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Overview and issues

Shiro Armstrong and Tom Westland

Asia and the global system

The global economy is confronted by huge uncertainties and challenges to the global trading system and global growth. The slow recovery from the global financial crisis (GFC) of 2007 and 2008 has led to protectionist forces and a backlash against globalisation in Europe and the US that threatens the global openness on which many countries, especially those in Asia, rely for development, peace and stability. In 1950, Asian per capita income, averaged across the region, was about 7 per cent of US per capita income; 60 years later, it was 21 per cent of US per capita income (The Maddison Project, 2013). What is more, this conceals vast variation across the region. Whereas some countries have languished (especially in South Asia), several countries in East Asia now have higher per capita incomes than the US, and others—including, importantly, China and India—continue to enjoy growth rates well above those of developed countries, which will ensure continued convergence of incomes over time. The astonishing achievement of many of the Asian economies in this period fully merits the title of ‘miracle’ with which it has often been garlanded.

Nonetheless, it is worth recalling that this achievement took place in a specific economic and institutional context that is by no means permanently assured. A liberal trading order globally was enshrined in the General Agreement on Tariffs and Trade and there was strong growth in

the advanced economies that ensured a market for exports from developing economies in Asia. After the GFC, there was no generalised repeat of the destructive beggar-thy-neighbour policies that followed the stock market crash of 1929; most countries understood that the maintenance of an open, rules-based order was a superior equilibrium outcome to one in which countries pursued economic policies at the expense of others, serving short-term interests but damaging longer-term ones.

The US's withdrawal from the Trans-Pacific Partnership (TPP) and Brexit in Europe, combined with unresolved economic and political difficulties in the Atlantic economies, signals a retreat of US and European leadership in global trade and investment liberalisation. The direction of US trade policy under the presidency of Donald Trump remains unclear, but the US could embrace a more aggressive bilateralism as it turns away from regional agreements with Europe and Asia. The cumbersome negotiating process used by the EU is opaque and deeply unpopular in the domestic politics of Europe. Given the pressures from political extremes, the weakness of economic growth and the underlying inward-looking nature of the single market, it is becoming more difficult for the nations of the EU to exercise joint leadership in pursuit of greater global economic integration. All the talk about a post-Brexit UK resuming its nineteenth-century role as a liberal vanguard notwithstanding, nor is it realistic to expect that Westminster (which will be obliged to spend most of its energy in the next decade or so extricating itself from the EU and, possibly, replicating trade agreements to which it was already a party) will supply much in the way of practical or intellectual leadership.

This is not an ideal time for such a vacuum to have opened. Trade growth has stalled since the GFC, falling from a rate close to double that of global gross domestic product (GDP) growth to one that barely keeps up with it. Asia was an engine of global trade and economic growth in the decade and a half after China's accession to the World Trade Organization (WTO), as Asian production networks proliferation and deepened. However, that rapid growth in trade from global value chains (GVCs) appears to have reached a plateau. The growth of trade in services has at least kept pace with global GDP growth. Stagnation of industrial country growth and the fall in investment appears to be responsible for three quarters of the slowdown in trade growth; the maturation of GVCs (in which finer and finer production fragmentation is reaching its limits) and rising protectionism have also played their part (International Monetary Fund [IMF], 2016, p. 65).

In this environment, economic reforms and liberalisation are politically more difficult to undertake. Countries are in search of a new strategy for development and opening up. The political economy of behind-the-border reforms and liberalisation is complicated and there are many new issues in cross-border commerce around the growth of information technologies. For the Asian nations, which have strong ambitions of development, there is a central interest in how to navigate these issues. There is much potential yet to be realised in South-East and South Asia and, of course, in China, where development remains dependent on engagement in the international system.

This volume reviews the current state of Asian economic integration but is primarily concerned with its future direction, given the new challenges thrown up by the adverse global context and the uncertainty that brings, and the new issues around international economic exchange in the twenty-first century.

The fourth industrial revolution in ecommerce, the internet, robotics and automation represent both a challenge and an opportunity for Asia and the world. Innovative policies regionally could contribute to positive and pre-emptive policies globally. Inspiration can be taken from the process that undergirded the Information Technology Agreement (ITA) and Environmental Goods Agreement (EGA) in the past. The ITA, which led to strong growth in the information communications technology sector in Asia at an early stage of its development and made GVCs possible, was an initiative first devised at the Asia–Pacific Economic Cooperation forum (APEC) and then subsequently implemented through the WTO. The EGA, a more recent example, is yet to progress as far. In this way, forums such as APEC can serve as intellectual proving grounds for ideas that are later taken to global institutions, including the WTO.

Both of the changes outlined here—the threat to globalisation led by the advanced economies of the North Atlantic and the new challenges to the way of conducting business—require creative and agile responses from Asia. A particular responsibility now devolves upon Asia to assume the mantle of leadership in open trade and economic policy strategy. **Mari Pangestu** and **Shiro Armstrong** begin to define what some of those responses might look like in **Chapter 2**. They describe the state of play in Asian economic integration and explain the ‘new normal’ for global and Asian economic integration. To do this, the situation up to now is reviewed, including the nature of the Asian economic cooperation and

integration that has taken place. This provides an introduction to the new ways to think about the issues that are examined in greater depth throughout the volume.

The Asian economic integration agenda

Former Director-General of the WTO **Pascal Lamy** provides a perspective in **Chapter 3** on global trade that is not all bad news. Growth in trade volume may be slowing down globally, but more appropriate measures of international trade—such as growth in value added—indicate rising trade intensity. This is especially the case in the highly integrated Asia–Pacific region. At the top of the agenda in regional economic cooperation in Asia is the need to deepen trade intensity and economic integration.

East Asia's rise to become a centre of global trade growth is the result of a commitment to opening up to trade, investment and competition as the primary means of achieving economic development. Border barriers to trade in manufacturing goods, especially electronics, parts and components, are low in East Asia, and foreign investment in manufacturing is largely liberalised. This, combined with the ITA (which was agreed to through APEC and later the WTO), allowed information and communications technology to proliferate, and made the logistics of production fragmentation possible. GVCs, or vertical specialisation and fragmentation of production, proliferated in East Asia.

In **Chapter 6**, **Hubert Escaith**, **Satoshi Inomata** and **Sébastien Miroudot** examine the key features of GVCs in the Asia–Pacific and their evolution. The inter-industrial network moved from a simple hub-and-spokes cluster, centred on Japan in 1985, to a much more complex structure in 2005, with the emergence of China and the involvement of more countries. Production networks have only spread and deepened since 2005, but with the transition of China's growth model from an export and investment-led model to a services and consumption-led model, and the resulting shift in the structure of regional trade, growth in the Asia–Pacific value chains has slowed.

Trade in parts and components has slowed in production networks but these value chains have evolved to include services trade, and these trade networks now involve trade in tasks, including research and development and even the movement of people. This evolution in value chains is happening ahead of the policies that might secure, regulate and sustain it.

In **Chapter 5**, **Wendy Dobson** and **Tom Westland** examine the question of how Asian countries can move up regional value chains and boost growth by pursuing structural reforms that favour the development of high value-added export industries. They examine financial reforms underway in India and China. Noting that the reform process is much more advanced in China than India, they observe that policymakers in both economies need to ensure that domestic financial policy settings in China and the broader real economy in India are considered in conjunction with financial reform. They argue that, for economies trying to increase the sophistication of their export baskets, financial reform can be a complementary strategy.

However, much of South Asia, and even some of South-East Asia, is yet to really join the GVCs. Those nations have strong ambitions of development that will depend on engagement in the international system. India's 'Look East' and 'Make in India' strategies are aimed at joining the East Asian production networks as the easiest way to realise comparative advantage and integrate into the regional and global economies. Given India's size in the South Asian region—and globally—its success or failure in sustaining development will have significant implications for regional and global economies.

In **Chapter 8**, **Dhiraj Nayyar** reviews the progress, challenges and reform agenda for India to do just that. As wages in China rise rapidly and much low-cost or labour-intensive manufacturing shifts out of China, there is an opportunity for India to take up this role. With a young and growing population, many tens of millions of new entrants will have to be absorbed into the labour force each year. The agenda is relatively clear and well known to India's reformers but, as Nayyar explains, the political economy of the country's federal system is complex and there is a need to reform the arcane labour and land ownership laws, and restrictions on trade between states; undertake infrastructure reform and investment; and overcome other major impediments to trade and investment liberalisation. Institutional creativity is required.

The scale of the challenge is considerable. India's opening up and globalisation story is a deeply domestic one. The economic circumstances in which India hopes to industrialise are not necessarily as favourable as those enjoyed by China from the 1980s to the late 2000s, given slow growth in the advanced economies; technological change that may mean a large endowment of labour will be less valuable than in the past;

and strong competition at the 'low' end of value chains from countries including Cambodia, Bangladesh and Vietnam (as well as a few African economies with increasingly competitive unskilled labour costs and large endowments of labour, like Ethiopia). Given this, one question that faces Indian policymakers is how the reform process in India connects with broader regional integration. India is a member of the Regional Comprehensive Economic Partnership (RCEP), but has yet to play much of a constructive role in driving the process. However, it would be a mistake for India to think that required domestic reforms—especially those regarding the state-owned sector, agricultural subsidies and the still substantial barriers to internal and external trade—are best conceived of as bargaining chips to be given up in formal trade agreement negotiations. Such reforms will yield growth dividends whether they form part of RCEP or some other regional or bilateral agreement, and they cannot be delayed until the conclusion of a regional agreement.

Just as many in East Asia emulated Japan and its success, the hope is that India can lead South Asia by example. Beyond the domestic reforms that need to be sustained in India, infrastructure investment is needed in the rest of South Asia and in parts of East Asia. This includes major infrastructure investment *within* countries to realise growth potential, and also infrastructure *between* countries. In most cases, the finances are available internally or through external initiatives and donors, but there is a lack of bankable projects because of domestic impediments. Infrastructure investment can be used as a lever for domestic regulatory reform and structural reform.

Reforms that encourage infrastructure investment will be important, as large pools of capital seek higher returns internationally and Chinese initiatives, such as the Asian Infrastructure Investment Bank (AIIB) and the Belt and Road Initiative (BRI), present new opportunities to connect countries and regions. The infrastructure connectivity master plan of the Association of Southeast Asian Nations (ASEAN), China's BRI and increased financing through the multilateral development banks all set out strategies or present opportunities to which countries in Asia and beyond can respond.

One question that will weigh deeply on the minds of policymakers is the vexed issue of sovereignty. As the Brexit vote made clear, citizens are not always in favour of supranational institutions, and will sometimes resent, or seek to reverse, reforms that restrict the ability of national governments

to make decisions in areas that have traditionally been considered their domain. This phenomenon poses deep challenges for reformers. How can deeper economic integration be designed in such a way that it does not provoke backlash? What kinds of social and political institutions—and forms of public engagement—are necessary to support this process? The kinds of reforms that are now being considered as part of the regional integration agenda are qualitatively different from those of previous eras, and careful thinking is required to tease out the political economy of integration in this new environment. In **Chapter 3**, Lamy explains that the increasingly multilocalised nature of production processes means that ‘precaution’ rather than ‘protection’ is becoming the frontier of multilateral trade governance. This refers to the harmonisation of value-based norms, and quality and safety-based standards, which reflect citizens’ collective preferences. Multilocalisation also creates more opportunities for non-sovereign actors, such as corporations and non-government organisations, to engage in the international trade system, a trend that is becoming more apparent. The efficiencies created by this evolving international trade environment will affect welfare in ways that are dependent on domestic social systems. Policymakers must ensure that the economic gains from trade also translate into social gains across society, especially for developing countries where inequalities have been on the rise.

The future of Asian regionalism

What will the economic future of the region look like in the next decade or two, and what transnational public goods will the region need then? Leaders and policymakers require mechanisms to jointly develop policies at the country and regional levels, beyond the range of the normal political and business cycle. For example, how do Asian countries collaborate on the movement of people? Are the present forums adequate for the task, or is there a need to renovate or redesign the cooperative architecture to address the issues of the future, let alone the ones faced now? Answering these questions requires not only an understanding of the new issues that the region faces, but also an appreciation of the history of Asian integration.

Asia’s integration with the global economy has always been different from the regionalism of Europe and North America. Many of the countries in the Asia–Pacific region formed part of imperial trading blocs in the

colonial period, with trade preferences discriminating strongly in favour of imperial metropolises. However, in the post-war era, Asian integration has been outward looking. The countries in East Asia were much more diverse than those of Europe or the US—with different economic, political and social systems and institutions—and there was a lack of trust on a political level between many countries in the region. Without political closeness between the many countries in East Asia, for reasons including unresolved histories of conflict, territorial disputes and regional rivalry, the most congenial mode of cooperation was one of non-interference in the domestic affairs of other countries. In **Chapter 9, Ponciano Intal** explains that economic cooperation that did not impinge on sovereignty led to arrangements that had no supranational authority.

The intellectual principles of APEC were openness, equality and evolution of cooperation. It was difficult for many countries in East Asia to deepen economic ties with neighbours at the expense of relations with countries outside the region. The latter principle distinguishes the Asian style of cooperation from the inward-looking regionalisms of Europe and the US, while the former principle distinguishes it from traditional multilateralism of institutions such as the WTO. The Kuching consensus that ASEAN laid out in 1990, which formed the basis of its participation in the APEC process, emphasised that sovereignty remained with nation states, and that APEC would be a consultative, voluntary body—not coercive. It was difficult for many countries in East Asia to deepen economic ties with neighbours at the expense of relations with countries outside the region. Further, the process of forging consensus meant that larger countries could not dictate terms to smaller countries.

However, the question remains, are the current arrangements and their mode of cooperation suited to the current challenges that Asian economies face in deepening the integration of their economies with each other and the rest of the world? Border barriers are already relatively low and the real impediments to increasing trade, investment and commerce are behind the border. Regulatory barriers, non-tariff measures and port and infrastructure inefficiencies are much larger barriers to international trade and investment than the few remaining transparent border barriers. The reform challenge is domestic and it is typically more complex and involves a larger range of interests than reforms to external barriers. This suggests a form of cooperation that is domestically driven, not negotiated with other countries. For example, take China's state-owned enterprise (SOE) reform. Chinese SOEs have a significant effect on competition, for

both domestic firms and foreign firms in China. The TPP includes a chapter on SOEs, largely aimed at Singaporean and Malaysian SOEs, but also with China in mind. However, China's SOE reform is a deeply domestic issue. While it is high on the Chinese reform agenda, there is an understandably strong desire for Chinese policymakers to define the timing, pace and nature of reform, as well as adapt to changing circumstances, instead of having those issues defined by external parties through negotiation. This is not a uniquely Chinese issue. Every country faces major structural reform challenges with similar sensitivities. Japan's labour market, corporate governance and other clearly identified issues on the structural reform agenda not only affect the domestic Japanese economy, but also its trade and investment. Given the backlash against globalisation, most acutely seen in the North Atlantic, economic cooperation that continues non-interference and avoids impinging on sovereignty would appear the most sustainable way forward.

What role, if any, is there for regional cooperation or regional arrangements in a world where the priority is domestic reform and countries are less inclined to negotiate away sovereignty?

ASEAN's economic cooperation and integration processes and achievements are often criticised for being 'talk shops' that do not deliver outcomes. **Somkiat Tangkitvanich** and **Saowarui Rattanakhomfu** review progress towards the ASEAN Economic Community (AEC) in **Chapter 7** and conclude, as many already know, that the AEC falls short of many self-declared targets and is, indeed, a work in progress. However, economic cooperation the ASEAN way—that is, non-interference in other countries, no legally binding commitments (e.g. the North American Free Trade Agreement) and no supranational authority (e.g. the European Court of Justice)—has managed to sustain and slowly achieve high levels of integration on par with Europe and other integrated regions (Armstrong & Drysdale, 2011). With Europe and the US fighting to maintain open markets and to sustain their regional approaches to cooperation, Asia's track record looks better by comparison than it did even a few years ago.

Nonetheless, there is strong desire to strengthen cooperation in ASEAN and to elevate cooperation to include commitments to which member states adhere. With ASEAN cooperation acting as the hub for broader Asian cooperation, there is already progress towards binding commitments in RCEP, but with an economic cooperation agenda central to that agreement. **Shen Minghui** in **Chapter 10**, and **Tangkitvanich** and

Rattanakhamfu in **Chapter 7**, compare the TPP and RCEP and discuss some of the features that will be needed in Asia to further integration and reform. At best, such an arrangement would combine the capacity building and consensus forging that has characterised and sustained Asian cooperation through APEC and ASEAN. At worst, it may be a low-ambition RCEP agreement that does not have credibility and does not progress regional integration or provide the needed assistance for domestic reform programs. A poorly designed binding agreement in Asia could set the integration process back, as has occurred in other parts of the world.

Asian leadership

Asia has benefited from US and European leadership in the global economy in the past. However, such leadership is no longer assured. In his seminal work on the Great Depression, Kindleberger (1986, pp. 288–90) argued that the downturn of the 1930s was ‘so widespread, so deep, so long’ because it occurred at a time when Britain had more or less relinquished its role as a global economic leader but before the US had taken up the baton. Therefore, there was no country willing to lend counter-cyclically, no country willing to police an open trading order and a system of stable exchange rates (and, particularly, no country willing to accept ‘distress goods’ in a crisis, resulting in the Smoot–Hawley tariff war) and no country willing to provide emergency liquidity in the crunch. With the British tied up in squabbles with the French over the latter’s sterling balances, and the US refusing to send ‘good money after bad’ by offering substantial discounting operations to the world economy, the global economy lacked a country that could take the lead in coordinating macro-economic policies and averting the worst of all outcomes. This is sobering history. It demonstrates the dangers inherent in a situation in which the leadership required to coordinate the supply of international public goods is lacking.

Although it is by no means clear yet that the US and European countries will step back fully from global leadership, in some ways this misses the point. Given the growth in the Asian economy, it is no longer possible, let alone appropriate, for the US to act alone in a leadership role. Indeed, the elevation of the Group of Twenty (G20) during the GFC as a critical leadership body and the sidelining of the G7/G8 demonstrated that the days in which the global order could conceivably be stewarded by a few, mainly Western, countries are over. Given the protectionist pressures

in the US and Europe, where the focus is expected to be on internal challenges for the foreseeable future, and given the scale and influence of Asia on the global economy, a particular responsibility now devolves upon Asia to assume the mantle of leadership of an open trade and economic policy strategy. The dimensions of that leadership include articulating a diplomacy that pushes back on anti-globalisation, forging ahead with regional liberalisation and reform initiatives and shaping policies that reach out in an inclusive way beyond the region. It needs to ensure that regional integration strategies—and, with the probable stagnation or collapse of the TPP, this means RCEP in particular—are structured in such a way that they buttress, rather than undermine, the global system. Such leadership should focus on areas of international economic interest in which cooperation has been lacking. For example, collective Asian leadership could examine connecting and providing coherence to the provision of infrastructure funding, ensuring that new (and welcome) regional initiatives, such as the AIIB and older bodies, such as the Asian Development Bank, are complementary and adhere to principles that ensure investment in regional connectivity yields the maximum benefit. Even more ambitiously, such leadership could begin to tackle the almost complete absence of global rule making on investment that has led to a confused and confusing web of bilateral and plurilateral treaties.

What is clear from these efforts is that the idea of Asian leadership is easier to state as a concept than to actually deliver. It is too much to ask of China—still a developing country that is properly cautious and not ready to step forward—nor can ASEAN provide leadership on its own. Collective Asian leadership is called for, in the tradition of other successful regional initiatives, such as APEC in the past. China, Japan, South Korea, Australia, Indonesia and India all need to be engaged. What then are the methods by which such leadership could be mobilised? Cooperation and coordination among Asian members within international forums such as the G20 has merit. Informal bilateral agreements on areas of positive-sum cooperation—such as the China–US agreement on climate change—may play some part. Since the supply of international public goods will always require some disproportionate contribution from leaders (without supranational enforcement mechanisms, of which very few successful examples can be found, as there will always be some degree of free-riding), it is natural that China be central to any regional or global provision of international public goods.

The BRI, China's major strategic initiative, could be a significant international public good. As **Shen** explains in **Chapter 10**, the BRI attempts to build closer economic, physical and institutional links between different countries, as well as between those countries and China. While there are domestic imperatives for the BRI, such as excess capacity that could be exported and the need to develop China's western regions, it is an international initiative that aims to link both land and maritime regions, with comprehensive agendas ranging from infrastructure and industrial parks to port networks and cultural exchanges. Whether the BRI succeeds or fails will depend on the extent to which other countries welcome it, and that will depend on whether it is open, transparent and in the interests of participating countries. Shen explains that China's economic success has relied on the open multilateral trading system and that China has a deep interest in the preservation and strengthening of that system for continued growth.

The best and most effective leadership that any country can provide is to undertake reforms and grow; leadership must start at home. Economic growth can provide neighbours, trading partners, the region and—in the case of Asia's largest economies—the rest of the world with some buoyancy. Sustaining Chinese or Indian growth or reviving the Japanese market would provide large positive spillovers to other Asian countries as well as to the US and Europe.

However, to be effective, Asian economic leadership in the provision of global public goods needs to engage with the rest of the world. This point is brought out by **Cyn-Young Park** in **Chapter 4**. She revisits the decoupling issue—that is, whether Asian growth has decoupled from that of the North Atlantic economies of the US and Europe. The GFC proved that debate to be wrong in the mid-2000s, and Park demonstrates that it is not true now. Asian economies have opened up to the global economy, not just to their neighbours, and the integration that has resulted means that there is great interdependence with other major markets internationally. The implications of Park's chapter are clear. Future Asian regional cooperation aimed at deepening regional integration and building Asian institutions for managing that integration cannot become inward looking and must remain open to US and other global interests. Deeper integration in Asia cannot come at the expense of those outside the region, especially at a time when many are looking for excuses to raise protectionist barriers.

Shen makes it clear in **Chapter 10** that to achieve the next phase of development in Asia—that is, for poorer countries to achieve middle-income levels, and for middle-income countries to become fully prosperous—an open global economic system is needed. As **Park** demonstrates in **Chapter 4**, Asian economies remain reliant upon global demand. Difficult domestic reforms are made easier with a more open and dynamic external economy that can absorb export expansion. Such reforms are also much easier, politically, when effective systems of income distribution and regional policy exist to cushion those who lose out from the opening process. The experiences—positive and negative—of advanced countries in the Americas and Europe can be instructive, although domestic policies must, of course, be sensitive to the local context.

Asia now has the economic weight, interest and responsibility to lead in the preservation and strengthening of the global trading system. Asia has an opportunity to contribute to the global economic system through regional initiatives like RCEP, APEC and the AEC, and through groupings that lead to broader membership, such as the idea of the free trade area of the Asia–Pacific. Importantly, economic diplomacy initiatives will not carry the day. What matters is what key countries in Asia do at home in terms of economic reform, further opening up and in learning the lesson that it is not trade protection or protection against competition and globalisation but social protections that will bring sustainable development.

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