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**ECONOMIC RELATIONS BETWEEN
SOUTH AND EAST ASIA: THE EVOLUTION OF
PAN-ASIAN INTEGRATION**

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ECONOMIC RELATIONS BETWEEN SOUTH AND EAST ASIA: THE EVOLUTION OF PAN-ASIAN INTEGRATION

I. Introduction

Unlike in Latin America, the East Asian development model of the past four decades did not contain any deliberate bias in favor of regionalism. East Asian countries adopted open market-oriented development policies and this led to their integration with both the global and regional economies. It was only in the late 1990s that East Asia began to pursue regionalism more actively. This development can be attributed, as Kawai (2005) and others have noted, to various factors such as growing economic interdependence in the region, the slow progress in multilateralism and popularity of regionalism elsewhere, and various lessons learned from the 1997-1998 financial crisis.

On the other hand, until the late 1980s, the South Asian countries were essentially closed economies and the opening-up measures of the early 1990s comprised both multilateral as well as regional and inter-regional approaches to trade liberalization. “Look East” policies in South Asia sought to establish trade and economic links with the dynamic ASEAN and now the ASEAN+3 countries in East Asia.

New regionalism and inter-regionalism in both East Asia and South Asia together with the underlying comparative advantages of these two sub-regions have led to growing – but still low – economic relationships between the two sub-regions. However, with the PRC and India being the two most dynamic countries in the world, economic relationships between East and South Asia are bound to increase in the future.

Against this background, the objectives of this paper are to: (i) review regionalism between South and East Asia (ii) provide quantitative measures of trade and investment integration between the two sub-regions, and (iii) highlight ADB’s catalytic role in promoting South Asia and East Asian economic relationships.

The paper is organized in four parts: the second part reviews regionalism in South and East Asia, the third part reviews the potential benefits of integration between the two sub-regions, and the fourth part discusses the next steps in promoting South and East Asia economic relationships.

II. Regionalism Between South and East Asia

Regionalism in Asia, which began in the 1990s, covers three areas - trade and investment, infrastructure and associated software, money and finance. While most of these efforts are mainly bilateral or subregional, more recently a large number of efforts have been initiated to promote trade and investment between South and East Asia or Pan-Asian integration (Table 1). The only initiative in the area of money and finance that seeks to bring together South and East Asia is the Asia Cooperation Dialogue which was established in 2002.

The most significant effort in the area of trade and investment is the signing of the India-Singapore Comprehensive Economic Cooperation Agreement (CECA) on June 2005. The CECA became effective in August 2005 and covers not only trade in goods but also services, investments and cooperation in technology, education, air services, and human resources. In addition, five FTA framework agreements have been signed between South and

East Asian countries and FTAs are under negotiation (Table 1). These are the ASEAN-India FTA, India-Thailand FTA, BIMSTEC FTA, Malaysia-Pakistan FTA, and Pakistan-Singapore FTA. Finally, six FTAs have either been proposed or the framework agreements are under negotiations – India-PRC, Pakistan-PRC, India-Korea, India-Japan, Singapore-Sri Lanka, and Malaysia-India. As in the case of East Asia, there appears to have been a proliferation of FTAs seeking to promote trade and investment between South and East Asia.¹ Many of these FTAs are, however, relatively new, but many are FTA Plus in the sense that they go beyond just tariff reduction into, for example, trade facilitation measures, partial movement of labor etc and have “early harvest” clauses which kick in soon after the framework agreement is signed (the ASEAN-India FTA is an exception as both parties have agreed not to pursue an early harvest program). This spate of cooperation agreements in recent years suggests that countries perceive significant advantages to be gained from regional cooperation.

III. Potential Benefits and Measures of Integration between South and East Asia

As Kumar (2002) has noted, there are significant complementarities between India (and more generally other South Asian countries) and East Asia. East Asia’s strength is in IT hardware and electronic equipment sector and this can be matched with India’s increasingly sophisticated and sustainable software capacities and its ability in chip design. East Asia’s need for R&D can also be partly met through East Asia’s investment in India and benefiting from India’s scientific talent pool. East Asia (excluding Japan) and South Asia are two of the fastest growing sub-regions in the world. Between 1994 and 2004, East Asia (excluding Japan) grew 6.9% annually, on average, while South Asian growth was 5.8%. Looking ahead, the dynamism of the two regions should also result in complementarities through mutually beneficial cooperation and integration.

Because of the existing complementarities, there are several potential benefits of closer economic cooperation between South and East Asia.² First, cooperation and integration leads to the expansion of the market for goods and services and increases the scope for both economies of scale and greater competition. Second, increased competition within the integrated region could lead producers outside the region to reduce their prices as well, lowering prices of imports to the region and improving its terms of trade. Third, a more integrated region could attract more foreign direct investment with its attendant benefits of technology and knowledge transfer and higher productivity. Fourth, and perhaps more importantly, regional cooperation agreements enable deeper and wider integration among member countries than what may be feasible within a multilateral framework. Cooperation on infrastructure and trade facilitation (e.g., transport, customs clearance, and product standards) and services (e.g. financial services and labor services) would likely lead to reduction in trade costs and result in welfare gains well in excess of that from mere tariff liberalization.

Studies on South and East Asia economic cooperation are relatively scarce. However, two studies suggest that the potential benefits of such cooperation are large. Mohanty, Pohit, and Roy (2004) estimate that a free trade area among JACIK countries (Japan, five

¹ This is in contrast to South Asia where there are presently only two FTAs – South Asia Free Trade Area (SAFTA) and Pakistan-Bangladesh FTA.

² Several potentially important non-economic benefits of cooperation and integration are enhanced political solidarity and security among member countries, greater bargaining power of member countries in international forums, and the possibility that cooperation agreements may serve as a commitment mechanism and help lock in reforms in member countries.

middle-income ASEAN countries, PRC, India, and Korea) could lead to a 2.2% of GNP increase in welfare gains for the region, ranging from 0.6% of GNP for the PRC to 3.1% of GNP for Singapore. When free trade is supplemented with free movement of investment and labor, welfare gains for the region rise to 3% of GNP. Another study published by ADB,³ which encompasses a larger number of countries in the two sub-regions, suggests that free trade by 2025 will increase real income in the region by 0.3% in India to 6.6% in Malaysia above the baseline. When other trade costs are assumed to decline by 50% by 2025 (e.g., through trade facilitation measures and improved efficiency of transport and communications, among others), real income increases above the baseline range from 8% in Japan to 116% in Malaysia by 2025.

Over the past decade, economic integration between the two sub-regions has been growing in tandem, albeit from a low base, partly reflecting the liberalization programs implemented by South Asian countries since the early 1990s, pursuit of regionalism in both South Asia and East Asia, and, in part, the recovery of East Asia from the 1997 financial crisis.

South Asia's exports to East Asia increased from \$5.1 billion in 1990 (or 19% of South Asia's exports) to \$21.3 billion (or 20.7%) in 2004. Similarly, East Asia's exports to South Asia increased from \$10.6 billion (1.5% of East Asia's exports) to \$43.2 (or 1.8%) (Table 2). This suggests that despite rising export shares, East Asian markets are more important to South Asia than vice versa. For South and East Asia as a whole (pan-Asia), intra-regional exports increased from 40.4% in 1990 to 51.7% of total exports in 2004, reflecting largely trade within East Asia. While both exports and imports of East Asia to/from South Asia have shown a marked increase, South Asia's imports from East Asia have risen much faster than its exports to East Asia. India and PRC, considering their relative size within the sub-regions, increased their shares in the two sub-regions' trade. Indeed, in South Asia, India was the only country which experienced an increase in trade with East Asia between 1990 and 2004. The scope for increasing welfare through further cooperation and integration is thus large. This will also enhance further the level of Pan-Asian integration. Data on bilateral flows of FDI are more difficult to obtain. Those available from UNCTAD show that net inflows of FDI from East Asia to South increased from \$12.9 million in 1990 to \$256.5 million in 2002 but East Asia still accounts for only 12% of South Asia's FDI inflows (Table 2).

IV. Next Steps: ADB Study

What are the next steps in promoting economic cooperation and integration between South and East Asia? South and East Asian economies have to overcome a number of challenges. First, the potential for trade diversion and trade deflection has to be minimized.⁴ Preferential tariffs granted to member countries may lead to diversion of trade if imports are sourced from a regional supplier that may be less efficient than one outside the region. Differential tariffs against extra-regional imports by members could also lead to trade deflection as exporters outside the region attempt to enter the regional market through the member with the lowest external tariff. These problems are likely to be magnified with overlapping agreements where a country is party to more than one bilateral agreement, sometimes among the same group of

³ See Brooks, Roland-Holst, and Fan Zhai (2005). The countries included are: Japan, PRC, Korea, Hong Kong, China, Taipei, China, Indonesia, Malaysia, Philippines, Singapore, Thailand, Viet Nam, Bangladesh, India, Sri Lanka.

⁴ This may be particularly pertinent for South Asian economies where imports attract generally higher tariff rates. The average of the tariff rates among South Asian countries was 15.3%, compared with 7% in East Asia, including Japan, and 8.5%, excluding Japan.

countries.⁵ Both of these risks could be minimized by limiting the margin of preference to members versus non-members. Furthermore, rules of origin that are specified on extra-regional imports to minimize trade deflection should be non-restrictive so that they do not heighten uncertainty for trade and investment, and their administrative costs are manageable. Second, in some member countries, tariff revenues are a significant portion of fiscal revenues. The loss of tariff revenues from trade diversion may need to be accompanied by fiscal reforms. Third, integration may lead to changes in the pattern of production across countries and sectors. These changes could arise from differences in comparative advantage and from location-specific clustering effects.⁶ As a consequence, the benefits from regional integration may not be equitably distributed across countries and sectors.

Policymakers should consider the so-called “spaghetti bowl” effects of the FTAs between South and East Asia. FTAs require implementation of strict rules of origin that involve administrative costs; if different agreements have different rules of origin, administrative costs could be high. To avoid such a situation, it is necessary to carefully design FTAs to be compatible with each other. A review system may need to be established.

Since regional cooperation and integration is an important mandate of ADB, President Kuroda has guided that ADB should take a more proactive role in promoting cooperation and integration across the Asia and Pacific. As part of this effort, ADB will conduct a major study on Economic Cooperation between East and South Asia starting next year. The main purpose of the study is to provide a roadmap of policy options to enhance economic cooperation and integration between East and South Asia. To develop the roadmap, the study will assess (a) potential benefits from enhanced cooperation between East and South Asia under a set of plausible scenarios, (b) the distribution of those benefits by countries and sectors, (c) measures to enhance cooperation in merchandise trade and investment, trade in services, and infrastructure and trade facilitation, (d) the consistency among different bilateral cooperation agreements that are in effect or proposed, (e) consistency with WTO obligations and (f) lessons from experience of economic cooperation in other regions, where applicable. The roadmap should help countries and ADB to devise strategies for effective regional economic cooperation and integration.

A number of studies will be commissioned - one on the potential benefits of regional economic cooperation between East and South Asia and their distribution, and three studies on specific areas of cooperation, including merchandise trade and investment, trade in services (e.g., financial services, labor services, and tourism, among others), and infrastructure and trade facilitation. ADB will also commission four country case studies to provide unique perspectives of individual countries or group of countries. These could include two economies each in East and South Asia. The findings of the studies will be discussed at a senior-level policy seminar, with representation of high-ranking policymakers from member countries.

⁵ For example, India, Myanmar, and Thailand are signatories to both BIMSTEC and ASEAN-India agreements.

⁶ Firms within an industry may cluster in particular locations to benefit from proximity to consumers and suppliers, availability of specialized labor or other inputs, and technological or knowledge spillovers from other companies located in the area.

**Table 1: An Annotated List of Free Trade Agreements (FTAs)
Between East and South Asia***

FTA SIGNED AND UNDER IMPLEMENTATION

- India-Singapore Comprehensive Economic Cooperation Agreement (CECA)
 - Under CECA (signed June 2005 and effective August 2005), India will remove duties on 506 products from Singapore immediately, on 2,202 items by April 2009, and cut duties on another 2,407 products to 50% by the same date
 - Singapore will scrap tariffs on goods made in India starting 1 August
 - The pact also covers services, investments, and cooperation in technology, education, air services, and human resources.

Framework Agreement Signed AND FTA Under Negotiation

- Framework Agreement covering the ASEAN-India Free Trade Area
 - Agreement signed in October 2003 and became effective in July 2004
 - An ASEAN-India Trade Negotiation Committee (AI-TNC) was established in March 2004 to negotiate the implementation of the provisions of the framework agreement
 - For India and ASEAN-6, excluding the Philippines, they have until 2011 to reduce or eliminate tariffs
 - Between India and Philippines, the schedule is until 2016
 - For India and new ASEAN members, India will reduce or eliminate tariffs until January 2011 while said ASEAN members will do the same until 2016
 - What rules of origin criteria to use remains an issue to be resolved
 - Both parties have agreed not to pursue the Early Harvest Program (EHP) and instead will focus on finalizing the FTA with initial commitments to reduce tariffs starting 1 January 2007
- India-Thailand Free Trade Area
 - The Framework Agreement for India-Thailand FTA (signed on October 2003, amended in 30 August 2004, and effective September 2004) reduces tariffs on 82 “early harvest” items by 50% in the first year, by 75% in the second year, and by 100% thereafter
 - The trade negotiating committee (TNC) met in April 2004; since then there has been eight meetings and the last one was held in September 2005
- BIMSTEC Free Trade Area
 - The Framework Agreement on BIMSTEC FTA (signed in February 2004 and effective June 2004) involves a reduction and elimination of tariffs starting July 2006 up to 2010 for India, Sri Lanka, and Thailand and up to 2017 for Bangladesh, Bhutan, Myanmar, and Nepal
 - The first TNC meeting was held in September 2004 and it was agreed that negotiations would start on trade in goods and then proceed to trade in services and investment
 - FTA will have 2 phases (for fast track and normal track products)
 - Members were scheduled to provide their sensitive lists to the TNC meeting on June 2005
- Malaysia-Pakistan Free Trade Agreement
 - In February 2005, Malaysia and Pakistan agreed to negotiate an FTA. The FTA would cover liberalization of trade in goods and services, investment, and economic cooperation.
 - Negotiations on goods and investment are expected to be completed by end-2005 while services would be negotiated after the Sixth World Trade Organization Ministerial Conference
 - In a June 2005 meeting of the TNC, both parties discussed the scope of products to be included under an Early Harvest Package (EHP), the time frame, rules of origin, areas to be covered under investment, and a Dispute Settlement Mechanism.
 - In the July 2005 meeting of the TNC, both parties offered a list of products for consideration by the EHP.
- Pakistan-Singapore Free Trade Agreement
 - Pakistan proposed an FTA with Singapore in June 2003. An exploratory FTA meeting in February

* FTAs signed and being negotiated by East and South Asian countries with other countries are not included.

- 2005 discussed the possible scope and timeframe for negotiations
- The first round of negotiations held in 24-26 August 2005 focused on key issues in trade in goods and services, investment, rules of origin, and legal chapters of the FTA.

FTA PROPOSED AND FRAMEWORK AGREEMENT UNDER NEGOTIATION

- **India-PRC Free Trade Area**
 - In June 2003, both parties agreed to set up a Joint Study Group (JSG) to expand trade and economic cooperation. The JSG was tasked to present a report and recommendation on comprehensive trade and economic cooperation by end of June 2004.
 - On 21 March 2005, the report of the India-China JSG on Comprehensive Trade and Economic Cooperation was finalized and it recommended an India-PRC Regional Trading Arrangement covering trade in goods and services, and investment and identified understandings for trade and investment promotion and facilitation, and measures for promotion of economic cooperation in identified sectors.
 - The JSG also recommended the appointment of a Joint Task Force to study in detail the feasibility and benefits of the regional trading arrangement
- **Pakistan-PRC Free Trade Agreement**
 - A Memorandum of Understanding on FTA and Other Trade Issues was signed on 5 April 2005 announcing the conclusion of the Joint Feasibility Study on Pakistan-PRC FTA and launching of negotiations on the FTA
 - The Agreement on Early Harvest Program (EHP), a basis for the establishment of an FTA, was also signed. Tariff reduction will start on January 2006 until January 2008 when all tariffs will be removed
- **India-Korea Comprehensive Economic Partnership Agreement**
 - In October 2004, India and the Republic of Korea decided to examine the feasibility of a Comprehensive Economic Partnership Agreement (CEPA). They formed a JSG which met on 27 January 2005 to sign its terms of reference.
 - The CEPA is envisioned to cover trade in goods and services, investment, and areas of economic cooperation.
- **Japan-India Economic Partnership Agreement**
 - On 29 November 2004, Japan and India agreed to establish a Japan-India JSG for a Comprehensive Study to review their economic relationship. The JSG had preliminary discussions on trade in goods, investment, and infrastructure development on 19-20 July 2005. The next meeting of the JSG is in November 2005.
 - The JSG was directed to submit a report within a year and to focus on the requirements for a comprehensive expansion of trade in goods and services, investment flows, and other areas of economic cooperation.
- **Singapore-Sri Lanka Comprehensive Economic Partnership Agreement (CEPASS)**
 - On 29 August 2003, Singapore and Sri Lanka agreed to begin exploratory talks in October 2003 on a CEPASS with the expectation of launching formal negotiations by 2004.
 - CEPASS is expected to be comprehensive, covering trade in goods and services, promotion and protection of bilateral investments, as well as other initiatives. The parties are also discussing an open skies policy to promote investment and tourism in Sri Lanka.
- **Malaysia-India Comprehensive Economic Cooperation**
 - In December 2004, Malaysia and India decided to look into a Comprehensive Economic Cooperation Agreement (CECA) including the possibility of an FTA. A JSG met in March, June, and August 2005.
 - The JSG will consider the recommendations of the ASEAN-India Experts Group on an FTA covering goods, services, and investments. Economic cooperation will be explored in the following areas: biotechnology, software development, science, and education, human resource development, infrastructure, tourism, and services.

Table 2: Exports

Exports (in million US\$)	1990	1995	2000	2004
<i>as % of Total</i>				
South Asia to South Asia	863.0	2,023.6	2,593.4	5,705.8
<i>as % of South Asia's Total Exports</i>	3.2	4.4	4.1	5.6
South Asia to East Asia	5,181.5	10,360.3	11,405.5	21,307.8
<i>as % of South Asia's Total Exports</i>	19.0	22.6	18.0	20.7
East Asia to South Asia	10,558.9	19,729.4	25,581.0	43,187.2
<i>as % of East Asia's Total Exports</i>	1.5	1.5	1.5	1.8
East Asia to East Asia	282,256.1	650,552.0	799,169.7	1,221,344.7
<i>as % of East Asia's Total Exports</i>	39.6	48.9	47.7	51.0
Pan Asia to Pan Asia	298,859.4	682,665.3	838,749.6	1,291,545.5
<i>as % of Pan Asia's Total Exports</i>	40.4	49.6	48.2	51.7

a/ East Asia consists of ASEAN+3; Hong Kong China; and Taipei,China.

b/ Pan Asia consists of ASEAN+3; Hong Kong China; Taipei,China; and SAARC member countries.

Source: IMF Direction of Trade (DOTS) CD-Rom, September 2005 and CEIC.

Table 3: FDI

FDI in reporting economy (in million US\$)	1990	1995	2000	2002
<i>as % of Total</i>				
South Asia^a from South Asia	0.9	1.5	9.4	11.0
<i>as % of South Asia's Total reported FDI</i>	0.4	0.1	0.4	0.5
South Asia from East Asia^b	12.9	219.0	271.5	256.5
<i>as % of South Asia's Total reported FDI</i>	6.5	14.5	10.7	12.0
East Asia from South Asia	2.9	23.1	50.8	7.0
<i>as % of East Asia's Total reported FDI</i>	0.0	0.4	0.4	0.0
East Asia from East Asia	5,485.1	41,668.8	57,196.5	46,883.5
<i>as % of East Asia's Total reported FDI</i>	62.1	72.9	44.4	57.0
Pan Asia^c from Pan Asia	5,501.7	41,912.4	57,528.3	47,158.1
<i>as % of East Asia's Total reported FDI</i>	60.9	71.4	43.8	55.9

a/ Refers to India, Bangladesh, and Pakistan (countries for which data are available).

b/ Refers to ASEAN+3 and Hong Kong, China.

c/ Pan Asia consists of East Asia and South Asia.

Source: UNCTAD FDI database. Detailed BOP basis net inflows data used, totals may differ from aggregate data.

Only Japan, PRC, Korea, Singapore, Thailand, and Pakistan have data for 1990. Hong Kong, China has no data for 1990 and 1995.

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