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Trade and Investment Cooperation in East Asia

Concerns, Prospects and Issues

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Abstract: This paper attempts to provide a context for the discussion of possible trade and investment cooperation in East Asia. First I describe the present role in the world economy of regional cooperative arrangements. These seem to be concerned primarily with foreign investment, secondarily with national economic-policy credibility, and thirdly with other issues, such as trade and migration. I discuss the changing role of East Asia in the global economy, especially with regard to the role of the multilateral trading system. This changing role raises the issue of possible East Asian cooperation, which I discuss in the light of the present function of regional arrangements. I attempt to identify potential benefits and dangers and the circumstances to which these are sensitive.

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I am delighted to be back at Korea University once again, and I feel privileged to be invited to participate in what promises to be a significant conference addressing an important topic. In my remarks I shall confine myself to describing the relevant general issues, as I see them, and leave to our distinguished contributors the more difficult tasks of addressing the critical details.

I. Introduction

In much of the world, regional cooperation emerged as an issue in recent decades as a possible means of encouraging successful international trade and investment. In East Asia the situation is quite different. The economic success is already present, and it has been achieved with relatively little conscious regional cooperation. Instead, it is

just that success, and the intra-regional economic activity that it is bringing about, that has now caused cooperation to become a more pressing issue. I suggest this perspective be kept in mind as I attempt to outline the types of regional cooperation possible, and discuss what their function has been thus far in other parts of the world. Three questions emerge from this discussion, to which I suggest possible answers. I address the apparent implications of all this for East Asia.

II. Types of Regional Cooperation

International economic cooperation can take many forms. I find it convenient to group them into three classes.

Consultation, coordination and simplification of customs procedures, investment regulations, etc. This, the weakest form of cooperation, involves contacts between national governments to address impediments to economic transactions between their nations. Such efforts are likely usually to be *ad hoc* responses to issues raised by their citizens regarding their own dealings with neighboring countries. But, with trade and investment among these countries increasing rapidly, it makes sense to have in place institutions and contacts that can respond promptly and efficiently to such concerns raised by economic agents.

“Open” negotiated trade and investment liberalization (the APEC model). Groups of East Asian countries could negotiate to lower their trade barriers in a nondiscriminatory way, that is, the reductions would apply to all countries, not just to the negotiating partners. Since the reductions would likely be centered on the goods that the partners especially trade among themselves, their mutual trade would be encouraged. But since the reductions would also be nondiscriminatory, the partners would collectively implement a unilateral liberalization relative to the rest of the world, presumably strengthening their engagement with the multilateral trading system.

The APEC aspires to such liberalization, but, with ultimate success still problematic, groups of East-Asian countries might wish to proceed on their own. The GATT

rounds prior to the Uruguay Round produced just this sort of liberalization: Since industrial countries were the most active participants, reductions in trade barriers centered on manufactured goods. But as the reductions were nondiscriminatory, they applied to all GATT signatories and, subsequently, to all WTO members. This experience appears to have been highly salutary. The industrial countries successfully liberalized greatly their mutual trade, and, when developing countries subsequently began increasing their production of manufactures, they found themselves dealing with an open multilateral trading system. No part of the globe has benefitted more from this experience than East Asia.

Preferential regional trading arrangements. Groups of East-Asian countries might establish customs unions or free-trade areas. This type of cooperation differs from the other two in three fundamental ways. First, it is actively discriminatory: Partners extend to each other concession that they do not make to non-partners. Second, whereas the two former types of cooperation may be implemented at any degree of intensity, preferential trading arrangements are expected to be more “all-or-nothing.” The WTO requires that such agreements provide for “substantially free” trade among members. While WTO panels do extend latitude in judging whether a proposed agreement violates the GATT, they are still expected to be quite comprehensive in scope. Third, since 1990 regional trade agreements have been the most common form of international economic cooperation, with over 250 now in existence. Most countries now participate in at least one such arrangement.

In view of the predominance of preferential trade agreements in regional cooperation, I next address them in some detail. The next section concerns the nature of regional agreements reached since about 1990.

III. The Stylized Facts of Contemporary Regionalism

The following six features are not exhaustive and do not characterize all recent regional initiatives — which are very diverse — but they do apply to most of the more important ones.

- Contemporary regionalism typically links one or more small countries with a big country.

In NAFTA, Mexico and Canada are each small economically, relative to the United States, and Brazil is dominant in Mercosur. Outside the Americas, the new central European members of the EU are tiny compared with the EU itself.

- The small countries usually have recently made, or are making, significant unilateral reforms.

This is dramatically true of Mercosur and of Mexico in NAFTA. And, outside the Americas, even more so of the central European countries, who had abandoned communism. But it also characterizes, to a lesser degree, the small industrial-country participants in various regional initiatives. Canada had turned away from Trudeau-style economic nationalism as it negotiated a free trade agreement with the US, and the Scandinavian applicants to the EU (except for Norway, which declined to join) had made significant reforms in some sectors (e.g., agriculture and banking).

- The degree of liberalization is usually modest, and not a dramatic move to free trade between members.

NAFTA actually gave only moderate liberalization: US tariffs were already low and NAFTA hedges sensitive sectors in all sorts of ways. Canada and Mexico have done more, but the most significant measures (largely Mexican) were unilateral and not part of NAFTA. Even the more ambitious Mercosur features liberalization modest relative to the members' unilateral liberalizations.

- The liberalization is due primarily to concessions by the small countries: The agreements are asymmetric.

NAFTA liberalization involved more “concessions” by Mexico and Canada than by the US. This is not true of Mercosur (perhaps because the large country, Brazil, is also a reformer?). In negotiations the EU is flexible on financial responsibilities and periods of adjustment, but maintains a take-it-or-leave-it attitude over the nature and structure of the EU itself. Partly this asymmetry reflects how the world has changed since the regionalism of the 1950s and 1960s: One reason small countries get only small tariff advantages is that large countries have small tariffs to begin with.

- Regional arrangements often involve “deep” integration: Partners address diverse economic policies beyond tariff barriers.

The EU is an obvious example. The US–Canada free-trade agreement and the subsequent NAFTA included a host of economic-reform commitments by Canada and by Mexico. Sometimes partners in regional arrangements exempt each other from acts of administered protection (such as antidumping duties), but often they do not (e.g., NAFTA). Sometimes partners are in effect granted rights of appeal denied to non-partners (NAFTA again). The latest three GATT rounds tried, with significant success, to broaden the scope of multilateral arrangements. But a major attraction of contemporary regionalism seems to be that negotiations with a small number of partners broadens the range of instruments over which fruitful negotiation is feasible.

In summary, *Contemporary regionalism typically involves reform-minded small countries “purchasing,” with moderate trade concessions, links with a large, country that involve “deep” integration but confer minor trade advantages.*

Question 1: *So, why do the small countries do it?*

IV. East Asia in A Changing World

The numerous preferential trading arrangements of the 1950s and 1960s, with the notable exception of western Europe, were ultimately failures. But the world economy has changed dramatically over the last half century, so contemporary regionalism is a response to a very different environment.

The changing world

The following are the most important ways the world of contemporary regionalism differs from that of the 1950s and 1960s, the days of the old regionalism.

- The multilateral liberalization by the industrial countries of trade in manufactured goods is much more complete now than it was during the days of the old regionalism.
- Most developing and transitional countries have abandoned the basically-autarkic, anti-market policies of the days of the old regionalism and are now determined to join the multilateral trading system. Often for such countries the old regionalism was a *substitute* for such entry; the new regional initiatives are intended as *complements*.
- Direct investment is much more prominent now than in the days of the old regionalism, is much more multilateral, and has been surging since the advent of contemporary regionalism. Potential hosts in the South were formerly suspicious if not hostile to direct investment: Now they try hard to attract it.
- Consistent with the above, the most dramatic changes in the costs of international transactions have been those dealing with information processing, communications, etc., suggesting a reduction in the costs of foreign direct investment relative to the costs of trade (other than the man-made costs).

The new regionalism is the product of a different world, addresses different needs, and possesses different characteristics from the old. This must be kept in mind. The above description suggests two further fundamental questions.

Question 2: *Why did so many countries around the world independently embark upon fundamental economic reform at about the same time (late 1980s, early 1990s)? A coincidence?*

Question 3: *Why did the numerous reform attempts, the renewed burst of regional initiatives, and the acceleration foreign direct investment all also occur at about the same time? Another coincidence?*

A personal anecdote suggests a possible answer to Question 2. I first visited India in the late 1980s, a few years before India began its reform efforts, to attend a conference. I took a taxi from the airport to the institute staging the conference. The taxi entered a wide unpaved street crowded with pedestrians, motor vehicles, bicycles, cattle, carts, etc., etc. The taxi driver adopted a simple strategy: He positioned himself in the middle of the street, kept a

hand on his horn, and floored the accelerator. I was terrified, convinced I was about to slaughter a sacred cow only a few minutes after entering the country! But it soon became clear that the driver knew what he was doing: The multitudes parted before us like the Red Sea before the Israelites. Relaxing, I looked about and soon noticed that all the automobiles I could see were similar and resembled a certain 1949 British vehicle (I'm not old enough myself to recall seeing British automobiles in 1949, but I have seen pictures). So it hit me: If in 1950, say, India was using trade barriers to sustain a domestic industry producing a vehicle of British 1949 design, they may have been devoting more resources to autos than necessary if they were instead imported, but at least they had a reasonably up-do-date product. But if, by 1989, the protected industry, shielded from international competition, had had no need to improve its product, the opportunity cost of remaining outside the multilateral trading system would have grown enormously.

Most countries of the South and the East, having minimized contact with the multilateral system for decades, were in just this position. Also, they could all see the success of the "tigers." Perhaps this is why so many countries independently attempted reform at about the same time: They were in the same leaky boat.

I'll subsequently suggest answers to the first and third questions. But now consider the changing role of East Asia.

East Asia

Probably the most visible aspect of the East Asian experience has been the success of the "tigers" (South Korea, Taiwan, Hong Kong, and Singapore). This success preceded the widespread policy reforms in the developing and transitional countries beginning in the late 1980s. Since then the success has spread to other East Asian nations.

An important ingredient in the success of the tigers was that they emphasized trade rather than its restriction. But they did not engage in preferential trading arrangements. Rather, they exploited the multilateral system. As pointed out above, successive GATT rounds reduced developed-country barriers on trade in manufactures. Initially this was of little significance to East Asia (except, to some degree, to Japan). But, when they began to produce manufactures for export, the fact that these reductions in trade barriers had been *nondiscriminatory* proved of critical importance. That is, *East Asian success has been based on a nondiscriminatory multilateral trading system, not on preferential trading arrangements.*

Other important ingredients in the tigers' success were significant investments in education and high domestic savings rates. Foreign direct investment was notably infrequent.

This is in dramatic contrast to those countries that have reformed since 1990: They view the ability to attract foreign direct investment as critical to successful development. It is true that, since the 1990s East-Asian financial crisis, foreign direct investment has become more important there. But this seems to me to be more a matter of these countries adjusting to their position in the multilateral system, rather than attempting to gain admittance.

Progress in East Asia has resulted in more extensive economic relations among East Asian countries. Intra-industry trade in the region has greatly increased. The more advanced East Asian countries are now more dependent than ever before on imports of intermediate goods from China. All this suggests that the potential for East Asian economic cooperation has greatly increased. But what sort of cooperation? To try to answer this, we must now look at the contemporary role of regional trading arrangements, the most common type of cooperation.

V. Contemporary-Regionalism

This section discusses the various roles that are played by contemporary regionalism.

Reform facilitation

Reforming countries apparently see the ability to attract foreign direct investment as key to successful entry into the multilateral trading system. Multinational firms are a prime means of technology transfer, and they can supply international contacts and modern commercial methods to countries which, because of their past policies, possess little of either. Competition among reforming countries to attract foreign direct investment is intense. Countries comprising a large part of the world are trying to reform at the same time, and most of them see direct investment as a key to success.

A small national advantage offers the hope of attracting a large amount of foreign direct investment. With similar countries competing, small advantages can prove decisive.

Consider first the effects of a possible preferential trading arrangement with a large partner country on a potential reformer. The trade preference extended to the large partner will increase imports from that partner.

However, the preference granted by the large country, though usually only small, is much more significant. From the point of view of firms considering direct investment to provide intermediate-stage inputs for the industrial-country partner's products, many reforming countries are basically equivalent, except for this small preference. Thus it attracts much such investment. This increases the likelihood that the reform will succeed because of the "investment diversion" the regional arrangement implies.

This gives a potential answer to my earlier question 1, asking why reforming countries find regional arrangements attractive even though they typically receive only "minor" concessions from their partners. The goal is to compete with other *similar* countries for direct investment, not to attract from their partners direct investments that would otherwise not be made at all. Such "investment creation" will be modest at best.

Such a regional arrangement will likely not be universally beneficial. Other countries desiring reform could well suffer. Suppose one country that would undertake reform anyway enters into a regional arrangement. Then direct investment for producing intermediate goods for that country's partner will be diverted there, and the country will still remain a potential host for other direct investment. Less direct investment remains for other reforming countries, reducing their prospects for success and perhaps deterring some of them from even attempting reform. Regionalism could produce "reform destruction," causing fewer countries to attempt reform and lowering the proportion of those who succeed. On the other hand, the country with the regional arrangement may not itself have attempted reform in its absence: "reform creation." Thus the number of countries attempting reform may either rise or fall, depending on the balance between reform creation and reform destruction.

Thus far I have considered the effects of an isolated regional arrangement. But they have become ubiquitous, so turn next to what will likely emerge if all countries freely consider whether to negotiate such regional arrangements, including the possibility of a single country entering multiple relationships.

If several reforming countries establish regional arrangements with a single industrial country, the value of the arrangements to the former will be eroded because direct investment may well tend to cluster mainly in some subset of them all. For this reason, the reforming countries will tend to spread themselves out in their choices of partners. If there are at least as many industrial countries as potential reformers, each of the latter can find a partner that will guarantee the success of its reform effort. This may or may not be true if there are fewer industrial countries, depending upon the amount of direct investment forthcoming. Nevertheless, the ability to enter freely into regional arrangements will maximize the extent and the probability of successful reform, and, by doing so, also maximize the number of countries induced to attempt reform.

The global interest calls for successful reform to be as widespread as possible. This will maximize the extent of the multilateral trading system, accentuating both the benefits that it generates and the number of nations which receive those benefits. But this global externality would be ignored by multinational firms, who will likely cluster their foreign investments together. A single regional arrangement may be either good or bad in its results. But a *regional general equilibrium* as just described will in effect internalize the global externality and produce an outcome unambiguously superior to what can be achieved without regionalism. And of course such widespread regionalism is what we now observe.

Note several features of this approach to regionalism. *First*, the major role of regionalism is to facilitate reform in the less developed countries. A secondary role (because it is marginal) is to stimulate investment. *Second*, the relation between multilateralism and regionalism is benign. Regionalism is the consequence of multilateral success, not failure, and it in turn strengthens rather than undermines the basis for a commitment to the multilateral order.

Reform commitment and credibility

While attracting foreign direct investment is crucial to the success of reform, so is sustained commitment to the reforms by the regime and its successors. Regional arrangements are useful here, and, to the extent that the reform attempt is due to the success of the multilateral system, so are the regional arrangements. The general characteristics important here are: reform-minded small countries linking up with a larger country in an arrangement featuring deeper integration.

A regional arrangement can be used as an external commitment to reform that will bind the government to the reform measures in the future. Multilateral negotiations are of little use for this purpose since they would not embody detailed reform measures by individual countries, and because they provide no enforcement mechanism should a country backslide. Regional arrangements can address both problems.

Because such arrangements allow for deeper integration, they can contain obligations to undertake specific measures central to the reform effort. This is quite clearly illustrated both by the free trade agreement between Canada and the U.S. and by the subsequent NAFTA. The fact that the agreement is with a big country (often the dominant trading partner) adds a credible enforcement mechanism.

The above discussion of the relation between the success of a reform effort and the ability to attract direct investment is also relevant here. In practice, the credibility of the commit-

ment of the government to its announced reform can in fact be very important in attracting direct investment and, in that way, ensuring the success of the reform. Even a regional arrangement with only modest preferences for the small country establishes an external commitment to reform that (weakly) binds future governments, thereby making the future preservation of reform (slightly) more credible. This in turn makes the country more attractive for direct investment, relative to similar countries without such external commitments. Thus the ability of a regional arrangement to bind the government to reform can be important for the success of that reform even when it confers only modest direct benefits.

Investment maintenance

The earlier discussion described the small-country participants as less developed, and modeled them differently than the “large” industrial countries. But in many cases the small participants in regional arrangements can hardly be described as less developed: Canada in NAFTA; Austria, Sweden, and Finland in the EU. Many East Asian countries are now no longer well characterized as “undeveloped.”

There are the former communist countries of central Europe to consider as well. The above analysis basically applies to them also. These countries are eager to attract direct investment, the ultimate success of their reform efforts remains both in doubt and dependent on their ability to attract such investment, and membership in the EU has given them a small advantage over other, similar, countries.

For small industrialized nations, however, the above discussion needs to be altered, because the objectives of these countries are different from those of the less developed countries. Their situation may be closer to those of the more advanced East Asian nations. Still the basic message of the earlier section applies here as well. For the small countries that joined the EU in the mid 1990s, the problem was not so much to attract new direct investment as to remain attractive sites, in an increasingly integrated world, for activities currently conducted there. The small advantage they obtained was not additional preference, but future participation in EU decision making. Thus the basic story applies.

VI. East Asian Concerns and Prospects

Now consider how the above discussion applies to the question of East Asian trade and investment cooperation. Consider each class of cooperation in turn.

Consultation, coordination and simplification of customs procedures, investment regulations, etc.

This basic type of cooperation is clearly desirable for countries, like those in East Asia, that are rapidly increasing their economic ties. It will surely happen by default, if these countries maintain a benevolent attitude towards mutual contact, but deliberate, high-level, attempts to encourage it would surely not be out of place.

“Open” regionally negotiated trade and investment liberalization

This form of cooperation lowers barriers to those international transactions of particular importance to East Asian nations while also strengthening ties to the multilateral trading system. The latter aspect in particular has much to recommend it. East Asian success is, after all, due in no small part to the ability of the region to exploit its ties to that multilateral system.

While East Asia has employed export-promotion policies to its benefit, protection and the need for domestic economic reform remain important issues for many countries in the region. Strengthened ties to the multilateral system are likely to be very useful here.

Preferential regional trading arrangements

Preferential cooperation raises the most complex issues. Consider now the possible relevance to East Asia of the above discussion of contemporary regionalism.

Reform facilitation. The argument here, you will recall, is that a regional arrangement with a large partner can help a country compete for the direct investment that

can facilitate the success of reform efforts aimed at entering the multilateral trading system. Long before the advent of the new regionalism, Japan, South Korea and other East Asian nations succeeded in becoming part of that system by relying on plentiful domestic savings rather than foreign investment. China's present situation is much more relevant. But China has already been notably successful in competing with other reforming countries for direct investment, no doubt because of the size of its domestic market (and potential future market). I conclude that the reform-facilitation component of contemporary regionalism is of questionable relevance to most East Asian countries today.

Reform commitment and credibility. Many East Asian countries have a strong need for economic reform. But the present need is for the political will to make the reforms, not for a means to add credibility to reforms that are being made. Unilateral measures are prior to regional ones. It is conceivable that a regional arrangement could make it easier to undertake unilateral reform in each country, but I see a stronger analogy with Mercosur than with NAFTA. Overall, this component of contemporary regionalism experience suggests that the case for regional preferential trading arrangements in East Asia is, at best, weak. "Open" regionally-negotiated liberalization of trade and investment policies seems far more likely to be useful.

Investment Maintenance. The idea here is that a regional arrangement can enable small countries, that are in the multilateral trading system and that have attracted direct investment, to remain attractive sites for such investment. Few East Asian countries seem to be in such a position. However, one could argue that, as a result of the East Asian financial crisis, South Korea and some other East Asian countries, already in the multilateral system, may well need to be able to attract direct investment in the future to remain there. Thus this component of contemporary regionalism experience suggests that a regional arrangement might be of use to such nations, though not likely to countries like China or Japan.

Overall, I conclude that the practice of contemporary regionalism implies that the case for East Asian regional integration is weak. But a *caveat* is in order. Perhaps a not-yet appreciated component of contemporary regionalism will make a stronger case. Perhaps.

VII. Concluding Remarks

The present discussion suggests the following reactions to proposals involving initiatives in the three respective types of East Asian cooperation.

- *Consultation, coordination and simplification of customs procedures, investment regulations, etc.* By all means stand ready to deal with unnecessary impediments to mutual economic contact.
- *“Open” negotiated trade liberalization.* This option, mutual cooperation that also implies further multilateral engagement with the world economy, should be pursued to the extent possible. Multilateral liberalization has been a crucial contributor to East Asia’s economic success thus far and it should be allowed to continue in that role.
- *Preferential regional trading arrangements.* TREAD CAREFULLY!