

STAFF PAPER

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REGIONAL COOPERATION AND INTEGRATION IN ASIA

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## Introduction

Asia is one of the most diverse regions in the world (in terms of geography, resources, people, customs, religions, politics and, most importantly, standards of living). The combined population of Asia is 3.5 billion (55% of the world population), with population ranging from 11,600 in Tuvalu to 1.3 billion in the People's Republic of China (PRC). Total GDP of Asia is over \$8 trillion in market prices and about \$17 trillion in purchasing power parity (PPP) terms. Four of the 10 largest economies in the world are now in Asia (Japan, the PRC, India, and Korea), but so are some of the smallest and most isolated economies in the world (Pacific islands). While Australia; New Zealand; Japan; Singapore; Hong Kong, China; and Taipei,China are among the richest economies in the world with per capita income in the \$20,000-\$40,000 range, countries such as Bangladesh, Cambodia, Lao People's Democratic Republic (Lao PDR), Kyrgyz Republic, Mongolia, Myanmar, and Tajikistan, remain among the poorest with per capita income of less than \$500.

Over the last three decades, Asia as a whole has experienced a dramatic economic transformation. The sustained high growth of over 6% annually was accompanied by a dramatic decline in the incidence of absolute poverty. Between 1990 and 2003, the percentage of the population surviving on less than \$1 a day fell from 34% to 19%. Asia as a whole is well placed to meet the Millennium Development Goals (MDGs) target of halving \$1 day poverty. With the incidence of poverty around 34% in 1990, halving poverty incidence would require that it be around 17% by 2015. Poverty in the region was already under 19% in 2003<sup>1</sup>.

Despite major achievements in reducing absolute poverty, more than 620 million Asians still live on less than \$1 a day; about 1.9 billion get by on \$2 a day. The incidence of poverty reduction is also uneven across Asia. Much of the progress in poverty reduction is the result of the performance of the PRC, India and Southeast Asian economies.

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<sup>1</sup> Kuroda (2006).

Thus, the greatest development challenge facing Asia remains poverty reduction and this is particularly pressing in low-income countries. Regional cooperation and integration (RCI) is one of the key instruments to address this development challenge in Asia. This paper (i) reviews the emerging trends in RCI in Asia; (ii) outlines a long term vision of RCI for Asia; (iii) articulates how RCI can help achieve ADB's overarching objective of poverty reduction, and (iv) provides an overview of ADB's role in promoting RCI in Asia.

## **Emerging Trends in Regional Cooperation and Integration in Asia**

The spread of information technology across the world, adoption of outward-oriented economic policies by an increasing number of countries, the rapid growth of large emerging market economies like the PRC and India, have brought Asian economies ever closer together. The private sector has played a major role in the globalization process and in increased regional economic integration. The acceleration of the globalization process and the private-sector driven vertical integration of production networks across countries have provided considerable impetus to regional economic integration particularly in East Asia. The collapse of the former Soviet Union led to the creation of independent states particularly in Central Asia. These economies had to begin not only nation building but also to initiate a new form of regional cooperation.

Physical connectivity has improved across most parts of Asia largely due to the economic development programs, both national and regional. Countries have been increasingly interconnected through land, sea, and air based transportation networks. Intra-Asian internet connectivity is growing at twice the pace of the trans-Pacific internet, reflecting growing potential for regional integration through development of e-commerce. The number of air routes within East Asia doubled from 54 in 1985 to 117 in 2000<sup>2</sup>. Between 1994 and 2005, intra-regional passenger traffic in Asia has almost doubled from about 500 billion passenger-kilometers per year to close to 1 trillion passenger-kilometers. In regions and subregions with a greater degree of integration, intra-regional travel has increased substantially. For example, intra-ASEAN travel has increased from 11 million tourists in 1994 to 23 million tourists in 2004<sup>3</sup>.

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<sup>2</sup> National Institute for Land and Infrastructure Management, Japan, 2005.

Figure 1. Asian Highway Network



The Asia Highway project, a cooperative arrangement among countries in Asia under the aegis of ESCAP that aimed to improve the highway system in Asia (which was suspended in 1975 for lack of financial assistance), has now been revived. The Intergovernmental Agreement on the Asian Highway Network, which was adopted in 2003, identified 55 Asian cross-border highway routes among 32 member countries to be developed to yield an Asian highway of over 140,000 kilometers. Under this project, existing roads will be upgraded and new roads constructed to link the highway networks in Asia. The budget and timeline for this project will be announced this year. The corridor is expected to improve economic links between East Asian countries, India, and Russia. When completed, this project will connect Tokyo to Istanbul and pass through the Korean Peninsula, the PRC, and other countries in Southeast Asia, Central Asia, and South Asia (see Figure 1).

<sup>3</sup> <http://aseansec.org>

Figure 2. Trans-Asian Railway Network



Source: United Nations

A Trans-Asian Railway project, which was hindered by political and economic obstacles for many years, has received a new momentum recently. The project is expected to facilitate movement of goods and people in Asia and provide accessibility for landlocked countries such as Lao PDR, Afghanistan, Mongolia, and the Central Asian republics. When completed, this project will provide 14,000 kilometers of continuous rail link between Singapore and Istanbul with possible further connections to Africa and Europe (see Figure 2).

Partially reflecting the improved physical connectivity and partially due to the continuous trade liberalization undertaken by many countries, the degree of trade integration in Asia has risen rapidly. Intra-regional trade now accounts for 55% of East Asia's total trade (sharply up from about 43% in the early 1990s, and higher than the 46% figure for NAFTA and only modestly lower than the 62% figure for the 15 European Union countries)<sup>4</sup>. Most of this increase in intra-regional trade has been due to the rising share of intra-regional trade in East

<sup>4</sup> [http://www.aric.adb.org/regionalcooperation/integration\\_indicators.asp?s=4&ss=12](http://www.aric.adb.org/regionalcooperation/integration_indicators.asp?s=4&ss=12)

Asia (from about 43% in the early 1990s to 55% in 2005). Trade integration in the other regions is occurring, but at a slower pace.

Since 1980, foreign direct investment (FDI) inflows into East Asia have more than quadrupled, reaching 31% of world FDI inflows in 2004. Over the same period, East Asia's sustained dynamism fueled an increase in FDI outflows from 5% to 14% of world outflows<sup>5</sup>. Notably, much of these flows were intra-regional – from Japan and the Newly Industrialized Economies to the countries of ASEAN and the PRC, and from ASEAN countries to one another and to the PRC.

The substantial realignment of exchange rates, particularly the yen-dollar exchange rate in the 1980s, and the remarkable technical progress achieved in information technology that reduced the cost of communications and logistics support, were among other external factors that led to increases in trade and investment flows. Moreover, greater competition among multinational firms due partly to liberalization and deregulation in various sectors in many countries in the world promoted their global activities<sup>6</sup>.

The enhanced economic integration and the opportunity for greater connectivity, in turn, have prompted governments to introduce several key regional cooperation initiatives in areas such as cross-border infrastructure development, trade and investment, money and finance, and the provision of various regional public goods in the health and environment sectors. These regional cooperation initiatives have further reinforced regional integration. Hence, regional cooperation and integration have become mutually reinforcing and interactive.

The 1997-98 Asian financial crisis was a landmark in RCI in Asia, especially in East Asia. Before the crisis, economic integration in Asia was mostly market-led and private sector-driven. Few government-led cooperation initiatives existed, and those that did were limited to the areas of cross-border infrastructure and trade. These included, for example, the establishment of the Asia Pacific Economic Cooperation (APEC) in 1989, the initiation of the ASEAN Free Trade Area (AFTA) in 1992, and the signing of the South Asian Preferential Trading Arrangement (SAPTA) in 1993. After the 1997-98 crisis, however, the market-led process began to be supplemented by a series of government-led initiatives, including those

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<sup>5</sup> Ibid

<sup>6</sup> Kawai (2005)

targeted at money and finance, trade and investment, and provision of other regional public goods (RPGs).

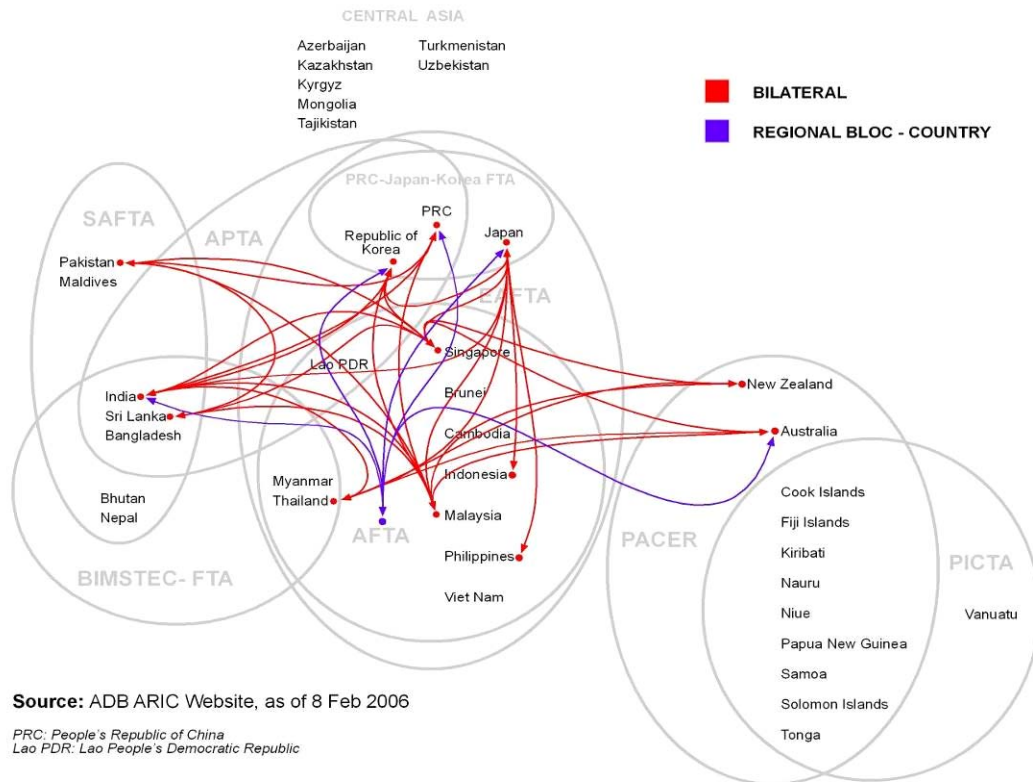
The focus of the postcrisis initiatives in regional monetary and financial cooperation in East Asia has been threefold. First, to improve the regional economic surveillance mechanism, the ASEAN Surveillance Process (ASP) and the ASEAN+3 Economic Review and Policy Dialogue (ERPD) have been established. Second, as a regional mechanism for short-term liquidity support, a network of bilateral swap agreements have been concluded as part of the well-known Chiang Mai Initiative (CMI), and ASEAN+3 officials are considering further options including multilateralization of the CMI. Third, to mobilize regional savings for regional investment and reduce the “double mismatch” problem (the currency mismatch and the maturity mismatch), the ASEAN+3 Finance Ministers have embarked on the Asian Bond Market Initiative (ABMI) involving measures to deepen and strengthen the region’s local currency bond markets.

In the area of trade and investment also, the postcrisis years have seen a growing number of government-led integration initiatives in East Asia and beyond. First, ASEAN accelerated its intra-regional trade cooperation initiative by advancing the deadline for the implementation of the AFTA from 2008 to 2002; the AFTA has thus been implemented about six years in advance. Second, ASEAN has established closer economic partnerships with its major trading partners, i.e. Japan, PRC, Republic of Korea, India, and Australia & New Zealand through a series of economic partnership agreements; one of the outcomes of these agreements would be the establishment of various FTAs between ASEAN and these countries.<sup>7</sup> Third, in other parts of Asia, a South Asian FTA (SAFTA) was established in January 2004, and is expected to be fully operational by 2016, and with support from ADB, the Central Asia Regional Economic Cooperation (CAREC) Program was established in 1997. Fourth, an Asia-Pacific Preferential Trade Agreement (APTA), which replaces the 1975 Bangkok Agreement, is now under negotiation. Finally, a number of bilateral FTAs have been signed or negotiated in recent years (see Figure 3).

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<sup>7</sup> To date, ASEAN has signed Framework Agreements on Comprehensive Economic Partnerships with Japan, PRC, Republic of Korea and India. The negotiations on FTAs with these countries have already embarked, covering trade in goods, services, and investment. The basis for FTA negotiations between ASEAN with Australia and New Zealand is the Joint Declaration of the Leaders at the ASEAN-Australia and New Zealand Commemorative Summit which was signed on 30 November 2004. The Trade in Goods agreement with China has been signed in November 2004 and its

Figure 3. Noodle-bowl Effect of FTAs



Asia also undertook several regional initiatives to provide a number of RPGs as a response to adverse cross-border impact of communicable diseases and environmental degradation. These included regional-level measures to contain HIV/AIDS, SARS, and Avian Flu, and initiatives to manage the environment. The Seventh ASEAN Summit held in 2002 adopted the ASEAN Work Program on HIV/AIDS which, among other things, aims to improve the access to drugs by the affected patients in the region; the ADB and the Secretariat of the Joint United Nations Program on HIV/AIDS (UNAIDS) signed a Memorandum of Understanding in February 2005 to strengthen cooperation in responding to the disease in Asia. In response to the outbreak of SARS, a Special ASEAN Leaders Meeting held in April 2003 in Bangkok established the SARS Containment Information Network that shares information, best practices, and new findings on SARS at the regional level. An ASEAN Agreement on Transboundary

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implementation has commenced since July 2005, while other agreements are under negotiations with targeted completion year of 2007.

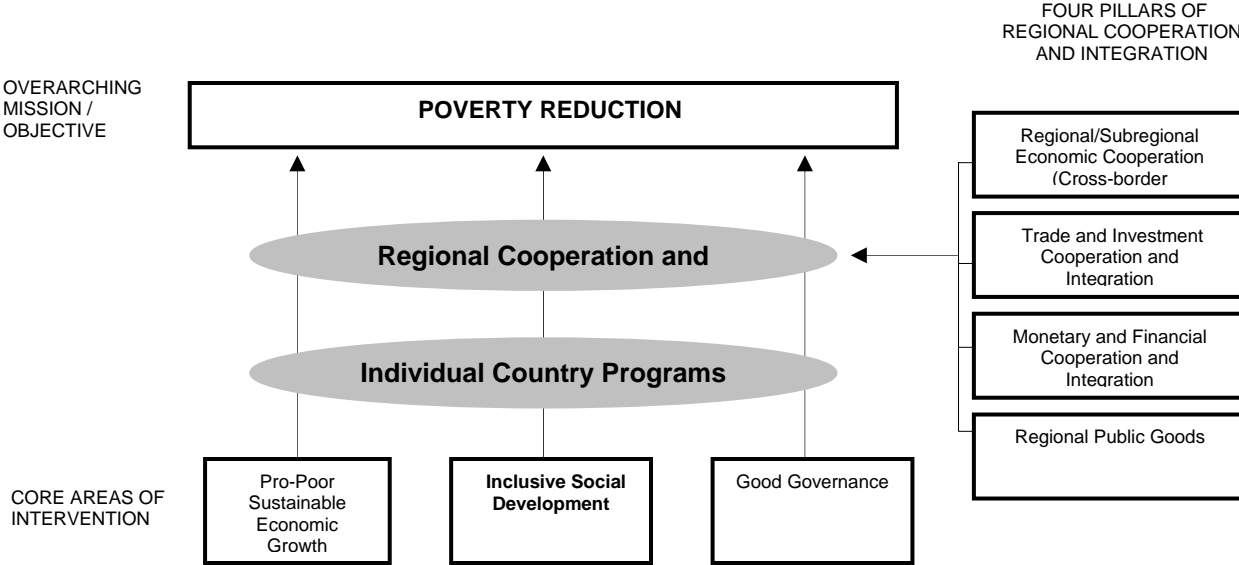


Haze Pollution was signed in June 2002, which provides a legal framework to facilitate regional cooperation in addressing cross-border impacts of haze pollution. A Clean Air Initiative for Asian Cities (CAI-Asia) was established in 2005 to address cross-border implications of air pollution across Asia.

**Regional Cooperation and Integration and Poverty Reduction in Asia**

From ADB’s perspective, RCI is not an end in itself, but only a means to achieve its overarching objective of poverty reduction in Asia (see Figure 4). RCI, if appropriately designed and managed, can help improve cross-border connectivity, increase regional trade and investment, promote efficient regional financial intermediation, reduce macroeconomic vulnerability to shocks, provide regional public goods (or reduce regional public “bads”), and improve the overall governance standards across the region. All of these will help reduce poverty and improve living standards in the region. For developing member countries, RCI thus provides an additional platform that can complement national-level policies and programs aimed at socio-economic development and poverty reduction.

Figure 4. ADB’s Mission and the Role of Regional Cooperation and Integration



RCI can enhance and complement domestic efforts at development, widening the range of options available to the participating countries. In particular, it can loosen the constraints of national boundaries on resources, factors of production, division of labor, and markets. This can

expand access to key inputs and enlarge the effective market accessible to participants. RCI therefore facilitates the realization of the development potential of the region, including gains through net increases in production and wealth, as well as the emergence, over time, of a more competitive economic structure. RCI is especially important for countries with limited access to markets and resources and for the poorer or lagging areas in national economies. In part, this is because RCI enables less developed economies in a region to take advantage of the improved connectivity and access to markets, and benefit more from increased cross-border flows of goods, services, capital, and people.

Deeper regional economic integration thus offers immense opportunities for the less developed countries, regions, and subregions within Asia to narrow their development gaps with the more developed partners, as demonstrated by the earlier successes of East Asia's tigers, middle-income ASEAN members, and more recently the PRC. These economies achieved successful industrialization by connecting their economies with more advanced economies in the region as well as the rest of the world by exporting relatively labor-intensive manufactured products<sup>8</sup>. Low income ASEAN members have seen high economic growth with their closer integration with the more developed partners. Economic growth that accompanies deeper economic integration tends to be "pro-poor".

The more developed countries in a region also benefit from RCI, since deeper regional integration eases constraints on their growth by allowing them to relocate labor-intensive industries and activities to their less developed neighbors and import labor-intensive products and services from these neighbors at cheaper prices. These benefits increase immensely if RCI also involves freer movement of people across national borders. Once regional integration reaches its advanced stage, say, deep monetary and financial integration, it gives a big boost to regional capital markets which, in turn, facilitates more efficient intermediation of a region's savings for investment.

RCI, if properly managed, thus offers a "win-win" outcome for a region's economies, rich and poor. This is because RCI facilitates resource allocation across the region in line with the principle of relative comparative advantage. The larger the number of countries covered and the broader the scope of RCI, the greater would be the benefits of RCI. It is easy to see that RCI has similar socioeconomic effects as globalization, especially in a region such as Asia, which

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<sup>8</sup> Kawai (2005).

now accounts for about 25% of world GDP at current exchange rates and about 35% of world GDP in PPP terms. In a way, therefore, RCI is a natural outcome of the globalization process. It makes countries gravitate towards their neighbors while they globalize their economies, as demonstrated by the gravity models of international trade. Geographical proximity thus acts as a natural catalyst for countries to embrace RCI en route globalization. Viewed this way, RCI can be an additional policy tool available for countries to manage their globalization process. The challenges and opportunities offered by globalization can thus be managed at three distinct levels—national, regional, and global. To maximize the benefits of RCI, it is important to ensure that it complements national and global initiatives.

Just as countries and sectors incur adjustment costs in the process of globalization, regional integration could also involve adjustment costs. While most of the benefits of integration become visible only over time and spread over the population at large, creation of more open and larger markets would entail financial and human costs of adjustment which can be felt and seen more immediately. The burden of adjustment could fall on a smaller set of groups who are vulnerable (less developed countries and regions, inefficient companies, and communities reliant on uncompetitive units and activities).

Unless such negative impacts are cushioned, adverse public reaction to integration can cloud recognition of the longer-term benefits, dissipating support so vital for RCI. Drawing on experience elsewhere, especially in Europe, these adjustment costs would need to be managed effectively to maximize the benefits and minimize the risks of RCI.

### **ADB's Support for Regional Cooperation and Integration in Asia**

ADB adopted a Regional Cooperation Policy (the Policy) in 1994<sup>9</sup>, which defined ADB's approach to promoting regional cooperation. It fleshed out one of the key mandates embodied in ADB's Charter: "The purpose of the Bank shall be to foster economic growth and cooperation in the region.... and contribute to the acceleration of the process of economic development of the developing countries in the region, collectively and individually"<sup>10</sup>.

Since 1994, ADB has made noticeable progress in implementing the 1994 RCP. In particular, ADB has assisted various subregional cooperation programs such as the Greater

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<sup>9</sup> ADB (1994).

<sup>10</sup> ADB Charter.

Mekong Subregion (GMS) program, South Asia Subregional Economic Cooperation (SASEC) program, the Central Asia (CAREC) program, and the Subregional Economic Cooperation in South and Central Asia (SECSCA) program. In the aftermath of the Asian crisis, ADB was requested by ASEAN and ASEAN+3 to support their initiatives on regional monetary and financial cooperation. In response, ADB established the Regional Economic Monitoring Unit (REMU) to support these regional initiatives, as well as transregional initiatives such as APEC and ASEM. ADB has supported the provision of RPGs to respond to cross-border impact of Avian Flu, HIV/AIDS, tuberculosis, and other infectious diseases that were spreading in the region at an alarming rate. ADB also responded rapidly to the Tsunami disaster by launching the largest grant program in its history. To date, ADB's total approved funding for the Tsunami-affected countries amounted to \$851 million, of which nearly 80% constituted grant.

Given the emerging trends of RCI in a number of areas, ADB began to take a fresh look at its support for RCI. The need for an 'external facilitator' such as ADB arises from the lack of incentives for individual countries to cooperate on their own to realize potential benefits from RCI. As the pace of globalization and regional integration accelerates, RCI in various forms can be expected to play an even greater role in the development of Asia—with important implications for ADB's role and operations. For ADB to play a greater role in supporting RCI in Asia, it should not only consolidate its on-going support for RCI, but should also take a more coherent, strategic approach to promoting RCI.

Against this backdrop, last year ADB made two important moves. First, on 1 April 2005, it established the Office of Regional Economic Integration (OREI) replacing and expanding REMU as ADB's focal point of its RCI activities; OREI is expected to enhance ADB's role in promoting RCI in Asia. Second, two Special Advisors to the President in charge of RCI have been appointed, who would coordinate and streamline the various RCI activities undertaken by many departments at ADB and advise for strategic measures and initiatives to enable ADB to play an enhanced role in furthering RCI in Asia.

Building on these measures, ADB is currently developing a RCI Strategy. When finalized, the Strategy would guide ADB's support for the on-going process of RCI in Asia in a coherent way as well as to generate desirable outcomes that are difficult for individual countries to achieve on their own. The RCI Strategy will also help promote "open regionalism" in Asia, making regionalism a building block rather than a stumbling block to a more liberalized global

economy and this will help achieve the RCI vision of an integrated, poverty-free, prosperous, and peaceful Asia.

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