vein, warned that a further spread of discriminatory bilateral trade agreements could harm growth prospects for Asia’s emerging economies. Afzal Ali, the ADB’s chief economist said, “A lot of these bilateral deals have nothing to do with economics. Instead, they (ADB’s member states) are mostly doing it for diplomatic reasons, including efforts to gain access to natural resources”.

The Director-General of WTO, Pascal Lamy, is also opposed to bilateral FTAs as they may not always be in the interest of developing economies. He feels that mid-sized and small countries especially may end up extending major concessions in areas of investment and intellectual property rights (IPRs) in order to gain access to the larger markets of US or Europe.

As agreements proliferate, a single country often becomes a member of several different agreements. This creates a ‘spaghetti bowl’ or what IMF recently described ‘noodle bowl’ of overlapping arrangements. Each agreement has different RoO, different tariff schedules, and different periods of implementation, and together they complicate customs administration. The customs agents report that it takes longer to process goods covered by preferential arrangements, and longer processing time drive up the cost of trade. In general, the larger the delays in customs the smaller the role of trade in GDP.

In a more recent controversy over the issue of signing a large number of bilateral/plurilateral FTAs



by India, the Indian National Congress - one of the member-parties of ruling coalition United Progressive Alliance (UPA) government - has raised concerns over the likely adverse impacts of such moves on the agricultural sector, especially edible oil, coffee, tea and pepper, as well as on manufacturing such as textiles. The main argument against it is the multiplicity of RoO and negative lists, which will create confusion and practical problems for custom administration resulting in loss to the business interests.

Macroeconomic stability, basic property rights, and adequate infrastructure regulation are all key. Indeed, trade agreements can reinforce positive elements in the domestic reform programme by anchoring policy to the agreement itself. But an RTA cannot substitute for sound domestic policies. Even well-designed agreements are of limited value if they are not implemented, and many RTAs have more life on paper than in reality. Weak implementation often afflicts South-South agreements. Monitoring mechanisms are many times inadequate and do not receive the sustained high-level political attention necessary to drive institutional improvements in, for example, adherence to tariff reduction schedules, customs, and border crossings.

In fact, about 66 percent of the decline in average tariffs in developing countries during the last two decades has come from unilateral reductions, as distinct from 25 percent coming out of the Uruguay Round and around 10 percent from RTAs. Moreover, product exclusions and restrictive RoO further limit the trade expanding effects of preferences. Nonetheless, the result of this proliferation is an increasingly complex global trading system where different countries' access to a given market is often governed by different sets of rules.

### Prerequisites for Success

The success of an RTA/PTA depends, to a large extent, on how the trade policy is integrated with the domestic policy framework. It is virtually impossible for entrepreneurs to take advantage of new opportunities whether they originate in market access through an RTA or a multilateral agreement or other sources if the domestic investment climate is not supportive. The prerequisites for success of an RTA *inter alia*, include: low external MFN tariffs; few sectoral and product exemptions;

nonrestrictive RoO tests that build toward a framework common to many agreements; measures to facilitate trade; large ex-post markets; measures to promote new cross-border competition, particularly in services; and rules governing investment and intellectual property that are appropriate to the development context.

### Conclusion

Regionalism has become a key component of the new international economic order. It offers countries, both developing and developed, a new and attractive complementary strategy to multilateralism. Today, most countries belong to one or more RTAs of some kind, 'shallow' or 'deep' integration. Furthermore, there are increasingly moves towards CECA or deep integration bilaterally or plurilateral regional economic cooperation. Asia-Pacific has been the latest region to catch up with the trend, and its countries are exerting renewed efforts to both deepen and expand regional and sub-regional economic integration, as reflected by a remarkable scale of negotiations underway.

The voices emanating from different parts of Asia point towards the idea of greater Asian Economic Community which is also evidenced by the efforts from different countries of Asia for creating deep and wide regional integration on the pattern of EU. The EAS and BFA provide an opportunity on a regular basis to conduct dialogue and exchange views, increase mutual understanding, expand mutual trust and promote regional cooperation.

Plurilateral arrangements such as ASEAN, SAFTA, BIMSTEC, GCC, ECO etc., and enhanced efforts to integrate each other through bilateral/plurilateral CECAs are pointers to the direction of the formation of the Asian Economic Community by 2020. The ADB President Haruhiko Kuroda, while supporting the idea of ACU on the pattern of the Euro, has gone on to say, "The European Style of Integration (for Asia) seems to have the greatest potential for realising the dynamic benefits of a common area and monetary policy". In sum, the formation of bilateral/plurilateral FTAs do not only bring economic benefits to the participating countries but also give an opportunity to develop political understanding and thereby reduce conflict, cross border tension and suspicion.

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### Endnotes

- 1 DFID Project Number 94 5881 "Assessing Regional Trade Agreements with Developing Countries: Shallow and Deep Integration, Trade Productivity, and Economic Performance", David Evans *et. al*, University of Sussex, Jan.2006, P-2.
- 2 Kumar, N. (2005): "A Broader Asian Community and a Possible Road Map", EPW Vol. XL NO. 36, P.3926-3931.

