

| Guest Editors' Remarks |

**Regional Economic Integration in Asia:
Challenges and Recommended Policies**Farhad Taghizadeh-Hesary¹⁺, Naoyuki Yoshino², Chul Ju Kim², Peter J. Morgan²¹*Tokai University, Japan*²*Asian Development Bank Institute*

Abstract Regional economic integration is one of the most effective ways of fostering stability, addressing regional challenges, and increasing rates of economic growth. Strengthening regional cooperation and integration in different Asian sub-regions offers great potential for eliminating poverty and achieving inclusive and sustainable development. Hurdles remain, however, for further integration. The willingness to commit to “unity in diversity” is important to overcoming this, requiring the acceptance of cultural, linguistic, social, religious, and political differences. Such complex unities have been achieved in the European Union (EU) and elsewhere (Fella, 2002). Currently, in most Asian sub-regions, such political ambitions for economic integration have been scarce. This implies that a more cautious approach is needed in Asia than in other places. However, by studying the European context, we can derive valuable lessons for better fostering economic integration. Regional economic integration should first ensure the maximization of benefits for all participants. With this, complete cooperation is required to develop an effective and uniform regional business environment. Second, a well-developed infrastructure with an absence of trade barriers is needed. Various Asian sub-regions (e.g., Central and South Asia), however, suffer from a lack of infrastructure, which hinders trade opportunities. Difficulties in accessing capital also presents a key obstacle. In this regard, the role of infrastructure financing is very important. In the EU, their European Investment Bank maintains equitable financing for intra-EU projects. Open engagements with partner countries also play a key role. Third, over the past 30 years, different institutional mechanisms have sprung into existence in Europe that have created the basis for strategic economic integration. Such institutional mechanisms and initiatives are needed in Asia.

Keywords: Economic Integration, Connectivity, Regional Cooperation, Asia

I. Introduction and Background

Geographical economic integration can lead to permanent increases in economic growth, because it increases the size of the economic market and improves the availability of goods and services, leading to a reduction in the cost of trade and an increase of efficiencies that lead to greater purchasing power. Starting from a position of isolation, close integration can be achieved by increasing the trade of goods or by increasing the flow of ideas (Rivera-Batiz

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and Romer 1991). According to Balassa (1961), regional economic integration is a process in which the differences and discriminations among national economies are gradually eliminated. Munakata (2006) pointed out that *regionalism* was institutional in nature, whereas *regionalization*, the process of regional economic integration, occurred by way of market development. Regional economic integration should, therefore, be examined in a broader perspective to represent all economic, political, and legal dimensions.

Economic integration can be classified into seven levels:

- 1) The first level is free trade. At this level, tariffs between member countries are significantly reduced, and some are abolished altogether. Each member country maintains its own tariffs with third-party countries. The general goal of free-trade agreements is to develop economies of scale and comparative advantages, which promote overall economic efficiency.
- 2) The second level is the custom union. At this level, member countries establish common external tariffs to third-party countries, and a common trade regime is achieved. Custom unions are particularly useful to level the competitive playing field and address problems of re-exportation.
- 3) The third level is the common market. Services and capital are free to move within member countries, creating expanding economies of scale and comparative advantages. However, each national market has its own regulations, including product standards.
- 4) The fourth level is the single market. All tariffs are removed for trade between member countries, creating a uniform (single) market. There is also free movement of labor. Monetary and fiscal policies among member countries are thus harmonized, creating a higher level of political integration.
- 5) The fifth level is the economic union, which entails a common market and a custom union. The participant countries have both common policies on product regulation, freedom of movement of goods, services, and factors of production (i.e., capital and labor). They also follow a common external trade policy.
- 6) The sixth level is an economic and monetary union, wherein a common currency is used (e.g., Euro).
- 7) The final level is the political union. This represents the most advanced form of integration with a common government, wherein the sovereignties of member countries are significantly reduced. This is only found within nation states, such as federations wherein regions have a level of autonomy from the central government (Rodrigue 2017).

Asian sub-regions exist at varying levels of economic integration, compared to Europe. Each Asian entity applies its own economic and political agenda. Apart from the Association of Southeastern Asian Nations (ASEAN), Asian economies exist in a loose cooperation scheme based on free-trade agreements. The ASEAN has created a common market, which is the third

level of economic integration. Europe has nearly achieved a complete political union with the European Union (EU) and their single currency.

It is important for Asian sub-regions to learn from the European experience to increase levels of regional economic integration in support of higher endogenous growth. Notably, not all successful experiences within a region are applicable to others, because of social, cultural, political, geopolitical, and economic differences.

The aftermaths of two world wars appears to have convinced Europe of the importance of integrating economies and politics. By pooling their economic resources (e.g., labor, capital, energy), they enjoy better results than via isolated governments. The EU has reaped vast economic benefits by developing common laws and increasing coordination among regional and national authorities, which further integrate regional economies. The EU also closely cooperated in security and foreign policies, state affairs, and justice measures (Taghizadeh-Hesary, 2019).

Integration in Asia is more driven by markets than by governments. Integration and cooperation among national authorities are less sophisticated. Among Asian sub-regions, Central and South Asia have the lowest levels of economic integration. Here, intra-regional trade remains low and significantly below that of Africa, the Middle East, Latin America, and Southeast Asia.

Although there are several differences between Asia and Europe, there are some important similarities between the two continents:

- Both have aspirations to achieve higher economic growth and improvements to welfare.
- Both pursue efforts to regulate over-globalization to preserve stability for civil society.

Both regions differ in similarly important aspects:

- In Asia, there is a high level of economic, social, and cultural diversity. During the development stage, it differs between developed economies (e.g., Japan and Republic of Korea) to that that are still developing. However, starting from a less divergent group, the EU has achieved high levels of relatively homogenous economies.
- In Asia, there are no such political ambitions. Thus far, there has been no willingness to relinquish sovereignties. Therefore, we should not assume that lessons drawn from the EU can simply be copied and implemented here.

II. Economic Integration in Europe

The process of financial and economic integration in the EU has emphasized issues related to the accessibility of public goods and the free movement of capital, labor, and market competition. Notably, internal European market development and security considerations are the main priorities for the EU. European economic integration boasts the following major economic

achievements:

- They have created and matured a single market. The implementation of a liberalized market and a common regulatory mechanism has proceeded well. Hence, the achievement of remarkable and deep integration. Regional economic integration has empowered investors and institutions to formulate Europe-wide strategies. This has resulted in stronger developments of trade and other financial venues. Furthermore, such strategies have resulted in higher economies of scale and efficiencies for the economic integration mechanism.
- They have created an economic and monetary union and have adopted a single currency. These developments have further consolidated and accelerated their single-market mechanism. The EU has witnessed strong increases in the capitalization of stock markets and many new enterprises.
- They have created the European Central Bank (ECB), resulting from the pooling of several economic monetary policies. The ECB is the central bank of the 19 EU countries that have adopted the Euro. In areas of employment policy and structural reforms, the practice of consensus was also adopted. Furthermore, integration efforts have benefited from member-state pressures. (Taghizadeh-Hesary, Subramanian and Panchanatham (2020))

The regional economic integration process of the EU has been progressing for 5 decades. This period includes the post-war birth of economic integration and the growth of the EU. The regional economic integration of the EU have been successful in both economic and political terms. There have been, of course, failures and rising tensions with regard to European sovereign debt, national banking crises, and Brexit. Nevertheless, the benefits of institutional, political, and economic development of the EU have been significant achievements. (Taghizadeh-Hesary, 2019)

The EU initiative started with a small association of economies, most of which were at the same level of development. These countries promoted integration with neighboring countries that were at a lower economic levels. Another feature of the European integration was that economically superior countries (i.e., Germany and France) took leadership of the integration.

Another important factor behind the economic integration in the EU was its removal of trade barriers including tariffs and non-tariff measures (NTMs). The NTMs include not only border measures (e.g., quotas), it also includes domestic policies (e.g., subsidies), and similar measures whose distortionary impact on trade is felt along marketing chains (e.g., standards, distribution restrictions). Some NTMs target exports, in some cases to stimulate and in others to restrict exports (Melo and Nicita, 2018). However, even in the EU, with the superior levels of economic integration, NTMs still present challenges. Thus, authorities are continuing to take necessary measures to eliminate or incorporate distorting trade measures.¹⁾

1) In a survey conducted by the International Trade Center in 2015 and 2016 on a sample of EU exporters (8,100 companies) across 28 countries and 26 sectors (ITC 2016), some 8,000 European exporters responded that 64%

A key factor behind the economic integration and connectivity of the EU is its well-developed infrastructure and the role that infrastructure investment has played. In 1958, the European Investment Bank (EIB) was created as a policy bank of the European Economic Community. Over the years, infrastructure became “top priority” with investments in the transport sector of more than 153-billion Euros between 2005 and 2015 (EIB 2016). Although the EIB focuses on intra-EU projects, engagements with partner countries under the umbrella of various initiatives also has an impact (Pascha, 2020). During the past 30 years, different institutional mechanisms and initiatives have emerged in the EU that have created the basis for the strategic re-orientation of this field.

III. Lessons from the European Economic Integration

Over the last 2 decades, Asia has experienced higher trade and investment growth compared with other regions (even excluding data from the People’s Republic of China (PRC)). Asia’s export-oriented development policies, supply-chain development, and production fragmentation has deepened trade and economic integration and has facilitated economic growth. Bilateral trade agreements have proliferated since the turn of the 21st century and have been the major focus of trade liberalization and international commerce. Currently, considering the United States vs. China trade war and the criticism directed at the World Trade Organization, Asian economies need to focus more on intra-Asian trade to promote regional economic integration while maintaining a positive growth rate.

There are, however, several EU experiences that ought to be considered to foster economic integration in Asia:

- At the regional level, cooperation in areas of investments, trade, and environment are required to strengthen and extend the ties among Asian countries. Regional cooperation is essential for making substantial progress in the regional economic integration of the financial market structures. Proper cooperation is further necessary for developing an effective and uniform regional business environment.
- The major economies of Japan, the PRC, and the Republic of Korea must take more prominent leadership roles to promote regional economic integration. The initiatives of ASEAN and ASEAN+3 have contributed towards an improved sense of community in Asia. However, such institutions have not yet achieved high political potential. The Asian economic integration progress depends on the region’s ability to reduce political tensions among the Asian economies.

experienced no major regulatory obstacles in their main markets. 36% reported restrictive regulations and related obstacles that acted as important impediments to their exporting activities.

- One of the key reasons behind the ease of connectivity in Europe is its well-developed infrastructure. Many Asian sub-regions suffer from an austere lack of infrastructure that impedes trade with neighboring countries. In this context, the role of infrastructure financing, such as those promulgated by well-established institutions (e.g., EIB), is critical.
- There are also intra-regional obstacles to cross-border economic interactions in the different Asian sub-regions, including high tariffs and cargo delays at borders, which impede intra-regional trade. Simultaneously, barriers are not limited to tariffs; NTMs should also be removed.

Finally, the objectives, purposes, dynamics, sequences, and forms of Asian regionalism will continue to remain distinct from those of the EU. Therefore, Asian countries should endeavor to further deepen their economic integration by fully accounting for such differences as evidenced by the practical and applicable lessons from the EU experience.

IV. Studies in This Issue

There are nine papers about the regional economic integration of Asia and/or Europe that assess the weak and strong points to recommend proactive policies. Empirical studies have considered various aspects of economic integration (e.g., monetary, fiscal, energy, and environment).

Vidya, Prabheesh, and Sirowa used a cross-country network analysis to answer whether trade integration was leading to regionalization. Their paper empirically assessed the structural changes using a sample comprising both developed and developing 50 countries over the last 2 decades. They analyzed their trade integration, leadership, and regionalization. The major findings of the study identified that trade regionalization was primarily dominated by developed regions, trade liberalization reduced the gap between the center and the periphery. Emerging economies emerged as leaders and export hubs of goods in the global market. Trade liberalization transformed and reshaped the world trade structure. Trade liberalization did not drive the shortening geodesic distances or shrinking transport cost.

Sadat Khan examined the spillover effects of trade shocks in Central, Eastern European, and Baltic nations. He sought to understand how a trade shock in each country affected the economic growth and inflation of others in the same region? He addressed this question by comparing the spillover effects of trade shocks using a global vector autoregression model of 10 countries. The results showed that the trade spillover effects were strong in the region and positively impacted regional economic growth and inflation. However, the Czech Republic, Slovakia, and Poland played greater roles in this transmission process compared to others.

Helble and Majoe studied the role of environmental regulations as drivers of international

trade. International trade is a key mechanism promoting the diffusion of energy-efficient technologies. However, little is still known how environmental regulations, such as those aimed at increasing energy efficiencies, have affected international trade in environmental and green goods. This paper studied the case of the Energy Performance of Buildings Directive, which was adopted in 2010 by the EU. The paper found strong evidence that EU member states that implemented the directive, gained substantially higher import volumes of environmental products at possibly lower prices. The study showed that the implementation of environmental regulations could spur the international trade of environmental products.

Venkatachalam studied South Asia's economic integration with East Asia with a focus on India. The economic integration of South and East Asia has advanced steadily since the 1990s, fueled by domestic reforms and the emergence of regional supply chains. Within South Asia, India has emerged as the largest trading partner and investment destination for East Asian economies. This paper assessed the experiences of South and East Asian economic integration by studying interesting questions about how much trade integration has achieved and what has impeded further integration. The study found that trade and investment linkages had grown casually. However, attaining the full potentials of economic integration were constrained by the insufficient depth in the application of existing trade agreements. This included barriers to service trade and poor infrastructure connectivity. The expansion of the Regional Comprehensive Economic Cooperation would significantly enhance greater economic integration in South Asia, particularly India with East Asia.

Nepal and Pajja explored the stability of the money-demand function in the South Asian Association for Regional Cooperation. They studied the causality of relationships among money demand, real income, price, and interest rate while focusing on South Asia for the period 1986-2017, based on panel data analysis. The empirical results highlighted a feedback loop between money demand and real income. However, it also revealed a short-run unidirectional causality stemming from price and interest rate to real income. It also found that there was a long-run bidirectional causality amongst these variables. The results indicate that the money-demand function was stable in South Asian economies during the considered time period. Therefore, money supply could be used as an appropriate instrument of monetary policy by the central banks of these countries to achieve overall price and macroeconomic stability.

Panthamit and Chaiboonsri identified the main determinants of China's outward foreign direct investment (OFDI) in the greater Mekong sub-region using a Bayesian panel-data approach. The results of the study showed that a higher economic growth rate, gross domestic product, and political stability tended to increase the likelihood of receiving Chinese OFDIs. However, higher foreign direct investment performance, inflation rate, rule of law, and business freedom tended to decrease the probability of receiving Chinese OFDIs. Compared to previous studies that only assessed economic variables, the innovation of this research lay in their inclusion

of socio-political variables.

Shi and Yao assessed the economic integration in Southeast Asia in a case study of the Association of Southeast Asian Nations power grid. The ASEAN Power Grid provided an interesting example of how and why beneficial economic integration might not proceed well. This paper compared Europe's experiences of energy-market integration with those of the ASEAN, identifying two models of regional power connectivity from the EU and Nordic Power Pool. The bottom-up approach in the Nordic Power Pool suggested that, unlike the EU, the ASEAN could still promote regional power connectivity without a super-national authority. The paper further suggested that the ASEAN Power Grid should not be limited by political boundaries to achieve the full benefits of recognition, cost-benefit sharing, soft enforcement mechanisms, and human resources.

Rasoulinezhad used panel-gravity analysis to study the energy trade and economic integration between the Commonwealth of Independent States (CIS) and China. The main findings of this paper revealed that the economic sizes of CIS members positively affected China's energy imports from the CIS. Furthermore, the CIS's annual energy export quantities to other countries than China significantly negatively impacted China's energy imports from the CIS. Regarding geographic distances, the findings showed a negative sign for the coefficient, meaning that geographical distance might have decelerated the flow of energy trade from the CIS to China. It also found that China's FDI in the CIS could determine and accelerate energy export flows running from CIS to China. The paper's major findings demonstrated a positive relationship between political risk in the CIS and the energy importing flows of China.

Kumari Selvarajan studied the dynamic relationships between financial integration and growth in Asian regions. Specifically, the study investigated the financial-growth nexus during the pre-crisis (1980-1995), post-crisis (1998-2015), and throughout the study period (1980-2015). The results showed a significant financial-growth relationship during the pre-crisis period. However, the impact waned during the post-crisis and overall time periods. The results offered hints to policymakers about the heterogeneity of each country, and the extent to which EU financial integration should be emulated.

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