

Regional Cooperation and Integration in a Changing World



The logo of the Asian Development Bank (ADB), consisting of the letters 'ADB' in white serif font on a black square background.

ADB

Regional Cooperation and Integration in a Changing World

Asian Development Bank

© 2013 Asian Development Bank

All rights reserved. Published 2013.
Printed in the Philippines.

ISBN 978-92-9092-049-4 (Print), 978-92-9092-050-0 (PDF)
Publication Stock No. RPT135515-3

Cataloging-in-Publication Data

Asian Development Bank.

Regional cooperation and integration in a changing world.
Mandaluyong City, Philippines: Asian Development Bank, 2013.

1. Regional cooperation and integration. 2. Trade and finance. I. Asian Development Bank.

The views expressed in this publication are those of the authors and do not necessarily reflect the views and policies of the Asian Development Bank (ADB) or its Board of Governors or the governments they represent.


ADB does not guarantee the accuracy of the data included in this publication and accepts no responsibility for any consequence of their use.

By making any designation of or reference to a particular territory or geographic area, or by using the term “country” in this document, ADB does not intend to make any judgments as to the legal or other status of any territory or area.

ADB encourages printing or copying information exclusively for personal and noncommercial use with proper acknowledgment of ADB. Users are restricted from reselling, redistributing, or creating derivative works for commercial purposes without the express, written consent of ADB.

Asian Development Bank
6 ADB Avenue, Mandaluyong City
1550 Metro Manila, Philippines
Tel +63 2 632 4444
Fax +63 2 636 2444
www.adb.org

For orders, please contact:
Department of External Relations
Fax +63 2 636 2648
adbpub@adb.org

 Printed on recycled paper.

For further information or discussion on the issues covered in the monograph, please contact the authors Iwan J. Azis, Head, Office of Regional Economic Integration (OREI) at iazis@adb.org (on leave at present at Cornell University) and Jayant Menon, Lead Economist, OREI (jmenon@adb.org). Comments from various ADB and ADB Institute staff and other institutions are acknowledged. The finalization of the monograph was coordinated by Ramesh Subramaniam, Senior Director, OREI with support from Guy Sacerdoti, Economics Editor, Charisse Tubianosa, Economics Officer and Carol Ongchangco, Associate Operations Coordinator.

Contents

Introduction	1
Section 1: Regional Integration: Costs and Benefits	3
Section 2: Trade Integration and Policy Challenges	16
References	43

Introduction

With Asia's continuing rise and growing impact on the global economy, regional cooperation and integration (RCI) is expanding, bringing with it both benefits and costs. To sustain region-wide economic growth, an integrated market for the free flow of trade and investment across the region is necessary. Some degree of cooperation, if not coordination, in macroeconomic policy should also be considered.

Intraregional trade in Asia, as well as South-South trade, has grown substantially. But the trade landscape is becoming increasingly complicated with the proliferation of free trade agreements (FTAs). As of January 2013, the economies of Asia were party to 109 ratified FTAs. This has raised concerns over distortions associated with the so-called "spaghetti" or "noodle bowl" effect. As with trade, financial integration in Asia has also been expanding, though less rapidly and from a low base. Although this has accrued benefits in terms of consumption and investment risk sharing, magnitudes remain small. The majority of Asia's savings continues to be intermediated outside the region.

This monograph attempts to address some of the financial and trade aspects of integration in Asia. It has two self-contained sections. Section 1 focuses on the costs and benefits of regional integration in general, and concludes with some pointers specific to financial integration. Section 2 deals with trade integration and related policy challenges. The analysis begs many questions. Some—but not all—can be answered by the suggestions offered in the two sections.

1. Regional economic integration appears to have reduced income gaps *between* countries through convergence. But the evidence shows it may also have increased inequality *within* countries. It also appears that physical and other forms of connectivity favor some countries over others. How can this be fixed? How can we increase the likelihood that greater integration boosts the welfare for all—both within and across countries?
2. Given Asia's vast diversity, the challenges for achieving greater trade and financial integration also vary. Are the challenges facing small, vulnerable, or resource-dependent economies very different from the others? How can these be addressed?

2 Regional Cooperation and Integration in a Changing World

3. Financial integration has trailed trade and physical integration. What are the critical barriers to promoting financial integration in Asia? To the extent that greater integration increases the risk of contagion, how can we better manage market integration to maximize benefits while minimizing costs?
4. What does the ongoing eurozone crisis mean for the future of financial integration in Asia and the Pacific?
5. What policies can reduce the risk of harmful spillover effects while continuing to allow countries to reap the benefits from greater financial integration? Is judicious use of capital controls an option? How should controls be viewed from a macroprudential perspective?
6. Are existing regional safety nets sufficient to help the region ride out the next crisis? What needs be done to further strengthen them?
7. With the impasse on a multilateral trade agreement, what is the next step? With the proliferation of FTAs, does the solution lie in consolidating multiple agreements into mega-blocs—such as the Regional Comprehensive Economic Partnership (RCEP) or the Trans-Pacific Partnership (TPP)? Or should countries that have FTAs with their major trading partners look to harmonize and multilateralize preferences, offering them equally to smaller non-member trading partners to do away with the need for rules of origin?
8. A number of Asian countries are members of both the RCEP and TPP; a significant few are members of the RCEP but not the TPP; and a majority of the region is in neither. Are the RCEP and TPP likely to compete or complement each other?
9. A recent trend in trade agreements is the emergence of cross-regional tie-ups of mega-blocs—such as Association of South East Asian Nations (ASEAN)-European Union (EU) and EU-United States (US) proposals. What are their prospects? And can these tie-ups meld together in moving toward a more harmonized world trading system?
10. Assuming all the current mega-bloc proposals (RCEP, TPP, EU-US, etc.) can be successfully and expeditiously concluded, how will this impact the upcoming World Trade Organization Ministerial Summit in December 2013 and the world trade system in general?

Section 1

Regional Integration: Costs and Benefits

The ongoing eurozone crisis has raised a range of questions about regional cooperation and integration (RCI), particularly relating to integration. This is healthy. There are fundamental differences between the Asian and European approaches to regional integration. The Asian RCI approach has been more bottom-up, market-driven and institution-light, with continuous efforts to foster strong cooperation across countries and subregions. Therefore, the eurozone crisis should not detract policymakers from cooperating closely, and there is no need for a fundamental shift in the RCI model per se. In one sense, the eurozone crisis has raised the importance of enhanced Asian regionalism even more.

Although the crisis did not originate in Asia, its economies were hit by the downturn in export demand from advanced markets (the United States [US] and Europe), and volatility in financial markets. This simply reflects Asia's openness. At present, Asian economies continue to rely on advanced markets as the destination for their final exports. As these economies are likely to experience a lengthy period of slow growth, Asia needs to continue to rebalance its sources of growth by strengthening domestic and regional demand. Regional cooperation can help support the process.

One needs to take a balanced look at various facets of regional integration. Both benefits and costs should be gauged carefully in evaluating proposals for regional integration. The overall aim of RCI, like any development agenda, is to boost prosperity and reduce poverty and inequality. Small and large economies alike should benefit from any regional integration agenda in a sustainable and equitable manner.

Benefits and Opportunities of Integration

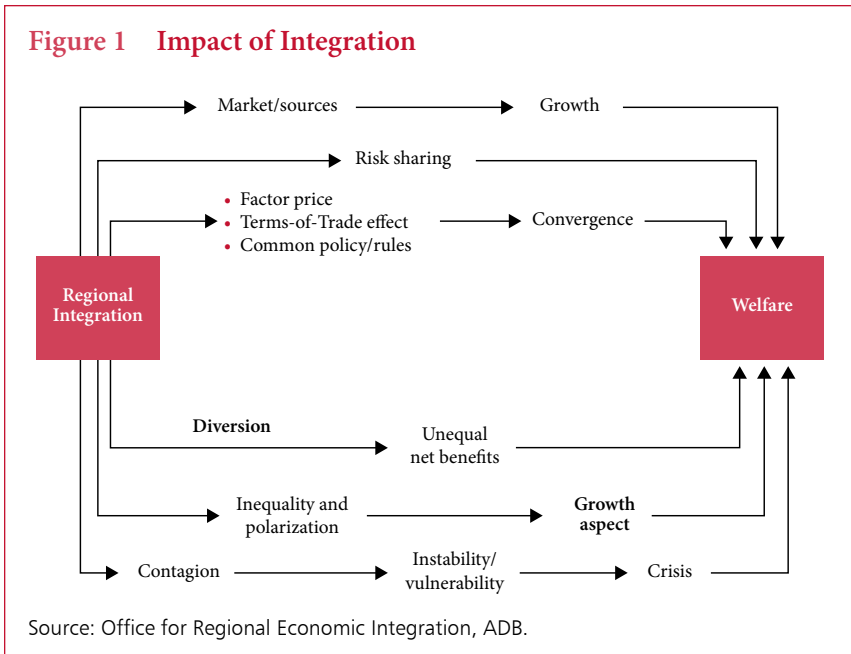
Regional integration expands markets and input sources, better allocating resources across the region and accelerating economic growth.

Regional economic integration is one way countries achieve national interests—only in concert with others. It expands national markets to the region. Like globalization, it can be thought of as an alternative to international embeddedness—or how one relates to the rest of the world. But unlike globalization, regional integration is geographical, and in some cases political. It is stronger institutionally than globalization, as rules tend to be tighter and peer pressure can be more intense.

Expanding markets and input sources beyond national boundaries is one of the most compelling arguments for integration. With an expanded market for goods and services, for both output and inputs, higher economic growth and improved welfare can be expected (**Figure 1**). Integration helps more efficient resource allocation across the region (or globally) in line with the principle of comparative advantage. If, as a result, productivity growth is enhanced, regional integration can accelerate economic growth and increase employment. But it is important to realize that integration may not generate the same benefits for all. Whether in trade, finance, or infrastructure, integration benefits some more than others. And when one measures the effects in a broader sense beyond the original purpose of integrating, some countries can even lose (Venables 2009).¹ So how the benefits of regional integration are distributed matters a great deal.

Asia's strong economic performance and resilience during the recent global financial crisis is testimony to the region's openness. The slowdown of external demand from the US and Europe, the "traditional" market for Asia's final goods exports, has been substituted by increased exports to other Asian countries, as well as to emerging markets outside the region. Growing production networks also strengthens intraregional trade. While the region continues to rely on the global market, the shift reflects a trend of growing regional integration, a process that accelerated since the 1997/98 Asian financial crisis. Other factors have certainly played important roles, but the trend of increased integration and the continued strength of production networks clearly show how the region can maintain market expansion and better resource allocation across the region.

¹ Venables argued that the gains from integration are unevenly distributed. He also showed the conditions under which some countries will lose from integration. In particular, the effects of preferential liberalization in regional integration will only benefit resource-poor countries, whereas non-preferential liberalization tends to benefit only resource-rich countries.

Figure 1 Impact of Integration

Regional integration appears to reduce income inequality between countries.

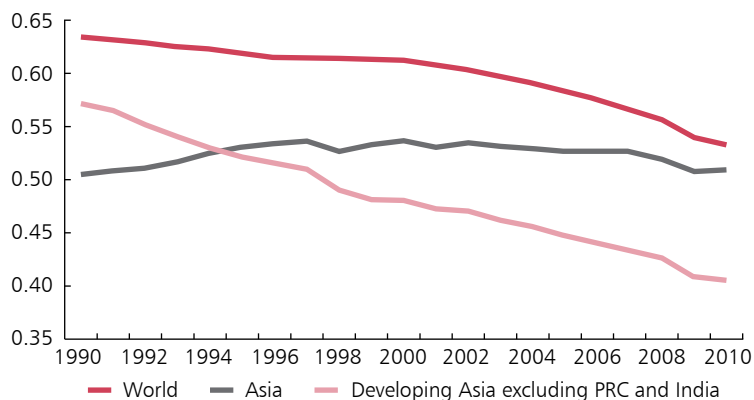
Most studies using the European experience indicate that regional integration coincides with a substantial decrease in income inequality between countries.² While economic factors are important, it is political integration that appears to drive the convergence. Institutional forces outweigh market forces in bringing national economies closer together (Beckfield 2009). Economic arguments show freer trade and factor mobility from integration allow less-developed members to grow faster than more-developed ones. Factor price equalization further supports the convergence hypothesis (Stolper and Samuelson 1941). In a two-country resource-rich/resource-poor model, lowering tariffs has a negative effect on real wages in the resource-rich country (most gains accrue to resource rent), while the resource-poor country benefits through terms-of-trade (TOT). This also supports the convergence hypothesis.

² See Leonardi 1995; Armstrong 1995; Armstrong and Vickerman; and Ben-David 2001. Some, however, found a pattern of divergence (see Slaughter 2001; and Arestis and Paliginis 1995). Part of the explanation rests on the interpretation of σ - and β -convergence, where σ -convergence is a decrease in gross domestic product (GDP) dispersion, hence showing how the distribution of income evolves, and β -convergence points to a negative relationship between growth and initial level of GDP (see Sala-i-Martin 1996).

An institutionalist economic explanation, however, places more emphasis on the formal structure and the role actors play in integration initiatives. It suggests that as economic actors follow common rules in a more integrated system, and markets increase in size and complexity, convergence will likely result. It also stresses the importance of politically established institutions. Thus, to analyze convergence, political relations matter more than regional markets or the process of economic development. Convergence can come from the diffusion of common development policies and the diffusion of common rules and market regulations.

In Asia's case, convergence is also detected; inequality between countries has been declining (**Figure 2**). Whether this is due to regional integration or other more forceful factors—or both—remains to be studied. Regardless, forces explained by the above theoretical arguments are likely part of the reason inequality between countries is narrowing.

Figure 2 Gini Coefficient Index^a



PRC = People's Republic of China.

Notes: Developing Asia is Asia excluding Japan and Oceania. Data unavailable for Afghanistan, the Cook Islands, Republic of the Maldives, the Marshall Islands, Nauru, and Timor-Leste.

^a Gini Coefficient is computed as follows:

$$Gini = \frac{-(n+1)}{n} + \frac{2}{n^2\mu_x} \sum_{i=1}^n ix_i$$

where x_i is the income of country i , μ_x is the average income of the population, and n is the total number of countries in the population. The Gini coefficient ranges from 0 (all countries have equal income) to 1 (all income held by one country).

Source: ADB calculations using data from *World Development Indicators*, World Bank and Penn World Table (PWT) 7.0 for Taipei, China.

Risk sharing is another possible benefit of integration; unfortunately, there is little empirical evidence that it happens.

Intuitively, more risk sharing through integration makes sense. But many empirical studies show that the degree of risk sharing following integration has been limited. Since the work of Backus, Kehoe and Kydland (1992), there have been several studies examining the presence of full risk sharing using cross-country income and consumption correlations. Most of them found that perfect risk sharing does not happen. Asia is no exception. Given an idiosyncratic shock, risk sharing in Asia was not strong, nor did it improve.

What causes this mismatch? Based on numerous studies across many countries, the mismatch could come from several factors, ranging from using domestic equity markets as a major source of finance (French and Poterba 1991), time horizon and measurement errors (Canova and Ravn 1996), consumption endowment uncertainty (Obstfeld 1994, Mendoza 1995), and the limited size of capital flows and higher sovereign default (Bai and Zhang 2005).

The effect of financial integration on economic growth has been well documented—more so than the effect of integration on international risk sharing.³ Theoretically, the consumption growth rate in integrating countries will be cross-sectionally independent of idiosyncratic variables as financial integration increases (Cochrane 1991). The key factor is greater insurance. If inter-regional or international capital markets are well integrated, countries can insure against idiosyncratic shocks. Individuals will invest more in high-risk and high-return assets if the risk can be shared or diversified (Obstfeld 1994).

In the case of Asia, financial integration remains limited; but it is increasing, especially after the 2008/09 global financial crisis. Using seven countries in East Asia for Granger-causality between growth rates in consumption, investment, and GDP between countries, the patterns of commonality differ between these variables despite evidence of common trends and factors. The results do not rule out the possibility that there is no causality between growth rates of those variables across pairs of countries. Thus, there is little evidence of an East Asian business cycle (with more synchronized business cycles, one might expect greater resilience to external shocks). There is also no consumption smoothing—the coefficients either have a wrong sign or are insignificant. When the period is split into before and after the 1997/98 Asian financial crisis, the results are generally the same—no evidence of consumption smoothing, even when there is a greater synchronization of business cycles among countries (especially after 1997).

³ See, for example, Levine 2001.

In analyzing the benefits, the opportunities, the costs, and the potential risks of regional integration and financial arrangement, Azis (2009) concludes that “The degree of risk sharing in Asia has been low, in contrast to the continually growing regional integration especially in the trade area.” Similarly, another study concludes that risk sharing in Asia is low intraregionally. For a given degree of contagion risk exposure, the US stands out as the one that reaps the most benefit from sharing risks with Asia. The study suggests that the region should promote efforts to increase the degree of risk sharing without exposing countries to greater contagion risks: “pursuing these regional policy avenues should receive a priority over a push for further overall financial integration whose welfare effect may be ambiguous” (Borensztein and Prakash 2011).

All in all, while the level of Asia’s financial integration may have increased, its benefits in terms of consumption and investment risk sharing have been limited. Although the concept of integration-driven risk sharing is ideal and conceptually sound,⁴ the impact of regional integration must be predicated not on an ideal world, but on the world as it is.

Costs and Risks of Integration

We hear more about the benefits of integration, especially when new regional cooperation initiatives are launched to strengthen integration—for example, positive spillover effects of infrastructure connectivity projects, initiatives to share risk, and better resource allocation by liberalizing markets to stimulate cross-border flows, among others.⁵ Much less is heard about the risks of integration.

The cascading effect of the ongoing eurozone crisis is a vivid reminder of the contagion risk of highly integrated systems.

The main argument against excessive integration is that it exacerbates contagion in times of crisis. Examples abound of financial crises rapidly spreading from one country to another, especially when integration is deeper due to either geographical proximity or a regional arrangement.

⁴ Under certain circumstances, however, theoretically, risk sharing should be avoided. While greater regional integration can lead to better risk dispersion, risk sharing can lower expected utility when the standard assumption of convexity and concave utility function does not hold. In particular, this is true when technologies are not convex (see Stiglitz 2010). Following this dictum, and given the fact that things like information, externalities, and learning processes give rise to a natural set of non-convexities, the intuition that integration should be desirable is wrong.

⁵ In some cases, cooperation and integration are promoted for political reasons and to build trust. Even if that is the case, the political windfall that follows can also lead to significant economic benefits.

While a shock may originate in the financial sector of one country, it can rapidly infect others across a region—affecting entire economies and damaging people’s welfare. For Asia, the damage caused by the 1997/98 Asian financial crisis is a powerful reminder of the danger of contagion. An idiosyncratic shock occurring in Thailand leaped across boundaries, devastating other economies. And yet the scale of integration in Asia at the time was more limited than now, despite some policy convergence. One can only imagine how much worse the crisis would have been had intra-Asian cross-border financial holdings been larger than they were.

In light of proposals for adopting a single currency, the risks of integration cannot be overemphasized. Many studies prior to the formation of the euro emphasized the benefits and opportunities of a single currency. This could be true for Asia as well. But when critical preconditions are not in place, and a desirable sequence is not followed (for example, political before economic integration), forcing a single currency can be costly and risky—as seen in the ongoing eurozone crisis. Taking into account these costs and risks—some of which are intangible—a single currency remains a long-term prospect for Asia. Even after running some sensitivity tests, the outcome remains the same (Azis 2009). Clearly, focusing only on the potential benefits but neglecting the risks and costs of having a single currency to promote regional integration could be counterproductive.

Trade diversion is another potential risk from regional integration that can damage people’s welfare.

Trade diversion is another classic risk of integration debated among academics and policymakers alike.⁶ In Asia, the South Asia Free Trade Area (SAFTA) is a notable example. Given relatively high levels of protection in the region, many predicted that the risk of trade-diversion would be rather high (Baysan, Panagariya, and Pitigala 2006). This could be minimized, however, when regional integration is pursued along with unilateral and multilateral liberalization (more on this in the next section). The trade-off between trade creation and trade diversion is often used to back North-South—rather than South-South—free trade agreements, as South-South arrangements are prone to trade diversion (sectors that develop have comparative advantage relative to partner countries, not globally). When geographical agglomeration effects are also at work, regional integration produces unequal net benefits; development takes place in a few countries rather than in all.

⁶ A customs union is a form of regional integration that is likely to cause the largest trade diversion where the effect is distributed unequally.

Integration tends to increase inequality within countries.

In a report by the Commission on the Measurement of Economic Performance and Social Progress, Stiglitz, Sen, and Fitoussi (2010) viewed inequalities as the first cross-cutting challenge for quality-of-life indicators. They argued that inequalities should be assessed comprehensively by examining differences in quality of life—across people, groups and generations.

Unlike the cross-country relationship between regional integration and income inequality, the relationship *within* countries is based on the idea that market competition and the labor/capital balance of power is a key determinant of income inequality. Unfortunately, empirical studies on this are scant, with most focusing on European integration. These studies argue that economic integration tends to create a larger labor market and increase wage competition between workers (Western 1997). With labor exposed to competition beyond national boundaries, its bargaining power weakens—either through unions losing influence or by other means. In this case, further integration is expected to increase inequality internally (Alderson and Nielsen 2002).

So what is the difference between the impact of globalization and regional integration, as both give rise to increased market competition? Labor markets expand more readily and labor is more competitive within regions than between regions. Consequently, firms can more easily exercise control over subsidiaries within regions. Also, political institutions tend to be more similar within regions than between regions. So one can hypothesize that regional integration is likely to exert a larger effect on labor unions, and thus have a more pronounced effect on income inequality.

When integration leads to lower inequality, government intervention and the welfare system play a major role.

In some cases, more developed institutions (like in Western Europe) can insulate workers from the pressures of international competition (Cameron 1978, Katzenstein 1985). Strong welfare states with generous unemployment benefits and training programs can help stabilize the national economy against the vicissitudes of international markets, such that worsening inequality can be averted when regional integration increases.

Again, most empirical evidence on this is based on Europe's integration experience. The welfare state shapes stratification directly through income transfers—and it can reduce inequality and poverty (Western 1997, Brady 2003). But European integration is also associated with limitations on an individual

country's government intervention, and also retrenchment of Western European welfare states through spending limits imposed by the “convergence criteria” of the 1992 Maastricht treaty (Korpi 2003). Lesser national autonomy due to regional integration contributes to the shrinking of the welfare state, one consequence being worsening income inequality.

In Asia's case, inequality within most countries has been widening (ADB 2012). This has occurred with rising economic integration. The simultaneous occurrence of two events does not imply causality, however. Since Asian integration is still limited compared with Europe, it is hard to draw any accurate conclusion on the link between regional integration and rising inequality within Asian countries. Current efforts to intensify regional cooperation to remove barriers to trade and finance, and to further market deregulation (“negative integration”), may produce forces more powerful than those caused by regulations to correct market failures (“positive integration”). This is evidence of this in Europe,⁷ and there is no reason why it cannot happen in Asia as well. When it does, within country inequality and polarization may worsen.

Unlike in the past, it is now widely acknowledged that income and wealth inequality has a clear negative impact on future growth prospects. Inequality is associated with a host of factors (ADB 2012), but also by insecurity of property rights, which will lower investment. This is common knowledge. But the uncertainty created by the diffusion of political and social instability—caused by inequality—also tends to raise rent-seeking and dampens investment, all of which challenge the standard argument for Kuznets' U-hypothesis.⁸ Thus, if regional integration leads to greater inequality within a country, growth and the prospect of improved welfare can be thrown off track.

Welfare as the Ultimate Goal

Like any policy or strategy, the goal of integration must be an improvement in welfare and quality-of-life—especially for the largest segment of society.

According to one Organisation for Economic Co-operation and Development (OECD) report, some 20 million jobs in both developed and developing countries

⁷ The convergence effect of regionalization on between-country income inequality in Europe outweighs the polarizing effect of regionalization on within-country inequality, such that the net total income inequality has declined. In other words, regional integration has a positive net effect on reducing total income inequality. See Scharpf 1997.

⁸ Inequality can also affect poverty by way of determining the growth-poverty elasticity. When the well-known effect of growth on poverty is added, a triangular relation between growth, inequality and poverty is established; see Bourguignon 2004.

have disappeared since the 2008/09 global financial crisis, and 21 million jobs must be generated in G20 countries just to match the pre-crisis employment rate (OECD and ILO 2012). The report also says this is impossible in the near term. If anything, there is a risk that the unemployment rate could increase.

As integration increases the likelihood of contagion, it raises the probability of a crisis. The policy response is often belt-tightening. While some argue that this is needed to restore confidence during a crisis, they neglect to consider the irreversible impact of wage cuts, tax increases, benefit reductions, and reduced subsidies that mainly affect the most vulnerable in low-income nations. There are an estimated 1 billion undernourished people worldwide, 60% of whom are women. And close to 180 million children under five have stunted growth due to lack of food—exacerbated by rising prices of basic commodities resulting from fiscal restraints.

The policy response to a crisis caused by an integration-driven contagion can damage welfare, especially when governments are belt-tightening.

The United Nations Children’s Fund (UNICEF) reports that, between 2010 and 2012, one-fourth of developing nations were excessively reducing public spending to below 2007 levels (Ortiz, Chai, and Cummins 2011). The study noted that “In the wake of the food, fuel and financial shocks, a fourth wave of the global economic crisis began to sweep across developing countries in 2010: fiscal austerity.” Indeed, despite fiscal stimulus measures to mitigate the impact of the global financial crisis, belt-tightening became widespread beginning in 2010. Based on information from 128 countries, the study found that governments basically relied on five ways to save cash—(i) cutting or capping wages (56 countries); (ii) phasing out or removing subsidies, mainly for fuel but also electricity and food (56 countries); (iii) rationalizing or means-testing social programs (34 countries); (iv) reforming pensions (28 countries); and (v) raising consumption taxes on basic goods (53 countries). In Asia, even without the crisis and austerity measures, several critical Millennium Development Goals (MDGs) will not meet their 2015 targets—such as maternal mortality rates, number of underweight children, and access to improved sanitation.

It is bad enough to have a crippled financial sector in a crisis, but the potential costs to welfare can be far worse.

The environmental impact of a contagion-driven crisis poses another serious welfare risk.

While a crisis can reduce pollution and resource consumption through reduced economic activity, the damage to the environment is more obvious. A weakened

economy tends to reduce environmental priorities. Working toward a quick recovery, promotion of environment-degrading enterprises does more than just harm those living nearby. It is easy to let the environment take a back seat to recovery. Some pro-environment policies are also likely to be shelved or delayed as cost and regulatory oversight tends to weaken during a crisis.

Policymakers need to be aware that a crisis arising from contagion can have multiple impacts.

The list is almost endless, but the bottom line is that, when regional integration raises the probability of contagion, the resulting crisis goes well beyond trade, finance and macroeconomics; it also affects what should be at the heart of all development policies and strategies: the triple bottom lines of economic development, social inclusion, and environmental sustainability.⁹ The ultimate test of regional integration should be the extent to which it can help member countries to achieve these three broad goals.

Integration and Unilateral Policies

While collective regional policies have their merit, unilateral policies can benefit both individual countries and the region.

While regional integration and collective regional policies have benefits, they are not necessarily superior to unilateral national policies. The East Asia Miracle of the 1980s and early 1990s is testament to the value of unilateral liberalization. To say that without integration, something bad will inevitably happen is wrong. To argue that a regional integration initiative or a regional agenda is the only way for an entire region to reap benefits is equally farfetched. Even without the risks of integration discussed earlier, this is the wrong way to think. Countries commit to a regional agenda because it benefits the nation, provides new opportunities, and allows them to allocate their own resources more efficiently. If they fail to see this and decide not to participate, it will not lead to disaster. This is very different from a global commons like addressing climate change.

If unilateral policies improve a country's economic performance, it is not difficult to imagine that there will be some positive spillover effects on the regional economy as well. In trade and financial integration, for example, if countries adopt policies that are good for themselves even without signing up for a regional

⁹ These are behind the Sustainable Development Goals (SDGs) recommended by the United Nations to make the world adopt a new set of global goals to succeed the 15 year Millennium Development Goals (MDGs) period that will end in 2015; see Sachs 2012.

initiative, their economic growth could become more robust and stable, which would also help the region.

National policies remain key for each country, but they can also play an important role in maintaining the integrity of domestic institutions—important for more effective implementation of regional initiatives.

Each country has the right to protect its own regulatory arrangements and institutions. In view of regional integration, it is important to provide national or domestic policy space to maintain the integrity of domestic institutions.¹⁰ Domestic policy space can be good for the regional economy so long as unilateral policy and national deliberations are based on facts and evidence for improving welfare. The cooperation agenda for regional integration can then focus on rulemaking, monitoring implementation of regional commitments, and minimizing negative spillovers. This approach may also improve the quality of national deliberations, making them more effective in improving welfare.

Cross-border holdings of financial assets are a case in point. Cross-border capital flows within Asia—especially in bond markets—remain relatively small. But individual markets have grown significantly, providing the necessary investment alternatives and ways to raise long-term funds. More importantly, this can avoid potential maturity mismatches. And because the growing market is in local currency, it will also avoid currency mismatches—the “double mismatch” problem which played a central role in creating the 1997/98 Asian financial crisis. And that came largely from domestic national policies. While a strong fixed income market in individual economies is welfare-improving, it also helps regional bond markets and the regional economy.

Cooperation to Manage Integration— The Case of Finance

Globalization and regionalization is a fact of life. Goods and services are traded and increasingly produced globally and regionally; labor and capital are becoming more mobile. It is clear that regional integration is progressing in Asia, and this has been strengthening further in the aftermath of the global financial crisis. But unlike Europe, Asian regional integration has been more market-driven, institution-lite and bottom-up. To the extent that greater integration can also raise the probability of contagion, there is a need to better manage the market process of integration to reap the benefits while minimizing potential costs.

¹⁰ A similar principle can also be applied to the concept of globalization (see Rodrik 2011).

In many cases, Asia needs to cooperate more and better—in trade, finance, macroeconomic policy, infrastructure (including energy), and on the environment. In some of these areas, greater cooperation will not necessarily lead to greater integration. Cooperation in providing financial safety nets is a clear example; it can mitigate the risks of contagion-driven crises with no direct impact on integration. On the other hand, cooperation in infrastructure connectivity will almost certainly increase the cross-border flows of goods, services, and people.

With continuing uncertainty over the global economy, any country is vulnerable to a contagion-driven crisis through real sector, trade and financial channels. Contagion through the financial channel is perhaps the most difficult to detect, yet its impact can be the most devastating—and affect the other two channels as well. While domestic macroeconomic policy can help mitigate the impact, sufficient foreign exchange reserves are usually the first line of defense to financial contagion. But a domestic safety net alone may be inadequate, even for a resilient Asia. If contagion effects are severe, markets may react indiscriminately. To the extent that an interconnected financial system raises the probability of spillover effects—and that the global nature of most crises calls for a coordinated policy response—a regional safety net can complement the domestic and global financial reforms needed to respond to systemic shocks. An effective financial safety net is thus needed.

The urgency of preparing regional safety nets is indisputable—as the next crisis could be rooted in new vulnerabilities, transmitted through different channels. Some can or cannot be detected (contagion channels do not mirror past events). Even in an economy with relatively robust macroeconomic and financial systems, closer cooperation for an effective regional safety net is needed. A collective regional initiative can often collide with flagging domestic political will. A fully-functioning regional financial safety net—supported by an effective surveillance system—can help member countries minimize the risk of contagion (Azis 2012; and Kawai, Morgan, and Takagi 2012).

Countries in Asia have made impressive progress in regional economic integration and cooperation. ADB has helped and continues to help facilitate this process. The region's diversity, development pattern and global links have generated a unique Asian model of regionalism—dynamic, open, multi-track, and multi-speed—which enhances prosperity not only in the region, but also in the rest of the world. Asia's open regionalism underscores the importance of strengthening trade, investment, and capital flows within the region while maintaining strong ties with, and remaining open to, the rest of the world. It aims to build a regionally integrated and globally connected Asia.

Section 2

Trade Integration and Policy Challenges

Asia is a relative latecomer to free trade agreements (FTAs); but over the past decade, the number of FTAs involving at least one country from the region has increased dramatically—creating the so-called “Asian noodle bowl.”¹¹ The proliferation has been greatest in Asia, a process accelerated by the global multilateral trade impasse.

By January 2013, ratified FTAs had more than tripled since 2002—to 109 from 36. There are another 148 FTAs at various stages of development, bringing the total to 257. Today, global FTA activity involves Asia more than any other region.¹²

Clearly, the delay in concluding the World Trade Organization’s (WTO) Doha Development Agenda (DDA) of multilateral negotiations drove FTA activity. This section does not question choices made by Asian policymakers, or revisit arguments on the first- versus second-best ways to liberalize trade. Instead, it examines the current situation and asks “where do we go from here, and how do we do it?” One could argue there are limited short-run options given this current environment. However, there is increasing recognition—even from FTA proponents—that the noodle bowl has become convoluted.¹³

Two key proposals have been advanced to disentangle the Asian noodle bowl: consolidation—which creates a regional FTA to harmonize bilateral FTAs; and multilateralization—which grants nondiscriminatory preferences to nonmembers, eliminating preference discrepancies.

¹¹ There is no generally accepted definition of Asia. But one used here is the ADB definition.

¹² The parties to Asia’s 101st FTA, the Republic of Korea and the United States (US), have 47 FTAs between them, 23 of which are in force. This FTA came just 2 weeks after the 100th FTA was ratified, between Japan and Peru. Even the Lao People’s Democratic Republic (Lao PDR)—a relatively poor, landlocked nation of only six million people—is involved in 13 FTAs, 8 of which are currently in effect, despite having struggled for more than a decade to meet the requirements for accession to the WTO.

¹³ Contributing to the administrative complexity of the sheer number of FTAs are the varying rules of origin (ROOs), different commencement dates, completion dates, tariff reduction schedules, exclusion lists (temporary and general), and any other item up for negotiated liberalization.

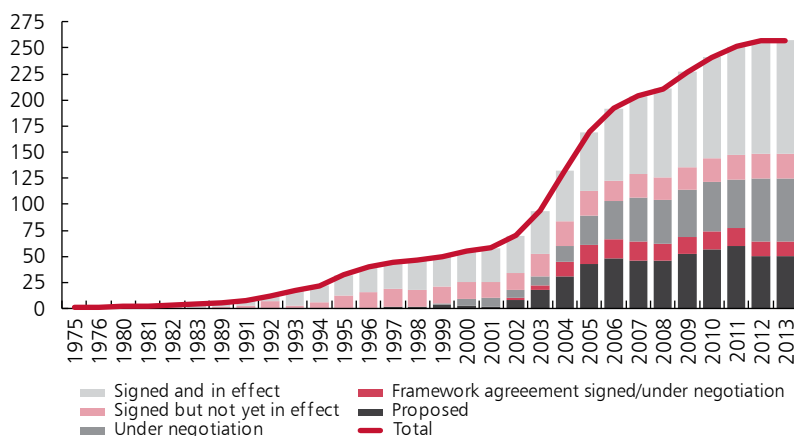
So where do we go from here? The number of FTAs will no doubt increase, given the current pipeline and with new proposals still the fastest growing segment. A speedy and successful conclusion to global multilateral negotiations would likely remove much of the motivation to pursue new FTAs. It may also dilute the preferences in many existing FTAs, thereby reducing their impact on trade and other flows. But the question remains as to whether a successful conclusion is even likely, let alone when. There is also renewed discussion of sectoral agreements on trade facilitation and other issues, which may substitute for such a more comprehensive multilateral round. The so-called cherry picking approach of sectoral agreements appears the most likely way to break the deadlock in moving away from the DDA's demanding all-or-nothing "single undertaking" option.

In any case, the current state of FTAs suggests that the DDA alone or some variant may be insufficient to neutralize today's highly complex and distorted trading environment, and complementary efforts will be required. So, how do we do it? Several proposals have been advanced to deal with the noodle bowl. These can be broadly grouped into two categories: consolidation and multilateralization of preferences. Consolidation involves compressing bilateral FTAs into a broader region-wide FTA where intraregional bilateral FTAs become redundant. Multilateralization of preferences, or multilateralization for short, grants non-discriminatory preferences to nonmembers, eliminating any margin of preference (MoP). Of the two approaches, multilateralization would be ideal. However, as we have seen in the DDA discussions, there are some very difficult issues that will take time to resolve. Yet, there are several interim steps that can prepare the groundwork for taking this approach, such as harmonized reduction of external tariffs and dilution of rules of origin (ROOs).¹⁴

FTAs in Asia: The State of Play

To set the stage, it is useful to begin by mapping the evolution of FTAs in Asia to help describe the current situation. Over the past decade, the number of FTAs involving at least one Asian country has more than tripled—from 70 in 2002 to 257 as of January 2013 (**Figure 3**). This surge in FTAs has been driven by a significant increase in the number proposed or under negotiation. In 2002, a quarter of the FTAs in the region were in proposed or negotiation stages. By early 2013, that share had increased to almost half the total. Of the 257 FTAs announced as of January 2013, 132 have been signed, with 109 already in effect; 75 are being negotiated, and 50 have been proposed (**Figure 4**).

¹⁴ These are discussed in further detail in Baldwin (2006, 2008) and Menon (2009).

Figure 3 FTAs by Status—Asia (cumulative, selected years)

FTA = free trade agreement.

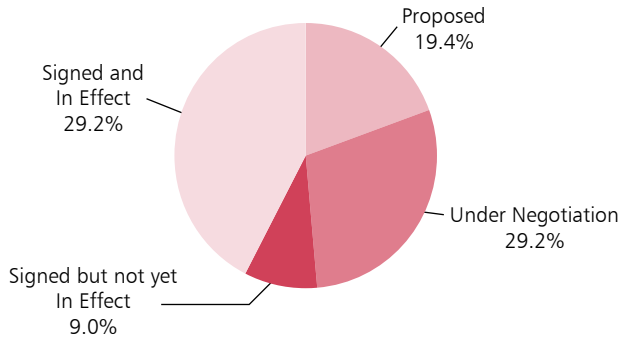
Notes: **Proposed** = the parties consider an FTA; governments or relevant ministries issue a joint statement on its desirability or establish a joint study group/joint task force to conduct feasibility studies. **Framework agreement signed/under negotiation** = the parties, through relevant ministries, negotiate the contents of a framework agreement (FA) that serves as a framework for future negotiations. **Under negotiation** = the parties, through relevant ministries, declare the official launch of negotiations, or start the first round of negotiations. **Signed but not yet in effect** = the parties sign the agreement after the negotiations have been completed, but agreement has yet to become effective. **Signed and in effect** = FTA provisions become effective, after legislative or executive ratification.

Source: ARIC FTA database (as of January 2013), Asian Development Bank.

In line with the globalizing trend in FTAs, close to three-quarters, or 189 of the total, were bilateral FTAs (involving two countries); only 68 were plurilateral (involving more than two countries) (**Figure 5**).

Within Asia, FTAs involving ASEAN+6 countries—the 10 ASEAN members plus Australia, the People's Republic of China (PRC), India, Japan, the Republic of Korea, and New Zealand—have increased at an even faster rate than Asia as a whole, growing more than six-fold—from 27 in 2002 to 179 in January 2013. To date, ASEAN+6 countries account for 70% of the total FTAs in Asia (**Figure 6**).

Of the 179 FTAs involving ASEAN+6 countries, the vast majority (130) are bilateral. Only a third (42) of these bilateral FTAs involves two ASEAN+6 countries; the rest are with countries outside the group; 67 of these involve an ASEAN+6 country and a trading partner outside Asia (**Table 1**). The growing

Figure 4 FTA Status—Asia, 2013

FTA = free trade agreement.

Notes: **Proposed** = the parties consider an FTA; governments or relevant ministries issue a joint statement on its desirability or establish a joint study group/joint task force to conduct feasibility studies. **Framework agreement signed/under negotiation** = the parties, through relevant ministries, negotiate the contents of a framework agreement (FA) that serves as a framework for future negotiations. **Under negotiation** = the parties, through relevant ministries, declare the official launch of negotiations, or start the first round of negotiations. **Signed but not yet in effect** = the parties sign the agreement after the negotiations have been completed, but agreement has yet to become effective. **Signed and in effect** = FTA provisions become effective, after legislative or executive ratification.

Source: ARIC FTA database (as of January 2013), Asian Development Bank.

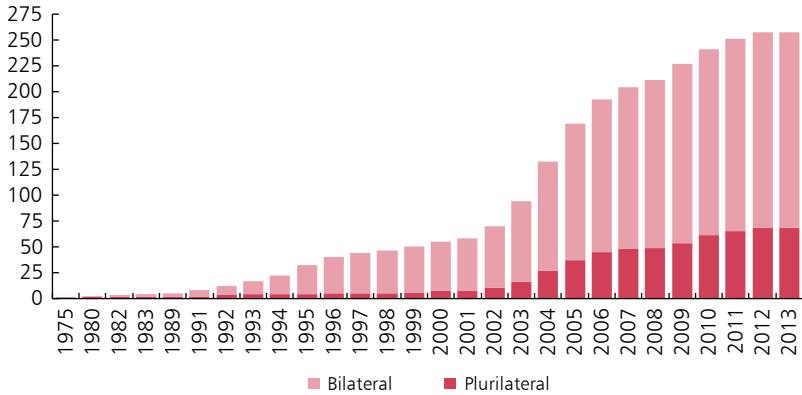
importance of non-Asian trading partners is mirrored in the membership of plurilateral FTAs (**Table 2**).

Perhaps not surprisingly, the rapid increase in FTAs in Asia has been led by Singapore, India, and the large economies of East Asia—the PRC, Japan, and Republic of Korea (**Figure 7**). As of January 2013, Singapore had the most with 37, of which 18 are currently in effect. India came in second with a total of 34 FTAs, 13 in effect. The Republic of Korea had a total of 32 FTAs, while the PRC and Japan had 27 and 26 FTAs, respectively. Pakistan also had 27 FTAs, 6 in effect. Within ASEAN, Malaysia, Thailand, and Indonesia were not far behind with 26, 26, and 21 FTAs, respectively.

Why are FTAs, especially bilateral, so popular?¹⁵ An important reason is disenchantment with the WTO.

¹⁵ See Menon (2007a) for details, and a taxonomy of motivations for pursuing FTAs.

Figure 5 FTAs by Scope—Asia (cumulative, selected years)

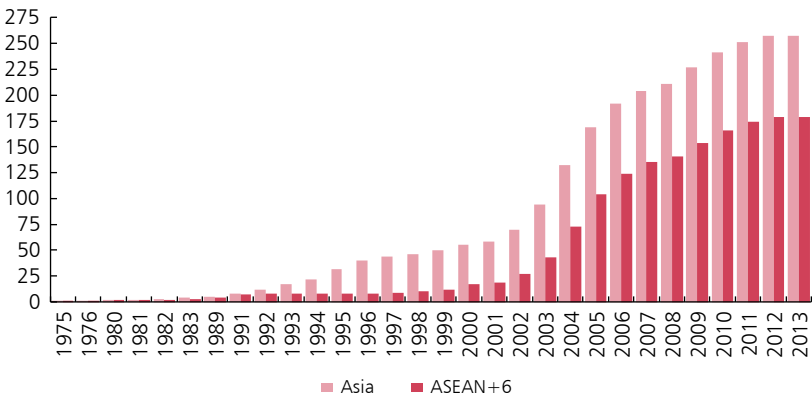


FTA = free trade agreement.

Notes: **Bilateral** refers to a preferential trading arrangement involving only two parties. **Plurilateral** refers to a preferential trading arrangement involving more than two parties. Data as of January 2013.

Source: ARIC FTA database, Asian Development Bank.

Figure 6 FTAs—Asia and ASEAN+6 (cumulative, selected years)



FTA = free trade agreement.

Notes: **ASEAN+6** = ASEAN plus Australia, the People's Republic of China, India, Japan, Republic of Korea, and New Zealand. Data as of January 2013.

Source: ARIC FTA database, Asian Development Bank.

Table 1 Bilateral FTAs by Geographic Area—Asia, 2013

Bilateral FTAs	2013
Within Sub-region	
Central and West Asia	17
East Asia	7
South Asia	8
Southeast Asia	1
The Pacific	2
Across Sub-region	
Central and West Asia + South Asia	2
East Asia + South Asia	4
East Asia + Southeast Asia	15
East Asia + The Pacific	8
Southeast Asia + South Asia	11
Southeast Asia + The Pacific	7
The Pacific + South Asia	2
With Non-Asian Countries	
Central and West Asia + Non-Asia	21
East Asia + Non-Asia	31
South Asia + Non-Asia	18
Southeast Asia + Non-Asia	26
The Pacific + Non-Asia	9
Total	189

FTA = free trade agreement.

Notes:

Central and West Asia—Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.

East Asia—China, People's Republic of; Hong Kong, China; Japan; Korea, Republic of; Mongolia; and Taipei, China.

South Asia—Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka.

Southeast Asia—Brunei Darrusalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam.

The Pacific—Australia; Cook Islands; Fiji Islands; Kiribati; Marshall Islands; Micronesia, Federated States of; Nauru; New Zealand; Palau; Papua New Guinea; Samoa; Solomon Islands; Timor-Leste; Tonga; Tuvalu; and Vanuatu.

Source: ARIC FTA database (as of January 2013), Asian Development Bank.

Table 2 Plurilateral FTAs by Geographic Area—Asia, 2013

Plurilateral FTAs	2013
Asian Plurilateral	12
Asian Plurilateral + Asian Country	7
Cross-regional Plurilateral	10
Non-Asian Plurilateral + Asian Country	33
Asian Plurilateral + Non-Asian Plurilateral	2
Cross-regional Plurilateral + Asian Plurilateral	1
Cross-regional Plurilateral + Asian Country	2
Cross-regional Plurilateral + Non-Asian Plurilateral	1
Total	68

FTA = free trade agreement.

Notes:

Asian Plurilateral refers to groupings of more than two countries where all the members are Asian countries.

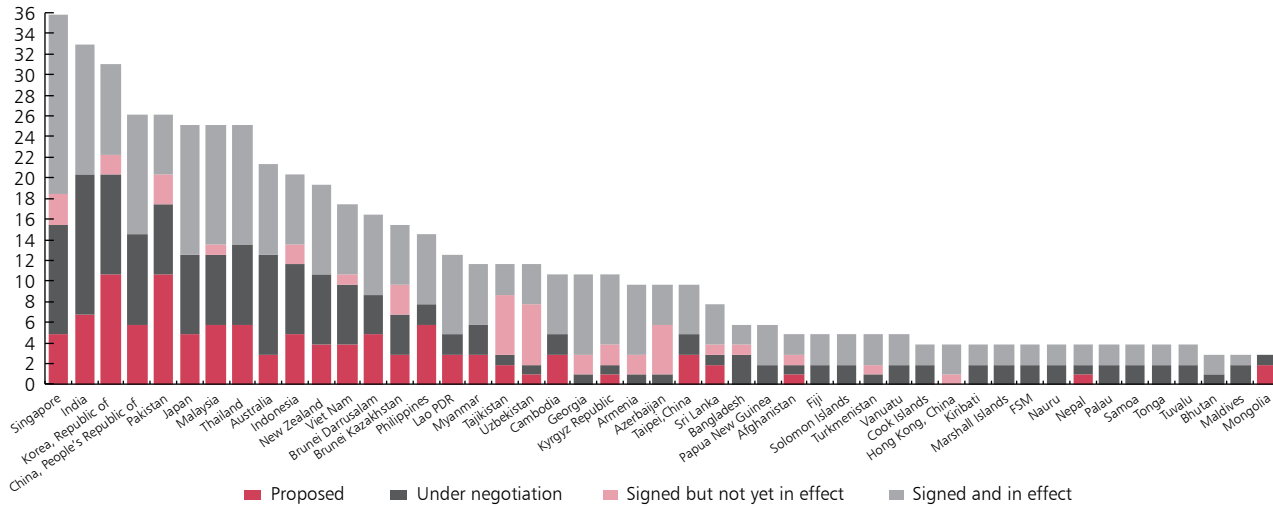
Cross-regional refers to groupings of more than two countries where all the members are a combination of Asian and non-Asian countries.

Source: ARIC FTA database (as of January 2013), Asian Development Bank.

The difficulties associated with concluding the DDA have simply reinforced this view. Many have pursued FTAs as a means of pressing ahead with their trade and liberalization agendas regardless.

FTAs are generally welfare enhancing, with respect to their members at least. The extent of the welfare improvement depends on the amount of trade created versus trade diverted, which in turn depends on a host of factors—including the extent, breadth and speed of the preferential liberalization. There are also longer-term dynamic effects that could accrue members through competitive and related effects, which are possible but difficult to quantify. FTAs have the potential to reach deeper agreements more rapidly on a range of areas—especially non-tariff issues—when there are only two or a few negotiating partners involved. Preferential accords involving some non-tariff measures—such as in services—can be more easily achieved regionally or bilaterally, compared with the large numbers at the multilateral level. Reforms in these difficult sectors and the more difficult non-tariff barriers have stalled at the multilateral level, and some FTAs have been successful in moving these agendas forward. The deep integration provisions in the (Republic of) Korea-EU (European Union) FTA and the Singapore-US FTA are cases in point. The [Republic of] Korea-US FTA, which includes provisions to promote and protect investment, also contains

Figure 7 FTAs by Status—Asia (cumulative, selected years)



FSM = Federated States of Micronesia, FTA = free trade agreement, Lao PDR = Lao People’s Democratic Republic.

Notes: **Proposed** = the parties consider an FTA; governments or relevant ministries issue a joint statement on its desirability or establish a joint study group/joint task force to conduct feasibility studies. **Framework agreement signed/under negotiation** = the parties, through relevant ministries, negotiate the contents of a framework agreement (FA) that serves as a framework for future negotiations. **Under negotiation** = the parties, through relevant ministries, declare the official launch of negotiations, or start the first round of negotiations. **Signed but not yet in effect** = the parties sign the agreement after the negotiations have been completed, but agreement has yet to become effective. **Signed and in effect** = FTA provisions become effective, after legislative or executive ratification.

Source: ARIC FTA database, Asian Development Bank.

an Investor-to-State Dispute Settlement Mechanism. Although the majority of FTAs involving at least one Asian economy have remained relatively shallow, the potential for deepening over time exists, and increases as the multilateral delay continues. These welfare effects are a clear economic motivation to pursue FTAs, and arguably their key economic benefit.

There are also non-economic benefits to FTAs. There is no doubt that political economy considerations also come into play, as FTAs can promote international ties beyond pure economics between a pair or group of countries. Indeed, it is often claimed that most—if not all—FTAs have political or strategic motivation. The fact that the EU was awarded the Nobel Peace Prize in 2012 is a recent and clear recognition of how a regional cooperation agreement can be more than just an economic imperative. Similarly, ASEAN's success has been on non-economic as well as economic fronts. All these suggest that the value of an FTA goes well beyond their direct economic impact.

FTAs may also be more politically feasible, as they tend to attract less attention, including from media. So the pressure from the political opposition at home (such as the anti-free trade lobby or particular “sensitive” industry groups) or from abroad (like traditional trade partners or other regional group members) will likely be low. This would quicken the speed of negotiation, and thus also the number of FTAs concluded.

A snowballing or domino effect has also been driving FTA growth. There is clearly momentum driving some of the growth in FTAs with countries not wanting to be left out. There are costs of doing nothing in an environment where FTAs are proliferating, when access to traditional markets may be affected. More than 5 years ago, one study (Baldwin 2008, p. 474) predicted such an effect could continue to play a role in the proliferation of FTAs in the region:

“If history is any guide, the domino effect in East Asia will spread to many, many more countries in the neighborhood. In Europe, for example, the playing out of several waves of domino effects has left the EU with preferential trade deals with every WTO member except nine. It is therefore conceivable that the 13 members of the ASEAN+3 group will end up signing a very large number of bilaterals in the coming years.”

These predictions appear to have been confirmed.

The final reason, which favors bilateral over plurilateral FTAs, relates to pure possibilities (or the maximum number) that are technically feasible. In theory, it is possible to have thousands of bilateral FTAs—many more than plurilateral

or one multilateral deal—because only two entities are involved. There are no geographical (regional) restrictions on membership. Indeed, any two countries, in any part of the world, for any reason, can come together to form a bilateral FTA. If “ n ” represents the number of countries in the world (a number approaching 200), it is technically possible to have up to $(n \times n - 1)$ bilateral FTAs, or more than 18,000 of them. Of course, this does not explain why bilateral FTAs are so popular. But they do suggest that, if they are, then they can proliferate dramatically and almost uncontrollably.

Despite their immense popularity, and the significant benefits they confer to members—both economic and non-economic—FTA negotiations and implementation come at a cost.

The costs of FTAs are increasingly apparent through data on utilization rates of preferences, which show many FTAs have yet to significantly impact actual trade and other flows. Although there is variation across studies on utilization rates of FTAs in ASEAN and East Asia, it is not uncommon to find these as low as 10%–20%; rarely are they above 30%. However, the most recent enterprise surveys conducted by ADB and ADBI in seven countries suggest that utilization rates could be improving, as firms become more aware of and familiar with FTAs—32% of firms in the sample reported that they used FTA preferences for exporting goods (Kawai and Wignaraja 2012). Despite these recent increases, utilization rates of one-third or less are low by any standard—including comparisons with Europe or North America.¹⁶

How do we explain these low utilization rates? ADB and ADBI surveys show that, while lack of information on FTAs was cited as the most significant reason, low MoPs and delays or administrative costs associated with ROOs are also significant barriers to the wider use of preferences (Kawai and Wignaraja 2011a, 2011b). Because the cost of complying with ROOs and other requirements are perceived to be higher than the expected benefits, importers choose to ignore the preferential tariffs and use most favored nation (MFN) rates. One study (Pomfret 2007) claims that much world trade continues using MFN rates, despite the proliferation of FTAs. Needless to say, this dilutes the potential benefits of FTAs. Previous FTA assessments have assumed complete utilization of preferences, and when more realistic utilization rates are employed, the positive impacts on economic welfare are almost equally diminished (Menon 2013a).

Apart from the underutilization of costly FTAs, another potential economic cost is greater trade diversion. This is well-known. But perhaps the biggest cost of FTA

¹⁶ To put this in a comparative perspective, utilization rates of below 50% are considered low in European preferential trading agreements (see, for instance, Augier, Gasiorek, and Lai-Tong 2005).

proliferation is its impact on the global trading system. While FTAs can produce significant benefits for members, there are harmful spillover effects that cannot be ignored. While major trading partners that are excluded may be individually hurt, raising the risk of retaliation, the overall trade landscape affecting all countries can be hampered as well, more so if the fallacy of composition applies. One study (Bhagwati 2008) argues that the system of preferences embedded in bilateral or even plurilateral FTAs is destroying the principle of nondiscrimination in trade, with FTAs serving as stumbling rather than building blocks. While this remains an open question, a key issue facing policymakers in the short- to medium-term is “what else can be done?”

The Doha Development Agenda (DDA): Compromise or Coma?

The difficulty of agreeing on the DDA’s ambitious program is clear; attention has shifted recently toward a compromise involving sectoral deals, including one that addresses trade facilitation.

The heads of all the multilateral development banks recently signed a petition promoting sectoral deals (Modern Ghana 2012). Enthused by this prospect, *The Economist* (2012a) has dubbed it the Global Recovery Round.

Concluding sectoral agreements may be one way to break the deadlock and pull the DDA out of its long-standing coma. But one concern is that it may actually reduce the incentive to conclude a comprehensive multilateral deal. This may well be warranted, as sectoral agreements dilute the strength of available trade-offs, and therefore reduce the ability to strike a bargain among countries with disparate interests. Although the multilateral framework remains the best way to deal with liberalizing sensitive sectors or difficult issues, this advantage rests on one key factor: the ability to trade concessions across a wide range of countries with divergent interests. That is the ability to offset the costs to countries of conceding protection in sensitive sectors—such as agriculture—against the benefits from increased market access in areas where they hold comparative advantage: for example, changing rules on investment, intellectual property, or services.¹⁷ A sectoral agreement may constrain negotiating positions and options within the WTO. In the same vein, each time an FTA allows a country to

¹⁷ A potent example was in the lead-up to the WTO meeting in Hong Kong, China in December 2005. Brazil and India, representing the apparent position of a majority of developing countries, proposed opening their markets further to industrial goods and services in exchange for the EU and the US dismantling the elaborate system of agricultural support. In the end, it did not happen, but for a host of mostly unrelated reasons (see Menon 2007a).

bypass this trade-off—simply through its choice of partner—and secure benefits without incurring costs, the task of liberalizing sensitive sectors is more difficult. The recent announcement to pursue a US-EU FTA highlights how a common interest—limiting liberalization in agriculture—can help facilitate an agreement (second in size only to that of the DDA), while simultaneously diminish prospects of addressing the most distorted sector in world trade. The problem, however, is that reaching a bilateral agreement is easier and more practical—with unquantifiable gains from a political economy perspective—in comparison with concluding a sectoral agreement involving several countries, let alone a multi-country multi-sector agreement.

Yet, with the likelihood of striking a single deal (like the DDA) already low, the benefits derived from successfully concluding a sectoral deal on trade facilitation should not be underestimated. Indeed, the benefits would be quite significant, and the prospect of concluding one by the time of the WTO Bali Ministerial Meeting in December 2013 is a further plus. On average, trade-weighted tariffs account for about 5% of trade costs, while logistical and other trade facilitation costs are about 10%. The WTO-based trade negotiations aim to bring these logistics costs down by half, or to an average of 5%—equivalent to removing all tariffs. These potential gains are substantial enough to warrant serious consideration, and perhaps counter concerns over the reduced incentives to conclude the more elusive, comprehensive deal.

Depending on timing and the form a multilateral deal eventually takes, both the need and urgency for other remedies could be reduced, although not removed. The longer it takes to conclude a multilateral deal and the weaker any eventual deal is, the greater will be the need and urgency for other remedies. If all that can be salvaged from the DDA is a sectoral deal, or a few sectoral agreements, then restoring order to the multilateral trading system will require a different approach.

Consolidation

Given the problems posed by FTA proliferation, consolidation involves compressing intraregional agreements into a broader regional FTA, making those between members of the broader region unnecessary or redundant.

The consolidation approach has gained ground as a way to disentangle the noodle bowl (Brummer 2007; Kawai 2007; and Park and Park 2009). Indeed, there are examples of defunct bilateral FTAs after the EU was created that lend credence to this approach. For example, the creation of the Central European Free Trade

Area (CEFTA) in 2006 successfully subsumed and nullified 32 bilateral FTAs involving CEFTA members. Also, the US-Canada FTA was superseded by the North American Free Trade Agreement (NAFTA). If successful, consolidation could be considered multilateralizing bilateral accords at the regional level, or “regional multilateralization”. In Asia, the ASEAN-led Regional Comprehensive Economic Partnership (RCEP) could pave the way for consolidating ASEAN FTAs under a single regional agreement.¹⁸ The RCEP will initially include all ASEAN+6 members.

The ASEAN-led Regional Comprehensive Economic Partnership (RCEP) could pave the way for consolidating ASEAN FTAs under a single regional agreement, although it is still too early to tell.

What are the likely welfare impacts of the RCEP? It remains too early to say, given that implementation and other pertinent details remain unclear—for instance, will the RCEP address existing FTAs between members or serve purely as a template for future negotiations? Nevertheless, the analytical framework for assessing FTAs and their expansion offers some useful pointers. An expanded region-wide FTA would be welfare-improving if it results in substantial terms of trade gains, where size matters. If the FTA is large enough, it could lead to improving the FTA’s *collective* terms of trade by reducing imports from and export supply to the rest of the world. This implies a substantial amount of trade-diversion. In this scenario, the welfare gains from improving terms of trade are large enough to offset the welfare loss associated with increased trade diversion (Menon 2000).

While this holds for the expanded FTA as a whole; the distribution of gains (or even losses for some) among group members may vary significantly. Given that ASEAN centrality is often emphasized—and with the ASEAN Free Trade Area (AFTA) the only plurilateral FTA involving a subset of RCEP members—the distribution issue could be assessed by examining how an expansion could affect AFTA. In other words, could an AFTA expansion to the RCEP result in a welfare outcome superior compared with the original AFTA? If the AFTA expansion results in a substantial amount of trade creation, then this could lead to some deterioration in the terms of trade, because part of the resultant increase in real incomes is likely to spill over into greater demand for imports from the rest of the world. Under this scenario, the welfare loss associated with deteriorating terms of trade would have to be smaller than the welfare gains from increased

¹⁸ The ASEAN Framework on the RCEP was formally endorsed at the 19th ASEAN Summit held in November 2011, and negotiations kicked off on 20 November 2012, on the sidelines of the East Asia Summit in Phnom Penh, Cambodia.

trade creation. In the end, the question on welfare impacts will be determined empirically.

The Trans-Pacific Partnership (TPP) is the other major preferential initiative that involves several RCEP members.

The TPP does not strictly fit as consolidation. Whereas the RCEP will initially involve countries already with existing bilateral FTAs, the network of bilateral FTAs between potential members of the TPP is far from complete. Instead, the TPP follows an *expansion* approach—it has an accession clause, and countries not involved in the networks of bilateral FTAs among potential members can also join the initiative (Hamanaka 2012, Drysdale 2013). The TPP agenda is wide-ranging and demanding, much more so than most other high quality FTAs, let alone DDA requirements. It is unclear whether many TPP members will be able to comply with these stringent requirements. Another challenge involves its current limited membership, which excludes major Asian countries such as the PRC and the Republic of Korea, although Japan has recently indicated its intention to join. A significant increase in Asian membership is needed before it can be a serious alternative to the RCEP. Should many Asian economies join, and the program comes to fruition without too many exemptions, the welfare effects could be significant. But as with the RCEP, the likely impact can only be empirically determined—therefore, it is too early to tell.

Despite this, consolidating existing FTAs through the RCEP or TPP expansion will likely continue in light of the difficulties in concluding multilateral negotiations. However, consolidation comes with its own set of challenges. FTAs are a highly heterogeneous group of agreements. They invariably have different tariff rates, treatment of quantitative restrictions, sector exemptions (and often different “phase-in” rates for each), ROOs that vary by product, and a host of other arrangements ranging from some service sector liberalization rules to labor and standards provisions. If consolidation moves ahead, the more likely outcome is a “race to the bottom” to reach consensus, with the result determined by the lowest common denominator, which would likely achieve very little, and could even set back reforms in some cases. The recent trend attempting to link regional blocs globally could increase the difficulties, as these tie-ups increase both the number of members and total diversity, as well as the degree of heterogeneity of accords that need to be harmonized.

Even if it were possible to implement a consolidated or expanded regional FTA, it would be critical to examine the incentives for policymakers to lobby their governments to join. If the provisions in bilateral FTAs are superior to those of a regional FTA, then utilization of the consolidated FTA will likely be low. One

example is the case of trade involving Sri Lanka and India. The South Asia Free Trade Area (SAFTA) came into effect in 2006, after a number of intraregional bilateral FTAs had been ratified, including an India–Sri Lanka FTA. Like most bilateral FTAs, the India–Sri Lanka agreement had better provisions to SAFTA's in almost all respects. As a result, 93% of Sri Lanka's exports to India currently enter duty free under the bilateral FTA (Weerakoon 2008). Thus, rather than consolidating and neutralizing the India-Sri Lanka or other bilateral FTAs, it appears the use of SAFTA has been quite limited given the existing bilateral FTAs. The results of one study (Rodríguez-Delgado 2007) seem to bear this out. Using a modified gravity equation, the effects of SAFTA's Trade Liberalization Programme (TLP), which started in 2006, were examined. The results showed that SAFTA would have a minor effect on regional trade flows. SAFTA's TLP would affect regional trade flows mainly by increasing India's exports and imports from Bangladesh and Nepal. Of course, it could be argued that this may be a timing issue, since full implementation of SAFTA is scheduled for 2016.

Proponents generally argue that deeper agreements can be achieved more rapidly on a range of areas when there are only two, or a few, negotiating partners involved. But many of the same proponents also promote FTA consolidation, without saying how these wider accords can be agreed to by a much larger group of countries. In fact, bilateral FTA consolidation—to create a regional agreement—may be more difficult than starting from scratch, particularly where potential members do not have any, or only a few, FTAs between themselves.

While the RCEP holds promise, it is interesting to note that most Asian bilateral FTAs are with countries outside the region (see Table 1). Hence, the RCEP will likely address roughly a third of all bilateral FTAs, leaving a significant majority of FTAs unaffected (Menon 2013b).

There is also a systemic concern associated with consolidating bilateral FTAs. Regional blocs may be seen as fragmenting the world trade system. While RCEP may rightly be Asia's response to the EU and NAFTA—more so now with the proposed EU-US FTA—a consolidated Asia-centered FTA may be viewed as another major bloc. It is therefore critical to coordinate South-South as well as North-South agreements to ensure that regional blocs do not become trade fortresses. This was heightened recently with the announcement of EU-US FTA negotiations.

If a consolidated FTA is perceived as isolating or discriminatory in any way, it could provide fresh impetus for a new wave of bilateral FTAs, as traditional trade partners outside the region seek to retain trade access with the newly formed FTA.

Perception and reality can vary, but in this context, perceptions may matter more in the end. It is quite likely that a new, large, consolidated bloc could be seen as threatening traditional non-member trading partners, however open the consolidated FTA is designed to be. If this perception holds—with more countries outside the region than inside—it is possible that total bilateral FTAs could actually increase. This could happen if the reduction in the number of intraregional bilateral FTAs through a consolidated FTA is more than offset by the number of inter-regional market restoring bilateral FTAs that it indirectly induces. This is hardly a remedy to the problems facing Asian economies or the world trading system. On the contrary, it could spin more noodles.

However, like the proliferation of FTAs, consolidation is a recent reality that must be addressed. So consolidation should not be seen as an end to itself, but rather as a means of preparing the groundwork for greater liberalization in some non-tariff areas—if it is viewed as part of the journey rather than the destination.

Multilateralization of Preferences

In remedying the noodle bowl and its distortions, multilateralization can be pursued in two ways—moving forward after consolidation, or proceeding unilaterally.

The first follows from the consolidation approach, whereby the harmonized accords of the consolidated FTA are offered to nonmembers on a nondiscriminatory basis. This would realize the full gains from consolidation, removing the potential for trade diversion and the costs associated with implementing ROOs, while reducing the risk of a new wave of market restoring FTAs. So once a country has concluded FTAs with most, if not all, of its major trading partners, it may then make sense to (i) equalize preferences across these FTAs; and (ii) offer them to non-FTA countries on an MFN basis. Instead of limiting the harmonized procedures to members, as pursued in regional blocs, this approach goes that one, critical, step further in multilateralizing them. There are several proponents of this approach (for example, Feridhanusetyawan 2005; Baldwin 2006, 2008; and Menon 2007b, 2009).

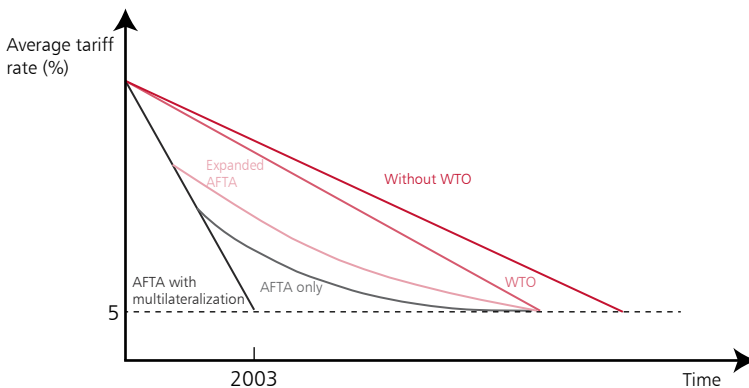
In the discussion on the practicality of consolidating FTAs, the difficulties associated with folding multiple, disparate FTAs into one big harmonized one were highlighted. But consolidation is not a prerequisite for multilateralization. Even without consolidation, or even if an attempt to consolidate fails to work, multilateralization can still be pursued unilaterally. Indeed, the need in this situation becomes more pressing from a welfare perspective.

Multilateralization can proceed from a consolidated regional FTA, or economies can seek multilateralization independently; but they both must overcome competing interests that lose from the dilution of preferences.

Although all this may be appealing in theory, how realistic is it in practice? There are precedents to the voluntary multilateralization of preferential accords. ASEAN's AFTA is a case in point—and the actions of its original members confirm this (Feridhanusetyawan 2005, Menon 2007b). When multilateralization is pursued in conjunction with aggressive preferential liberalization such as with AFTA, the goal of free, nondiscriminatory trade can be reached sooner. To illustrate, trade liberalization outcomes under AFTA—with and without multilateralization—can be portrayed in stylized form (**Figure 8**). The outcome under a WTO-based multilateral deal is also depicted, as a reference point, to identify the goal of free and open trade (defined here as 0%–5% average tariff rates).

How can AFTA be used to move its members toward this ultimate goal? If AFTA is implemented on a purely minimalist basis, or without any multilateralization of tariff preferences, then the time taken to reach its goal is unchanged. Average tariff rates do fall more rapidly however, particularly up to AFTA's 2003 deadline for 0%–5% internal tariff rates, but this gain could be offset by the trade diversion

Figure 8 The Speed of Tariff Liberalization With and Without Multilateralization: AFTA and WTO



AFTA = ASEAN Free Trade Area, WTO = World Trade Organization.

Source: Adapted from J. Menon. 2007a. Building Blocks or Stumbling Blocks? The GMS and AFTA in Asia. *ASEAN Economic Bulletin*. 24(2). pp. 254–266.

that it would also induce.¹⁹ If AFTA expands its membership—or participates in a consolidation exercise such as proposed by the RCEP—then the pace of reduction increases but the end-point remains unchanged. If, however, members choose to multilateralize their preferences soon after AFTA becomes effective, then the deadline for free and open trade moves closer to AFTA's deadline of 2003. In reality, the preferences for a majority of tariff lines were fully multilateralized before the AFTA deadline. For instance, by 2002 preferences were fully multilateralized—or the MoP was zero—for more than half of the tariff lines for the original ASEAN members, while more than two-thirds had MoPs of less than 10% (Feridhanusetyawan 2005). This share continues to increase yearly, although admittedly the MoP for a range of sensitive products remains high. If these remaining tariff lines are dealt with relatively soon, then the deadline will fall somewhere between 2003 and possibly before a multilateral deal is concluded. In any case, AFTA has already served as a building block enabling its original members to achieve their goal much faster, because of the multilateralization of the majority of preferences.

At the Asia-Pacific Economic Cooperation (APEC) Leaders' Summit in Subic Bay in 1996, President Fidel Ramos of the Philippines raised the option of multilateralizing the AFTA accords within APEC. At the time, Indonesia had already begun providing its AFTA accords to other APEC members. Although this proposal was never formally adopted by AFTA, the original members have been pursuing multilateralization of their accords as well, not just within APEC, but on an MFN basis on a wide range of products. As most trade liberalization world-wide has been unilateral, there is a strong basis for optimism in promoting this approach. For instance, the World Bank (2005) estimates that—between 1983 and 2003—unilateral actions comprised the bulk of liberalization, or 65% of developing-country tariff reductions (see also ADB 2011). In particular, with respect to the original ASEAN members, a highly liberalizing competitive unilateralism took place in the 1980s and 1990s to attract FDI from Japan into regional production networks (Vezina 2010).

As mentioned, preferential accords in non-tariff areas—such as services—can be more easily reached regionally or bilaterally when a smaller number of participants are involved. If these breakthroughs can be achieved, and if they can be harmonized within a consolidated FTA, then implementing multilateralization would be easier, and the potential gains much greater. The accords in these areas are quite easily multilateralized once they have been negotiated (Lloyd 2002, Hoekman and Winters 2007). This is because the instrument of protection in many services, for example, is regulation of one form or the other—such as rules

¹⁹ This deadline applies to the original ASEAN members, while the newer member countries have been given more time.

related to foreign investment, competition policy, or government procurement. The same applies to the myriad measures relating to trade facilitation (see Hamanaka, Tafgar, and Lazaro 2010 for examples of how trade facilitation measures in FTAs can be multilateralized), as well as sanitary and phytosanitary measures, technical product standards, certification procedures and processes, and mutual recognition arrangements relating to professional qualifications. These regulations are quite naturally applied in a nondiscriminatory fashion, treating domestic and foreign firms equally. This is quite different from tariffs affecting trade in goods, where domestic/foreign and intra-foreign discrimination is the objective.

Unlike tariff liberalization, it is often difficult or costly to remove non-tariff barriers or measures (NTBs or NTMs) preferentially. It is usually impractical for these types of concessions to be exchanged in a discriminatory fashion—once an NTB or NTM is removed, the cost of excluding nonmembers will likely be high, if not prohibitive, as with most public goods. This difficulty and associated cost varies by type of measure. While export subsidies or export licensing, for example, could be offered or applied preferentially, production subsidies cannot be reduced in the same way. With reducing production subsidies arguably the biggest barrier to reforming agricultural trade, this is a major problem (Bhagwati 2013).²⁰

In terms of supporting global trade liberalization, the multilateralization process fares well. Because preferential tariff reduction schedules are generally quite ambitious and rapidly paced, this approach can also accelerate multilateral trade liberalization.

What then stands in the way of pursuing this approach? Clearly the desire to secure more reciprocal concessions or market access is a key factor. While the benefits from reciprocal liberalization outweigh unilateral actions, the more relevant question currently is how much longer should countries wait for reciprocity from countries outside any existing FTA, while foregoing the gains from multilateralization. Furthermore, the low utilization rates of FTAs in Asia also suggest that the benefits expected from reciprocity may be seriously overestimated. The potential for trade deflection further erodes expected benefits. Given the difficulties of linking mega-blocs together, as noted in a recent editorial

²⁰ Even if it were possible to exclude third parties, this could seriously derail the reform program. A recent study by UNESCAP (2011) notes that preferential treatment negotiated with selected trading partners typically involves additional documentation. The study presents evidence of significant delays associated with such requirements, as FTAs have adopted different approaches to the rules on substantive measures relating to trade facilitation. Moreover, differences in scope, depth, and level of detail often translate into varying degrees of administrative inefficiency, through a maze of different procedures applied to respective trading partners under different FTAs.

(*The Economist* 2012c), the risk is very real. Taken together, there is little basis for holding off on multilateralization to try and gain reciprocity in a residual set of countries not covered by existing FTAs. There is, however, a greater need to make the case for multilateralization more strongly, especially when resistance from vested interests and other lobbies can stand in the way (Menon 2013b).

Interim Steps to Multilateralization: Harmonized Reduction of MFN Tariffs and Dilution of Rules of Origin

There are two interim steps that can be used on the way toward multilateralization—harmonizing reduction of MFN tariffs; and diluting rules of origin (ROOs).

As attempts to multilateralize face resistance, what are the interim steps that can be taken to prepare the groundwork for multilateralization? While “pure” unilateral actions are commonplace and account for the vast majority of trade liberalization observed worldwide, the multilateralization of FTA-based preferences is so far much less commonplace. One way forward is to reduce the MoP and the distortions it creates by bringing down MFN tariffs themselves. When brought down gradually, the MoP is not zero in the interim or at the end, but much smaller. This approach may be more realistic when members feel committed to the preferential arrangement and therefore prefer a measured approach that retains some integrity of the arrangement, especially in the interim. When employing this method, an aggressive stance would involve a coordinated approach—such as harmonizing MFN tariffs, as with a Customs Union—to the lowest rate in the region. This does not require an established Customs Union, however, as in the case of Latin American FTAs (Estevadeordal, Freund, and Ornelas 2007). This aggressive approach is preferred, if practicable, in harmonizing MFN tariffs through coordinated reduction.

To some extent, this approach can be considered a mirror to multilateralization, only more pragmatic in its gradualism, and with an eventual result that is less ambitious (non-zero MoP). It also differs from multilateralization in that it applies only to tariffs but not non-tariff measures.

The second possible interim step is the dilution of ROOs through liberalization. If FTA members are not yet ready to give up reciprocal preferences, then this approach could be seen as preparing the groundwork for that process. It could be done through harmonization, and expanding rules of cumulation. If ROOs are sufficiently liberalized and rules of cumulation adequately expanded, it can remove distortions associated with artificial sourcing of inputs simply to

meet regional accumulation requirements. This will reduce the incentive for the spoke or peripheral countries to pursue FTAs with either the hub or other spokes in order to prevent (non-preferential) spoke-spoke trade being diverted to (preferential) hub-spoke trade. The Pan-European Cumulation System (PECs) is a good model for how this can work (Gasiorek 2007).

If rules of cumulation are sufficiently expanded and then harmonized across different agreements, complete multilateralization of tariff accords is no longer needed. In this sense, liberalizing ROOs, like harmonized reduction of MFN tariffs, can be thought of as an alternative means to the same end. Like the harmonized reduction approach, it would apply mainly to tariff measures. It should be noted however, that the high share of product fragmentation trade—as a result of the vertical specialization spread across this region—is likely to limit the extent to which a system like PECs could be successfully introduced. Multilateralization, when pursued by all members of the consolidated bloc, also delivers reciprocity the same way that a consolidated FTA does. This was, after all, the idea behind the “open regionalism” approach in the original conception of APEC (Drysdale and Patrick 1979, Garnaut and Drysdale 1994). But with multilateralization, the possibility of addressing non-tariff barriers and regulatory reforms is enhanced, as they are naturally non-excludable once achieved and therefore easier to reach when pursued without the constraint of requisite excludability. Therefore, in East Asia in particular, dilution of ROOs may still serve mainly as a sequential complement that prepares the groundwork—rather than a substitute—for multilateralization.

Neither multilateralization nor consolidation—or interim measures—can directly result in any change in barriers existing in nonmember countries.

Barriers facing members in export markets outside the region remain an important issue preventing the realization of further welfare gains to all parties. A multilateral deal would do this, but, as mentioned, reaching a deal appears increasingly remote. In the quest for reciprocity, members of a consolidated bloc may wish to pursue tie-ups with other blocs—and this is becoming increasingly popular (*The Economist* 2012c). The recent decision to create the world’s largest FTA between the EU and US will increase pressure to pursue such tie-ups, either with this mega-FTA or with others around the world.²¹ Although such tie-ups may be inevitable, adding to the benefits members receive, does it become an end point in and of itself?

²¹ In fact, the EU has been aggressively pursuing FTAs with countries globally, and tie-ups with other FTAs. So has the US, although to a lesser extent.

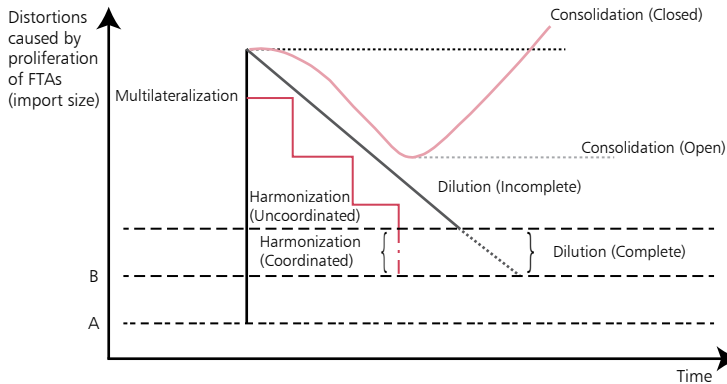
As with a consolidated regional FTA, an expanded inter-regional one should be viewed as a means rather than an end. Issues relating to trade diversion will remain, although they could begin to diminish as the mega-bloc grows, but the risk of trade deflection could increase. Concerns over incomplete utilization would also remain and significantly erode potential benefits expected on the assumption of full utilization. Any expanded FTA would only realize its full potential—while removing these risks and the need to implement ROOs—when preferences are multilateralized. In fact, such tie-ups between large blocs should make eventual multilateralization easier, as members would have secured preferential access with a larger number of trading partners. In the absence of a multilateral deal, multilateralization should still remain the end game.

Comparing the Relative Merits of Consolidation, Multilateralization, and the Interim Steps to Multilateralization

In disentangling the noodle bowl and promoting liberalization more generally, the assessment and likely impact from consolidation, multilateralization, and the two interim steps to multilateralization—harmonized reduction of tariffs and dilution of ROOs—can be summarized. Again, in stylized form, the likely welfare effects of each remedy on a single country relating to its own (import) barriers can be portrayed (**Figure 9**), before considering the benefits and challenges of each (**Table 3**). The stylized framework captures only imports and only tariffs, while it is broadly applicable to non-tariff parameters as well.

Two points are worth highlighting. First is the fact that multilateralization produces the most significant reduction in distortions and does so in the shortest time. It can eliminate not only MoPs, but also some distortions associated with discriminatory non-trade restrictions, especially in services. It can achieve this in the shortest time because it involves a one-off decision, as opposed to staggered (harmonization) or gradual (dilution) changes.

If multilateralization is the most preferred approach, the least preferred is consolidation. Although distortions fall initially, as (some) intraregional FTAs are neutralized, they can rise again if (i) a “lowest common denominator” outcome prevails, whereby the average level of distortions actually increases; and/or (ii) they induce new extra-regional FTAs. If the consolidated FTA is perceived as being relatively closed, then it is likely that distortions could increase substantially. Even if the consolidated FTA is “open” and is perceived to be so, the reduction in distortions is lowest among the four approaches because most FTAs involving an Asian country are inter-regional, and these are not addressed using

Figure 9 Stylized Welfare Effects of Different Remedies

FTA = free trade agreement.

A: Distortions (Trade Barriers).

B: Distortions (Trade and Non-Trade Barriers).

Source: J. Menon. 2009. Dealing with the Proliferation of Bilateral Free Trade Agreements. *The World Economy*. 32(10). pp. 1381–1407.

consolidation alone. If the share of intraregional trade involving final goods is high, however, consolidation does offer benefits to exporters through increased access to each others' markets. Reciprocal access would offset the welfare losses associated with the distortions described above.

These stylized impacts can be better understood by cataloguing the benefits and challenges of the different approaches, considering unilateral liberalization for completeness (**Table 3**). It is clear that each has its own strengths and weaknesses, with its severity varying by approach. Furthermore, the most beneficial may not be politically feasible, however, so trade-offs must be struck.

Summing Up Trade Policy

Although consolidation and multilateralization are not mutually exclusive, the former is a means while the latter is an end. While consolidation can assist with multilateralization, history shows that unilateral actions—of which multilateralization is a special case—are not only feasible but account for most trade liberalization.

Table 3 The Trade Journey—Benefits and Challenges of Trade Liberalization

Steps in the Sequence of Trade Reforms	Benefits	Challenges
Unilateral Liberalization	<ul style="list-style-type: none"> • Maximizes trade creation without trade diversion • No need for coordination (Note: 65% of developing tariff reductions from 1983–2003 were unilateral) 	<ul style="list-style-type: none"> • Lack of reciprocity is politically costly
Consolidation	<ul style="list-style-type: none"> • Political capital for governments and policymakers • Higher welfare generally assured for members • Potential for long-term dynamic partnerships by opening up markets, providing growth opportunities, and promoting competition, among others • Potential to achieve deeper reforms, because of the smaller number of economies involved, compared with the WTO, for instance 	<ul style="list-style-type: none"> • Trade diversion (although FTAs also create new trade) and deflection • Complexity of dealing with different ROO • Low utilization rates may limit benefits, especially given high transaction costs in drafting and negotiating FTAs; • Consolidated FTA may not negate the use of bilateral FTAs if the commitments of the latter are superior • Could tax consumers and producers if a lower cost supplier lies outside the region and if trade diverted as a result of high MoPs • Possible retaliatory actions by nonmembers if significantly harmed
Harmonized Reduction of External Barriers	<ul style="list-style-type: none"> • More practical with flexible pace of implementation • MoP reduction secured indirectly and therefore more feasible 	<ul style="list-style-type: none"> • More easily applied to tariff than non-tariff measures

continued on next page

Table 3 *continued*

Steps in the Sequence of Trade Reforms	Benefits	Challenges
Dilution of Rules of Origin (ROOs)	<ul style="list-style-type: none"> • Practical if members are unwilling to give up reciprocal preferences • Reduces trade diversion and the “export of protection” 	<ul style="list-style-type: none"> • Applies only to tariffs and any domestic content requirements of investment provisions • Less effective in Asia (certainly East Asia) given the high share of production network trade and low value-added
Multilateralization of Preferences	<ul style="list-style-type: none"> • Flexible if pursued unilaterally, but coordinated form delivers reciprocity to all parties involved • Realizes full gains from consolidation • Amenable to building block approach, although consolidation is not prerequisite for multilateralization • Removes potential for trade diversion or deflection • Eliminates costs associated with implementing ROOs • Reduces/eliminates risk of a new wave of market-restoring FTAs 	<ul style="list-style-type: none"> • Time consuming and fraught with political difficulties if concessions or preferences are extended to all • A key stumbling block is securing reciprocity from—and/or market access to—third parties • Liberalizing non-tariff barriers is complex, and vested interests (such as agriculture) prevent extending preferences to nonmembers

The proliferation of FTAs has been greatest in Asia. The noodle bowl—with more than 100 FTAs involving at least one Asian economy—is an understandable response to the global multilateral impasse. Yet its sheer complexity and diversity requires reform. Reviving Doha (the DDA) alone may be insufficient, and the prospects for doing so are not high. It is more likely the DDA will be sliced into a host of sectoral agreements. Against this backdrop, two key proposals have been advanced to disentangle the Asian noodle bowl—consolidation and multilateralization. Consolidation builds a regional FTA to harmonize bilateral

FTAs—such as the RCEP—while multilateralization grants nondiscriminatory preferences to nonmembers, eliminating preference discrepancies.

These two approaches, however, need not be mutually exclusive. Should the consolidation approach result in a regional FTA, it does not preclude multilateralization. The preferences of a regional FTA could still be offered to outsiders on a nondiscriminatory basis. Indeed, consolidation, if possible, should be viewed as a means to an end. However, several questions on consolidation remain, such as (i) how multiple bilateral agreements—each with its own defining rules and characteristics—can be folded into one agreement without resorting to the lowest common denominator to reach consensus; and (ii) how to address inter-regional bilateral agreements, which constitute the majority of Asia’s FTAs—including RCEP members. The recent trend favoring tie-ups between regional blocs could address part of the problem associated with “(ii)”, but may exacerbate the difficulties involved with “(i)”, as tie-ups increase both the number and diversity of members. Both issues are addressed by multilateralization however, whether applied independently or jointly with consolidation. Although consolidation requires multilateralization, the reverse is not true. Countries are free to pursue multilateralization independently. But they must overcome competing interests that lose from the dilution of preferences—usually the same interests that favored the FTAs to begin with.

Because most trade liberalization to date has been unilateral, there is much to support this approach. The argument that unilateral actions such as multilateralization lack the proper incentives and are therefore impracticable ignores the lessons of history. Nonetheless, policymakers handling trade in Asia and in other regions continue to face considerable challenges. The arguments presented in this special section, which favor multilateralization—or consolidation as an interim step—should not be construed as underestimating these problems. But the case for multilateralization should be made stronger, and pursued more strongly, as the welfare gains will likely be larger.

Conclusion

This section has examined the key policy issues and challenges facing Asia relating to financial and trade integration. Like any policy or strategy, the goal of integration must be an improvement in welfare and quality-of-life—both within and across countries. Regional integration can expand markets and input sources, better allocating resources across the region, thus accelerating economic growth. It can also improve risk-sharing. But there are also downside risks, ranging from potential contagion to growing income inequality and polarization.

While the level of Asia's financial integration may have increased, its benefits in terms of consumption and investment risk sharing have been limited. Closer economic links helped reduce income disparities across Asia, but inequality within countries has risen. Large portions of Asia's population have not benefited from increased prosperity overall. The cascading effect of the ongoing eurozone crisis is a vivid reminder of the contagion risk for systems overly integrated and where not all pre-conditions are in place.

While collective regional policies have their merit, unilateral policies can benefit individual countries and the region; it remains important to use national policies to maintain the integrity of domestic institutions. This is ably demonstrated by the current complication in Asia's trade policy landscape, following the plethora of FTAs. Indeed, FTA proliferation has been greatest in Asia, where the global multilateral impasse has helped create an Asian noodle bowl, with more than 100 ratified FTAs involving at least one Asian economy.

Two key proposals have been advanced to disentangle the Asian noodle bowl: consolidation—which creates a regional FTA to harmonize bilateral FTAs; and multilateralization—which grants nondiscriminatory preferences to nonmembers, eliminating preference discrepancies.

The ASEAN-led RCEP could pave the way for consolidating ASEAN FTAs under a single regional agreement, although it is still too early to tell. Multilateralization can proceed from a consolidated regional FTA, or economies can seek multilateralization independently; but they both must overcome competing interests that lose from the dilution of preferences.

Although consolidation and multilateralization are not mutually exclusive—consolidation is a means; multilateralization is the end—history shows that unilateral actions (of which multilateralization is a special case) are not only feasible but account for most trade liberalization to date.

References

- ADB. 2012. *Asian Development Bank Outlook 2012: Confronting Rising Inequality in Asia*. Manila.
- _____. 2011. Cooperation in Trade Policy. In *Asian Economic Integration Monitor*. July. Manila. pp. 42–47.
- A. Alderson and F. Nielsen. 2002. Globalization and the Great U-Turn: Income Inequality Trends in 16 OECD Countries. *American Journal of Sociology*. 107. pp. 1244–99.
- P. Arestis and E. Paliginis. 1995. Divergence and Peripheral Fordism in the European Union. *Review of Social Economy*. pp. 261–283.
- H.W. Armstrong. 1995. An Appraisal of the Evidence from Cross-Sectional Analysis of the Regional Growth Process within the European Union.
- H.W. Armstrong and R.W. Vickerman, eds. *Convergence and Divergence among European Regions*. London: Pion.
- P. Augier, M. Gasiorek, and C. Lai-Tong. 2005. The Impact of Rules of Origin on Trade Flows. *Economic Policy*. 20(43). July. pp. 567–624.
- I. J. Azis. 2012. “Asian Regional Financial Safety Nets? Don’t Hold Your Breath.” *Public Policy Review*. 8 (1).
- _____. 2009. Regional Financial Arrangement. In I. Azis. *Crisis, Complexity and Conflict*. London: Emerald.
- D. Backus, P. Kehoe and F. Kydland. 1992. International Real Business Cycles. *Journal of Political Economy*. 100 (4). pp. 745–775.
- Y. Bai and J. Zhang. 2005. Financial Integration and International Risk Sharing. *Working Paper, Department of Economics, Arizona State University*.
- R. E. Baldwin. 2008. Managing the Noodle Bowl: The Fragility Of East Asian Regionalism. *The Singapore Economic Review*. 53(3). pp. 449–478.
- _____. 2006. Multilateralising Regionalism: Spaghetti Bowls as Building Blocs on the Path to Global Free Trade. *The World Economy*. 29(11). pp. 1451–1518.

- T. Baysan, A. Panagariya, and N. Pitigala. 2006. Preferential Trading in South Asia. World Bank Policy Research Working Paper Series. 3813. Washington, DC: World Bank.
- J. Beckfield. 2009. Remapping Inequality in Europe: The Net Effect of Regional Integration on Total Income Inequality in the European Union. *International Journal of Comparative Sociology*. 50(5-6). pp. 486–509.
- D. Ben-David. 2001. Trade Liberalization and Income Convergence: A Comment. *Journal of International Economics*. 55. pp. 229–234.
- J. Bhagwati. 2013. Why the TPP is Undermining the Doha Round. *EABER-SABER Newsletter*. 14 January. <http://www.eastasiaforum.org/2013/01/14/why-the-tpp-is-undermining-the-doha-round/>
- _____. 2008. *Termites in the Trading System: How Preferential Agreements Undermine Free Trade*. New York: Oxford Free Press.
- E. Borensztein and L. Prakash. 2011. Asian Financial Integration: Trends and Interruptions. *IMF Working Paper*. No. 11/4. January 2011.
- F. Bourguignon. 2004. *The Poverty-Growth-Inequality Triangle*. Paper Presented at the Indian Council for Research on International Economic Relations.
- D. Brady. 2003. The Politics of Poverty: Left Political Institutions, the Welfare State and Poverty. *Social Forces*. 82.
- C. Brummer. 2007. Ties that Bind: Regionalism, Commercial Treaties, and the Future of Global Economic Integration. *Vanderbilt Law Review*. 60(5). October. pp. 1349–1408.
- D. Cameron. 1978. The Expansion of the Public Economy: A Comparative Analysis. *American Political Science Review*. 72. pp. 1243–61.
- F. Canova and M. Ravn. 1996. International Consumption Risk Sharing. *International Economic Review*. 37 (3).
- J. Cochrane. 1991. A Simple Test of Consumption Insurance. *Journal of Political Economy*. 99(5). pp. 957–976.
- P. Drysdale. 2013. Asia and the International Trade Regime. *East Asia Forum*. 7 January. <http://www.eastasiaforum.org/2013/01/07/asia-and-the-international-trade-regime/>
- P. Drysdale and H. Patrick. 1979. *An Asia–Pacific Regional Economic Organisation: An Exploratory Concept Paper*. Washington, DC: Congressional Research Service, Library of Congress.

- A. Estevadeordal, C. Freund and E. Ornelas. 2007. *Does Regionalism Affect Trade Liberalization towards Non-Members?* Washington, DC: Inter-American Development Bank.
- T. Feridhanusetyawan. 2005. Preferential Trading Agreements in the Asia–Pacific Region. *IMF Working Paper*. No. 05/149. Washington, DC: International Monetary Fund.
- K.R. French and J.M. Poterba. 1991. Investor diversification and international equity markets. *American Economic Review Papers and Proceedings*. 81. pp. 222–226.
- R. Garnaut and P. Drysdale. 1994. Asia–Pacific Regionalism: The Issues. In R. Garnaut and P. Drysdale, eds. *Asia Pacific Regionalism: Readings in International Economic Relations*. Sydney: Harper Educational. pp. 1–7.
- M. Gasiorek. 2007. Multilateralizing Regionalism: Relaxing Rules of Origin. Paper presented to the Conference on Multilateralizing Regionalism, WTO and CEPR. Geneva. September.
- S. Hamanaka. 2012. Evolutionary Paths toward a Region-Wide Economic Agreement in Asia. *Journal of Asian Economics*. 23 (2012). pp. 383–394.
- S. Hamanaka, A. Tafgar, and D. Lazaro. 2010. Trade Facilitation Measures under FTAs: Are They Discriminatory against Nonmembers? *Global Trade and Customs Journal*. 5(10). pp. 399–410.
- B. Hoekman and L. A. Winters. 2007. Multilateralizing ‘Deep Regional Integration’: A Developing Country Perspective. A paper presented to the Conference on Multilateralizing Regionalism, WTO and CEPR. Geneva. September.
- P. Katzenstein. 1995. *Small States in World Markets*. Ithaca, NY: Cornell University Press.
- M. Kawai. 2007. Evolving Economic Architecture in East Asia. *Discussion Paper*. No. 84. Tokyo: ADB Institute.
- M. Kawai, P. J. Morgan, and S. Takagi (Eds). 2012. *Monetary and Currency Policy Management in Asia*. Edward Elgar: London.
- M. Kawai and G. Wignaraja. 2012. Dealing with the Noodle Bowl of Asia’s Free Trade Agreements. *Asian Pathways*. 24 April. <http://www.asiapathways-adbi.org/2012/04/dealing-with-the-noodle-bowl-of-asias-free-trade-agreements/>
- M. Kawai and G. Wignaraja. 2011a. Asian FTAs: Trends, Prospects and Challenges. *Journal of Asian Economics*. 22(1). pp. 1–22.

- M. Kawai and G. Wignaraja, eds. 2011b. *Asia's Free Trade Agreements: How is Business Responding?* Cheltenham, UK: Edward Elgar.
- W. Korpi. 2003. Welfare-State Regress in Western Europe: Politics, Institutions, Globalization, and Europeanization. *Annual Review of Sociology*. 29. pp. 589–609.
- R. Leonardi. 1995. *Convergence, Cohesion, and Integration in the European Union*. New York: St. Martin's Press.
- R. Levine. 2001. International Financial Liberalization and Economic Growth. *Review of International Economics*. 9 (4). pp. 668–702.
- P. Lloyd. 2002. *New Regionalism and New Bilateralism in the Asia-Pacific*. Singapore: Institute of Southeast Asian Studies. http://www.pecc.org/publications/papers/trade-papers/1_SII/12-lloyd.pdf
- E. Mendoza. 1995. The Terms of Trade, the Real Exchange Rate and Economic Fluctuations. *International Economic Review*. 36. pp. 101–137.
- J. Menon 2013a. Preferential and Non-Preferential Approaches to Trade Liberalization in East Asia: What Differences do Utilization Rates and Reciprocity Make? *ADB Working Paper Series on Regional Economic Integration*. No. 109. Manila: Asian Development Bank.
- _____. 2013b. How to Multilateralise Asian Regionalism. *East Asia Forum*. 6 January. <http://www.eastasiaforum.org/2013/01/06/how-to-multilateralise-asian-regionalism/>
- _____. 2009. Dealing with the Proliferation of Bilateral Free Trade Agreements. *The World Economy*. 32 (10). pp. 1381–1407.
- _____. 2007a. Bilateral Trade Agreements. *Asian-Pacific Economic Literature*. 21 (2). November 2007. pp. 29–47.
- _____. 2007b. Building Blocks or Stumbling Blocks? The GMS and AFTA in Asia. *ASEAN Economic Bulletin*. 24 (2). August 2007. pp. 254–266.
- _____. 2000. The Evolving ASEAN Free Trade Area: Widening and Deepening. *Asian Development Review*. 18 (1). pp. 49–72.
- Modern Ghana*. 2012. A Down Payment on Development: Conclude a WTO Trade Facilitation Deal. 21 June. <http://www.modernghana.com/news/402659/1/a-down-payment-on-development-conclude-a-wto-trade.htm>
- M. Obstfeld. 1994. Risk-Taking, Global Diversification, and Growth. *American Economic Review*. 84. pp. 1310–1329.

- OECD and International Labour Organization (ILO). 2012. Joint statement by ILO Director-General Juan Somavia and OECD Secretary-General Angel Gurría on the occasion of the G20 Labour and Employment Ministers Meeting. Guadalajara, Mexico. 17 May.
- I. Ortiz, J. Chai, and M. Cummins. 2011. Austerity Measures Threaten Children and Poor Households: Recent Evidence in Public Expenditures from 128 Developing Countries. *Social and Economic Policy Working Paper*. UNICEF.
- I. Park and S. Park. 2009. Consolidation and Harmonization of Regional Trade Agreements (RTAs): A Path Toward Global Free Trade. Paper presented in the International Conference on Globalisation, Growth and Development in Asia. Kuala Lumpur. 14–15 January.
- R. Pomfret. 2007. Is Regionalism an Increasing Feature of the World Economy? *The World Economy*. 30 (6). pp. 923–947.
- J.D. Rodríguez-Delgado. 2007. SAFTA: Living in a World of Regional Trade Agreements. *IMF Working Paper No. 07/23*. Washington, DC: International Monetary Fund.
- D. Rodrik. 2011. The Globalization Paradox. *Making It*. 24 August.
- J. Sachs. 2012. From Millennium Development Goals to Sustainable Development Goals, *Viewpoint*, Vol 379, June 9.
- X. Sala-i-Martin. 1996. Regional Cohesion: Evidence and Theories of Regional Growth and Convergence. *European Economic Review*. 40. pp. 1325–1352.
- F. Scharpf. 1997. Economic Integration, Democracy, and the Welfare State. *Journal of European Public Policy*. 4. pp. 18–36.
- M. Slaughter. 2001. Trade Liberalization and Per Capita Income Convergence: A Difference-in-Differences Analysis. *Journal of International Economics*. 55. pp. 203–228.
- J. Stiglitz. 2010. Risk and Global Economic Architecture: Why Full Financial Integration May Be Undesirable. *NBER Working Paper Series*. No. 15718. Massachusetts: NBER.
- J. Stiglitz, A. Sen, and J-P. Fitoussi. 2010. *Mis-Measuring Our Lives: Why GDP Doesn't Add Up/The Report by the Commission on the Measurement of Economic Performance and Social Progress*. New York, US: The New Press.
- W. Stolper and P. Samuelson. 1941. Protection and Real Wages. *Review of Economic Studies*. 9 (1). pp. 58–73.
- The Economist*. 2012a. Goodbye Doha, Hello Bali. 8 September.

_____. 2012b. Banyan: Partners and Rivals. 22 September.

_____. 2012c. Free Exchange: Building Blocks. 22 December.

United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP). 2011. *Trade Facilitation in Regional Trade Agreements*. Bangkok: UNESCAP. <http://www.unescap.org/tid/publication/swp211.pdf>

A. Venables. 2009. Economic Integration in Remote Resource-Rich Regions. *OxCarre Working Papers*. No. 022. Oxford: Oxford Centre for the Analysis of Resource Rich Economies.

P. Vézina. 2010. Race-To-The-Bottom Tariff Cutting. *Graduate Institute of International and Development Studies Working Paper*. No: 12/2010. July. Geneva: Graduate Institute of International and Development Studies.

D. Weerakoon. 2008. "India's Role in SAARC: Integration and the Way Ahead", paper presented to the ADB-ICRIER Workshop on South Asian Integration. March. New Delhi.

B. Western. 1997. *Between Class and Market: Postwar Unionization in Capitalist Democracies*. Princeton, NJ: Princeton University Press.

World Bank. 2005. *Global Economic Prospects 2005: Trade, Regionalism, and Development*. Washington, DC: World Bank.

Regional Cooperation and Integration in a Changing World

Asia is on the rise with increasing significance in the global economy. In parallel, regional cooperation and integration is becoming stronger, bringing both benefits and costs. The region is diverse, and so are the challenges that must be overcome to achieve greater trade and financial integration. For trade, with the Doha Round stymied, what is the best route to take in untangling the noodle bowl of FTAs? And how best to deepen financial integration? How does integration impact inequality—within and across countries? There are risks to integration. How should they be addressed?


This monograph—prepared for the 2013 Asian Development Bank Annual Meeting—aims to stimulate debate and further research on the role regional integration can play in sustaining growth, reducing poverty, and promoting welfare and future prosperity for Asia and the Pacific.

About the Asian Development Bank

ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to two-thirds of the world's poor: 1.7 billion people who live on less than \$2 a day, with 828 million struggling on less than \$1.25 a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.

Asian Development Bank
6 ADB Avenue, Mandaluyong City
1550 Metro Manila, Philippines
www.adb.org

 Printed on recycled paper.

Printed in the Philippines