

ASIA-PACIFIC ECONOMIC COOPERATION: THE GOODS MARKET

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This article looks into the static and dynamic effects of free trade areas such as the ASEAN Free Trade Area (AFTA) and the Asia-Pacific Economic Cooperation (APEC). It emphasizes the political economic role by these groupings in a step-by-step process of opening up and liberalization. It also examines some of the costs of joining APEC and what may be done to ease the process of adjustment.

Background

In 1989, the Asia-Pacific Economic Cooperation (APEC) was born during a conference in Canberra, Australia. Since then, there has been a relatively rapid increasing commitment to the idea of economic integration. This was confirmed during the Bogor conference in November 1994 where APEC leaders adopted a timetable for the achievement of free and open trade and investment in the region, taking into account the differing levels of development among the members. The latest report of the Eminent Persons Group of APEC noted the intensification of trade disputes in the world, emphasized the dangers to multilateralism in the new trends, and proposed several actions to start the process of closer cooperation in the Asia Pacific.

In a recent article, *The Economist* noted a growing trend among countries to group into free trade areas (FTAs). Included in the new trend are the North American Free Trade Agreement (NAFTA) among Canada, Mexico and the

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United States and the ASEAN Free Trade Area (AFTA) among the members of the ASEAN. Just this year, the Mercosur, a customs union among Argentina, Brazil, Paraguay, and Uruguay was created. The writers cautioned against too liberal an enthusiasm for free trade areas because of the dangers these posed to the preferred world multilateral trading system embodied by the newly-ratified World Trade Organization (WTO).

The Economics of Free Trade Areas

The basic question about the proliferation of free trade areas is whether they will bring economic benefits. The basis for judging the desirability of FTAs flows from the perceived advantages of trade which enable economies to exploit comparative advantage, allow specialization and economies of scale and provide other efficiencies conducive to welfare increase and growth. Current conventional wisdom, especially after the collapse of Eastern Europe, indicates that the best approach is to open trade with the rest of the world, with some exceptions.¹ This is one of the main reasons for the principle of non-discrimination (more formally the MFN or most favored nation clause) in the General Agreement on Tariffs and Trade (GATT) and, now, the World Trade Organization (WTO). Free Trade Areas and customs unions, by discriminating between members and non-members, violate this general principle. At the same time, FTAs are formed in order to promote trade among member economies. The result is ambiguous for free trade areas; there are advantages and there are weaknesses. Arndt (1993) states that there is a presumption that in economic integration, the reduction of resistances improves welfare through more

¹ See for example Dornbusch (1992). For the exceptions, see Helpman and Krugman (1985) and Rodrik (1992).

efficient static resource allocation. But the welfare-enhancing effects of economic integration are only presumptive; the net effect on welfare depends on the balance between trade creation and trade diversion.

The main ambiguity as far as the static benefits of free trade areas are concerned has to do with whether the gains from "trade creation" outweigh the losses from "trade diversion." The dynamic considerations depend, among others, on whether the formation of free trade areas ultimately advances or deters the progress of global trade. Domestic production for commodities protected under the existing system of tariff and quotas may be replaced by production of the same commodities in member countries of an FTA that may be formed. The more efficient production of the commodities now allowed by the FTA will therefore lower the cost of the commodities in the importing member country. At the same time, the resulting reallocation frees resources for the production of commodities where the country enjoys comparative advantage. These benefits of trade creation is an important argument for the formation of FTAs.

On the other hand, there may be a commodity being produced so efficiently in a non-member country as to overcome the initial (i.e. non-FTA) protection and is, therefore, being imported by a member. With the formation of the FTA, a less efficient member country (with the privileges afforded by the FTA) would now be able to supplant the non-member. This would mean a substitution by higher cost production in place of the lower cost production. This trade diversion is one of the main dangers posed by free trade areas.

Why FTAs may still make sense

My thesis today is that the dynamics of arriving at national policy decisions are very important dimensions in assessing the desirability of regional trade groups. For that, let us review the role of AFTA in ASEAN's economic

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integration before discussing global trade reforms. AFTA may be viewed as a step towards economic integration, particularly since it is an improvement on the ASEAN-PTA. More important, however, market forces are already driving economic integration in ASEAN without reference to the political readiness of the member states to yield part of state sovereignty to a larger unit. Among these market forces are increased intra-ASEAN investments and trade linkages as exemplified by the Singapore-Johor-Riau Growth Triangle, the evolution of ASEAN production bases and networks through foreign investments, especially Japanese, Taiwanese and Korean, and the internationalization of ASEAN business groups. If successfully implemented, AFTA will be another facet of growing ASEAN economic interdependence and integration. APEC could very well follow the same route.

AFTA as Part of a Process

One way to look at AFTA is as part of an evolutionary process of ASEAN cooperation. One useful concept is that of *momentum*. As one more step in increasing economic cooperation, it pushes the whole process forward. In doing so, it increases the speed and strength of the whole movement, gathering permanence for itself along the way. It may be useful to think of AFTA as part of a package of policies as ASEAN countries further reshape their ties with the rest of the world, including those with former colonial rulers.

The dynamic and complementary relationship between an individual member's stance with regards to ASEAN commitments and its own internal policies also enhances the chances that AFTA will be a useful step in economic integration. As it requires more outward orientation from members, it strengthens the internal forces for openness, in turn further increasing its thrust. One may expect AFTA ultimately to become more entrenched as a result of this "virtuous cycle."

A third reason for believing that it is a step in economic integration is to think of it as part of an overall movement for global economic cooperation, although admittedly a digression. By getting social and economic institutions used to the idea of openness, it may make decisive groups more amenable to overall economic openness. Getting countries, especially those coming from protectionist modes, used to the discipline of international commitment is a difficult job by itself, as I think the experience of the Philippine shows.

AFTA (and APEC) can push this outward orientation in two ways. First, opening up an economy entails adjustment costs and difficult side-effects. AFTA, by starting with a smaller group of countries as a first step, makes it easy to identify specific side-effects and to design alleviation policies. Spreading the burden of adjustments and financing of alleviation policies is also easier if negotiated among a smaller number of participants. In the second step, the resulting openness of the ASEAN economies may then make it easier to open to the rest of the world because the second-stage adjustment costs are less.

The second step follows from the lighter burden of a "two-stage process." As the AFTA process takes root, crucial groups within the ASEAN economies become used to having an open economy. This then pushes the movement for global liberalization forward. Krugman (1990) has precisely this view towards regional trading blocks. He is not too worried about these blocks because (a) they're going to happen, whatever is done now by policymakers, and (b) as long as these regional blocks are not exclusive against outsiders, the trade creation effects are probably going to outweigh trade diversion consequences.

Some Qualifications

This optimistic view has some dangers, however. First is the possibility that the "two-step process" may stop at

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the first stage. As a free trade area evolves it could provoke a bunker mentality of hiding behind the regional walls. This could happen especially if other regional trading blocs start becoming more protectionist. Thus, instead of pushing global liberalization further, FTAs may serve to carve the world into separate, semi-independent blocs. Second, it might also be easier to slow down the process of openness within the small group process of free trade areas. Instead of deciding how to spread the burden of adjustment costs, ASEAN may end up dividing the market among a small number of internal monopolists.

APEC as an Economic Area

The analogy that may be drawn between APEC, or any other free trade area for that matter, and ASEAN as illustrated above, indicates the advantages as well as the dangers of forming a free trade area (beyond the net benefits of trade creation and diversion). The advantages are that the process of economic integration is made less threatening, more manageable, and more politically feasible. The dangers are essentially the possibility of stalling and the diversion over time of energy away from the economic integration process. Distinctive characteristics of APEC may provide some clue as to which of these forces are stronger.

Elek (1992) observes that the success of East Asian economies is based on: 1) good economic management, 2) high saving rates, 3) ability/willingness to take advantage of changing international opportunities, and 4) relatively open multilateral trading system during recent decades. This fact has substantially influenced the nature of APEC to which the East Asian NICs belong. From the start, the understanding among members of APEC is that it would be consistent and complementary to the WTO. Arndt (1993) states that what distinguishes APEC is the emphasis on non-discrimination, and defense of the open multilateral world trading system. Its main objective is increasing intra-regional trade rather than decreasing trade with the rest of the world and is devoted to the principle of inclusion,

not exclusion, believing that this will be the key to the success of regionalization. This very strong commitment of multilateralism² is an important characteristic of APEC.

The Costs of Change

Even with this commitment by APEC members, dangers are still present in the difficulties and uncertainties that economic integration poses to individual sectors, industries and firms. As countries in the region become more integrated, their own economic structures will change in response to the new possibilities offered by the larger market and investment area. The opportunities themselves bring pain. In each country, sectors and industries on which families and nations have invested resources are buffeted by the changing environment. Individuals and firms find that the value of their capital, both physical and human, are either being enhanced or eroded.

There are two immediate effects. First, at the initial stages, until the benefits of economic integration become clear and firm, economic actors experience uncertainty and the result could be a slowdown in investment and other activities which require medium and long-term horizons. Thus, while the pace and strategy of structural change may be decided in stages, the acceptance of the economic approach must be unmistakable and as broad a support as possible must be sought before being started. Otherwise, the benefits will only be exhausted by domestic uncertainty and resistance. Second, whatever ultimate surplus benefits may be achieved, structural change entails adjustment costs.³ These costs need to be managed and mitigated

² Coincidentally, this is also an underlying principle of the ASEAN Free Trade Agreement.

³ See, for example, Cornia, Jolly and Stewart (1987).

because doing so will reduce the welfare cost of the change and also because doing so maintains the political support for the policies needed.

Some misinterpretations have crept into the popular literature which we need to recognize. For example, adjustment costs have often been used as a basis for resisting structural change forming part of a sloppy, perhaps, unintentional and illogical contention that openness is bad. That, of course, is not accurate. The ultimate test is whether the overall outcome *inclusive of adjustment costs* is desirable. The pattern of costs and benefits depends on the country in question. In some, others could argue that economic integration at certain times could be counter-productive. However, conventional wisdom now suggests that for the developing countries of the Asia-Pacific region, economic integration would be largely beneficial over the long run. The management and mitigation of adjustment costs only serve to increase the net benefits. For some countries, this would be the only alternative in the face of the changing world environment.

By the nature of economic change, some sectors and industries are going to be under pressure when economic integration is undertaken. This is, after all, the definition of structural change. Some will become larger parts of the economy, others will lose share. However, no generalization can be made that some factors of production such as labor, or portions of the economy such as the poor would be worse off. In fact, given the history and the existing structure of most developing economies in the Asia-Pacific, the expectation is that the welfare of labor as an "economic class" and the poor as an "income class" will probably improve. However, it is also true that noticeable portions of labor and the other economic classes of business/capitalist and landowners (both rich and poor) will be under pressure. Those enjoying the monopoly returns under protectionist policies will have to adjust painfully to the open economy. But the overall impact is expected to be democratizing.

Still, it is true that portions of the labor force will have to shift industries and even areas of residence. And the poor are most vulnerable among those who will have to adjust. Even business firms will need to be assisted in shifting capital from one activity to another. These and other portions of society will have to be assisted in their adjustment to the changed circumstances. These adjustments costs are not negligible. The social and political pressure of this change will challenge statesmen and policymakers in the member countries.

What can be done

These expected adjustments require utilizing the advantages that the smaller group of a free trade area offers. The more detailed dialogue made possible by the limited number of participants may enable countries to side-step or smooth the rough edges of structural, social and political changes. However, programs to minimize the adjustments costs will have to be discussed, agreed upon, monitored and understood by all members in order to allay suspicions of one-upmanship that could arise.

The need to manage the change implies the acceptance of certain principles and the development of structures as APEC evolves. Some suggestions for how the next steps are to be managed have been made. Elek (1992) has suggested the next steps for Asia-Pacific region: i) enhanced exchange of information about trading patterns; ii) increased transparency of trade and investment policies; iii) reducing uncertainty in international transactions; iv) harmonization and/or mutual recognition of policies, regulations and standards; and v) non-discriminatory lowering of tariffs and barriers to labor and capital movements. These types of understanding are necessary as countries address adjustment costs to the distinctive structures of their economies. Governments need to minimize their internal adjustment costs in ways that are understandable to other members and advance rather

than deter the process of economic integration. Policymakers and government officials could discuss these or other steps in the near future.

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